LEGAL SERVICES CORPORATION

OFFICE OF INSPECTOR GENERAL

INSPECTION REPORT

CONTRACT SERVICE AND RELATED EXPENSE PAYMENTS

95-056

JULY 1995

LEGAL SERVICES CORPORATION
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OFFICE OF INSPECTOR GENERAL

July 18, 1995

TO THE BOARD OF DIRECTORS

This report transmits the results of the Inspection of Contract Service and Related Expense Payments (OIG Project 95-056). The Inspection was conducted in accordance with the Quality Standards for Inspections promulgated by the President's Council on Integrity and Efficiency.

Management's decisions and comments have been incorporated where appropriate within the report, and are appended in full to the report. The OIG will review the progress of corrective actions taken in response to this report in February 1996, and will report our findings to you.

Copies of the report will be provided to the appropriate committees of Congress as requested. The report will not be released to the public for 30 days unless the contents of the report are disclosed publicly sooner. If you have any questions, please direct your inquiries to me or Mr. Robert Holliday, Assistant Inspector General for Program Integrity at (202) 336-8833.

Edouard R. Quatrevaux
Inspector General

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BACKGROUND

On August 6 and September 7, 1993, President Clinton nominated the present Legal Services Corporation Board of Directors. The Senate confirmed the Board and the Board was sworn-in during November 1993. Effective January 1, 1994, the Board appointed an interim President to oversee LSC's transition under the new Board and, in June 1994, he accepted the position on an indefinite basis.

The President appointed a number of people to assist him in fulfilling his responsibilities. All were hired, at least initially, pursuant to employment contracts for temporary, transition periods. For ease of reference, these interim managers, including the LSC President, the independent contractors hired to assist them, and the one additional member of senior management hired under contract during the period under review, are referred to as the "transition team."

Most members of the transition team lived outside the Washington, D.C. metropolitan area and did not relocate. Many members of this team assumed indefinite positions at LSC at the end of their contracts.

Position	Original Contract Employment Date
President	January 1, 1994
Executive Vice President	January 3, 1994
Director, OPEAR/OPS	January 11, 1994
Assistant to the President	January 12, 1994
Special Assistant to the President	April 12, 1994
Independent Contractors (2)	January 17, 1994
Acting Director, OPS	January 3, 1995

The interim President and the Executive Vice President assumed their positions on an indefinite basis in June and July 1994, respectively. The Director of the Office of Program Evaluation, Analysis and Review/Office of Program Services (OPEAR/OPS) accepted an indefinite appointment as the Director of OPEAR in mid-July 1994. One of the independent contractors was offered and declined the position of the Director of OPS and the other independent contractor ceased to work for LSC in mid-August 1994. The Special Assistant to the President was a temporary employee from April 12, 1994 until her appointment as an indefinite employee effective September 1, 1994. The Assistant to the President was appointed an OPEAR Program Officer in early January 1995 and the Acting Director of OPS became the Director of OPS at the expiration of her contract on April 18, 1995.

In October 1994, the Office of Inspector General (OIG) met with the Executive Vice-President to notify the Corporation of OIG concerns regarding the travel of the Director of OPEAR and a trip taken by the Special Assistant to the President. By memorandum, the Executive Vice-President notified the OIG that the travel identified by the OIG as a cause for concern would cease.

In September 1994, the OIG had scheduled an inspection of travel and contractor payments for the latter part of Fiscal Year 1995. However, on April 4, 1995, a Washington, D.C. newspaper published an article criticizing the LSC-funded travel of the Director of OPEAR. Also, on April 4, 1995, Congressman Harold Rogers requested related information regarding LSC employees, contract employees, consultants, and transition team members. On April 6, 1995, the OIG initiated the inspection of contract services and related payments.

RESULTS IN BRIEF

The inspection covered the period of January 1, 1994 through March 30, 1995 and examined payments to, for and/or on behalf of members of the LSC transition team. See Appendix I for Objectives and Appendix II for Scope and Methodology.

The inspection determined that LSC's internal control structure over temporary employees, contract employees and independent contractors and related benefits and privileges was inadequate and/or ineffective. The Corporation extended benefits to some of the transition team not offered to other Corporate employees or authorized in LSC policies. This occurred during a period in which the Corporation's management had instituted personnel-related austerity measures.

The inspection found that:

> some members of the transition team received benefits not authorized in the corporate policies and not available to all LSC employees,
>
> in some instances LSC did not report all employee and independent contractor 1994 compensation to the Internal Revenue Service and did not comply with tax withholding requirements,
>
> the Director of the Office of Program Services was classified inappropriately as an independent contractor,
>
> lack of a policy on frequent flyer mileage permits potential conflicts of interest and resulted in unnecessary expenses,
>
> LSC employees used Government contract fares for personal travel which violated both its Memorandum of Understanding with the General Services Administration and Omega Travel Services and its own travel policies.

Although most of the benefits discussed below were not provided for by the LSC Administrative Manual or Personnel Policy Manual, or any other documented LSC policy, they, with the exception of employee personal travel at Government contract rates, were not prohibited by LSC policies or applicable law or regulation. The LSC President, as chief executive of the Corporation, had the authority to approve expenditures for purposes related to the statutory business of LSC. The payments reviewed were sufficiently related to LSC's statutory purposes to place them within the scope of expenditures that may be lawfully approved by the President. The President waived all benefits for himself during the transition period, including medical and retirement benefits.

In some instances, however, the manner in which benefits were delivered violated provisions of LSC travel policy, as expressed in Chapter 6 of the LSC Administrative Manual.[1] Those provisions included, for example -- a prohibition against personal travel at Government contract rates; a requirement that only the most economical travel be approved; and, a prohibition against selection of a specific airline or flight based on the traveler's personal preference rather than on the costs and benefits to LSC.

Moreover, in some cases the value of these benefits was not appropriately reported to the individual involved or to the Internal Revenue Service ("IRS") under the Internal Revenue Code ("IRC" or "Code"). In no instance did LSC treat the value of these fringe benefits as compensation to the employee or contractor involved. While exclusion from compensation was within the Code in some instances, it was not appropriate in all.

The OIG has requested an opinion from the Comptroller General of the United States concerning the ownership and use of frequent flyer mileage premiums obtained by LSC employees as a consequence of official travel.

FINDINGS

A. Some Members Of The Transition Team Received Benefits Not Authorized in the Corporate Policies And Not Available To All LSC Employees.

Contracts between the Corporation and various members of the transition team provided certain fringe benefits which were not available under LSC's Personnel Policy and Administrative Manuals and, therefore, were not available to other LSC employees. The additional benefits included travel between LSC and home, payment of private health insurance, apartments leased at Corporate expense, reimbursement for child care and housekeeping, salary increases, parking, and special retirement benefits. The LSC Board of Directors and management imposed a salary freeze for all the Corporation's regular employees during calendar year 1994 as a cost savings measure. This action was taken because of a $2,000,000 management and administration deficit inherited from the prior management.

[1] Chapter 6 is "the official travel policy of the [LSC]," and, by its terms, it governs "travel by any board member, employee (regular or temporary), consultant or invited guest paid for in whole or part with LSC funds." Chapter 6, Part I.A.

1. **Travel Between Home and LSC**. Employment contracts for the Director of OPEAR/OPS and the Assistant to the President provided for reasonable travel home. They travelled to their homes at LSC expense 58 times during the inspection period. The term "Reasonable transportation expenses" was not defined in the contracts or the Corporation's Administrative manual.

2. **Medical Insurance Outside LSC Plan**. The Corporation paid over $8,000 to the Executive Vice President, Director of OPEAR/OPS and the Assistant to the President in 1994 for outside medical insurance. As of the date of this Report, the Corporation continued to compensate the Director of OPEAR for medical insurance. The payments did not exceed amounts the Corporation would have paid for the employees' insurance through the LSC plan.

3. **Apartment Leases**. The Corporation leased apartments for the Director of OPEAR, Assistant to the President and an independent contractor. The total of lease and related utility payments was over $24,900. Leasing the apartments was cost effective when compared to daily hotel lodging expenses.

4. **Child Care and Housekeeping**. An independent contractor was compensated at a rate equivalent to approximately $104,000 per year and was entitled by contract to reimbursement of child care and housekeeping expenses. The Corporation paid the contractor $1,330 for child care and $1,114 for cooking.

5. **Management Salary Adjustments**. Effective October 1, 1994, during the general pay freeze, the Executive Vice President and the Director of OPEAR/OPS received salary increases of 18% and 15%, respectively. The personnel files for these two employees contained no justification for the salary increases.

6. **Parking**. In 1994, the Corporation paid Central Parking System $1,320 for a parking space for the Executive Vice President. As of June 1, 1995, LSC continued to pay $120 per month for the Executive Vice President's parking. LSC's practice in recent administrations has been to pay parking for its President and, in the more distant past, it has paid for other employees' parking.

7. **Retirement Benefits**. The contracts of the Executive Vice President, Director of OPEAR/OPS and the Assistant to the President, which expired, provided for direct payment to them of amounts contributed by LSC to the retirement program upon their departure from LSC.[2]

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[2]The Corporation later determined that the Director of OPEAR/OPS and Assistant to the President were fully vested in the Corporation's thrift plan because of their prior LSC employment. In April 1994, their retirement clauses were modified.

Providing benefits beyond those authorized in written policies can have the effect of removing such benefits from the existing system of internal controls provided by the official written policies. In some instances benefits were paid which were not permitted either by the LSC Personnel Policy Manual or a contract in effect at the time. Management's ability to operate outside established internal controls and the structure's failure to identify such deviations are indicators of an inadequate internal control structure.[3] In addition, granting these benefits to some transition team members while freezing salaries and suspending leave accrual for the regular LSC workforce created the appearance of favoritism.

Recommendation 1. The Corporation provide no benefits that are not expressly authorized by the Personnel Policy Manual or Administrative Manual.

Management Response.[4] "Management agrees with the Report's conclusion that benefits paid to members of the transition team, such as paid travel between home and Washington, D.C., payment of medical insurance outside of the LSC plan, housing in Washington, and, in one instance, child care and housekeeping, were not unlawful or otherwise improper.

With respect to the criticism of the decision to provide benefits beyond those authorized in written policies to members of the transition team, the Report does not give sufficient consideration to the business-related reasons why the contractual arrangements were necessary and appropriate under the special circumstances presented. In early December, 1993, Alexander Forger was invited by the new Board of Directors of LSC to become the President of the Corporation on an interim basis while a search was undertaken for the selection of a permanent President. Mr. Forger's mandate from the Board was to restore the stature and effectiveness of the legal services program and to redesign the Corporation's monitoring function to make it more effective. In addition, Mr. Forger was charged with addressing LSC's large financial deficit resulting from prior Management's decision to move into a new headquarters without first renting its old offices, a decision made apparently without objection. To accomplish this mandate, it was essential to attract a group of senior managers who were already highly experienced and knowledgeable in the delivery of legal services to low-income people.

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[3]Chapter 6, Part I.F. of the LSC Administrative Manual requires travelers to submit Travel Expense Reports within 20 working days of travel completion. However, members of the transition team routinely did not comply with this requirement. Some expense reports were submitted over six months after travel was completed. The Corporation did not have a system in place to ensure prompt submission of travel expense reports nor did the Corporation's policies establish a consequence for failure to comply with current submission requirements. This internal control structure weakness diminished the Comptroller's ability to provide timely, accurate reports of the Corporation's travel expenditures to division directors and the Board of Directors. Moreover, undue delay in submitting and processing travel expense reports unnecessarily exposed the Corporation to increased opportunity for misuse of travel funds.

[4]With the exception of the footnotes, the responses of Management are quoted in full throughout the report. The footnotes appear in full in the copy of the Management Response which is attached as Appendix V.

In the months of December 1993 and January 1994, it was extremely difficult to find individuals who were willing to join the transition on short notice and to accept the positions without any guarantee of future employment. People whose experience and skills made them uniquely qualified to accomplish the transition tasks resided outside of Washington, D.C., were in mid-career with established homes and family responsibilities, and could not simply pick up and move to Washington for a temporary, short-term assignment. Rather than lose these individuals entirely, Mr. Forger determined that it was reasonable under the circumstances to make it possible for these individuals to work in Washington on a short-term bases. While such arrangements were not set forth in the LSC Personnel Manual, Mr. Forger understood that the Manual did not preclude such arrangements in the case of temporary employees and he was assured that he had legal authority and flexibility to make these arrangements because of the extraordinary circumstances presented.

Management disagrees with the Report's conclusion that the contractual arrangements indicate 'an inadequate control structure.' The arrangements were set forth in written contracts executed by each member of the transition team; the contracts were reviewed and approved by the Office of General Counsel and were available to any LSC employee responsible for personnel administration or fiscal practices. The OIG itself was able to rely upon these contracts in performing its Inspection. Moreover, there is no evidence in the Report that the arrangements were abused. Leasing apartments rather than paying for daily hotel lodging resulted in a significant savings to the Corporation. The payment of medical insurance outside the LSC plan was limited so that there would be no additional costs to LSC and, in one instance, even resulted in a savings to LSC for a period of time. Even LSC's payment of travel home for two transition employees was no more costly and far more efficient than if these individuals had remained at their homes and worked for LSC as consultants. Finally, as noted in the Report, the President waived all benefits during the transition period, including medical and retirement benefits.

Management also disagrees with the Report's conclusion that an appearance of 'favoritism' resulted from the payment of special benefits to the transition team. The arrangements were made in order to obtain the services of several key employees who otherwise could not have assisted in the transition. Members of the transition team who did not have these problems, because they already lived in Washington, D.C., were not paid the benefits. Nor, of course, were regular employees who lived with their families in the Washington area. It is unlikely that any of them would have or could have thought themselves the victims of 'favoritism'.

Finally, Management does not agree with the Report's recommendation that LSC provide <u>no</u> benefits not authorized by the Personnel Manual or the Administrative Manual. Although these written policies should continue to govern in most circumstances, it cannot be certain that special circumstances, such as those presented in the transition, will not arise again. Management should have the flexibility to deal with these future circumstances as warranted.

Management also wishes to point out a number of instances in which the Report omits significant facts relating to the provision of various benefits. For example, the Report states that the Executive Vice President and the Director of OPEAR/OPS received salary increases effective October 1, 1994, although a Board imposed salary freeze was in effect at the time. in fact, the salary fixed on October 1, 1994 for both employees was the first time that a salary was determined for them as permanent employees. Until that date they had continued to receive the same salary as had been paid during the period of their temporary employment.

The Report also states that LSC's practice in the past has been to pay parking for its President, thereby suggesting that the decision to pay parking for the Executive Vice President deviated from prior practice and constituted an additional expense. In fact, in the past LSC has paid parking for employees other than the President, including the Vice-President, Corporate Secretary, and Director of Policy Development and Communications. And, in this instance, the President himself did not request a parking space so that LSC continued to pay for only one space.

The Report states that LSC agreed with three of the members of the transition team to make lump-sum payments equivalent to the amount of the Corporation's retirement plan contributions upon termination of their employment if the contributions had not then vested. As the Report notes, these arrangements were amended when it was learned that two of these individuals were already vested under the LSC plan because of service credits earned in earlier years, and the third employee never received a lump-sum payment because she became a member of the permanent staff. The Report does not acknowledge that these arrangements were an appropriate effort to insure that the individuals would receive the benefit of the retirement contributions, since they were expected to be employed for periods shorter than the plan's vesting schedule, nor that LSC has entered similar arrangements in the past for the same reason."

OIG Comments. The OIG disagrees that the employment contracts constituted an adequate control structure. We noted that contracts were made effective retroactively and modified retroactively, and that some benefits were provided without a written contract in effect.

B. In Some Instances LSC Did Not Report All Employee and Independent Contractor 1994 Compensation to the Internal Revenue Service and Did Not Comply with Tax Withholding Requirements.

The Corporation did not comply with the Internal Revenue Code's requirements regarding tax reporting and withholding of employee and contractor compensation. Except as otherwise specifically provided in the Code, gross income is all income from whatever source derived, including compensation for services, which includes the value of fringe benefits. The value of a fringe benefit provided in connection with the performance of services is includable in gross income as compensation, unless specifically excludible under a Code provision.

LSC obtained two legal opinions on travel related payments. One, from its Office of General Counsel (OGC) in the Spring of 1994 and the second, at the request of the Assistant to the President, from a law firm in the Summer of 1994 for a fee of $1,585. The Corporation also received an OGC opinion of December 14, 1994 concerning medical insurance reimbursements and moving related expenses.

In early October 1994, the OIG informed the Executive Vice President that it believed LSC's payment for the Director of OPEAR's travel between LSC and home and a trip by the Special Assistant to the President to her home, was inappropriate and subject to criticism. LSC Management's Response, dated November 11, 1994, stated that LSC had not considered the employee's travel between LSC headquarters and his home to be personal travel but, "to avoid any concerns about appearance or appropriateness, the Corporation and the employee have agreed that, as of the date he became a regular employee, October 1, 1994, LSC would no longer pay his travel to and from LSC headquarters and his permanent residence in Colorado." However, the inspection revealed that management did not cease payment of personal travel and lodging expenses for the Director of OPEAR/OPS and the Assistant to the President.

