Tax Treatment of Payments by Cities to Employees on Active Duty as a Reservist or Member of the National Guard

Question

The question is how must a city treat the payments the city is authorized to make to its employees called to active military service to make up the difference between their military pay and what they would be paid as a city employee.

Opinion

In my opinion, the city's supplemental payments should be treated as regular wages reported on the W-2 form and are subject to all the required withholdings.

Discussion

Authority for Military Pay Supplements by Municipalities

The first question that must be explored is whether it is legal for cities to make these supplemental payments. In my opinion it is legal even if the city employee volunteers for the military service. The federal law makes it illegal for reserve officers and National Guard members who consent to the military service to receive certain payments from sources other than the government. 18 *United States Code Annotated* § 209 provides in pertinent part as follows:

> (a) Whoever receives any salary, or any contribution to or supplementation of salary, as compensation for his services as an officer or employee of the executive branch of the United States Government, of any independent agency of the United States, or of the District of Columbia, from any source other than the Government of the United States, except as may be contributed out of the treasury of any State, county, or municipality ... shall be subject to the penalties set forth in section 216 of this title.
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> * * *
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> (c) This section does not apply to a special Government employee ... .

18 *U.S.C.A.* § 202 provides in part:

> A Reserve officer of the Armed Forces or an officer of the National Guard of the United States who is voluntarily serving a period of extended active duty in excess of one hundred and thirty days shall be classified as an officer of the United States within the meaning of section ... 209 ... . A Reserve officer of the Armed Forces or an officer of the National Guard of the United States who is serving involuntarily shall be classified as a special Government employee.

Most city employees temporarily serving in the military under these sections would be considered "special Government employees" to whom § 209 would not apply. Even for the few that might be serving voluntarily, however, § 209 allows contributions from "the treasury of any

State, county, or municipality. " Therefore, in all situations, the federal law allows municipalities to make supplemental payments to their employees in the military. Moreover, the purpose of § 209 is to prohibit conflicts of interests and undue influence on government actors. This purpose is not served by prohibiting municipalities from supplementing their employees' military pay.

T.C.A. § 8-33-109 specifically provides:

> After the fifteen (15) working days of full compensation, any public employer may provide partial compensation to its employees while under competent orders.

It is my opinion that municipalities may supplement the pay of their employees who are serving actively as reservists or in the National Guard under both federal and state law.

Employment Status of Activated Municipal Employees

The crux of this question, at least according to IRS rulings, is whether the reservist's or National Guardsman's employment with the municipality terminates when he or she is called up. Under Tennessee's law, the employment clearly is not terminated. Note the language from T.C.A. § 8-33-109 that "any public employer may provide partial compensation to its employees. " If these people were anything other than employees, Tennessee local governments would not have the authority to make the payments. It would be an illegal use of public funds and would violate the public purpose doctrine for a municipality to make a payment to a private individual. And why should a city pay its former employees a supplement and not all others from the city that have been called up?

There appear to be two (2) IRS Revenue Rulings that are pertinent. One deals with the situation when employment with the civilian employer continues and the other deals with the situation when it terminates. Rev. Rul. 68-238 states:

> The M Company voluntarily pays to its employees the difference between their normal earnings and the amount actually received by them from the State for the time they are temporarily absent from work to serve as members of the State National Guard. The employment relationship between the company and its employees is not disturbed by this service in the Guard.
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> Under the circumstances, the payments made by the M Company to its employees who are temporarily absent from work while they are serving in a State National Guard are 'wages' for services performed, or to be performed, by the employees for the company. The payments of these 'wages' are subject to the taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act and to the Collection of Income Tax at Source on Wages.

