MESSAGE FROM THE DIRECTOR

This newsletter gives us the opportunity not only to provide articles of interest on technical topics, but to help keep you informed of recent news within the IRS that affect government entities. There are two developments we want to make you aware of in this issue.

Form 941, Employer's Quarterly Federal Tax Return, is undergoing a major redesign for 2005. The form will now be two pages, although it requests essentially the same information. The added length is due to changes in font size, shading, and instructions that are intended to make the form easier to read and accurately complete. Each part will have a clear, brief description summarizing the information asked for. The adjustments section and the deposit schedule information have been expanded and clarified, and we expect that this will reduce errors and make filing easier for you and for IRS to process.

The Form 941 Schedule B, Report of Liability for Semiweekly Schedule Depositors, has been redesigned as well. We believe that the new instructions and format will reduce confusion about who must complete the form, and what information to enter.

If you are an employer, the new Form 941 (and Schedule B, if appropriate) will be mailed to you prior to filing in the first quarter of 2005.

The office of Federal, State and Local Governments (FSLG) previously solicited comments from the FSLG members of the TE/GE Advisory Committee (ACT) on the viability of a possible voluntary compliance assistance program (VCAP) designed specifically for FSLG taxpayers. We encouraged the ACT members in turn to seek feedback from members of the National Conference of State Social Security Administrators. The proposal would have provided a structured program under which a FSLG entity could voluntarily correct specific employment tax issues prior to an examination by the Service. We appreciate all the comments we received on the VCAP proposal.

After reviewing all the comments and weighing all the positive and negative implications of such a program, we have decided that a formal VCAP program unique to FSLG taxpayers is not feasible at this time. As you are aware, employment tax issues are not unique to FSLG taxpayers. Private employers face essentially the same problems and concerns that government entities might encounter in regards to employment taxes. Thus a program such as the Classification Settlement Program is available across the board to all employers with the reclassification issue; the Service has not provided different opportunities or different outcomes based on the type of employer. Unless and until we can make additional VCAP mechanisms available more broadly, or can better identify relevant differences among taxpayer groups, we have not found a way to implement a different program just for government entities.

Although we are sorry to inform you that a structured program for FSLG entities is not in the cards at this time, we certainly will continue to work one-on-one with FSLG entities on particular issues. Also, we will feed what we learn from that process into further educational materials and procedural improvements. We strongly encourage any

government entity that believes there may be a problem with their tax obligations to come forward and contact an FSLG Specialist. In many cases, the situation can be corrected in less time and at less cost than if addressed later in an examination. We remain committed to providing the best service possible in meeting your Federal tax obligations. A list of all local FSLG Specialists appears at the back of this newsletter.

NO-ADDITIONAL-COST SERVICES AND QUALIFIED EMPLOYEE DISCOUNTS FOR PUBLIC EMPLOYEES

BY JOYCE REINSMA AND TED KNAPP, FIELD SPECIALISTS (CENTRAL)

Fringe benefits are a form of pay for the performance of services. Generally, any fringe benefit provided by an employer is taxable and includible in a recipient's pay unless the law specifically excludes it. If an employee is the recipient of a taxable benefit, the benefit is subject to employment taxes and must be reported on Form W-2, Wage and Tax Statement. This article will primarily address the two fringe benefits excluded from gross income: "no-additional-cost services" and "qualified employee discounts".

Many public municipalities have park districts that offer a variety of amenities to the public. Examples of such amenities can include swimming pool facilities, fitness and weight room facilities, and public golf courses. When these amenities are offered to the public for a fee and the same amenities are offered to an employee at no cost, the possibility of a taxable benefit to the employee has to be weighed and considered by the employer.

Generally speaking, the benefit may be totally excluded from income as a "no-additional-cost service" (see Internal Revenue Code (IRC) section 132(a)(1)) or partially excluded from income as a "qualified employee discount". (IRC section 132(a)(2)). However, this may not always be the case, depending on how the benefit is offered to the employee and who is allowed use of the facility. The benefit must be offered only to a person who is defined as an "employee" (IRC section 132(h)) and the benefit cannot be excluded from income if it is only offered to highly compensated employees. (IRC section 132(j)).

No-Additional-Cost Service

A "no-additional-cost service" is a service offered by the employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services, and the employer incurs no additional cost (including foregone revenue) in providing the service to the employee. (IRC Sections 132(b)(1) and (b)(2)).

First, the employer must provide the service to its customers in the ordinary course of its line of business. This statement contains two conditions that should be evaluated separately. First, the service must be offered by an employer to its customers. In the case of park district, facilities such as golf courses, fitness facilities, and swimming pools are made available to the public and usually for a fee of some amount.