Most of the extra benefits provided to the transition team were provided for in employment contracts executed by the LSC President, and Chapter 7 of LSC's Administrative Manual permits payments for certain travel and relocation expenses. However, as detailed below, a number of the payments permitted by the contracts and/or Administrative Manual were not excludible from the income of the recipient.[5]

1. **Personal Travel And Apartment Leases.**

The Director of OPEAR. According to the Corporation's personnel files, the Director was appointed a regular salaried employee, effective January 11, 1994. The contract had a termination date of July 17, 1994. A July 7, 1994 letter from the LSC President to the Board of Directors stated that an offer had been extended to the Director of OPEAR to continue to serve in that capacity. At the July 16, 1994 Board of Directors meeting, the President announced that the Director ". . . has agreed to continue on as a director of OPEAR."[6] Therefore, a realistic expectation that the Director would hold the position indefinitely arose no later than July 16, 1994. The

[5] Under Section 132(d) of the IRC, payments of expenses by an employer which, if paid for by the recipient, would be deductible by the recipient as a business expense under section 162 of the Code are excludible from the recipient's reported compensation. Expenses of commuting to and living near the principal place of business are generally non-deductible personal expenses. IRC §262. Expenses of commuting to and lodging near a temporary job, however, may nonetheless be deductible, but no temporary job can last more than one year. IRC § 162. A job cannot be considered temporary after a realistic expectation arises that it will be of permanent or indefinite duration or will last for more than one year. Rev. Rul. 93-86, 1993-40, 11/24/93.

[6] July 16, 1994 LSC Board of Directors meeting, transcript page 46.

only documented change in the Director's employment subsequent to that date was a salary adjustment executed by the President, dated October 4, 1994, with an effective date of October 1, 1994.

However, LSC continued to pay for some of the Director's trips home after July 16, 1994. Between July 17, 1994 and December 31, 1994, at LSC expense, the Director made 10 additional trips home -- four direct from Dulles Airport and six as extensions to LSC-related business trips. LSC also continued to pay the rent on his Washington, D.C. apartment through October 1994.

All amounts paid or reimbursed by LSC from July 17, 1994 through December 31, 1994, for the Director's lodging in Washington, D.C. and travel to his domicile were compensation and not excludible from his 1994 income under the law.

Assistant to the President. According to LSC records, the Assistant to the President became a regular employee of LSC on January 12, 1994. The Assistant's employment contract, dated February 16, 1994, was retroactive to January 12, 1994 and had a termination date of September 7, 1994.[7] The contract was extended from September 7 through November 30, 1994 and, by letter of December 2, 1994, the contract was further extended until December 31, 1994. Finally, by letter dated December 31, 1994 with acceptance by the Assistant dated January 4, 1995, the term of the his employment contract was extended from January 1, 1995 through January 11, 1995, one year to the day from the start of his employment at LSC.[8]

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[7]By his signature on August 10, 1994, the Assistant to the President accepted a replacement contract dated August 2, 1994, which was retroactive from July 1, 1994 to September 7, 1994, the same termination date as the original contract. Modifications to the original contract were not significant for present purposes.

[8]Based on LSC records, the Assistant to the President was originally appointed to the position of Program Officer as of January 1, 1995. The official personnel action form effectuating this change in his position was dated January 9, 1995. The second official personnel action form making this same change as of January 12, 1995 was dated February 6. The Assistant to the President had requested this change in the date of his indefinite appointment. In a January 25, 1995 memorandum to the LSC Executive Vice President, he wrote:

> "I should not have been appointed effective January 1. I accepted the job offer on January 5, and began working the following week. I began work as a temporary employee on January 23, 1994, and we agreed that my new permanent appointment should be effective on January 12. As a result of this conclusion, my contract as a temporary employee needs to be extended for January 1 through January 12. [General Counsel] has handled prior extensions and should be asked to take care of this one."

In a February 1, 1995 e-mail message to the Executive Vice President, the Assistant to the President wrote: "My employment form will show I commenced employment 1/12/95. I'll pass along to [General Counsel] a request for a contract extension through 1/11/95."

These documents appear to require a conclusion that both the letter dated December 31, 1994 from the LSC President, which extended the Assistant to the President's employment contract from January 1, 1995 through January 11, 1995, and the Assistant to the President's January 4, 1995 signature on that letter, were backdated. That "December 31" contract extension appears to have been created sometime after February 1, 1995.

Thus, according to some LSC records, he became a Program Officer on January 12, 1995, the day after the fifth and last contract expired.[9] However, Corporation payroll records reflect that effective January 1, 1995, his salary was reduced from the Assistant to the President contract rate of $90,000 to the current rate of pay of $85,000 as a Program Officer. Further, an Official Personnel Action form signed by the Director of OPEAR and Director of OHR on January 9, 1995, appointed him a Program Officer, effective January 1, 1995.

According to the Director of OHR, at the end of January 1995, the Executive Vice President told her to contact the Corporation's General Counsel and request an 11-day contract for the Assistant for the period of January 1 through 11, 1995, and to prepare a new Official Personnel Action form appointing him a Program Officer, effective January 12, 1995. The Director of OHR stated that the change in the Assistant's appointment date was done to allow LSC to pay a portion of his COBRA[10] insurance coverage for the month of January 1995. According to General Counsel, the contract extension for January 1 through 11, 1995 was prepared on February 24, 1995. The General Counsel stated it was his understanding that management's intent was to allow the Assistant to stay on contract for exactly one year and no longer because of the tax consequences. In an interview, the Assistant (now Program Officer) stated that the initial conclusion was to make the employment effective retroactive to January 1, 1995 but because of the consequences of temporary versus indefinite employment and the related travel and lodging expenses, a January 12, 1995 indefinite employment date was established.[11] It appears that the contract extension dated December 31, 1994, was executed on February 24, 1995 by the LSC President and was expected to allow the Assistant to earn a higher salary as an Assistant to the President, to receive special benefits and to avoid tax consequences on those benefits.

Under the legal opinions obtained by LSC and prepared by the OIG, the latest date on which the Assistant's realistic expectation could have changed from one of temporary employment to one of indefinite employment was January 5, 1995. This was the latest date on which, according to the Assistant, the offer of indefinite employment was accepted. After an offer of indefinite employment was made by LSC and accepted by the Assistant, he should have no longer been classified as a temporary

[9] During an interview, the Assistant to the President stated that he had requested, and LSC had obtained, legal opinions on the taxability of certain payments he received from LSC. One of these, the August 18, 1994 letter from outside counsel for $1,585, was forwarded to the Assistant to the President by LSC's Office of General Counsel with a cover memorandum dated August 19, 1994, and again with one dated September 9, 1994. Both the August 18 cover memorandum and outside counsel opinion concluded that the Assistant to the President's travel expenses would be excludible from his income as long as his employment at LSC did not last more than one year and as long as there was not a realistic expectation that his employment would last indefinitely or for more than one year.

[10] Consolidated Omnibus Budget Reconciliation Act of 1986.

[11] June 13, 1995 OIG interview of the Assistant to the President.

employee. A written offer of employment, with a stated date of February 3, 1995, was accepted by him in writing with a stated date of February 6, 1995.

LSC reimbursed the Assistant for his Washington, D.C. apartment rent for January 1995 and paid the utilities through February 4, 1995. LSC also paid for three round trips to Boston and one trip back to LSC, between January 7 and 31, 1995.

Amounts paid or reimbursed by LSC after January 5, 1995 for the Assistant's lodging in Washington, D.C. and travel between LSC headquarters and his domicile in Massachusetts were compensation not excludible from his income under the law and are subject to withholding.[12]

Director of OPS. Under a contract with an execution date of January 27, 1995 and retroactively effective as of January 3, 1995, the current Director of OPS was hired as "Acting Director of the Corporation's OPS, . . . continuing until you assume the position of Director of OPS as a regular, full-time employee." The contract was to be renegotiated if the Director was ". . . unable to assume the position of Director of OPS on a regular, full-time basis on or about April 17, 1995." The Corporation extended a written offer of employment dated April 17, 1995, to her for the position of Director, OPS, commencing April 18, 1995. Her acceptance of this offer is dated May 5, 1995.

The contract appeared to contemplate that the Director of OPS would continue in the position on an indefinite basis. The Director was entitled, under this contract, to continue to serve as the Executive Director of the Legal Services Corporation of Alabama (LSCA), an LSC grantee, but was not to earn compensation from both on the same day. The contract also entitled her to reimbursement, according to the Corporation's Administrative Manual, for five trips, which she took, between Washington, D.C. and her home in Alabama and for meals and lodging within the District of Columbia area. The contract stated that, in view of the reimbursable trips it allowed, the Director would not be entitled to moving expenses permitted by the Administrative Manual. LSCA records show that the Director of OPS resigned as its Executive Director effective April 14, 1995.

During the contract period, the Director was transitioning from an old job at LSCA to a new one at LSC. Her new job at LSC was, from the outset, expected to be the new indefinite business location during the year. From January 1995 through April 17, 1995, when she held jobs with LSC and LSCA, she worked substantially more days, and earned a substantially greater amount for the days worked, at LSC than at LSCA. LSC records show that she was paid for 41.07 days as the Director of LSC's

[12]One trip from the Assistant to the President's home in Boston to his job in Washington, D.C. may have been excludible from his income as relocation expenses under Section 132 of the Code.

OPS during the contract period at a rate of $103,000 per year. According to LSCA, during the contract period, she was paid for 29 days of work and two holidays as Executive Director at a rate of $67,500 per year.

The Director's expenses for traveling home to Alabama and meals and lodging while in Washington, D.C. would not be deductible as business expenses in connection with work at LSC, and therefore, are not excludible from her 1995 compensation, because the position at LSC was indefinite as opposed to temporary and LSC was the principal place of employment.

2. **Medical Insurance**

Outside of its regular medical insurance plan for employees, LSC provided payments earmarked for insurance reimbursement directly to three employees. These payments were in compliance with the employees' contracts, with the exception of payments to the Director of OPEAR after his contract expired in July 1994. Under the law, to exclude the payments from employee income, an employer must obtain proof of premium payment by the employee. LSC did not require proof that the employees had, in fact, paid insurance premiums. In two instances, however, LSC nonetheless received sufficient proof to ascertain the existence and payment of the insurance -- the Director of OPEAR for 1994 and the Assistant to the President for February 1994 -- therefore, those payments would appear to be excludible from income. In the other instances, however, the required proofs were not obtained and the reimbursement would not be properly excludible from income under the law. The amounts paid by LSC was compensation to the employees and should have been treated as such for payments made in calendar year 1994 and should be treated as such for payments made in calendar year 1995.

3. **Child Care and Housekeeping**.

Child care, unless provided under an employer's plan according to the Code, and housekeeping are nondeductible and non-excludible personal expenses. On May 9, 1994, based on one receipt for child care and six receipts for cooking, LSC paid a contractor for child care and cooking expenses. Because the individual was an independent contractor rather than an employee, LSC was not required to withhold payroll and income taxes from this amount. However, LSC should have reported the amount as income on the contractor's Form 1099, but did not.

Unreported Compensation										
	Executive Vice President		Director OPEAR		Assistant to the President/Program Officer		Contractor		Director OPS	
	1994	1995	1994	1995	1994	1995	1994	1995	1994	1995
Travel	$0	$0	$1,638	A	$0	$799	$0	$0	$0	$2,038
Lodging	$0	$0	$2,670	$0	$0	$1,785	$0	$0	$0	$3,657
Per Diem	$0	$0	$0	$0	$0	$0	$0	$0	$0	$1,601
Medical	$2,132	$0	$0	$1,131	$2,133	$0	$0	$0	$0	$0
Child Care	$0	$0	$0	$0	$0	$0	$1,330	$0	$0	$0
Cooking	$0	$0	$0	$0	$0	$0	$1,114	$0	$0	$0
Total	**$2,132**	**$0**	**$4,308**	**$1,131**	**$2,133**	**$2,584**	**$2,444**	**$0**	**$0**	**$7,296**

A. The Director of OPEAR's travel home at LSC expense in 1995 consisted of stops during a business trip. A value for these stop-offs was not determined.

Recommendation 2. The Corporation review and revise its personnel and administrative policies related to employee benefits to reflect current withholding and reporting requirements under the Internal Revenue Code.

Recommendation 3. The Corporation determine the amount of unreported compensation for its employees and contractors and make appropriate payments to the Internal Revenue Service.

Management Response. "With respect to Recommendation 2, Management agrees that it should review the tax treatment of all benefits, and it will do so. With respect to Recommendation 3, Management requested outside tax counsel to review the finding and conclusions in the Draft Report regarding the reporting of benefits paid to members of the transition team. Counsel has advised that, while the issue is a close one, the conservative approach is for LSC to treat payments noted in Finding B for certain employees as compensation. Based on this advice, Management is in the process of making the necessary adjustments and will file the appropriate forms with the IRS.

However, Management believes that several assertions in this portion of the Report require amplification or correction:

> Although July 16, 1994, will be used for tax purposes as the effective date of the Director of OPEAR's indefinite employment, based on the advice of counsel, it should be noted that while the Director indicated his willingness to

accept a position in mid-July, agreement was not reached on the final terms and conditions of his indefinite employment until October because of the press of other matters.

The Report states that the Director of OPEAR made ten trips to Denver between July 17, 1994 and December 31, 1994 at LSC's expense and that LSC continued to pay the rent on his apartment in Washington, D.C. through October 1994. As noted above, the tax treatment of the Director's travel to Colorado prior to October 1, 1994 will be adjusted. The Report is not correct that LSC paid for the Director's personal travel after October 1, 1994; the personal portion of all such trips was reimbursed.

As for the Assistant to the President, he was asked in early January to take a permanent job as a Program Officer and he accepted on January 5, 1995, subject to agreement on satisfactory terms. He did not assume the Program Officer position until January 12, 1995. While Management, based on the advice of counsel, agrees to treat January 5 as the date upon which an expectation of continued employment arose, it will continue to use January 12 as the date of his permanent employment for other purposes."

OIG Comment. The Director of OPEAR's reimbursement was not made until 1995, and therefore LSC's payment for his travel was compensation for 1994 tax purposes.

C. The Director Of The Office of Program Services Was Classified Inappropriately As An Independent Contractor.

The Director of the Office of Program Services (OPS) vacancy was announced by the Corporation on September 30, 1994 with a closing date of November 15, 1994. The announcement stated that the Director of OPS is "[u]nder the general direction of the Executive Vice President." The announcement described the duties as including participation "as a part of LSC Senior Management" in policy issues; review and approval of personnel actions affecting the staff of OPS; development of internal operating procedures; and development and oversight of the OPS operational and program budget. The current Director of OPS formally applied for the position by letter of November 15, 1994 and the hiring was announced by the President of the LSC to the Board and staff on December 21, 1994. The title and job description entrusted the Director of OPS with supervision of an important corporate function. The Director of OPS is a long-standing and senior management position.

Under the Code, the Director was an employee of LSC from the beginning of the contract and must be treated as such. LSC did not have a reasonable basis for treating her as an independent contractor because its decision to do so was not based on judicial precedent, published rulings, an IRS letter, a past IRS audit or long-standing industry practice. Second, LSC treated the Director as an employee after the contract expired although her duties were indistinguishable from what they were while she was treated as a contractor. Finally, LSC has always treated the Director of OPS as an employee.[13] Therefore, the Director was an employee of the Corporation during the term of the contract and must be treated as such by LSC in withholding and reporting of compensation for calendar year 1995.

Recommendation 4. The Corporation review its practices with respect to classification of independent contractors to ensure that such practices comply with the Internal Revenue Code and the Corporation's policies.

Management Response. "During the period from January 3, 1995 through April 17, 1995, the Director of OPS was employed only on a part-time basis, while she concluded her job responsibilities in Alabama, and her principal LSC duties in this period involved becoming familiar with LSC projects for which she would be responsible after assuming the position full time. With respect to Recommendation 4, Management also asked outside tax counsel to review the Report's finding with respect to the classification of the Director of OPS. Tax counsel has recommended that the Director be reclassified as an employee for tax purposes. The correction can be made in the same fiscal year and the tax consequences will be minimal. Management will also consult tax counsel with regard to classification of other consultants."

OIG Comments. None.

D. Lack Of A Policy On Frequent Flyer Mileage Permits Potential Conflicts of Interest and Resulted In Unnecessary Expenses.

The Corporation did not have a policy on ownership of frequent flyer mileage earned by its employees on official travel. The Corporation's Administrative Manual did not make reference to frequent flyer mileage awards. However, Chapter 6 of the LSC Administrative Manual did set parameters for travel. It required that only the most economical travel be approved and it prohibited selection of a specific airline or flight based on the traveler's personal preference rather than on the benefits to LSC. Furthermore, this chapter required travelers to use contract air carriers for all LSC travel between cities designated "city-pairs" by the GSA.

The Director of OPEAR had a frequent flyer membership with United Airlines and 96 percent of his LSC-paid travel was on United Airlines. At times, the Director had been ticketed on United and at other times he exchanged tickets obtained by the LSC travel office for flights on other airlines for United tickets. From January 11, 1994 through April 1995, the Director of OPEAR accumulated some 292,000 United Airlines miles as a consequence of official LSC travel. Of these miles, over 100,000 were earned on official LSC mileage and over 100,000

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[13] Rev. Proc. 85-18, 1985-1 CB 518.

additional miles were earned on this travel based on the Director's United Airlines Premier Executive status. An additional 77,000 miles were earned for hotel stays, rental cars and Premier Plateau bonuses, while on official travel for LSC.

During an interview, the Director of OPEAR stated that when he interviewed for his position, his desire to retain ownership of frequent flyer miles earned as an employee of the Corporation was expressed to management. Corporate management informed him that it did not have a policy on frequent flyer mileage and that it was not necessary to include a clause regarding ownership of frequent flyer mileage in his employment contract because it was not prohibited to retain such mileage for personal use. The Director also stated that he directed his staff to book him on United Airline flights whenever possible. He stated that he requested United Airlines to enable him to earn frequent flyer mileage and enjoy other benefits of his United Airlines Mileage Plus account.

The Director's most frequent destination was to his home in Colorado. United was the contract carrier to Denver from Dulles Airport. The Director of OPEAR stated that he chose United for these trips because it provided non-stop flights, helped avoid weather delays and, therefore, was less time-consuming and more convenient for him. He was not aware that it cost $140 more for this United flight than for indirect flights available on the contract carrier out of National Airport and was not informed of the price differential by LSC's travel office.[14] These flights accounted for the bulk of the unnecessary costs incurred by LSC for the Director's preference for United Airlines flights. On another occasion he traded in a non-stop ticket to New Orleans on a Government contract carrier for an indirect, non-contract United flight. He stated he did so to earn frequent flyer mileage. United agreed, at his request, to honor the contract price so that there was no additional expense to LSC for the more time-consuming United flight.

