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Feb. 2, 1998

**Action on Decision**

**Subject:** John D. and Karen Beatty v. Commissioner  
106 T.C. 268 (1996)  
T.C. Dkt. #8273-94

**Issue:** Whether the court correctly determined that petitioner was entitled to reduce gross receipts by cost of goods sold to determine gross income?

**Discussion:** Petitioner, John D. Beatty, was a county sheriff in Indiana. Indiana statute required petitioner to provide meals to the prisoners incarcerated in the county jail, at his own expense. In turn, petitioner received a payment from the county on a per meal basis at a specified rate established by the State. In 1991, petitioner received \$109,952 in meal allowances. Petitioner reported the \$109,952 as gross receipts on Schedule C and claimed cost of goods sold of \$68,540. Petitioner reported profit of \$41,412 from the meal allowances. Federal Insurance Contributions Act (FICA) taxes were not withheld or paid on the profit.

The government argued that the \$109,952 paid to petitioner as meal allowances was additional employee compensation includible in income as wages. The government further asserted that the costs petitioner incurred in connection with the meals were employee business expenses deductible as miscellaneous itemized deductions. Petitioner argued that he was an independent contractor with respect to the meal program.

The Tax Court declined to address the question of whether petitioner was an employee or an independent contractor because, under these facts it held, such a determination had no income tax consequences. In the Tax Court's view, determining petitioner's gross income from the program was all that was necessary to resolve the controversy between the parties. The Tax Court held that petitioner had \$41,412 in

income, computed by subtracting cost of goods sold from the gross receipts petitioner received as meal allowances.

This result, given the unique facts in this case, is acceptable to the Service and we will no longer litigate with identically situated taxpayers whether they are entitled to a cost of goods sold offset provided they use the accrual method of accounting for the purchase and sale of the food used in providing meals to the prisoners.

This opinion has left unanswered the question of whether, in similar cases, the profit from the meal allowances is subject to the Old Age, Survivors, and Disability Insurance (OASDI) portion of the FICA tax. Whether FICA applies to the net profit depends upon the specific facts of each case. In general, a FICA obligation exists if there is an employer-employee relationship and a payment of wages with respect to employment. Additional special rules govern whether FICA applies to state and local government employees. I.R.C. § 3121(b)(7) provides that service performed in the employ of a state or local government is not employment for FICA purposes subject to certain exceptions. Section 3121(b)(7)(E) provides that services included under an agreement described in Section 218 of the Social Security Act are not exempt from employment. In addition, effective for service performed after July 1, 1991, I.R.C. § 3121(b)(7)(F) provides that any individual performing services for a state or local government is engaged in employment, unless such individual is a member of a retirement system sponsored by the state or local government. Section § 3121(b)(7)(F)(v) provides that the inclusion in employment required by I.R.C. § 3121(b)(7)(F) does not apply to an employee in a position compensated solely on a fee basis that is treated as a trade or business for purposes of I.R.C. § 1402(c)(2)(E).

Thus, if a similarly situated sheriff is covered by a section 218 Agreement, the net profit is subject to FICA. If there is no Section 218 Agreement, whether a sheriff is subject to FICA depends upon the application of I.R.C. § 3121(b)(7)(F). The exception in I.R.C. § 3121(b)(7)(F)(v) would not be available to a sheriff compensated under the meal allowance program as the payments are not fees within the meaning of I.R.C. § 1402.

Recommendation:

Acquiescence.

GMH  
MEO

/s/

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Approved: STUART L. BROWN  
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/s/  
By: \_\_\_\_\_

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