Second, the service must be offered in the "line of business" in which the employee performs substantial services. An employer's "line of business" is determined by reference to a two-digit standard industrial classification coding (Income Tax Regulations 1.132-4) that is found in the Enterprise Standard Industrial Classification Manual. Although presently the Statistical Policy Division of the U.S. Office of Management and Budget uses the North American Industry Classification System (NAICS) which provides detailed coding up to six digits in description, the Internal Revenue Service still uses the codes provided in the Enterprise Standard Industrial Classification (ESIC) Manual to determine an employer's line of business for purposes of the availability of exclusions from gross income for certain fringe benefits under section 132 of the Internal Revenue Code.

Determining the line of business in which an employee performs substantial services can be difficult with respect to government entities. The two-digit coding for the administration of government entity programs under ESIC is 90. Many governmental functions are unique to governmental entities (maintaining a police force, collecting real estate taxes, passage of legislation, etc.).

Other functions of a governmental entity may be analogous to private sector operations such as schools, hospitals, or transportation facilities and are listed along with private sector enterprises of the same type under different "line of business" codes. For example, schools would be classified in ESIC as educational services with a two-digit code of 82; hospitals are classified under a two-digit code of 80.

Public Administration is shown in ESIC Manual as a two-digit code of 90. It can be difficult to identify separate establishment details for many government agencies. To the extent that separate establishment records are available, the administration of governmental programs is classified as two-digit code 90, Public Administration, while the operation of that same governmental program is classified elsewhere in ESIC based on the activities performed (emphasis added)".

The governmental employer must determine what the "line of business" is and which employees perform substantial services in that "line of business". A city that administers community recreation programs (such as golf programs, fitness centers, swimming pools, etc.) may have employees who administer the program under one "line of business" coding Public Administration (92) and employees who operate the program under "line of business" coding Arts and Recreation (71). Employees who operate the recreation programs can have income excluded because the fringe benefit is considered as a no-additional-cost service; those employees who administer the program may not.

The employer must incur no additional cost (including foregone revenue) in providing this service to the employee (IRC section 132(b)(2)). Services that are eligible for treatment as no-additional-cost services include excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services. (Regs.1.132-2(a)(2)). Presumably, overhead and operating costs remain substantially the same whether or not employees are provided the service and thus, no additional cost is incurred. No revenue should be lost because an employee is offered this service. A common example of a "no-additional-cost service" is an empty

seat on an airplane when boarding begins. At the time an employee on standby boards the plane, the airline incurs no additional costs either in operating expenses or in foregone revenue from a paying passenger.

With the operation of a public golf course, the same issues must be weighed. Particularly in summer months, excess capacity at a popular public golf course is at a minimum for certain times of the day. If employees are allowed to play without limitation during prime tee times on the golf course in summer months, paying customers would not be able to use the course: the employer incurs an additional cost in foregone revenue. Routinely reserving the golf course facilities well ahead of time would also present a real possibility of foregone revenue from the paying public. If potential revenue is lost, the benefit can not meet the "no-additional-cost" conditions. (IRC section 132(b)(2)).

Even if "no-additional-cost service" exclusion from gross income does not apply, some gross income for the dollar value portion of the service that is a "qualified employee discount" can be excluded. (IRC section 132(a)(2)).

Qualified Employee Discount

A "qualified employee discount" is allowed if the discount does not exceed (in the case of qualified property) the gross profit percentage of the price at which the property is offered by the employer to customers. In the case of qualified services, the discount can be up to 20 percent of the price at which the services are being offered by the employer to customers. (IRC section 132(c)).

The term "qualified property or services" means any property (other than real property and other than personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. (IRC section 132(c)(4)).

For example, an employee wishes to reserve a prime period "tee-time" on the golf course. This will not qualify as a "no-additional-cost" service because of probability of foregone revenue. However, up to 20 percent of the price at which the service is offered to customers can be excluded from his taxable wages as a "qualified employee discount". A "qualified employee discount" can also apply to the rental of a golf cart by an employee. Use of a golf cart may not be a "no-additional-cost service" since expenses for gas, maintenance, and repairs are incurred when it is used. However, up to 20 percent of the price at which the service is being offered by the employer to customers may be excluded from the employee's taxable wages as a "qualified employee discount."

Who Is Treated As an Employee?

It is important to note that when an employer provides fringe benefits that are either "no-additional-cost services" or "qualified employee discounts", the person receiving the service must meet the definition of "employee" in order for the income to be excluded. (IRC section 132(h)).