The Director's ability to direct his staff to book flights based on his personal preference and convenience, without any question from responsible employees of LSC, along with the Corporation's approval of the accumulation of officially earned frequent flyer miles for personal use and its failure to enforce existing travel rules, created a serious potential for conflicts of interest, both real and apparent.

Recommendation 5. The Corporation develop and implement a frequent flyer benefits policy which will avoid conflicts of interest or the appearance thereof.

Management Response. "While there has been no written policy regarding ownership of frequent flyer awards earned on official LSC travel, it has been the long-standing practice of the Corporation to allow its employees to retain frequent flyer benefits for their personal use. This is documented in a 1986 memorandum from the General Counsel to the Secretary of the Corporation in which he concluded that no provision of law prohibits the Corporation from

[14] The Director is responsible for a Fiscal Year 1995 travel budget of $747,000.

treating frequent flyer benefits in this way. In the early 1990s, a former LSC President considered whether to change the practice and concluded he would not.

Management recognizes that by not attempting to recover frequent flyer awards earned on official travel, LSC may give up the opportunity to defray some official travel expenses. However, it should be noted that there would be significant administrative difficulties in attempting to recapture frequent flyer awards from individual employees and the unsuccessful experience of many federal agencies which have attempted to do so. For these and other reasons, the former President of LSC concluded that any savings to LSC would not justify the additional administrative costs associated with a change in policy. As directed by the LSC Board of Directors at its meeting on July 14, 1995, Management will review the frequent flyer issue again, including the potential for conflicts of interest, taking into account the experience of federal agencies and other relevant entities. The results of this review will be incorporated into a written policy.

With regard to the specifics of travel by the Director of OPEAR, the Report suggests that he incurred unnecessary expense by flying on United Airlines from Dulles Airport solely to accumulate additional frequent flyer miles. In fact, the Director could have flown on United from National Airport as well. He flew on United from Dulles because the flights to and from Denver were nonstop, whereas flights from National on United and other carriers take much longer and frequently would not have allowed him to reach home by Friday evening or to return to Washington, D.C. until very late on Monday. As the Report notes, the Director was not informed by the LSC travel office or Omega Travel Services nor was he otherwise aware of cost differences between flights from National Airport and flights from Dulles to Denver. However, whenever he was cognizant of cost differences in booking his flights, he took steps to insure that LSC incurred no extra cost, as he did with regard to the trip to New Orleans mentioned in the Report."

OIG Comment. Responsible corporate officials stated unequivocally that there was no corporate policy. Northwest Airlines, not United Airlines, was the Government contract carrier from National Airport to Denver and therefore, use of United from National Airport to Denver would have violated LSC policy and the GSA contract.

E. LSC Employees Used Government Contract Fares For Personal Travel Which Violated Both Its Memorandum Of Understanding With The General Services Administration And Omega Travel Services And Its Own Travel Policies.

Through an arrangement with the General Services Administration (GSA), LSC was allowed to use Government contract travel rates. LSC's Memorandum of Understanding (MOU) with Omega World Travel, Incorporated (Omega), required that, if personal travel were combined with official travel, the traveler would be responsible for any increased costs associated with the arrangements. The GSA - Omega contract prohibited use of contract fares for any personal travel, including those instances where portions of personal travel are substituted for a leg of an officially authorized trip.[15] Moreover, Chapter 6 of the LSC Administrative Manual prohibited personal travel at Government contract rates.[16]

1. **Misuse of Government Rates Due to Misclassification of Personal Travel.**

In the following instances, the use of Government contract rates for personal travel was a consequence of misclassification of indefinite employees as temporary.

- **The Director of OPEAR** became an indefinite employee in mid-July 1994. The Corporation, however, considered him a temporary employee until October 1, 1994. From mid-July 1994 through October 1, 1994, he traveled to his home eight times with airline tickets purchased from Omega at the Government contract rate by LSC.

- **Special Assistant to the President**. The Corporation purchased Government contract fare tickets through Omega for the Special Assistant to travel from D.C. to Boston to D.C. for a "change in travel plans due to necessity to be in D.C. for Corporation," in August 1994. During the Special Assistant's interview, she said the trip was to attend her brother's wedding. Following an October 1994 informal OIG inquiry into LSC employee travel, the LSC Executive Vice-President notified the OIG by memorandum of November 11, 1994, that ". . . to avoid any concerns about appearance or appropriateness in this matter, [the Special Assistant] has offered to reimburse LSC for the travel costs and we have accepted her offer." The Special Assistant reimbursed LSC for the cost of the travel, after initiation of this inspection, on April 27, 1995.

- **The Director of OPS** became an indefinite employee of LSC on January 3, 1995, therefore, all travel between her home in Alabama and Washington, D.C. was personal. The Corporation, however, considered her employment as temporary through April 17, 1995. The Director of OPS took five trips home on tickets purchased by LSC through Omega at Government rate between January 3 and April 2, 1995 and one trip to Washington, D.C. on April 17, 1995.

2. **Misuse of Government Rates Due to Failure to Follow Rules.**

In other instances, employees apparently were allowed to travel at government rate although there was no mistaken belief that the travel was official.

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[15] General Services Administration Contract Number GS-OWF-53322, Part I, Section C.I.A.(3)(a).

[16] LSC Administrative Manual, Chapter 6, Part V.C.

- **The Director of OPEAR** traveled to his home in Denver five times during three official trips, from October 1, 1994 through February 12, 1995, after LSC classified him as an indefinite employee. The personal travel was combined with official travel. During an interview, the Director stated that he had spoken to the LSC Comptroller about some of the personal trips to Denver and had been told that the airfare was less expensive than returning to Washington, D.C. between official business. Evaluation of the fares revealed the difference to be *de minimis*. The Government contract rate amount was withheld from the Director's subsequent travel settlement for three of these personal trips.

- **The Director of OPS.** In late April 1995, the Director combined personal travel with official travel on one occasion. Travel was at the Government contract rate, with tickets purchased by the Corporation from Omega. As of June 7, 1995, the Director of OPS's travel expense report for this travel was not processed. According to the Corporation's travel office, the Director of OPS is to reimburse the Corporation $266 for the personal portion of the $1,087 airfare. The LSC travel office confirmed that the Director's personal portion of the trip was purchased at the Government contract rate, contrary to the provisions of the MOU.

Recommendation 6. The Corporation evaluate and revise its internal control structure over employee personal and official travel to ensure compliance with the LSC-Omega Memorandum of Understanding and other applicable laws and regulations.

Management Response. "Management disagrees with the Report's conclusion in Point 1 of Finding E that Government contract rates were used for personal travel as a consequence of misclassification of indefinite employees as temporary. The trips made by the Director of OPEAR and the Director of OPS were paid for by the Corporation pursuant to its employment agreements with these individuals. These trips therefore were not 'personal'. Insofar as LSC was bound to pay the fares for these trips, Management was advised by the Office of General Counsel that it was proper, under its agreements with the General Services Administration and Omega Travel, to use the government contract rates. Even if these individuals were misclassified for tax purposes, LSC's payment of the travel was proper and the use of Government contract rates for the fares paid by LSC was also proper.

Finally, with respect to the second point raised by the Report, Management agrees that Government contract rates should not be used when an LSC employee combines personal and business travel or when an employee makes a purely personal trip. In a few instances an employee was permitted to use contract rates for personal travel and to reimburse LSC on that basis. This should not have happened and, as set forth in recommendation 6, Management is reviewing its internal procedures to ensure that these lapses do not recur."

OIG Comment. Management takes the position that a trip paid for by LSC pursuant to an employment contract, even if the travel was personal in nature, is official travel. LSC cannot make a personal trip official simply by deeming it so. Otherwise it could bind itself to pay for all nature of employee personal travel and allow such travel at Government contract rate in violation of the MOU with GSA and the GSA contract with air carriers. Moreover, the Director of OPEAR's employment contract expired in mid-July 1994 and LSC was not bound to pay his travel thereafter.

RECOMMENDATIONS

Recommendation 1. **The Corporation provide no benefits that are not expressly authorized by the Personnel Policy Manual or Administrative Manual.**

Recommendation 2. **The Corporation review and revise its personnel and administrative policies related to employee benefits to reflect current withholding and reporting requirements under the Internal Revenue Code.**

Recommendation 3. **The Corporation determine the amount of unreported compensation for its employees and contractors and make appropriate payments to the Internal Revenue Service.**

Recommendation 4. **The Corporation review its practices with respect to classification of independent contractors to ensure that such practices comply with the Internal Revenue Code and the Corporation's policies.**

Recommendation 5. **The Corporation develop and implement a frequent flyer benefits policy which will avoid conflicts of interest or the appearance thereof.**

Recommendation 6. **The Corporation evaluate and revise its internal control structure over employee personal and official travel to ensure compliance with the LSC-Omega Memorandum of Understanding and other applicable laws and regulations.**

APPENDIX I

APPENDIX I

Objectives

1. To determine whether consultants were properly classified under relevant sections of the Internal Revenue Code.

2. To determine total 1994 payments to, for and/or on behalf of the transition team.

3. To verify that 1099s were appropriately issued to individuals and filed with the IRS (and included all payments).

4. To verify that individuals under contract did not receive employee benefits such as health, life, dental insurance, retirement contributions, vacation, eligible leave, sick leave and personal leave.

5. To identify and quantify any inappropriate payments to individuals under contract.

6. To identify and report all noted instances of violations and potential violations of laws, regulations and policy (fraud, waste, abuse or mismanagement) to the Board of Directors.

APPENDIX II

APPENDIX II

Scope

The inspection covered the period of January 1, 1993 through March 30, 1995 and included payments to, for and/or on behalf of the following individuals: 1) LSC President, 2) Executive Vice President, 3) Director of OPEAR, 4) Assistant to the President, 5) Special Assistant to the President, 6) two contractors, and 7) the Director of OPS.

Methodology

We reviewed applicable LSC policies and procedures and Federal laws and regulations to determine the requirements for payments to, for and/or behalf of the transition team.

We reviewed the relevant laws and the Internal Revenue Code to determine required treatment for payments to, for or on behalf of the transition team and to determine if LSC complied with relevant laws, the Internal Revenue Code, and regulations.

We reviewed memoranda from the Corporation's General Counsel and correspondence from outside law firms contracted by the Corporation to opine on the Federal income tax treatment of certain travel and living expenses paid by the Corporation on behalf of certain members of the transition team.

We examined all the travel expense reports (TER) and supporting documentation submitted by the transition team and arrayed the information to determine travel related payments made by LSC to, for or on behalf of the transition team.

We reviewed records of Omega Travel Corporation for transition team travel to determine the reliability of Corporate records.

We reviewed the employment and consultant contracts of the transition team to document when members of the transition team became employees of the Corporation.

We analyzed time and attendance records of the transition team and compared to TERs to verify transition team accountability.

We interviewed certain members of the transition team for information regarding employment contracts, benefits, etc.

We interviewed the Corporations' comptroller and accounting manager for clarification of expenses submitted to LSC for reimbursement by the transition team.

On a limited basis, we reviewed the Corporation's internal policies and procedures comprising the internal control structure for employing, contracting and payments to, for or on behalf of the transition team, to determine the vulnerabilities, if any, in (1) LSC's travel policy with respect to the ordering and payment of airline/rail tickets and the renting of cars purchased through Omega travel services; and (2) LSC's Administrative policies that might affect the payment of salaries, benefits, allowances, fees, services, and related expenses.

We compared procedures performed by Corporate personnel to procedures prescribed in the Corporation's manuals to determine whether the controls in place were in operation and effective.

We subpoenaed and reviewed certain information from United Airlines regarding frequent flyer benefits.

APPENDIX III

LEGAL SERVICES CORPORATION

MEMORANDUM

TO: Jerome Rodgers
Senior Auditor

FROM: Renée L. Szybala
Assistant Inspector General - Legal Review

DATE: July 7, 1995

RE: Contract Service and Related Expense Payments Inspection --
Review of Legal Issues Raised by Certain Fringe Benefits

This memorandum[1] provides the results of a review of legal issues raised by LSC's payment, during the period January 1994 to March 1995, to members of the transition team, and other senior managers hired under contract during this period ("transition team"), of certain fringe benefits not available under the LSC Personnel Policy Manual. The benefits that have been identified for review are:

1. reimbursement for the cost of travel between Washington, D.C. and a home located outside the Washington area, and for the cost of lodging while in the Washington, D.C. area. These benefits were provided to five members of the transition team.

2. payments for maintaining health insurance outside of LSC's health insurance plan. This benefit was provided to three members of the transition team.

3. reimbursement for child care and housekeeping costs. This benefit was provided to one member of the transition team.

4. a paid parking space in the garage in the building housing the LSC headquarters. This benefit was provided to one member of the transition team.

[1]The Table of Contents for this memorandum is attached.

SUMMARY

All the benefits provided were within the authority of the President of LSC. Not all of them, however, were appropriately excluded by LSC from the income of the recipient under the Internal Revenue Code ("Code" or "IRC"). The monetary value of at least a portion of the following should have been reported as compensation to the individual involved, and LSC should have withheld and deposited the appropriate amounts for income and employment tax purposes:

1. **Travel to and from a home outside of, and lodging in, the Washington, D.C. area --**

   a) **Director of OPEAR** -- At the point in time at which there was a realistic expectation that the employment of the individual appointed as Director of LSC's Office of Program Evaluation, Analysis and Review (OPEAR) was permanent or of indefinite duration, the costs of his lodging in Washington, D.C. and of his travel between Washington, D.C. and his domicile in Denver, Colorado would no longer have been deductible by him as business expenses, and, therefore, were no longer excludible from his income by LSC. Based on the facts, the latest that this occurred was July 16, 1994. Amounts paid for these purposes after that date were, and should have been treated as, income to the Director of OPEAR in calendar year 1994.

   b) **Assistant to the President** -- At the point in time at which there was a realistic expectation that the employment of the individual appointed as Assistant to the President of LSC was permanent or of indefinite duration, the costs of his lodging in Washington, D.C. and of his travel between Washington, D.C. and his domicile in Boston, MA. were no longer excludible from his income as deductible business expenses. Based on the facts, the latest that this could have occurred was on January 5, 1995 when, according to this employee, he accepted an offer of permanent employment. Amounts paid for these purposes after that date, to the extent not excludible from income as relocation expenses, are, and should have been treated as, income to this individual in calendar year 1995.

   c) **Director of OPS** -- There was a realistic expectation that individual appointed as the Director of LSC's Office of Program Services (OPS) would remain in that position permanently or for an indefinite duration when she started work at LSC in January 1995, at which time LSC became her principal place of business. The costs of her lodging in Washington, D.C. and of her travel between Washington, D.C. and her domicile in Alabama, therefore, would not have been deductible to her as business expenses in connection with either a temporary job or a secondary job. They were, therefore, not properly excludible from her income by LSC. All such expenses paid by LSC, are and should be treated as, income to the Director of OPS in calendar year 1995.[2]

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[2]The expense of traveling back to Alabama in connection with business there, however, is likely to be deductible to this Director on her personal tax return as a business expense in connection with a second job.

2. **<u>Payments for outside health insurance.</u>**

Under section 106 of the Internal Revenue Code, employer-paid premiums for accident or health insurance are excludible from employee income. Under a 1961 Revenue Ruling, employer payments for health insurance premiums made directly to employees are excludible only to the extent that the employer requires an accounting to insure that such insurance is in force and that the premiums are being paid by the employees. LSC provided payments earmarked for insurance reimbursement directly to three employees without requiring proof that health insurance premiums had, in fact, been paid by those employees. In two instances, however, LSC nonetheless received sufficient proof to ascertain the existence and payment of external health insurance, and it is reasonable to conclude that in those two instances -- the reimbursements received by the Director of OPEAR for 1994 and the Assistant to the President for February 1994 -- the payments were excludible from income under section 106. In all other instances, however, the required proofs were not obtained and the reimbursement would not appear to be properly excludible from income under the law.

3. **<u>Reimbursement for child care and housekeeping costs.</u>**

Child care and household expenses, unless provided under an employer's plan in accordance with the Code, are non-deductible and non-excludible personal expenses. All amounts paid to one of the consultants for such purposes were compensation to her in 1994 and should have been treated as such. Because this consultant was an independent contractor rather than an employee, LSC would not have been required to withhold payroll and income taxes from this amount.

4. **<u>Paid Parking Space</u>**

The amounts LSC has paid and continues to pay for the parking space of LSC's Executive Vice-President are properly excludible from her income under the Internal Revenue Code.

DISCUSSION

I. Was the Provision of these Benefits In Accordance with Applicable Laws?

Providing through contract for the payment of the benefits listed above did not violate any applicable law, regulation or policy. Although most of these benefits were not provided for by the LSC Administrative or Personnel Policy Manuals, or any other documented LSC policy, they do not appear to have been expressly prohibited by LSC policies. The President of LSC, as Chief Executive of the Corporation, with authority to manage the Corporation's day-to-day affairs, has the power to authorize expenditures for purposes related to the statutory business of LSC. All of the payments under review were sufficiently related to LSC's statutory purposes to place them within the scope of expenditures that may be lawfully approved by the President. Payments for these benefits were, therefore, legally authorized.

The fact that LSC had the legal authority to provide these benefits, however, does not mean that the actual payment of these benefits was done in a manner which complied with applicable LSC policies or with tax laws. It appears that, in some cases, the value of the benefits was not appropriately reported to the individual involved or to the Internal Revenue Service ("IRS") under the Code. In no instance did LSC treat the value of these fringe benefits as compensation to the employee or contractor involved. While exclusion from compensation was appropriate in most instances, it was not, as discussed below, appropriate in all.[3]

II. Was the Value of the Benefits Properly Excluded From Compensation for Tax Purposes?

A. Excludibility From Income, Generally

Except as otherwise specifically provided in the Code, gross income means all income from whatever source derived, including compensation for services, which includes the value of fringe benefits. IRC § 61(a)(1).[4] Items specifically included in income are covered in part II of the Code, section 71 and following, and items specifically excluded from income are covered in part III, section 101 and following. IRC § 61(b).