This ruling appears to be the most pertinent for our situation. The other ruling – and the one that the IRS appears to rely on to give general advice relative to the tax treatment of these payments – is Rev. Rul. 69-136 and deals with former employees of companies that have decided to make

these supplemental payments to the former employees. The first of the two companies discussed in the ruling will make every effort, according to the opinion, to re-employ the returning former employee but makes no guarantees. For the second company discussed, the former employees will perform no services for the company following their induction since they have been called for an indefinite time. In these situations in which the employment terminates, the IRS rules that the supplemental payments are not "wages" subject to FICA, FUTA, and income tax withholding.

The situations described and ruled on in Rev. Rul. 69-136 are not the situation for public employers in Tennessee. Under state law and in reality in personnel offices across the state these persons called to duty are still considered employees of the municipality. This view also has substantial support under federal law. 38 *U.S.C.A.* § 4316, part of the Uniformed Services Employment and Reemployment Rights Act, provides that:

> (b)(1) ... a person who is absent from a position of employment by reason of service in the uniformed services shall be –
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> (A) deemed to be on furlough or leave of absence while performing such service; and
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> (B) entitled to such other rights and benefits not determined by seniority as are generally provided by the employer of the person to employees having similar seniority, status, and pay who are on furlough or leave of absence under a contract, agreement, policy, practice, or plan in effect at the commencement of such service or established while such person performs such service.

This language clearly expresses the congressional intent that these persons called to service are still to be considered employees of the civilian employer. They are under this law "absent from a position of employment" and are to be treated as on a "leave of absence. " They are still entitled to the employment rights enumerated. Only if the employee provides written notice that he/she will not return to employment after the military service will these employment rights not apply. 38 *U.S.C.A.* § 4316(b)(2)(A)(ii). Subsection (d) of this section allows the person whose employment is interrupted by military service to use accumulated leave during this period.

The one case decided under this section that touches on this issue also supports the position that employees on military leave are still considered employees. In *Lapine v. Town of Wellesley*, 167 F. Supp.2d 132 (D. Mass. 2001), the court held that a veteran returning to a police position after a three year period of military service was entitled to vacation benefits as if he had been serving in the police position during the period in question, since under the circumstances the pay was a reward for length of service and not short term compensation for work performed.

Supreme Court cases decided under laws protecting persons who serve in the military also support the notion that the time in the military is also to be counted as a time of employment with the civilian employer. In *Accardi v. Pennsylvania Railroad Company*, 383 U.S. 225 (1966), former tug boat firemen for the railroad whose jobs were abolished sought to be given credit in their separation allowance for the time they spent in the military in World War II. The amount of the separation allowance or severance pay was determined by the length of "compensated

service" with the railroad. The employees had worked for the railroad both before the war and afterwards. In computing their severance pay, the railroad did not count their military service. The Supreme Court held that this period of military service should have been counted. In interpreting the applicable law at that time, which was the Selective Training and Service Act of 1940, the Court held that its intention:

> [W]as to preserve for the returning veterans the rights and benefits which would have automatically accrued to them had they remained in private employment rather than responding to the call of their country. 383 U.S. at 231, 231.

In *Alabama Power Company v. Davis*, 431 U.S. 581 (1977), an employee brought a similar claim about a pension plan. The employee had worked for the power company both before and after WWII. The company did not count the time the employee served in the military toward his pension benefits. The applicable law at the time was § 9 of the Military Selective Service Act, which has language nearly identical to that from USERRA quoted above. The Court held that the military time should have been included:

> [P]ension payments are predominantly rewards for continuous employment with the same employer. Protecting veterans from the loss of such rewards when the break in their employment resulted from their response to the country's military needs is the purpose of § 9. That purpose is fulfilled in this case by requiring Alabama Power to pay Davis the pension to which he would have been entitled by virtue of his lengthy service if he had not been called to the colors. 431 U.S. at 594.

Likewise, the purpose of USERRA is to put employees on military leave on the same footing relative to their employers as they would have had if they had not served, to the extent possible. This purpose is not served by curtailing benefits such as social security that, like the severance pay and the pension in the above cases, would normally accrue to the employee if he did not serve in the military.