Certain individuals can be treated as employees for purposes of the "no-additional-cost" and "qualified employee discount" exclusions. These individuals include former

employees in that line of business who are separated from service with that employer because of retirement or disability, and any widow or widower of any individual who died while employed by the employer in the line of business in which the service is being offered.

In general, the use of "no-additional-cost services" and "qualified employee discounts" by the spouse or a dependent child of the employee shall be treated as use by the employee. A dependent child means any child of the employee who is a dependent of the employee, or both of whose parents are deceased and who has not attained age 25. (IRC section 152(e)).

Reciprocal agreements between employers allow any service provided by an employer to an employee of another employer to be treated as provided by the employer of such employee if the service is provided pursuant to a written agreement between those employers, and neither of the employers incurs any substantial additional costs (including foregone revenue) in providing the service.

In practical terms, why does the definition of an "employee" matter? If a municipal park district offers free golf course passes to an employee with no restrictions as to who can join him on the golf course, the dollar value of those passes may be taxable wages to that employee if those persons do not meet the definition of an "employee" as described in the preceding paragraphs above. For example, an employee receives four passes to the golf course worth $25 each. He decides to invite three friends to join him. If these individuals are not "employees" by virtue of either a relationship test or a reciprocal agreement between employers as described above, $75 of the value of the services received by that employee is taxable wages to him. This would be case whether a "no-additional-cost" exclusion was considered or if a "qualified employee discount" was considered.

Finally, before applying exclusion of income rules to either no-additional-cost services or qualified employee discounts, there can be no discrimination in favor of highly compensated employees. Exclusions for "no-additional-cost" services or "qualified employee discounts" services apply to highly compensated employees only if the fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees. (IRC section 132(j)). As a general rule, this caution is probably less relevant to government employers than to those employers in the private sector. Nevertheless, it is an important consideration to keep in mind.

Facts and circumstances can vary from employer to employer with respect to questions regarding lines of business, highly compensated employees, excess capacity, what constitutes lost revenues, etc. For specific written advice about a unique set of conditions, the employer can contact IRS for a private letter ruling.

PAYMENTS TO ATTORNEYS

BY MAE WHITLOW, FSLG SPECIALIST (SOUTHEAST)

Wages paid to an attorney who is your employee are reportable on Form W-2. But where do you report non-employee payments made to an attorney?

General Requirement

Section 6045(f) of the Internal Revenue Code states that a return is required in the case of payments to attorneys, requiring that any "person engaged in a trade or business and making a payment (in the course of such trade or business)… shall file a return." A payment to which this subsection applies is a payment to an attorney in connection with legal services (whether or not the legal services were rendered to the payer) that is not required to be reported under section 6041 or 6051.

Section 6045(f) was added to the Code in 1997. Regulations were first proposed in 1999, and after considering all of the comments on those proposed regulations; the IRS and the Treasury Department promulgated new proposed regulations on May 17, 2002. The proposed regulations provide that payments to attorneys are reportable if over $600 in the aggregate and also provide that Form 1096 and Form 1099 are the forms to be used for the required return and statement.

You must file Form 1099-MISC for payments to an attorney made in the course of your trade or business in connection with legal services. This applies whether or not the legal services are provided to you and whether or not the attorney is the exclusive payee.

The information required to be reported includes the name, address and TIN of the payee attorney. A payer is required to solicit a TIN from the attorney at or before the time the payer makes a payment to the attorney. A payment for which a return of information is required under this section is subject to backup withholding under section 3406 and related regulations.

Applying the Requirement to Attorney Fees

This requirement may raise several questions. Is Form 1099 required if the payments represent nontaxable income to the attorney? Is the attorney required to provide the requested information if the payment represented a nontaxable payment to him/her? Does I.R.C. § 6045(f) require you to issue a Form 1099 in this situation? Are you required to solicit the attorney's TIN? If the attorney receiving the payment refuses to provide his/her TIN, is backup withholding required?

No provision of the statute or proposed regulations requires a payment to an attorney to be deemed income to the attorney in order for it to be reportable. There are specific exceptions in the proposed regulations, but none of them are for non-income payments. Rather, the exceptions generally relate to payments that are reportable under other provisions, for example, payments of wages by an attorney's employer (reportable on a Form W-2), or payments of compensation or profits to a partner-attorney by the partnership (reportable on a schedule K-1), etc.

While the amount paid is not income to the attorney, it is nevertheless reportable, since it is made in connection with legal services.

Backup Withholding

The proposed regulations require backup withholding if an attorney-payee does not provide his/her TIN. The legislative history of section 6045(f) clearly indicates that payments to attorneys are subject to backup withholding. Attorneys are required to promptly supply their TINs to persons required to file these information reports, pursuant to section 6109. Failure to do so could result in the attorney being subject to a penalty under section 6723 and the payments being subject to backup withholding under section 3406.