As a general rule, then, the value of a fringe benefit provided in connection with the performance of services is includible in gross income as compensation, unless specifically excludible under a Code provision.

B. Reimbursement for Travel Home and Lodging in Washington D.C.

1. The Law

a) Excludibility -- Working Condition Fringe

Under section 132(a)(3) of the IRC, a fringe benefit which qualifies as a "working condition fringe" is specifically excluded from gross income. A working condition fringe includes the value of property or services provided to an employee which would be deductible to the employee as a business expense under section 162 if paid by the employee. IRC § 132(d).[5] For purposes of section

[3]It should be noted that if the value of benefits which must be included in compensation would cause the employee's compensation to exceed the $108,000 statutory cap on LSC employee compensation, there would be a violation of section 1005(d) of the LSC Act. 42 U.S.C. § 2996d(d). The LSC Act does not define compensation. But under the IRC, compensation for services includes fringe benefits. 26 U.S.C. § 61(a)(1). But see, GAO Opinion B-210338 (Aug. 31, 1983). The statutory cap does not appear to have been exceeded here.

[4]See also, IRC §§ 33121(a) and 3306(b) which define "wages" for Social Security, Medicare ("FICA") and Federal Unemployment Tax ("FUTA") purposes to mean all renumeration for employment, including the cash value of all benefits paid in other than cash.

[5]See also, IRC §§ 3121(a)(20)(FICA), 3306 (b)(16)(FUTA) and 3401(a)(19)(income tax withholding) ("wages" do not include any benefit provided to or on behalf of an employee if at the time it is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under § 132).

132(a)(3), "employee" includes an independent contractor. 26 CFR § 1.132-1(b)(2)(iv).

To be excludible as a working condition fringe, the business expense must meet the substantiation requirements of section 274 of the Code. 26 CFR §§ 1.132-5T(a)(1)(ii) and (c)(1).[6] In addition, an amount which would be deductible by the employee under a section other than 162 (or 167, which is irrelevant here), is not a working condition fringe. 26 CFR § 1.135-5T(a)(1)(ii).[7]

Thus, to the extent that the recipients of LSC-paid travel home and living expenses in Washington, D.C. would have been entitled to business expense deductions under section 162 for these expenses if they had paid these expenses themselves, LSC was correct to have excluded such amounts from the compensation of the employees and independent contractors involved. Conversely, to the extent that these amounts would not have been valid deductions to the employees under section 162, LSC under-reported income and, for employees, under-withheld any payroll and income taxes due.

b) <u>Deductibility as Business Expense -- § 162</u>

Under section 162(a)(2) of the Code, ordinary and necessary business expenses are deductible from income and include traveling expenses, which themselves include the cost of meals and lodging, <u>while away from home</u> in pursuit of business. On the other hand, the cost of meals and lodging while a taxpayer is in the location of his usual place of business, and the cost of commuting from the taxpayer's domicile to his usual place of business are generally non-deductible personal expenses. <u>See e.g.</u>, IRC § 262 ; 26 CFR § 1.262-1 (personal, living and family expenses not deductible).

A line of cases and Revenue Rulings, however, established an exception to this general rule for taxpayers with temporary jobs away from the location of their domiciles and usual work. The rationale is that a taxpayer should not be required to move for a temporary job and therefore, the taxpayer's "tax home" would not be considered to have changed until such time that it is clear that

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[6]Briefly, in order to obtain a deduction for traveling expenses while away from home under 162, the taxpayer must substantiate by adequate records or by sufficient evidence corroborating his own statement (A) the amount of the expense, (B) the time and place, and (C) the business purpose. IRC § 274(d). The regulations under this section provide very detailed guidance concerning what constitutes adequate substantiation under different circumstances. <u>See</u>, 26 CFR § 1.274-5T, *et seq*. Where an employee incurs business expenses deductible to him under 162, he need not report the reimbursement received as income if he is required to and does make an "adequate accounting" to his employer (as defined in § 1.274-5T(f)(4)) and if the reimbursement equals the expense. 26 CFR § 1.274-5T(f)(2)(i). An employee who is not required to make an "adequate accounting" to the employer, or who does not make one although required, must submit with his tax return the form required for claiming employee business expense deductions, and provide the information required by the form and by the regulations. 26 CFR § 1.274-5T(e)(3). Independent contractors must also substantiate each element of a reimbursed travel expense or include such reimbursements in income. 26 CFR § 1.274-5T(h)(2).

LSC's travel requirements, if complied with, generally seem sufficient to meet the substantiation requirements. A review of the adequacy of the accounting provided to LSC by the employees and contractors for particular payments under discussion is beyond the scope of this memorandum.

[7]Section 119 of the Code also provides explicit authority for the exclusion of meals and lodging from an employee's income, but that section concerns meals and lodging provided for the convenience of the employer on the employer's premises and is not relevant here.

the job is permanent or, at least, of indefinite duration. See, e.g., *Markey v. C.I.R.*, 490 F.2d 1249, 1253 (6th Cir. 1974). Thus, during the period of time that the job at the remote site is "temporary," the expenses of commuting to the job area and of food and lodging while in the job area, are deductible as business expenses under section 162.

An amendment to section 162 of the Code, effective as to costs incurred after December 31, 1993, provides that "for the purposes of section 162(a)(2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year." Energy Policy Act of 1992, P.L. No. 120-486, § 1983. Although the regulations of the Internal Revenue Service ("IRS") have not yet been changed to reflect this statutory amendment, the IRS has provided guidance in Revenue Ruling 93-86, 1993-40, 11/24/93. Under this Revenue Ruling, the effect of the amendment is to shorten the outer time limit for temporary employment from the two years permitted by the case law to one year.

This does not mean that all employment in a new location can be treated as "temporary" for one year; it means only that no employment can be treated as temporary for more than one year. Within a year, the question of whether the job is temporary is answered by reference to the relevant facts. As the IRS explained in Revenue Ruling 93-86:

> Accordingly, if employment away from home in a single location is realistically expected to last (and does in fact last) for 1 year or less, the employment will be treated as temporary in the absence of facts and circumstances indicating otherwise. If employment away from home in a single location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment will be treated as indefinite, regardless of whether it actually exceeds 1 year. If employment away from home in a single location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes.

2. Facts, Discussions and Conclusions

None of the costs incurred by LSC to reimburse transition team members for travel to and from homes outside of, and for lodging in, the Washington, D.C. area was included in the income of the individuals involved. This treatment of the value of this fringe benefit was correct only to the extent that the employment of each of these individuals was temporary and did not, and was not, at any time, realistically expected to, last for more than one year. Because the answer to this question is dependent on the facts of the individual case, each individual will be separately discussed.

a) The Director of OPEAR

Facts: According to LSC records, the Director of OPEAR began to travel on LSC business at LSC expense on November 28, 1993. He was appointed director of the LSC Office of Program Analysis, Evaluation and Review (OPEAR) and Office of Program Services (OPS), as a regular salaried employee, on January 11, 1994.

Inconsistent with his classification as a regular employee, which is defined in the LSC Personnel Manual as someone hired for "continuous and undetermined periods of time,"[8] the Director of OPEAR was given an employment contract, dated February 2, 1994, with a term of little more than six months. The contract was retroactive to January 11, 1994 and had a termination date of July 17, 1994.[9] Under it, he was entitled to all LSC employee benefits and additional benefits not available to the LSC workforce as a whole, including reimbursement for reasonable lodging in the District of Columbia area and reasonable transportation expenses for travel between D.C. and his home in Denver, Colorado. Under the LSC Personnel Manual, temporary employees, those hired under contract for temporary periods of time, are not entitled to full employee benefits.

LSC paid per diem and hotel charges for this Director whenever he was at LSC headquarters from November 28, 1993 through January 1994. On February 1, 1994, LSC rented an apartment for him in Washington, D.C. The rent for the apartment was thereafter paid directly to the landlord by LSC. LSC also paid the travel expenses incurred by the Director of OPEAR as a consequence of his trips home to Denver. Between November 28, 1993, and July 16, 1994, he made approximately 21 such trips at LSC expense.

A July 7, 1994 letter from the President of LSC, to the Board of Directors stated that he had extended an offer to this transition team member to serve as Director of OPEAR. At the Board of Directors meeting on July 16, 1994, the President announced that this individual "has agreed to continue on as a director of OPEAR." (Tr. p. 46.) This was one day before the expiration of this transition team member's employment contract . When interviewed, the Director of OPEAR stated that he could not recall the precise date on which he accepted permanent employment at LSC. He stated, however, that it was sometime in early to mid-July 1994.

LSC continued to pay for trips home to Denver for the OPEAR Director, at government rate under a government travel contract, through September, 1994. He made seven such trips between July 17

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[8]The LSC Personnel Manual recognizes three categories of employees at LSC: **"regular"** employees, who are hired for "continuous and undetermined periods" of time and who are eligible to receive Corporation benefits; **"temporary"** employees, who are "contracted by the Corporation usually for periods of 30, 60 or 90 calendar days subject to renewal and extension," and who are eligible only for workman's compensation, holiday pay and, to the extent he or she works in excess of 1,000 hours in a 12-month period, enrollment in LSC's pension plan; and **"consultants,"** who are "usually independent contractors," who are retained "to provide advice and opinions or for specific projects as needed," and who are not eligible for Corporation fringe benefits. LSC Personnel Manual ("Pers. Man.") at I, § 10.

[9]An amendment to this contract dated April 7, 1994 did not modify any provisions relevant here.

and September 25, 1994.[10] LSC then paid for this Director to travel to Denver an additional seven times between October 1, 1994 and the end of April 1995. LSC also continued to pay the rent on his apartment in D.C. through the end of October, 1994.

__Discussion__: The execution of a contract with a limited term of less than one year supports a conclusion that the employment of the Director of OPEAR, at the outset, was realistically expected to last for one year or less. He has remained at LSC for more than one year, however, and thus at some point, under the law, the expectation changed to one of employment realistically expected to last more than one year. IRC § 162(a)(2); __Rev. Rul.__ 93-86, __supra__. The facts and circumstances indicate that the latest date on which this individual's realistic expectation could have changed from one of temporary to one of indefinite employment was July 16, 1995.[11] Because on that date it was publicly announced that he had agreed to remain in his position at LSC indefinitely, the conclusion is inescapable that his employment after that date was no longer "temporary" under the rulings of the IRS.

A taxpayer's expenses for lodging in the area of, and for commuting to, his permanent place of business are not deductible as business expenses while "away from home" under section 162 of the Internal Revenue Code. "Deeply ingrained in the whole tax structure. . . is the basic proposition that the cost incurred in traveling between one's home and business is a nondeductible personal expense." *Buccino v. United States*, 3 Cl. Ct. 658, 660 (1983). __See, also,__ *Tidwell v. C.I.R.*, 298 F.2d 864, 865 (2d Cir. 1962); *Donnelly v. C.I.R.*, 262 F.2d 411, 412 (1959). A decision by the taxpayer to live in a location removed from the place of business does not convert that commute to a deductible business expense.

> Given that a taxpayer's choice of residence is based on a variety of personal considerations, and that his choice determines the cost of traveling to his place of employment, it follows that these expenses are personal to the taxpayer.

Buccino v. United States, __supra__ at 661. __See, also,__ *Comm'r v. Flowers*, 326 U.S. 465, 474, 66 S.Ct. 250, 254, 90 L.Ed. 203 (1946).

To the extent that these expenses, paid by LSC, would not have been deductible to the Director of

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[10] In early October, 1994 the Office of Inspector General informed LSC's Executive Vice President that it believed LSC's continued payment for this transition team member's travel home to Denver was inappropriate. The response, dated November 11, 1994, stated that LSC had not considered travel by the Director of OPEAR between LSC headquarters and his home to be personal travel but that "to avoid any concerns about appearance or appropriateness, the Corporation and the employee have agreed that, as of the date he became a regular employee, October 1, 1994, LSC would no longer pay his travel to and from LSC headquarters from his permanent residence in Colorado." According to LSC personnel records, this transition team member had become a regular employee on January 11, 1994. The only change reflected in the OPEAR Director's personnel records as of October 1, 1994 was a raise in salary.

[11] Obviously, the "realistic expectation" of indefinite employment arose at some point prior to the public announcement of the fact that the Director of OPEAR's employment was permanent. The date on which the public announcement was made is more certain, however, and therefore has been used as the relevant date for tax purposes.

OPEAR under section 162, they were not excludible from his income under section 132(a)(3) of the Code. There appears to be no other provision of the Code under which these payments could properly be excluded from income.

Conclusion: All amounts paid or reimbursed by LSC after July 16, 1994 for the Director of OPEAR's lodging in Washington, D.C. and travel between LSC headquarters and his domicile in Colorado were compensation to him which were not excludible from his 1994 income under the law.

b) The Assistant to the President

Facts: According to LSC records, the Assistant to the President became a regular employee of LSC on January 12, 1994. Inconsistent with his classification as a regular employee, which, at LSC, is employment for an indefinite period (Pers. Man. I § 10), he was given an employment contract, dated February 16, 1994, with a term of slightly more than eight months. The contract was retroactive to January 12, 1994 and had a termination date of September 7, 1994.[12] Under it, this transition team member was to serve as Assistant to the President of LSC and was entitled to all LSC employee benefits and additional benefits not available to the LSC workforce as a whole. Under the LSC Personnel Policy Manual, temporary employees, those hired under contract for temporary periods, are not entitled to full employee benefits. The contract also stated that he would receive reimbursement for reasonable per diem and lodging in the District of Columbia area and reasonable transportation expenses for travel between D.C. and his home in Boston.

In an August 10, 1994 memorandum to the Executive Vice President, the Assistant to the President asked "Will we extend the contract beyond September. Everything seems to suggest that we will. How long?" By letter dated September 9, 1994, the term of his contract was extended from September 7 through November 30, 1994. By letter dated December 2, 1994, the term of the contract was further extended until December 31, 1994.

Finally, by letter dated December 31, 1994, which contains an acceptance by the Assistant dated January 4, 1995, the term of his employment contract was extended from January 1, 1995 through January 11, 1995, one-year to the day from the start of his employment at LSC.[13] Thus, according

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[12]By his signature on August 10, 1994, the Assistant accepted a replacement contract dated August 2, 1994, which was retroactive from July 1, 1994 to September 7, 1994, and which had the same termination date as the original contract. None of the modifications made by this replacement contract was significant for present purposes.

[13]Based on LSC records, this transition team member was originally appointed to the permanent position of Program Officer as of January 1, 1995. The official personnel action form effectuating this change in his position was dated January 9, 1995. The second official personnel action form making this same change as of January 12, 1995 was dated February 6. The Assistant had requested this change in the date of his permanent appointment. In a January 25, 1995 memorandum to the Executive Vice President wrote:

> I should not have been appointed effective January 1. I accepted the offer on January 5, and began working the following week. I began work as a temporary employee on January 12, 1994, and we agreed that my new, permanent appointment should be effective on January 12. As a result of this conclusion, my contract as a temporary employee needs to be extended for January 1 through January 12. [The General Counsel] handled prior

to LSC records, the Assistant to the President became a Program Officer on January 12, 1995, the day after his contract expired. A formal written offer of employment dated February 3, 1995 was accepted by him in writing on February 6, 1995.

During his interview by the OIG, this transition team member stated that he had been interviewed for the position of Program Officer by the Executive Vice-President and the Director of OPEAR in late October 1994 and that the position had been offered to him in late December. He stated that the employment had been negotiated for a time before that offer was made. He stated that, at the time he received the offer, he had been making arrangements to return home to Boston, and decided to think about the offer while at home. He stated that he accepted the permanent position on January 4 or 5 after he returned to LSC from that trip to Boston. This member of the transition team also stated that he considered himself a temporary employee until January 12, 1995, when his last contract expired.[14]

LSC began to pay the rent on an apartment for this transition team member in Washington, D.C. on February 10, 1994, and continued to do so through February 4, 1995, when he moved out. In a February 1, 1995 e-mail to the Executive Vice President, copied to LSC's Comptroller, he stated that the costs of this apartment "for the month of January and the first four days of February, will continue to be borne by LSC (part transition, part of my new employee in a temporary lodging under the Manual)."

LSC also paid the travel expenses incurred by the Assistant to the President as a consequence of his travel home to Boston. Between January 12, 1994, and January 4, 1995, he made 25 such trips at LSC expense. In the same February 1, 1995 e-mail to the Executive Vice President noted above, this member of the transition team stated that "My travel for the period prior to 1/12 is construed as transition team travel." LSC also paid for three additional round-trips home to Boston, and one additional one-way trip back to LSC, between January 7 and 31, 1995.

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temporary employee needs to be extended for January 1 through January 12. [The General Counsel] handled prior extensions and should be asked to take care of this one.

In a February 1, 1995 e-mail message to the Executive Vice President, this individual wrote: "My employment form will show I commenced employment 1/12/95. I'll pass along to [the General Counsel] a request for a contract extension through 1/11/95."

These documents appear to require a conclusion that both the letter dated December 31, 1994 from the LSC President which extended the Assistant to the President's contract from January 1 through 11, 1995, and that Assistant's January 4, 1995 signature on that letter, were backdated and that the December 31 contract extension was created sometime in February 1995.

