

IRS Payroll Compliance Problems

The City of Sulphur is reporting that the IRS in a “payroll compliance check” and “education session” has determined that the city council, city attorney and city treasurer must be classified as employees and receive a W-2. The attorney and treasurer maintain local firms and have been paid as independent contractors with a 1099. The classification of the city council members as employees is a new twist on a multi-year, multi-state problem.

This IRS approach began in Oklahoma in 2006. As a result, the Oklahoma Association of Municipal Attorneys (OAMA) at their Fall 2007 Workshop discussed this issue. In addition, in 2007 the City of Henderson, Texas city attorney filed an IRS appeal of his designation as an employee in an IRS compliance audit. The IRS reversed itself and settled with the attorney “based on the hazards of litigation”. However, while a welcome victory, it is a mixed blessing since the IRS letter does not appear to set any precedent for future IRS actions. Both the [OAMA paper by Oklahoma City attorney Margaret Love](#) (.doc) and the [appeal by the Henderson, Texas city attorney](#) (.rtf) are being placed on the OML website on the Legal Homepage under the subtopic “Public Officials”.

Independent contractor factors ignored. If the IRS factors for independent contractors are applied to most professionals – he/she would not fit the definition of an employee. However, the IRS has declined to apply this standard. As a result we have had private attorneys serving as city attorneys tell us that they intended to resign rather than fight the IRS.

IRS Using State Law. The premise used in the past by the IRS is to look at the “public office” held by the professional and designating them as an employee regardless of the nature of the relationship. They point to the fact that, either by charter or by municipal ordinances, city attorneys/judges etc. are appointed by the governing body and/or appointed by the city manager with the approval by the city council. They focus on the duties of attorneys (or other professionals) which were to an extent found in the charter/ordinances/state law. As a result, the IRS refused to apply the general independent contractor legal principles to determine if these professionals are independent contractors. See Publication 963 for the government’s analysis of this issue.

OML Changes State Law in 2007. Given the IRS focus on state law duties, in response, the League amended state law in an attempt to make clear that the independent contractor standards apply to municipal professionals. This new law is found at 11 O.S. Section 8-115. It states in relevant part that a municipal “attorney, prosecutor, judge, engineer or other professional . . . pursuant to a retainer or contract for professional services shall be presumed to be an independent contractor and not an employee for all purposes if the terms of the contract are consistent with established common law pertaining to independent contractors as reflected in 26 C.F.R., Section 31.312(d)-2.” This OML legislation was effective on November 1, 2007.

[Click here to go back to previous page](#)