Section 3406 requires backup withholding when a payee of a "reportable payment" fails to furnish his/her TIN to the payer upon request. Under section 3406(b)(3), a reportable payment includes a payment under section 6045. Under section 3406(b)(4), a "reportable payment" is determined without regard to any minimum amount that must be paid before a return is required (except for payments not exceeding $10). Accordingly, even though the proposed regulations under section 6045(f) provide that a return and statement are not required for payments not exceeding $600 in the aggregate, that minimum amount is not applicable where an attorney-payee fails to furnish his/her TIN. Accordingly, payments to attorneys that are larger than $10, but not larger than $600, are subject to backup withholding if the attorney refuses to supply his/her TIN.

In summary, you are required to file a Form 1096 and issue a Form 1099 for all nonwage payments to attorneys aggregating $600 or more. In addition, if the payee refuses to provide his/her TIN, backup withholding is required; there is no $600 threshold for backup withholding.

Follow-up on Volunteer Workers

In our June 2004 issue, we discussed the tax treatment of volunteer workers and stated the general rule that anything of value received in exchange for services is taxable income, even if the worker is considered a volunteer or receives no regular salary. If the employee is covered by social security and Medicare, these taxes are applicable to the value of the amounts received, with certain exceptions.

Section 3121(b)(7)(F) of the Internal Revenue Code provides that wages paid to state and local government employees after July 1, 1991, are subject to mandatory social security and Medicare coverage, unless the employees are covered by a qualifying retirement system of their state government or its subdivision or instrumentality, or are covered under a voluntary Section 218 Agreement with the Social Security Administration. However, workers who participate in a qualifying retirement plan and are also covered by a voluntary Section 218 Agreement between the state Social Security Administrator and the Social Security Administration are subject to social security and/or Medicare taxes on any compensatory consideration they receive, even if those workers are also covered by a state retirement plan. In determining whether benefits conferred upon volunteers are subject to social security and Medicare taxes, there is no difference between employees under mandatory coverage and those covered by a Section 218 Agreement.

For more information on social security coverage rules, see Publication 963, Federal-State Reference Guide, available at http://www.irs.gov/pub/irs-pdf/p963.pdf , or visit the Social Security Administration web site at www.ssa.gov.

TAX EXEMPT BONDS: QUALIFIED PRIVATE ACTIVITY BOND PUBLICATION

BY JOE GRABOWSKI, TAX EXEMPT PROGRAM ANALYST

The Office of Tax Exempt Bonds has released a new publication that outlines the federal tax rules and filing requirements applicable to qualified private activity bonds. Publication 4078, Tax-Exempt Private Activity Bond Compliance Guide, is available in printed copy and on the IRS website at www.irs.gov/bonds.

Qualified private activity bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are used for a defined qualified purpose by an entity other than the government issuing the bonds (the "conduit borrower").

This publication provides an overview for state and local government issuers and conduit borrowers of bond proceeds of the general post-issuance rules under the federal tax law that apply to municipal financing arrangements commonly known as qualified private activity bonds. The general rules covered in this publication apply to the following qualified purposes:

• Section 142 – Exempt facilities such as airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the furnishing of local electric energy or gas, local district heating or cooling facilities, qualified hazardous waste facilities, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities, and qualified public education facilities;

• Section 143 – Qualified mortgages and qualified veterans' mortgages;

• Section 144 – Qualified small issue manufacturing facilities, qualified small issue farm property, student loans, and qualified redevelopment projects;

• Section 1394 – Qualified enterprise zone and empowerment zone facilities.

The post-issuance federal tax rules covered in this publication are generally applicable to qualified private activity bonds and fall into three basic categories:

• Requirements related to issuance;

• Use of proceeds and financed property requirements; and

• Arbitrage yield restriction and rebate requirements.

The publication also provides a description of the Tax Exempt Bonds Voluntary Closing Agreement Program (VCAP). This program provides remedies for issuers who voluntarily come forward to resolve a violation.

For information regarding the general rules applicable to governmental bonds or qualified 501(c)(3) bonds, see IRS Publications 4079, Tax-Exempt Governmental Bonds, and 4077, Tax-Exempt Bonds for 501(c)(3) Charitable Organizations, respectively.

For additional information regarding any of these publications or the tax-exempt bond program in general, contact Cliff Gannett, Manager of Tax Exempt Bonds Outreach, Planning and Review at 202-283-9798 or visit the TEB website at www.irs.gov/bonds.

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