[14]It appears that at least one of the reasons why the Assistent and LSC entered into an 11-day temporary employment contract, after he had already accepted a permanent position, may have been to permit him to remain at the higher salary he received as Assistant to the President for as long as possible. His compensation under his contract, at the time it expired, was $90,000 a year. His permanent position as a Program Officer was at a salary of $85,000. In an e-mail to the Executive Vice President on February 1, 1995, the Assistant stated that "An extension will be submitted shortly, which will require adjustments in my pay for the first half of the month." The "extension" referred to appears to be the contract dated December 31, 1994. In addition, two legal opinions on the excludibility of his travel expenses from income had been obtained by LSC at this transition team member's request and tax consequences may have also been in mind.

Discussion: The execution of a contract with a limited term of less than one year supports a conclusion that the employment of the Assistant to the President, at the outset, was realistically expected to last for one year or less. He has remained at LSC for more than a year, however, and thus at some point, under the law, the expectation changed to one of employment realistically expected to last more than one year. IRC § 162(a)(2); Rev. Rul. 93-86, supra. The facts and circumstances indicate that the latest date on which his realistic expectation could have changed from one of temporary to one of indefinite employment was January 5, 1995, which was, he stated, the latest date on which he accepted an offer of permanent employment.[15] After an offer of permanent employment had been accepted by this transition team member, the conclusion is inescapable that his employment no longer could realistically be expected to be temporary.

A taxpayer's expenses for lodging in the area of, and for commuting to, his permanent place of business are not deductible as business expenses while "away from home" under section 162 of the Internal Revenue Code. E.g., *Buccino v. United States*, supra, 3 Ct. Cl. at 660. To the extent that the expenses incurred by LSC on his behalf for lodging in D.C. and travel home to Boston would not have been deductible to this member of the transition team under section 162 after January 5, 1995, they were not excludible from his income as a "working condition fringe" under section 132(a)(3) of the Code.

There is, however, another provision of the Internal Revenue Code under which some of these payments may properly be excludible from this transition team member's income. Under section 132(a)(6), gross income does not include any fringe benefit which is "a qualified moving expense reimbursement." A qualified moving expense reimbursement is an expense paid by the employer which would be deductible as moving expense under section 217 if paid directly by employee. IRC 132(g). Section 217 provides a deduction for moving expenses in connection with "the commencement of work by the taxpayer. . .at a new principal place of work." IRC § 217(a). "Moving expenses" means only the reasonable expenses of moving household goods and personal effects and traveling from the former residence to the new one. IRC § 217(b).[16] It appears that any qualified moving expenses incurred by LSC for this transition team member in January 1995 could, under the circumstances, be considered to be in connection with the "commencement of work." See, 26 CFR § 1.217-2(a)(3).

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[15]Obviously, it is unlikely that the "realistic expectation" of indefinite employment arose at the moment that permanent employment was accepted, rather than at some earlier time. The date identified by this individual as the date of his acceptance is more certain, however, and has therefore been used as the relevant date for tax purposes. His stated view that he should be treated as a temporary employee for tax purposes through January 12, 1995 must be rejected. For tax purposes, it is not the date, if any, on which the employment became permanent on the records of the employer which is relevant, but the date on which the belief that employment would be temporary changed to a "realistic expectation" that it would last for more than one year. Clearly that happened here prior to January 12, 1995.

[16]The Statutory Notes to this section in the U.S. Code Annotated explain that the 1993 statutory amendments deleted several formerly deductible moving expenses including travel, meals, and lodging while in search of new residence, meals and lodging while occupying temporary quarters in new location, and qualified residence sale and lease expenses. The regulations implementing section 217 have not yet been amended to reflect the 1993 changes. The existing regulation, however, should continue to be relevant to the extent that it speaks to provisions of the statute which were not deleted.

LSC continued to pay for this individual's lodging in the D.C. area for approximately one month after January 5, 1995. Such lodging expenses in the area of the new place of work are not deductible under section 217. LSC also paid for three additional round trip flights for this transition team member from LSC to Boston after January 5, 1995, and one additional one-way trip from Boston to D.C. Section 217 permits a deduction only for the cost of traveling between the old place of work and the new one. The cost of additional trips between the two locations is not part of deductible traveling expenses. 26 CFR § 1.217-2(b)(4). Although payment of such expenses by LSC may have been permissible under the relocation provisions of LSC's Administrative Manual,[17] such expenses would not have been deductible to this member of the transition team beyond the cost of traveling from Boston to Washington, D.C.

__Conclusion__: None of the amounts paid or reimbursed by LSC after January 5, 1995 for this transition team member's lodging in Washington, D.C. and travel between LSC headquarters and his domicile in Boston were deductible to him under section 162 of the Code. These amounts were therefore not excludible as a "working condition fringe" under section 132(a)(3). It appears, however, that the cost of one trip from Boston to Washington, D.C. after that date would have been deductible to this transition team member under section 217 of the Code and, therefore, is excludible from his income as "a qualified moving expense reimbursement" under section 132(a)(6).

Except for the cost of that one trip from Boston to D.C., all amounts paid or reimbursed by LSC after January 5, 1995 for this employee's lodging in Washington, D.C. and travel between LSC headquarters and his domicile in Massachusetts were compensation to him which are not excludible from his 1995 income under the law.

c) __Consultant 1__

__Facts__: According to LSC records, the first consultant began to travel on LSC business at LSC expense on January 28, 1994 and was hired to provide services to LSC as a consultant under a contract dated and executed on February 9, 1994. Consistent with her classification as a consultant, which is defined in the LSC Personnel Manual as "usually" an independent contractor, Pers. Man. I § 10.3, this consultant's contract did not provide her with a title at LSC, had a limited term, stated that she was not eligible for the fringe benefits available to LSC employees and that she was not subject to Social Security withholding. This consultant was entitled under this contract, however, to certain fringe benefits not available to LSC employees and to reimbursement for lodging in the District of Columbia area and transportation expenses for travel between D.C. and her home in Washington State, in accordance with the Corporation's Administrative Manual. She was to be compensated at a stated monthly rate based on days worked for LSC as shown on an LSC timesheet.

[17]Chapter 7 of LSC's Administrative Manual permits many relocation expenses that were deleted from Section 217 of the Code in 1993 and are no longer deductible or excludible. To the extent that LSC desires to continue to reimburse relocating employees for such expenses, it will be required to report and treat non-deductible amounts as income to the employee. In addition, it appears that the "letters of authorization" required by the Administrative Manual for reimbursement of relocation expenses were not obtained in the case of this transition team member. Ad. Man. Chap. 7 §§ 3, 6.

The February 9 contract was retroactive to January 17, 1994 and had a termination date of April 17, 1994. Thereafter, a new contract, dated and executed on May 18, 1994, went into effect with a termination date of August 17, 1994. LSC paid this consultant's per diem and hotel charges whenever she was at LSC headquarters from January 28 through August 4, 1994. It also paid for her transportation between Seattle and D.C. on nine occasions between January 28 and August 4, 1994. The last date for which it paid compensation to this transition team member for her services under the May 18 contract was August 15, 1994.

Discussion: The facts support a conclusion that this consultant's job at LSC, at the outset, was realistically expected to last for less than one year and, in fact, lasted for seven months. There are no facts and circumstances, moreover, indicating that there was ever a realistic expectation that her work at LSC headquarters would last for more than one year or be of indefinite duration. See, IRC § 162(a)(2); Rev. Rul. 93-86, supra.

Conclusion: This consultant's travel expenses, including the cost of transportation to her home in Washington State and meals and lodging while in Washington, D.C. would be deductible to her under section 162(a)(2) of the Code as business expenses incurred while away from home in pursuit of temporary work. As a result, the value of these payments on her behalf by LSC was properly excluded by LSC from her 1994 income as a "working condition fringe" under § 132(a)(3) of the Code.

d) Consultant 2

Facts: According to LSC records, the second consultant began to travel on LSC business at LSC expense on January 17, 1994, and was hired to provide services to LSC as a consultant under a contract dated and executed on February 16, 1994. Consistent with his classification as a consultant, this transition team member's contract did not provide him with a title at LSC, had a limited term, stated that he was not eligible for the fringe benefits available to LSC employees and that he was not subject to Social Security withholding. This consultant was entitled under this contract, to reimbursement for lodging in the District of Columbia area and transportation expenses for travel between D.C. and his home in California in accordance with the Corporation's established guidelines. He was to be compensated at a stated daily rate, not to exceed 10 days a month without prior approval, based on days worked for LSC reported on the LSC timesheet. LSC records show that this consultant was generally paid for an average of six days a month during the time he provided services to LSC.

The February 16 contract was retroactive to January 17, 1994 and had a termination date of April 30, 1994. Thereafter, new contracts were executed which extended this consultant's contract for one or two months at a time.[18] The final renewal, signed and dated November 10, 1994, extended his

[18] I.e., a 5/18/94 renewal extended the contract from 5/1 to 7/31/94; an 8/25/94 renewal extended it from 8/1 to 8/31/94; and a 9/28/94 renewal extended the contract from 9/1 to 10/31/94.

contract through the period November 1 to December 31, 1994.[19]

LSC paid this transition team member's per diem and hotel and/or rent charges whenever he was at LSC headquarters from January 17 through August 31, 1994. On February 3, 1994, LSC began to pay the rent on a Washington, D.C. apartment for him. LSC also paid for his travel from LSC to his home in California. Between January 12 and December 31, 1994, this transition team member made 10 such trips at LSC expense. He vacated the apartment provided to him by LSC in August, 1994. The last date for which LSC paid compensation to this consultant for his services as a consultant was September 30, 1994.

Discussion: The facts support a conclusion that this consultant's job at LSC, at the outset, was realistically expected to, and in fact did, last for less than one year. There are no facts and circumstances, moreover, indicating that there was ever a realistic expectation that his work at LSC headquarters would last for more than one year or be of indefinite duration. See, IRC § 162(a)(2); Rev. Rul. 93-86, supra.

Conclusion: This consultant's travel expenses, including the cost of transportation to his home in California and meals and lodging while in Washington, D.C. would be deductible to him under section 162(a)(2) of the Code as business expenses incurred while away from home in pursuit of temporary work. As a result, the value of these payments on his behalf by LSC was properly excluded by LSC from his 1994 income as a "working condition fringe" under § 132(a)(3) of the Code.

e) The Director of OPS

Facts: According to LSC records, this transition team member traveled on LSC business at LSC expense from Alabama to LSC headquarters in Washington, D.C. in October of 1994 and again in November of 1994. On December 21, 1994, her hiring to fill the position of Director of the LSC Office of Program Services ("OPS") was announced in a memorandum from the LSC President to the Board and staff.

On January 2, 1995, LSC paid for this transition team member to travel from Alabama to the District of Columbia where, from January 3 to 10, 1995, she served as the director of OPS. She returned to Alabama on January 10 and came back to LSC on January 22 where she served as the Director of OPS until returning to Alabama on January 28. All travel expenses for these trips, and all her lodging and per diem expenses in D.C., were borne by LSC.

Under a contract executed by her on January 27, and retroactively effective as of January 3, this transition team member was hired as "Acting Director of the Corporation's Office of Program Services," "continuing until you assume the position of Director of OPS as a regular, full-time

[19]LSC apparently offered this consultant another extension which would have extended his contract beyond one year. He never executed this extension.

employee." The contract was to be renegotiated if she was "unable to assume the position of Director of OPS on a regular, full-time basis on or about April 17, 1995."

Although it entrusted her with an important corporate position, this Director's contract classified her has a "consultant" and treated her as an independent contractor. Consistent with her classification as a consultant, the contract stated that she was not eligible for the fringe benefits available to LSC employees and that she was not subject to Social Security withholding.

The Director of OPS was entitled under this contract to continue to serve as the Executive Director of the Legal Services Corporation of Alabama ("LSCA"), an LSC grantee, but was not to earn compensation from both on the same day. The contract also entitled her to reimbursement, in accordance with the Corporation's Administrative Manual, for five trips between D.C. and her home in Alabama and for meals and travel within the District of Columbia area. The OPS Director took five such trips at LSC expense within the contract period. During the contract period, LSC also bore the expense of her meals and lodging while in D.C. The contract stated that in view of the reimbursable trips it allowed, this Director would not be entitled to the moving expenses permitted by the Administrative Manual.

Under her contract, the Director of OPS was to be compensated by LSC on a daily basis, at the daily equivalent to the rate of $103,000 per annum, for days worked as shown on the LSC timesheet. LSC records show that she was paid at this rate for 41.07 days' work as the Director of OPS during the contract period. During days she was paid by LSC, this Director was generally on unpaid leave from LSCA and often worked for LSCA on days for which she was not paid by LSC. She was paid at the daily equivalent to the rate of $67,500 per annum by LSCA. According to LSCA, she was paid at this rate for 29 days' work and two holidays as Executive Director during the contract period.[20]

The contract of the Director of OPS with LSC was not renegotiated. She received a written offer of employment dated April 17 for the position of Director, OPS, commencing April 18, 1995. She signed her acceptance of this offer on May 5, 1995. LSC records show that she became an employee of LSC on April 18, 1995. LSCA records show that she resigned her position as Executive Director there as of April 14, 1995. She was later paid by LSCA for work as a contract employee on four additional days in April and two in May, 1995.[21]

<u>**Discussion**</u>: The facts do not support a conclusion that this Director's job at LSC was realistically expected to last for one year or less. To the contrary, the contract demonstrates, on its face, that the parties expected her tenure at LSC to be permanent or at least of indefinite duration. <u>See</u>, Rev. Rul. 93-86. She was not hired under this contract to a position expected to last one year or less, but to

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[20]During the contract period, this Director also received payments from LSCA for the last pay period in 1994 and for two weeks vacation.

[21]This Director made an additional trip to her home in Alabama at LSC expense on April 23, 1995, which was subsequent to the date on which she became a full-time LSC employee. LSC is expecting reimbursement for this trip.

a position expected to last "until you assume the position of Director of OPS as a regular, full-time employee." Because LSC, from the outset, was realistically expected to be her place of employment indefinitely, her job at LSC cannot be considered "temporary" for purposes of section 162(a)(2) of the Code. It was, at best, indefinite.

This does not end the inquiry, however. Although this Director's job with LSC was expected to be of indefinite duration, she had two jobs from which she earned income at two different locations during the term of the contract.

> If the taxpayer is engaged in business at two or more separate locations, the "tax home" for purposes of IRC § 162(a)(2) is located at the principal place of business during the taxable year.

Putnam v. United States, 826 F.Supp. 988, 994 (W.D. La. 1993); *citing, Markey v. C.I.R.*, 490 F.2d 1249 (6th Cir. 1974); Rev. Rul 75-432, 1975-2 C.B. 60; Rev. Rul. 60-189, 1960-1 C.B. 60. See also, Rev. Rul. 93-86, supra; *Green v. C.I.R.*, 298 F.2d 890 (6th Cir. 1962); *Ney v. United States*, 171 F.2d 449 (8th Cir. 1948), *cert denied*, 336 U.S. 967, 69 S.Ct. 940, 93 L.Ed. 1119 (1949) (taxpayer who accepted job in Washington, D.C., which was originally expected to be temporary, but which extended for more than three years, at which he spent most of his time, while retaining paid corporate position and domicile in Arkansas, could not deduct expenses for travel, food and lodging in Washington, D.C. because his job in Washington was indefinite and his expenses there were personal rather than business expenses.)

It appears that during the contract period, this Director was transitioning out of her old job at LSCA and into her new one at LSC. Her job at LSC was, from the outset, expected to be her new indefinite or permanent place of employment. Indeed, even during the first quarter of the year, when she held both the job at LSC and the job at LSCA, this Director worked substantially more days, and earned a substantially greater amount for the days worked, at LSC than at LSCA. "The taxpayer's principal post of business or employment is usually the location where he carries on most of his business activities and earns most of his income." 4 U.S. Tax Rptr. ¶ 1624.125 (1995). See, also, *Markey v. C.I.R.*, supra 490 F.2d at 1255. In essence, LSCA became a temporary job and LSC a permanent job when the contract with LSC was signed. It appears, therefore, that LSC's location became the new "tax home" of the OPS Director.

The expenses incurred by the Director of OPS in traveling to her second job in Alabama may nonetheless be deductible to her as a business expense. She would be able to deduct such amounts as expenses incurred in pursuit of business while away from home if the requirements of section 162 are satisfied. But the fact that Washington, D.C had likely become her tax home for purposes of § 162 appears to mean that payment by LSC of her expenses of traveling to her second job in Alabama would not be excludible from her income as a working condition fringe under section 132.

The regulations under section 132 make it clear that the business expense deduction must be allowable to employee in connection with the employer's business in order for payment of the expense by the employer to be excludible from income as a working condition fringe. If the expense is deductible in connection with some other business of the employee, the employer must add the payment to the employee's income, and the employee can claim the deduction. 26 CFR § 1.132-5(a)(2).[22]

There appears to be no other tax provision that would permit the amounts paid by LSC for this Director's travel to and lodging in Washington, D.C. to be excluded from her income. Once again, under the law, the costs incurred in traveling between one's home and principal place of business is a nondeductible personal expense, and a decision to live in a location removed from one's place of employment does not convert the commute to a deductible business expense. E.g., *Flowers*, supra, 326 U.S. at 474; *Buccino v. United States*, supra, 3 Cl. Ct. at 660-61.

Conclusion: It appears, therefore, that the travel expenses of the Director of OPS, including the cost of transportation to her home in Alabama and meals and lodging while in Washington, D.C. would not be deductible to her under section 162(a)(2) of the Code as business expenses incurred while away from home in pursuit of temporary work or in pursuit of a second job, because her job at LSC was of indefinite length from the outset and Washington, D.C. appears to have become her new "home" for purposes of section 162. As a result, the value of these payments on her behalf by LSC would not be properly excluded by LSC from her 1995 income as a "working condition fringe" under section 132(a)(3) of the Code. To the extent that such expenses were incurred by this Director in connection with her business in Alabama, however, she may be able to deduct them under section 162 on her income tax return.

C. Payments For Outside Health Insurance

1. The Law

Under section 106 of the Internal Revenue Code, "gross income of an employee does not include employer-provided coverage under an accident or health plan." IRS regulations under this section provide that the employer may make this contribution to an accident or health plan for employees by (1) paying the premium, or portion of the premium, on a policy of insurance covering one or more of his employees, or by (2) contributing to a separate fund or trust which provides benefits directly or through insurance to one or more employees. 26 CFR 1-106-1.

Although neither this statute nor the regulations under it expressly provide for the excludibility of payments made directly to the employee, the potential excludibility of such direct payments is implicitly recognized in the definition of "wages" for FICA and unemployment tax purposes in sections 3121(a)(2) and 3306(b)(2) of the Internal Revenue Code, respectively. Those definitions

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[22] The regulation provides a number of examples to illustrate this section. In those examples, the payment may still be excludible as a working condition fringe if the employee's work for the second employer is substantially related to the work of, and provides a substantial business benefit to, the first employer that paid for the travel. 26 CFR § 1.132-5(a)(2)(ii). The situation here does not seem to fit under those illustrations.

exclude from the definition of "wages"

> any payment by an employer "made to, or on behalf of, an employee. . . under a plan or system established by an employer which makes provision for employees generally . . .or for a class or classes of his employees on account of sickness or accident disability or medical or hospitalization expenses.

The question of when a direct payment to the employee can be considered to be part of a "plan" or "system" of employer-provided insurance is the focus of several IRS Revenue Rulings. In 1957, for example, the IRS held that amounts paid directly to the employee were not excludible from income because they were not payments to an insurance company, trust or fund.[23]

In 1961, however, in Revenue Ruling 61-146, 1961-2 CB 25, the IRS held that insurance reimbursements made directly to employees were excludible under the facts of the case. There, the employer paid a portion of the premiums for employees covered under the employer's group health plan. For those employees not covered by the employer's group policy who paid the premiums for other coverage themselves, the employer paid a portion of the premiums "upon proof that the insurance is in force and is being paid for by the employees." The IRS found that the three methods used to reimburse employees in that case were all equivalent to, or the same in practical effect as, direct payment by the employer to the insurance company. The employer:

(1) reimburses each employee directly once or twice a year for the employer's share of the insurance premiums upon proof of prior payment of the premiums by the employee;

(2) issues to each employee a check payable to the particular employee's insurance company, the employee being obligated to turn over the check to the insurance company; or

(3) issues a check as in method (2) except the check is made payable jointly to the insurance company and the employee.

Method (1), direct payment to the employee, was found to be sufficient because "proof is required by the employer that hospital and medical insurance is in force for the employee and that premiums for the period involved have been paid by the employee and because the employer's payment is stated to be in reimbursement for the employer's share of the insurance premium." The earlier revenue ruling cited above was distinguished because in that case the employer "did not require an accounting. . .that the funds were expended in the acquisition of insurance coverage."

In each of three subsequent authorities which cite Revenue Ruling 61-146, however, it was found that sufficient assurance that the payments were used for health insurance was not present, and Revenue

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[23]Rev. Rul. 57-33, 1957-1 C.B. 303 (payments by employer to employees, under union contract, for the purpose of purchasing hospitalization insurance not excludible because they were not payments to insurance company, trust or fund; fact that union provided assurance that no payments were used for other purposes was immaterial.)

Ruling 61-146 was distinguished rather than followed. In Revenue Ruling 85-44, 1985-1 CB 22, the IRS held that payments to an individual of court awarded damages for unpaid health insurance premiums could not be excluded from income and distinguished Revenue Ruling 61-146 as requiring "verification that the premiums were actually paid" to render insurance payments made directly to the employee excludible. In the case before it, "there was no reimbursement of insurance actually paid by [the employee], nor did [the employer] verify that insurance was actually in force and paid for by" the employee.

Similarly, in Revenue Ruling 75-241, 1975-1 CB 316, amounts paid by the employer to employees for the purpose of purchasing health insurance, under a government contract requiring the employer to provide health insurance benefits, were found to be income. The IRS explained that because the employer "had no legal or contractual obligation to and did not verify that the cash payments were actually used by the employees to purchase health and welfare benefits, the employees had complete disposition of the funds."

In *Adkins v. United States*, 693 F.Supp. 574 (N.D. Ohio 1988), *aff'd*, 882 F.2d 1078 (6th Cir. 1989), the court held that amounts paid directly by the employer to employees in settlement of a lawsuit in connection with employer's termination of health insurance were not excludible from income under section 106. The court noted that Revenue Ruling 61-146 had earlier been distinguished by the IRS as requiring employer verification of "the amounts and whether payments were actually made by the employee." *Id.* at 577. It went on to state that "Section 106 clearly applies to contributions made by the employer to hospital, medical and accident benefit insurance programs, trusts, or funds. Section 106 does not contemplate, nor infer, direct payments to the employee."Id.

Thus, the holding of Revenue Ruling 61-146, that direct payments made by an employer to employees in reimbursement of health and accident insurance premiums may be excludible from gross income under section 106 of the Code, appears to be limited to those situations where the employer requires an accounting to ensure that the funds are actually expended in the acquisition of insurance coverage. Under the ruling, such an accounting consists of proof that the insurance is in force and that premiums for the period involved have been paid by the employee.

2. Facts

LSC pays a share of the premiums for all employees who choose to be covered by its group health insurance plan. Neither that plan nor LSC's written policies permit employees generally to waive coverage under that plan and receive cash from LSC to be applied against insurance provided by other employers or obtained by the employee individually. This benefit was provided by contract in 1994 to three employees who were entitled, under their contracts, to reimbursement from LSC for amounts they paid for "employee benefits," "with the exception of dental and long-term disability insurance." Each of the contracts stated that "the total amount reimbursed shall not exceed the amount the Corporation would otherwise pay on your behalf to provide the benefits to which you would be entitled as a regular employee of Corporation for the purposes of LSC's Personnel Manual."

Although the contracts provided that LSC would provide "reimbursement" for amounts "paid" by these employees, they did not require any particular accounting or proofs of payment to be provided. Such proofs, however, were nevertheless provided in some instances.

The Executive Vice President: The term of the Executive Vice President's contract, dated January 27, 1994, was from January 3 through July 3, 1994, to continue at the pleasure of the Board for a period not to exceed six months. Paragraph 6 of her contract provided that "you will be entitled to reimbursement for any amounts you pay to continue the employee benefits you were receiving from your previous employer the National Legal Aid and Defender Association" (NLADA).

The Executive Vice President received a check from LSC dated 3/15/94 for $1,066.14, which was identified on the check stub as "Reimb. of Health Ins. Prem. 1/94-3/94." She received a second check for the same amount dated 6/15/94, identified on the check stub as "Reimb. of Health Ins. Prem. 4/94-6/94.[24]

In addition to copies of the checks and stubs and the voucher for each of them, the file contains the following documents relating to these payments:

- o An invoice to the Executive Vice President dated February 28, 1994 from NLADA which showed the following: "March 1994 Insurance --Health $724.50, --Life $21.13, --Acc. Death $4.88" for a total of "$750.51."[25] The invoice also showed "PAST DUE $1,109.32" and stated "Note: Employer Contributions $554.67, Employee Contributions $169.83." The past due amount appears to be equal to two months of employer contributions.

- o A March 9, 1994 memorandum from the LSC Benefits Administrator to the Executive Vice President which responded to her request for information regarding the employer contributions to LSC's group health plan. The memo showed that LSC paid $355.38 a month for each employee covered.

- o A March 11, 1994 memorandum from the LSC Benefits Administrator to the LSC Comptroller forwarded "backup materials regarding health premiums for" the Executive Vice President and stated that pursuant to her contract, she "should be reimbursed in the

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[24]LSC records show that the Executive Vice President reimbursed LSC $355.38 for the June reimbursement and that she became a participant in LSC's group insurance plan as of June 1, 1994.

[25]Under section 106 of the IRC, if the employer contributions are made under an insurance policy, trust or fund which provides other benefits in addition to accident and health benefits, the exclusion provided by section 106 applies only to the portion of the employer's contribution which is allocable to accident or health benefits. 26 CFR § 1.106-1. It appears that this may create no difficulties here because the amount of the LSC monthly employer contribution to health insurance is less than the NLADA monthly health insurance contribution. In addition, employer contributions to group-term life insurance is separately excludible from gross income under section 79 of the Code if certain criteria are met. See, 26 C.F.R. §1.79-0, *et seq.*

amount of $355.38 per month retroactively from January 3, 1994." A handwritten calculation on the memo shows that 355.38 multiplied by 3 for "Jan, Feb, Mar" is 1,066.14. The approval of the Comptroller is noted on the memorandum.

What these documents show is that LSC determined the reimbursement it would provide in accordance with the terms of the Executive Vice President's contract and determined the amount of that reimbursement based on the amount it would have paid for employer contributions for her under its own group policy. These documents also show the amount that this transition team member would have to pay to keep her benefits from the NLADA in force and show that that amount was more than the amount of the LSC employer contribution to its health plan.

What these documents do not show is that the Executive Vice President actually paid to keep her NLADA benefits in force. There is, for example, no cancelled check from this transition team member showing payment of the NLADA invoice, nor any other document from which a conclusion that she paid to keep her insurance in force could be drawn. Indeed, the past due amount on the NLADA invoice shows that the Executive Vice President had not currently paid the amounts required to keep her NLADA benefits in force.

Director of OPEAR: The contract of the OPEAR Director, dated February 2, 1994, was effective from January 11, 1994 until July 17, 1994. Paragraph 6 of that contract provided that "you will be entitled to reimbursement for any amounts you pay to continue the employee benefits you were receiving immediately prior to joining the Corporation."

This transition team member received a total of $4,685.16, identified on the check stubs as "Reimbursements of health insurance premiums," for the period January 11, 1994 through March 1995. These payments were made at the rate of $355.38 a month in 1994 and $377.12 a month in 1995, which were equal to the cost of LSC's contributions to its group health plan for all employees. These payments to the Director of OPEAR appear to be ongoing at this writing.

In addition to copies of the checks and stubs and the voucher for each of them, the file contains the following documents relating to these payments:

- A copy of a Kaiser Permanente "Plan 950-Individual Membership Agreement 1994."
- A copy of an April 12, 1994 letter from Kaiser Permanente to the Director of OPEAR which apparently transmitted the above Plan and informed him that his membership rates for 1994 were "$366.60 per month" "which is automatically deducted from your bank account on the 6th day of the month."
- A March 9, 1994 memorandum from the LSC Benefits Administrator to the Director of OPEAR which responded to his request for information regarding the employer contributions to LSC's group health plan. The memo showed that LSC paid $355.38 a month for each employee covered.

What these documents show is that LSC initially determined the reimbursement it would provide in accordance with the terms of this transition team member's contract and determined the amount of that reimbursement based on the amount it would have paid for employer contributions for him under its own group policy. They also show the amount the Director of OPEAR would have to pay to keep his pre-existing benefits in force in 1994 and that that amount was more than the amount of the LSC employer contribution to its health plan in 1994. They show that this Director actually paid for these premiums through 1994 due to his arrangement with Kaiser under which the premiums were directly withdrawn from his account monthly in 1994.

What they do not show is the authority for the payment of these amounts for the Director of OPEAR after the expiration of his contract on July 17, 1994. There is was not a document on file which evidenced that he continued to keep this insurance in force, and pay the premiums, in 1995. Finally, the documents on file did not show the amount of this transition team member's premium for the Kaiser insurance in 1995. It is noted that the amount of the LSC reimbursement in 1995, $381.38 monthly, exceeded the $366.60 monthly Kaiser premium in 1994.

The Assistant to the President: The contract of the Assistant to the President, dated February 16, 1994, was effective from January 12, 1994 through September 7, 1994. The termination date was ultimately extended through January 11, 1995. Paragraph 6 of the contract provided that "you will be entitled to reimbursement for any amounts you pay to continue the employee benefits you were receiving immediately prior to joining the Corporation."

The Assistant received a check from LSC dated 3/23/94 for $103.46, which was identified on the check stub as "Reimbursement of Basic Life and Health Insurance (Tufts) Premiums for 2/94." He received three additional checks from LSC totalling $2,132 for the period July 1 through December 31, 1994.[26] These reimbursements were at the rate of $355.38 a month and were all stated to be either "reimbursement" or "payment" "of health insurance premium."

In addition to copies of the checks and stubs and the voucher for each of them, the file contains the following documents relating to these payments:

- A copy of the Assistant's paystub from his prior employment for the period "2/28/94" which showed deductions of $100 for health insurance, $3.46 for basic life insurance and other amounts for additional insurance coverage. A hand written notation on the paystub indicates that the amounts shown are for a one month period.

- A March 3, 1994 memorandum from the LSC Benefits Administrator to the Assistant to the President which responded to his request for information regarding employer contributions to LSC's health and basic life group insurance plans. The memo showed that, for each employee, LSC paid $355.38 monthly for health insurance and $4.69 monthly for

[26] It appears that after receiving reimbursement for February, 1994, the Assistant was not reimbursed for insurance again until July, 1994. The reimbursements then continued through the end of 1994.

basic life insurance. Hand written notations on the memorandum show that the amounts shown on his paystub for dental and disability insurance would not be reimbursed because they are "covered here."

- o An October 3, 1994 memorandum from the LSC Office of Human Resources to the Comptroller which stated that "pursuant to the terms of [the Assistant's] contract dated August 2, 1994, [he] should be reimbursed in the amount of $355.38 per month retroactively from July 1, 1994." The approval of the Comptroller is noted on the memorandum.

These documents show that for February 1994, the Assistant had life and health benefits in force from a previous employer and that he actually paid the employee share of the premiums for that month through a payroll deduction. They also show that LSC determined the reimbursement it paid to him for the month of February 1994 in accordance with the terms of his contract and determined the amount of that reimbursement based on the amount he had actually paid for those benefits that month. The amount reimbursed by LSC for the month of February was equal to the amount the Assistant had paid. These documents also show that LSC appears to have determined the amount of the reimbursement made to the Assistant to the President for the months of July through December 1994 based on the amount it would have paid for employer contributions for him under its own group policy.

What these documents do not show is that the Assistant had health insurance in force, and actually paid the premiums for that insurance, for the months of July through December. They do not show what it would have cost for him to continue his pre-existing insurance or that that amount would have equalled or exceeded the amount of the LSC reimbursement.

3. Discussion

The Executive Vice President received reimbursement from LSC for health insurance premiums in accordance with her contract for the period January through May 1994. The Director of OPEAR received reimbursement for health insurance premiums in accordance with his contract from January through July 1994. He continued to receive such reimbursement after the expiration of his contract in July 1994 to the present. The Assistant to the President received reimbursement for insurance premiums in accordance with his contract for February 1994 and for the period July through December 1994.

It appears that LSC did not require an accounting to show that insurance was in force and premiums were being paid as a condition to receiving reimbursement. The facts show that LSC, nonetheless, received evidence from which a conclusion could be drawn that health insurance was in force for, and was paid for by, the Director of OPEAR in 1994 and the Assistant to the President in February 1994, and that the amount of LSC's reimbursement did not exceed the employee's cost. It is likely, but not certain, that the IRS would accept as sufficient the individual proofs in these instances although the proofs had not been required by the employer.[27]

Beyond these two instances, however, evidence that insurance was in force and that the premiums were being paid for by the employees is lacking. It appears that LSC determined the amount to reimburse the Executive Vice President in 1994, the Assistant subsequent to February 1994 and the Director of OPEAR in 1995 based only on the amount of its own contribution to premiums for its employees without regard to the existence or payment of outside policies for these individuals. It is unknown whether the payments made by LSC actually served to reimburse the employees for amounts they had paid to keep health insurance in force.[28]

4. Conclusion

Under the facts, there appears to have been adequate proof to verify that, in 1994 for the OPEAR Director and in February 1994 for the Assistant to the President, the individuals involved had health insurance in force and paid premiums which exceeded or equalled the amount of LSC's reimbursement. It is reasonable to assume that LSC reimbursement of those particular insurance costs would be excludible under section 106 of the IRC.

For the other health insurance reimbursements made by LSC, however, the Executive Vice President in 1994, the Assistant after February 1994 and the Director of OPEAR in 1995, there do not appear to have been adequate safeguards to insure that the insurance was (or, in the case of the OPEAR Director, is) in force and that the payments received from LSC were used by the employees to support the cost of programs in which they may have been enrolled. No accounting was required, and there is no evidence that the funds were not being diverted for other purposes. It is likely that these amounts paid by LSC as health insurance reimbursements were not excludible from the gross income of the employees under section 106 of the Code.

D. Reimbursement for Child Care and Housekeeping Costs

1. The Law

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[27] In these instances, LSC had proof that "insurance is in force and is being paid for by the employee" prior to making the reimbursements. Rev. Rul. 61-146, supra. But see, Rev. Rul. 57-33, supra, where the IRS, found that payments to employees required by the employment contract "for the express purpose" of purchasing health insurance was income, although the union assumed responsibility for making sure the payments were used for insurance and "in no instance are payments under the contract being made or used for a purpose other than providing the hospitalization and surgical insurance benefits."

[28] Assuming that the employees actually paid for and had insurance in force during the relevant periods, LSC may be able to obtain adequate proofs which meet the requirements of Revenue Ruling 61-146 through a retroactive accounting requirement in order to support LSC's exclusion of these amounts from the income of the employees involved in 1994. It is unknown whether such later acquired proofs would be acceptable to the IRS. LSC, if it chooses, could clear up the uncertainty by formally seeking the advice of the IRS.

Section 129(a) of the Internal Revenue Code provides for the exclusion from employee gross income of payments by an employer for a dependent care assistance program. "Employee" is defined so as to include an independent contractor. IRC §129(e)(3). There are a number of requirements that a dependent care assistance program must meet under section 129, including that it must be a separate written plan and it must not discriminate in favor of highly paid employees. I.RC. § 129(d). LSC has no dependent care assistance program under section 129(a).

Unless specifically exempted by a Code provision, under the Internal Revenue Code, gross income means all income, including fringe benefits received as part of compensation for services. I.R.C. § 61(a)(1). Section 129 is the only section which could be found which permits employer payments for child care and household expenses to be excluded from income. Thus, outside of a section 129 plan, payments by an employer for these purposes are part of compensation and must be included in the income of the recipient.

Although these amounts must be included in income and are not allowable as deductions,[29] the taxpayer may be entitled to a tax credit under section 21 of the Code which provides a credit for certain "household and dependent care services necessary for gainful employment."

2. The Facts

Under her contract dated February 9,1994 and effective January 17 to April 17, 1994, one transition team member was entitled to reimbursement of up to $1,200 a month for reasonable child care and housekeeping expenses incurred by her as a result of her absence from her home.[30] On May 5, 1994, this consultant received a check from LSC which included payment of $1,114.46 for housekeeping expense reimbursements for the period January 19 to April 16 and $1,330 for child care expense reimbursement for the period January 17 to April 16, 1994.

3. Discussion and Conclusion

The reimbursements to this transition team member were in accordance with the terms of her contract. There is, however, no tax provision which would allow LSC to exclude the amounts it paid to her for housekeeping and child care.

The $2,444.46 which LSC paid to this consultant for child care and housekeeping expenses should have been included in her income for 1994.

[29] Section 262 of the Code provides: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

[30] This contract was renewed, by an agreement dated May 18, for the period April 18 to August 17, 1994. The May 18 agreement did not include the provision for reimbursement of child care and housekeeping expenses.

E. Employer Paid Parking

1. The Law

Under section 132(a)(5) of the Internal Revenue Code, gross income does not include any fringe benefit which qualifies as a "qualified transportation fringe." A qualified transportation fringe includes "qualified parking," which is parking which does not exceed $155 a month, and is provided by the employer to the employee at or near the business premises of the employer. I.R.C. §§ 132(f)(1)(C), (f)(2)(B) and (f)(5)(C).

2. The Facts

The Executive Vice President's January 1994 contract did not provide for her to receive LSC-paid parking. The contract expired in July 1994 and the Executive Vice President has remained at LSC as an employee under the Personnel Manual. LSC began to pay for a monthly parking spot for her in February 1994 and has continued to pay for this parking spot since that time. The parking spot is located in the garage of the building which houses LSC's headquarters. The fee for this parking is $120 monthly.

3. *Discussion and Conclusion*

There is no documented authorization for LSC's payment of this fringe benefit. The arrangement, however, meets the requirements of section 132(a) and (f) and therefore qualifies as a "qualified transportation fringe," rendering the amounts LSC has paid and continues to pay for the Executive Vice President's parking space properly excludible from her income under the Internal Revenue Code.

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APPENDIX IV

LEGAL SERVICES CORPORATION

MEMORANDUM

TO:	Jerome Rodgers Senior Auditor
FROM:	Renée L. Szybala Assistant Inspector General -- Legal Review
DATE:	July 7, 1995
RE:	Contract Service and Related Expense Payments Inspection **Employee vs. Independent Contractor**

This memorandum provides the results of a review of the characterization as independent contractors of certain individuals who provided services to LSC pursuant to contract during the period January 1994 to March 1995. Of the three individuals who were treated as independent contractors, one, the Director of the Office of Program Services (OPS), was incorrectly classified.

I. The Law

Employer responsibilities -- Under the Internal Revenue Code, 26 U.S.C. ("IRC" or "Code"), every individual who performs work for another is either an employee or an independent contractor. A correct characterization of the employment relationship is necessary in order for the employer to fulfill its responsibilities under the Code. The employer, generally, must withhold and pay Social Security and Medicare ("FICA")and income taxes and pay unemployment taxes ("FUTA") on wages paid to an employee.[1] These responsibilities all carry tax return filing requirements. An employer may also have to make deposits of the Social Security, Medicare and income taxes withheld before the return is due.

On the other hand, an employer does not generally have to withhold or pay any taxes on payments to an independent contractor. Improper classification of an employee as an independent

[1] E.g., IRC §§ 3111 (FICA liability); 3301 (FUTA liability); 3402 (income tax withholding); 3403 and 3501 (liability for amounts withheld and due under FICA, FUTA and income tax provisions).

contractor, therefore, will lead to failure to properly withhold and deposit taxes and file returns due and may carry serious consequences.[2]

Common law -- Whether an individual is an employee for employment tax purposes is generally determined under common law rules. E.g., IRC § 3121(d)(2).[3] Guides for determining the status of a worker as an employee or contractor are found in three substantially similar sections of the employment tax regulations. 26 CFR § 31.3121(d)-1(c); 31.3306(i)-1; and 31.3401(c)-1.

> These sections provide that generally the relationship of employer and employee exists when the person or persons for whom the services are performed have the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so.
>
> Conversely, these sections provide, in part, that individuals (such as physicians, lawyers, dentists, contractors, and subcontractors) who follow an independent trade, business, or profession, in which they offer their services to the public, generally are not employees.
>
> Finally, if the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial.

Rev. Rul. 87-41, 1987-1 CB 296.

Revenue Ruling 87-41, supra, provided further guidance through the identification of 20 factors, distilled from cases and rulings, relevant to the question of whether sufficient control is present to establish an employer-employee relationship. An IRS summary of that list is attached as Attachment 1. The 20 factors are guides only and the importance assigned to any factor depends on the occupation and factual context in which the services are performed. None of the factors alone

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[2] Incorrect classification of an employee as an independent contractor, which does not have a reasonable basis under Internal Revenue Service rules, will result in employer liability for employment taxes for that individual and increased liability where reporting requirements have been willfully disregarded. IRC § 3509. Such improper classification may also subject the employer to liability for penalties. Failure to make a required withholding tax deposit, for example, subjects the employer to penalties of from 2 to 15% of the underpayment, unless the underpayment was due to reasonable cause. IRC § 6656. A monthly penalty of 1/2 to 25% of the tax due applies to failure to pay withholding taxes. IRC § 6651. Willful failure to withhold employment taxes from the wages of an employee subjects an employer to an additional penalty of 100% of the taxes that should have been withheld and paid. IRC § 6672.

[3] Certain types of workers are specifically treated as employees by statute, regardless of the common law rule. Any officer of a corporation, for example, is a statutory employee for Social Security purposes under 26 IRC § 3121(d). The workers under consideration here are not covered by a statutory employee definition.

is controlling and all are unlikely to be relevant in any given situation. Application of the factors should not obscure the substance of the relationship, "that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee." Id. In doubtful cases, the IRS will determine the nature of the relationship upon the filing of a Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.*

Statutory "safe harbor" provisions -- Under current law, the employer is protected from liability for employment taxes if:

- o the employer has a "reasonable basis" for treating the worker as an independent contractor;
- o the employer has not treated the worker as an employee for employment tax purposes in any period; and
- o neither the employer nor the employer's predecessor have treated an individual holding a substantially similar position as an employee for employment tax purposes for any period after 1977.

An employer has a "reasonable basis" for the decision to treat a worker as an independent contractor if it relies on (1) judicial precedent, published rulings, or a technical advice memorandum or letter ruling issued to the taxpayer; (2) a past IRS audit on any tax issue in which there was no employment tax assessment for substantially similar workers; or (3) long-standing industry practice. Rev. Proc. 85-18, 1985-1 CB 518.[4]

II. Facts

Three members of the transition team were treated as independent contractors by LSC. The contracts for two of these individuals classified them as independent contractors; were for limited terms; did not provide them with titles at LSC; made them ineligible for the usual LSC employee benefits; and stated that they were not subject to Social Security withholding. Under these contracts, these two consultants were not to perform any of the ongoing tasks required by LSC in the performance of its statutory responsibilities. Rather, they were to "assist with the Corporation's transition by providing such professional services as may be requested." Thus, on their face, the contracts of these two transition team members raise no questions, and the decision to classify them as independent contractors appears to have been a reasonable one.

The contract of the Director of OPS was similar to the contracts of the other two consultants in certain respects. For example, it classified her as an independent contractor, made her ineligible for the usual LSC employee benefits, and stated that she was not subject to Social Security

[4]This Revenue Procedure implemented the provisions of section 530 of the Revenue Act of 1978. See, also, 15 United States Tax Reporter ¶ 86,502, *citing*, section 530 of the 1978 Revenue Act (P.L. 95-600), as amended by section 9(d) of P.L. 96-167(1979), section 1 of P.L. 96-541 (1980), and section 296(c) of P.L. 97-248(1982).

withholding. But the contract and situation of the Director of OPS also differed from that of the other two consultants in ways that are significant and that raise questions about the reasonableness of her classification as an independent contractor.

Under her January 27, 1995 contract, which was effective January 2, 1995, this consultant was hired as "Acting Director of the Corporation's Office of Program Services." The Director of the Office of Program Services ("OPS") is a long-standing and important position within LSC senior management. In addition, the contract appeared to contemplate that this individual would retain the position of Director of OPS on an indefinite basis. It stated that she would retain the "acting" title "continuing until you assume the position of Director of OPS as a regular, full-time employee." The contract was to be renegotiated if this individual was "unable to assume the position of Director of OPS on a regular, full-time basis on or about April 17, 1995." The Acting OPS Director was entitled under this contract to continue to serve as the Executive Director of the Legal Services Corporation of Alabama ("LSCA"), an LSC grantee, but was not to earn compensation from both on the same day. When interviewed by the OIG, LSC's Executive Vice President stated that the decision to classify the Director of OPS as an independent contractor was based on the advise of the LSC General Counsel and others.

The facts disclose that another member of the transition team had been serving as the Director of OPS, as well as the Director of LSC's Office of Program Evaluation, Analysis and Review ("OPEAR"), under a contract effective from January 11 until July 17, 1994. He was treated as an employee by LSC for employment tax purposes during the term of this contract. His acceptance of the position of Director of OPEAR on an indefinite basis was announced on July 16, 1994.

LSC posted to fill a vacancy in the position of Director of OPS on September 30, 1994. The Position Announcement (Attachment 2, hereto) stated that the Director of OPS is "[u]nder the general direction of the Executive Vice President." It described the duties of the Director as including participation "as a part of LSC Senior Management" in LSC policy issues; review and approval of personnel actions affecting the staff members of OPS; development of internal operating procedures for OPS; and development and oversight of the OPS operational and program budget. The individual hired had formally applied under this announcement on its closing date, November 15, 1994. In a December 21 memorandum to the Board of Directors and staff of LSC, the LSC President stated that he was "pleased to announce the hiring of [this individual] as the new Director" of OPS.

Thereafter, this individual served as the Director of OPS. She signed and received documents as the director of OPS, gave reports as the Director of OPS and received information as the Director of OPS. Her contract with LSC was not renegotiated. She received a written offer of employment dated April 17 for the position of Director, OPS, commencing April 18, 1995. She signed her acceptance of this offer on May 5, 1995. LSC records show that she became an employee of LSC as of April 18, 1995. During an OIG interview, the Executive Vice President, stated that there was no significant change in this individual's duties, or in LSC's supervision of her as of the day she became an employee.

II. Discussion

This individual's title and job description as the Director of OPS entrusted her with supervision of important corporate functions. Under most of the 20 IRS factors which could be said to apply to these facts, the OPS Director was an employee of LSC from the beginning of her contract. For example, LSC had the right to control her activities; her services were fully integrated into the business of the Corporation; and were to be rendered personally; she could not personally hire and pay her assistants, and the workers she supervised were employees of LSC; a continuing relationship was contemplated; she worked on LSC's premises with LSC materials; she could not make a profit or loss based on her LSC activities; and she did not offer services to the public. See Attachment 1.

In such circumstances, the classification of this Director's status as an independent contractor in her contract is immaterial. Rev. Rul. 87-41, supra. It thus appears that she was an employee during the term of her contract and must be treated as such unless LSC can take advantage of the "safe harbor" provisions of the law.

It does not appear that LSC can meet any of the three tests that must be met in order for it to take advantage of the provisions that would it excuse it from paying employment taxes for the Director of OPS. First, it does not appear that LSC had a "reasonable basis" for treating her as an independent contractor, because its decision to do so was not based on judicial precedent, published rulings, an IRS letter to it, a past IRS audit, or long-standing industry practice. Second, LSC treated this individual as an employee after her contract expired although her duties were indistinguishable from what they were while she was treated as a contractor. Finally, LSC has always treated the Director of OPS as an employee. Indeed, it treated this individual's immediate predecessor as an employee although he held the position on a temporary basis. See, Rev. Proc. 85-18, supra.

III. Conclusion

This Director was an employee during the term of her contract and must be treated as such for employment tax purposes by LSC.

THE TWENTY COMMON LAW FACTORS USED TO DETERMINE A WORKER'S CLASSIFICATION

The 20 factors indicating whether an individual is an employee or an independent contractor are:

1) *Instructions.* An employee must comply with instructions about when, where, and how to work. Even if no instructions are given, the control factor is present if the employer has the right to control how the work results are achieved.

2) *Training.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the purchasers of their services.

3) *Integration.* An employee's services are usually integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.

4) *Services rendered personally.* An employee renders services personally. This shows that the employer is interested in the methods as well as the results.

5) *Hiring assistants.* An employee works for an employer who hires, supervises, and pays workers. An independent contractor can hire, supervise, and pay assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.

6) *Continuing relationship.* An employee generally has a continuing relationship with an employer. A continuing relationship may exist even if work is performed at recurring although irregular intervals.

7) *Set hours of work.* An employee usually has set hours of work established by an employer. An independent contractor generally can set his or her own work hours.

8) *Full-time required.* An employee may be required to work or be available full-time. This indicates control by the employer. An independent contractor can work when and for whom he or she chooses.

9) *Work done on premises.* An employee usually works on the premises of an employer, or works on a route or at a location designated by an employer.

10) *Order or sequence set.* An employee may be required to perform services in the order or sequence set by an employer. This shows that the employee is subject to direction and control.

11) *Reports.* An employee may be required to submit reports to an employer. This shows that the employer maintains a degree of control.

12) *Payments.* An employee is generally paid by the hour, week, or month. An independent contractor is usually paid by the job or on a straight commission.

13) *Expenses.* An employee's business and travel expenses are generally paid by an employer. This shows that the employee is subject to regulation and control.

14) *Tools and materials.* An employee is normally furnished significant tools, materials, and other equipment by an employer.

15) *Investment.* An independent contractor has a significant investment in the facilities he or she uses in performing services for someone else.

16) *Profit or loss.* An independent contractor can make a profit or suffer a loss.

17) *Works for more than one person or firm.* An independent contractor is generally free to provide his or her services to two or more unrelated persons or firms at the same time.

18) *Offers services to general public.* An independent contractor makes his or her services available to the general public.

19) *Right to fire.* An employee can be fired by an employer. An independent contractor cannot be fired so long as he or she produces a result that meets the specifications of the contract.

20) *Right to quit.* An employee can quit his or her job at any time without incurring liability. An independent contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.

ATTACHMENT 2

LEGAL SERVICES CORPORATION

POSITION ANNOUNCEMENT
EXTERNAL POSTING

POSITION: Director

POSTING NO.: #1044

LOCATION: Office of Program Services
Legal Services Corporation
750 First Street, N.E., 11th Fl.
Washington, D.C. 20002-4250

DATE POSTED: 09/30/94

DATE CLOSED: 11/15/94

SALARY CLASSIFICATION: Unclassified

DESCRIPTION:

The Legal Services Corporation is seeking a Director for its Office of Program Services. Under the general direction of the Executive Vice President, the Director is responsible for planning and implementing research and initiatives related to the effective delivery of legal services to the poor, and evaluating the results. Areas of focus will include, but not be limited to national and state support, private attorney involvement and client engagement. The Director in cooperation with other appropriate divisions will assist in the dissemination of the results of its research and initiatives and their adoption in the delivery system, as appropriate.

DUTIES AND RESPONSIBILITIES:

- Participates as part of LSC Senior Management to adopt LSC policy and make recommendations and presentations to the LSC Board of Directors regarding policy issues.
- Oversees the development, implementation and evaluation of projects related to the delivery of legal services.
- Makes recommendations and authorizes expenditures for grant awards related to delivery research initiatives.
- In cooperation with other division managers, assesses the results of delivery research and initiatives and promotes their implementation in the delivery system, as appropriate.

- Reviews and approves personnel actions affecting staff members of the Office of Program Services. Develops internal operating policies and procedures for office operations.

- Develops and oversees the operational and program budget for the Office of Program Services.

MINIMUM QUALIFICATIONS:

A law degree and eight (8) years of experience in the delivery of legal services to low-income persons.

SALARY AND BENEFITS:

Salary dependent upon qualifications and experience, plus an attractive benefits package.

APPLICATION PROCEDURE:

Please submit a detailed chronological resume (non-returnable), including current salary by November 15, 1994 to:

Legal Services Corporation
Office of Human Resources/EO (#1044)
750 First Street, N.E., 11th Floor
Washington, D.C. 20002-4250

AN EQUAL OPPORTUNITY EMPLOYER

If a reasonable accommodation in the application process is needed, please notify the Office of Human Resources/EO.

APPENDIX V

JUL 8 1995

LEGAL SERVICES CORPORATION

Memorandum

To: Edouard Quatrevaux
Inspector General

From: Alexander D. Forger
President

Date: July 18, 1995

Re: Transmittal of Management Response to Report

Attached please find Management's Response to OIG Report No. 95-056, as provided to us on July 14, 1995.

MANAGEMENT RESPONSE

to

OIG INSPECTION REPORT NO. 95-056

"CONTRACT SERVICE AND RELATED EXPENSE PAYMENTS"

July 18, 1995

Introduction

LSC Management is gratified that the Inspector General's Report concludes that the contractual arrangements with members of the transition team were not unlawful or otherwise improper.

The bulk of the Report considers technical issues of internal policy and procedure and tax withholding and reporting requirements. At its meeting on July 14, 1995, LSC's Board of Directors directed Management to consider the Report's recommendations and take appropriate action.

With regard to the specific question of the taxability of the benefits at issue, Management will follow the IG's interpretation and make the necessary adjustments.

In addition, Management agrees that in a few instances proper ticketing and reimbursement procedures were not followed with regard to combined personal and business travel, and will review its internal procedures to ensure that such lapses do not recur.

The following response sets forth in more detail the position of LSC Management with respect to each of the Report's Findings and Recommendations, including a description of actions already initiated in several areas. The Response also sets forth a number of areas in which Management believes that the Report omits relevant facts and in which Management disagrees with factual assertions.

Finding A: Members of the Transition Team Received Benefits Not Authorized in the Corporate Policies And Not Available To All LSC Employees.

Response: Management agrees with the Report's conclusion that benefits paid to members of the transition team, such as paid travel between home and Washington, D.C., payment of medical insurance outside of the LSC plan, housing in Washington, and, in one instance, child care and housekeeping, were not unlawful or otherwise improper.[1]

With respect to the criticism of the decision to provide benefits beyond those authorized in written

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[1] The Assistant Inspector General - Legal Review made the same point as the Report in even stronger terms in a memorandum attached as Appendix III to the Report:

> Providing through contract for the payment of the benefits listed above did not violate any applicable law, regulation or policy... The President of LSC, as Chief Executive of the Corporation, with authority to manage the Corporation's day-to-day affairs, has the power to authorize expenditures for purposes related to the statutory business of LSC. All of the payments under review were sufficiently related to LSC's statutory purposes to place them within the scope of expenditures that may be lawfully approved by the President. Payments for these benefits was (sic), therefore, legally authorized.

In footnote 3 to the memorandum, the Assistant Inspector General states that the value of the benefits must be included in compensation in determining whether the statutory cap set forth in section 1005(d) of the LSC Act has been exceeded. The General Accounting Office has determined otherwise, however. See, Opinion B-210338 (Aug. 31, 1983). In any event, the memorandum concludes that "[t]he statutory cap does not appear to have been exceeded here."

policies to members of the transition team, the Report does not give sufficient consideration to the business-related reasons why the contractual arrangements were necessary and appropriate under the special circumstances presented. In early December, 1993, Alexander Forger was invited by the new Board of Directors of LSC to become the President of the Corporation on an interim basis while a search was undertaken for the selection of a permanent President. Mr. Forger's mandate from the Board was to restore the stature and effectiveness of the legal services program and to redesign the Corporation's monitoring function to make it more effective. In addition, Mr. Forger was charged with addressing LSC's large financial deficit resulting from prior Management's decision to move into a new headquarters without first renting its old offices, a decision made apparently without objection. To accomplish this mandate, it was essential to attract a group of senior managers who were already highly experienced and knowledgeable in the delivery of legal services to low-income people.

In the months of December 1994 and January 1995, it was extremely difficult to find individuals who were willing to join the transition on short notice and to accept the positions without any guarantee of future employment. People whose experience and skills made them uniquely qualified to accomplish the transition tasks resided outside of Washington, D.C., were in mid-career with established homes and family responsibilities, and could not simply pick up and move to Washington for a temporary, short-term assignment. Rather than lose these individuals entirely, Mr. Forger determined that it was reasonable under the circumstances to make it possible for these individuals to work in Washington on a short-term basis. While such arrangements were not provided for in the LSC Personnel Manual, Mr. Forger understood that the Manual did not preclude them in the case of temporary employees and he was assured that he had legal authority and flexibility to make these arrangements because of the extraordinary circumstances presented.

Management disagrees with the Report's conclusion that the contractual arrangements indicate "an inadequate control structure." The arrangements were set forth in written contracts executed by each member of the transition team; the contracts were reviewed and approved by the Office of General Counsel and were available to any LSC employee responsible for personnel administration or fiscal practices. The OIG itself was able to rely upon these contracts in performing its Inspection. Moreover, there is no evidence in the Report that the arrangements were abused.[2] Leasing apartments rather

[2] The only suggestion of "abuse" in the Report is its finding that members of the transition team did not file their travel expense reports in accordance within the prescribed thirty

than paying for daily hotel lodging resulted in a significant savings to the Corporation. The payment of medical insurance outside the LSC plan was limited so that there would be no additional costs to LSC and, in one instance, even resulted in a savings to LSC for a period of time. Even LSC's payment of travel home for two transition employees was no more costly and far more efficient than if these individuals had remained at their homes and worked for LSC as consultants. Finally, as noted in the Report, the President waived all benefits for himself during the transition period, including medical and retirement benefits.

Management also disagrees with the Report's conclusion that an appearance of "favoritism" resulted from the payment of special benefits to the transition team. The arrangements were made in order to obtain the services of several key employees who otherwise could not have assisted in the transition. Members of the transition team who did not have these problems, because they already lived in Washington, D.C., were not paid the benefits.[3] Nor, of course, were regular employees who

days. Although not excusable, this failure had no connection to the payment of benefits not set forth in the Personnel Manual and it did not result in any extra or improper costs to LSC; it merely delayed the expense reimbursements received by the individuals involved.

[3] Management has not made a systematic effort to determine whether similar benefits have been paid to LSC employees in the past. As described in GAO Opinion B-210338 (Aug. 31, 1983), one

lived with their families in the Washington area. It is unlikely that any of them would have or could have thought themselves the victims of "favoritism."

Finally, Management does not agree with the Report's recommendation that LSC provide no benefits not authorized by the Personnel Manual or the Administrative Manual. Although these written policies should continue to govern in most circumstances, it cannot be certain that special circumstances, such as those presented in the transition, will not arise again. Management should have the flexibility to deal with these future circumstances as warranted.

Management also wishes to point out a number of instances in which the Report omits significant facts relating to the provision of various benefits. For example, the Report states that the Executive Vice President and the Director of OPEAR/OPS received salary increases effective October 1, 1994, although a Board imposed salary freeze was in effect at the time. In fact, the salary fixed on October 1, 1994 for both

former President of the Corporation was permitted two round trips per month to his home in Indiana before his family could relocate to the Washington area, and his living expenses in Washington were paid by LSC. According to the GAO, the Corporation's first President also was permitted to delay his relocation to Washington until his children completed the school year; he directed LSC from his home in California and traveled to Washington, when necessary, at LSC expense. Id. We are also informed that the Corporation paid for private medical insurance on behalf of the former Inspector General.

employees was the first time that a salary was determined for them as permanent employees. Until that date they had continued to receive the same salary as had been paid during the period of their temporary employment.

The Report also states that LSC's practice in the past has been to pay parking for its President, thereby suggesting that the decision to pay parking for the Executive Vice President deviated from prior practice and constituted an additional expense. In fact, in the past LSC has paid parking for employees other than the President, including the Vice-President, Corporate Secretary, and Director of Policy Development and Communications. And, in this instance, the President himself did not request a parking space so that LSC continued to pay for only one space.

The Report states that LSC agreed with three of the members of the transition team to make lump-sum payments equivalent to the amount of the Corporation's retirement plan contributions upon termination of their employment if the contributions had not then vested. As the Report notes, these arrangements were amended when it was learned that two of these individuals were already vested under the LSC plan because of service credits earned in earlier years, and the third employee never received a lump-sum payment because she became a member of the permanent staff. The Report does not acknowledge that these arrangements were an appropriate effort to insure that the individuals would receive the benefit of the retirement contributions, since they were expected to be employed for periods shorter than the plan's vesting schedule, nor that LSC has entered similar arrangements in the past for the same reason.

Finding B: In Some Instances LSC Did Not Report All Employee and Independent Contractor 1994 Compensation to the Internal Revenue Service and Did Not Comply with Tax Withholding Requirements.

Response: With respect to Recommendation 2, Management agrees that it should review the tax treatment of all benefits, and it will do so. With respect to Recommendation 3, Management requested outside tax counsel to review the finding and conclusions in the Draft Report regarding the reporting of benefits paid to members of the transition team. Counsel has advised that, while the issue is a close one, the conservative approach is for LSC to treat payments noted in Finding B for certain employees as compensation. Based on this advice, Management is in the process of making the necessary adjustments and will file the appropriate forms with the IRS.[4]

However, Management believes that several assertions in this portion of the Report require amplification or correction:

> Although July 16, 1994, will be used for tax purposes as the effective date of the Director of OPEAR's indefinite employment, based on the advice of counsel, it should be noted that while the Director indicated his willingness to accept a position in mid-July, agreement was not reached on the final terms and

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[4] With regard to the taxability of LSC's reimbursement of three employees' medical insurance outside of the LSC plan, tax counsel has advised that where additional proof of payment is submitted to LSC, this should be sufficient to meet LSC's obligations, and such proof has now been provided.

conditions of his indefinite employment until October because of the press of other matters.

The Report states that the Director of OPEAR made ten trips to Denver between July 17, 1994 and December 31, 1994 at LSC's expense and that LSC continued to pay the rent on his apartment in Washington, D.C. through October 1994. As noted above, the tax treatment of the Director's travel to Colorado prior to October 1, 1994 will be adjusted. The Report is not correct that LSC paid for the Director's personal travel after October 1, 1994; the personal portion of all such trips was reimbursed.

As for the Assistant to the President, he was asked in early January to take a permanent job as a Program Officer and he accepted on January 5, 1995, subject to agreement on satisfactory terms. He did not assume the Program Officer position until January 12, 1995. While Management, based on the advice of counsel, agrees to treat January 5 as the date upon which an expectation of continued employment arose, it will continue to use January 12 as the date of his permanent employment for other purposes.[5]

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[5] Management disagrees with a number of the assertions in this section. First, the General Counsel of LSC did not state that it was his "understanding" that management's intent was to allow the Assistant to stay on contract for exactly one year and no longer because of tax consequences; the General Counsel stated to the OIG representative that he had no knowledge of Management's intent with respect to the effective date of the Assistant's employment as a Program Officer and that anything he might say in this regard would be "speculation." Second, it is unreasonable to suggest that one of the purposes of changing the Assistant's appointment date from January 1 to January 12 was to allow him to earn a higher salary, since the difference in compensation between the two positions for the 11 day period was only $153, before taxes. Third, while it is true that the Assistant requested that the effective date of his appointment be changed from January 1 to January 12, the reason, which was explained to the OIG, was to permit him to return to Boston on Friday, January 6 at LSC's expense under his existing travel arrangement, a request which was perfectly reasonable in view of the fact that he did not reach agreement on his position as Program Officer until after he had come to Washington in his former position at LSC's expense. Fourth, while, as reported by the Director of OHR, one of the

Finding C: The Director Of The Office of Program Services (OPS) was Inappropriately Classified As An Independent Contractor.

Response: During the period from January 3, 1995 through April 17, 1995, the Director of OPS was employed only on a part-time basis, while she concluded her job responsibilities in Alabama, and her principal LSC duties in this period involved becoming familiar with LSC projects for which she would be responsible after assuming the position full time. With respect to Recommendation 4, Management also asked outside tax counsel to review the Report's finding with respect to the classification of the Director of OPS. Tax counsel has recommended that the Director be reclassified as an employee for tax purposes. The correction can be made in the same fiscal year and the tax consequences will be minimal. Management will also consult tax counsel with regard to classification of other consultants.

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purposes of the change in the Assistant's appointment date was to insure that LSC would reimburse him for the January, 1995 COBRA premium, the Report does not mention, as the Director of OHR also stated to the OIG representative, that the Assistant had been unable to cancel the COBRA coverage for the month of January because he did not have sufficient notice of his change in status at LSC, and it was therefore reasonable for LSC to reimburse him for this amount under its previous agreement with him.

Finding D: Lack of Policy On Frequent Flyer Mileage Permits Potential Conflicts of Interest and Resulted In Unnecessary Expenses.

Response: While there has been no written policy regarding ownership of frequent flyer awards earned on official LSC travel, it has been the long-standing practice of the Corporation to allow its employees to retain frequent flyer benefits for their personal use. This is documented in a 1986 memorandum from the General Counsel to the Secretary of the Corporation in which he concluded that no provision of law prohibits the Corporation from treating frequent flyer benefits in this way. In the early 1990s, a former LSC President considered whether to change the practice and concluded he would not.

Management recognizes that by not attempting to recover frequent flyer awards earned on official travel, LSC may give up the opportunity to defray some official travel expenses. However, it should be noted that there would be significant administrative difficulties in attempting to recapture frequent flyer awards from individual employees[6] and the unsuccessful experience of many

[6] These costs result from the fact that airlines are unwilling to allow travelers to establish separate accounts for their business-related travel or to credit businesses for frequent flyer awards when they pay for a ticket.

federal agencies which have attempted to do so.[7] For these and other reasons, the former President of LSC concluded that any savings to LSC would not justify the additional administrative costs associated with a change in policy. As directed by the LSC Board of Directors at its meeting on July 14, 1995, Management will review the frequent flyer issue again, including the potential for conflicts of interest, taking into account the experience of federal agencies and other relevant entities. The results of this review will be incorporated into a written policy.

With regard to the specifics of travel by the Director of OPEAR, the Report suggests that he incurred unnecessary expense by flying on United Airlines from Dulles Airport solely to accumulate additional frequent flyer miles. In fact, the Director could have flown on United from National

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[7] Although employees of federal agencies are prohibited from using frequent flyer awards earned on official travel, this policy has not resulted in significant benefits to the agencies. Rather, it has been reported that as a result of this policy many federal employees either do not participate in frequent flyer programs or accumulate but do not use awards earned on official travel pending a change in federal policy or their retirement. Thus, neither the employees nor the agencies benefit from the award programs. In order to encourage employees to use the awards for official travel, one federal agency now makes a cash award to employees who use their frequent flyer benefits for official travel equivalent to 50% of the savings to the agency. It is unclear whether even this practice will have a significant positive effect on agency travel costs.

Airport as well. He flew on United from Dulles because the flights to and from Denver were nonstop, whereas flights from National on United and other carriers take much longer and frequently would not have allowed him to reach home by Friday evening or to return to Washington, D.C. until very late on Monday. As the Report notes, the Director was not informed by the LSC travel office or Omega Travel Services nor was he otherwise aware of cost differences between flights from National Airport and flights from Dulles to Denver. However, whenever he was cognizant of cost differences in booking his flights, he took steps to insure that LSC incurred no extra cost, as he did with regard to the trip to New Orleans mentioned in the Report.[8]

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[8] The Report also fails to mention the specific reason the Director wished to retain frequent flyer miles for personal travel. When the Director was asked to come to Washington to assist in the transition period, his wife and teenage daughter were unable to relocate to Washington from their home in Colorado because of the uncertain duration of the transition and their work and school commitments in Colorado. Allowing personal use of frequent flyer credits made it possible for the Director to bring his family to Washington on occasion, necessitating fewer trips home.

Finding E: LSC Employees Used Government Contract Fares For Personal Travel Which Violated Its MOU With GSA And Omega Travel Services And Its Own Travel Policies.

Response: Management disagrees with the Report's conclusion in Point 1 of Finding E that Government contract rates were used for personal travel as a consequence of misclassification of indefinite employees as temporary. The trips made by the Director of OPEAR and the Director of OPS were paid for by the Corporation pursuant to its employment agreements with these individuals. These trips therefore were not "personal". Insofar as LSC was bound to pay the fares for these trips, Management was advised by the Office of General Counsel that it was proper, under its agreements with the General Services Administration and Omega Travel, to use the government contract rates. Even if these individuals were misclassified for tax purposes, LSC's payment of the travel was proper and the use of Government contract rates for the fares paid by LSC was also proper.[9]

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[9] When she was offered the position of Director of OPS in December, 1994, the Director indicated that she could not move to Washington for several months because of her current responsibilities as Executive Director of the Legal Services Corporation of Alabama. The President and Executive Vice President concluded that it was important to LSC to have the Director assume the position immediately, albeit on a part-time basis, and they agreed therefore to have LSC pay for up to five round trips from Alabama to Washington. The trip to Washington on April 17, 1995 was the first leg of a trip which also involved business related

Finally, with respect to the second point raised by the Report, Management agrees that Government contract rates should not be used when an LSC employee combines personal and business travel or when an employee makes a purely personal trip. In a few instances an employee was permitted to use contract rates for personal travel and to reimburse LSC on that basis. This should not have happened and, as set forth in recommendation 6, Management is reviewing its internal procedures to ensure that these lapses do not recur.

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trips to Nashville, Tennessee and Tulsa, Oklahoma, with a return trip to Alabama. Since the Alabama-Washington-Alabama segments of this trip were not covered in the five trips previously agreed to by LSC, the Director of OPS agreed to pay for part of the ticket and she instructed the Comptroller's office to deduct the correct amount from amounts otherwise owed to her as travel reimbursements from this and other trips. The Director's understanding is that the amount she will pay will be calculated at commercial rates.

The use of Government contract rates for the August, 1994, trip by the Special Assistant to the President also had nothing to do with her status as a temporary employee and was appropriate under the circumstances. The Special Assistant had for many months been scheduled to participate in her brother's wedding in Boston beginning at 5:00 p.m. on Friday, August 5, 1994. She had planned to drive to Boston on that Friday and to return on Monday. At the last minute it developed that other staff in the LSC Executive Office could not be in the office on either that Friday or Monday, and the Special Assistant was requested to change her travel plans so that she could be present. This required that she travel to Boston by air rather than automobile. The Executive Vice President agreed that, since the costs of the airplane trip were incurred to accommodate LSC they would be paid by LSC, and the ticket was accordingly charged at the Government contract rate. Weeks later, after OIG questioned this expense, the Special Assistant volunteered to pay for the airplane trip in order to avoid any appearance of impropriety. Since it was then too late to change the billings for this trip, the amount which she paid was calculated at the government rate charged to LSC when the trip was still regarded as an official trip.

APPENDIX VI

Major Contributors to this Report

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