FSLG Newsletter March 1 Edition
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MESSAGE FROM THE GE DIRECTOR

CHARLES PETERSON, DIRECTOR, GOVERNMENT ENTITIES

In recent years, the Internal Revenue Service has been asked to identify areas where tax compliance can be improved. In his first statement as Commissioner of the Internal Revenue Service in May 2003, Mark W. Everson spoke before a House subcommittee and addressed three areas of concern the IRS would focus on under his administration: continuing the reorganization; continuing the information technology modernization program, and strengthening the integrity of the tax system through enhanced enforcement activities. Specifically, he addressed the relationship between compliance and service:

> "Together, service and enforcement equal compliance. Providing taxpayers with the services they need to understand and voluntarily meet their tax obligations is one part of the equation. The other half is providing the appropriate level of enforcement."

The office of Federal, State and Local Governments (FSLG) is committed to increasing the awareness of governmental as much as possible concerning these enhanced activities. Based on our interaction with you through our outreach and compliance activities in past years, we can suggest some areas that you may see emphasized in FSLG compliance activities in the near future:

Abusive schemes – For governmental entities, this may include improper classification of employees as contractors, leaseback arrangements that allow

private companies to claim expenses for governmental functions, and improper retirement or benefit plan arrangements.

Information returns – Improper reporting or failure to report payments to vendors, contractors, etc.

Employee fringe benefits – Failure to include in income, when taxable, such benefits as employee meals, lodging, clothing, and the personal use of vehicles.

FSLG and the IRS remain committed to the best possible service to you to help you understand your obligations and work to correct potential problems voluntarily. If you have questions about the law or seek assistance, please contact your local FSLG Specialist. A directory is provided in the back of this publication.

NEW PROPOSED REGULATIONS FOR STUDENT SOCIAL SECURITY COVERAGE

BY DENISE BOWEN, TE/GE TAX LAW SPECIALIST

Section 3121(b)(10) of the Internal Revenue Code (IRC) sets forth the conditions under which students may be exempt from social security and Medicare taxes (the "student FICA exception"). It provides that employment for purposes of FICA does not include services performed in the employ of a school, college, or university (SCU), or certain affiliated tax-exempt organizations in relation to the SCU (related §509(a)(3) organization), if the service is performed by a student who is enrolled and regularly attending classes at an SCU. The IRS issued proposed regulations on February 24, 2004, amending 26 CFR part 31 under §3121(b)(10) of the IRC.

The proposed regulations clarify the definitions of an SCU and a student for purposes of the student FICA exception by addressing two issues regarding the applicability of the exception to medical residents and interns: (1) whether an organization carrying on educational activities in connection with the performance of services is an SCU within the meaning of §3121(b)(10), and (2) whether certain employees performing services in the nature of on the job training have the status of a student who is enrolled and regularly attending classes for purposes of §3121(b)(10).

The Characteristics of an SCU

The student FICA exception applies to services only when both the employer status and the student status requirements are met. The employer status requirement is met if the student is employed by an SCU or a related §509(a)(3) organization. If an SCU or a related §509(a)(3) organization sponsors an on the job training program, but the service recipient is the common-law employer, the exception is not applicable.

For example, a medical residency program may include assignments at a hospital that is not a part of the same legal entity as the SCU and is not a related §509(a)(3) organization. If this is the case, and the hospital where the services are performed is the common-law employer, the question arises as to whether the hospital qualifies as an SCU. Under existing regulations, the term "SCU" for purposes of the student FICA exception is construed in its commonly or generally accepted sense. Further, the IRS maintains administratively that an organization meets the definition of an SCU only if its primary function is education.

The IRS has also maintained administratively that a teaching hospital is not an SCU within the commonly or generally accepted sense of the term, because a teaching hospital's primary function generally is to provide patient care. In a recent case, the IRS argued that the primary function standard under §170(b)(1)(A)(ii) of the IRC and the related regulations reaches a result that is consistent with the commonly or generally accepted sense standard. This argument was rejected, and the proposed regulations clarify this issue by replacing the common sense standard with the primary function standard.

The Employer Status Standard

The proposed regulations incorporate a *primary function standard* by revising §31.3121(b)(10)-2(c) as follows:

> (c) School, College or University. A school, college, or university is described in section 3121(b)(10) if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.

Section 170(b)(1)(A) of the IRC defines specific classes of organizations for charitable deduction purposes and distinguishes them into categories based on various criteria. One such class, §170(b)(1)(A)(ii), is defined in §1.170A-9(b)(1) of the Income Tax Regulations and provides in part:

> An organization is described in §170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities… Thus, in order to qualify as an educational organization under §170(b)(1)(A)(ii), it is not enough that the organization carries on educational activities; instead, the organization's primary purpose must be to carry on educational activities.

The IRS maintains that the primary function standard in §170(b)(1)(A)(ii) is consistent with the language of §3121(b)(10) and the related regulations, and reaches a result consistent with the commonly or generally accepted sense standard of the existing regulations. The term hospital is commonly used to describe an organization with the primary function of caring for patients. While a hospital may conduct educational activities, even classes or degree programs, the activities that define hospitals in the public mind are patient care. The primary defining characteristics of schools are the conduct of classes for an identified set of students leading to the awarding of a credential demonstrating mastery of some subject matter.

The Student Status Standard

The second component of the student FICA exception is the requirement that the employee in question be a student. The statutory test for student status is whether the individual is "enrolled and regularly attending classes" at the SCU. Under existing regulations, the status of the employee as a student performing the services is determined on the basis of the relationship of such employee with the organization for which the services are performed. An employee will have the status of student only if the services are performed "as an incident to and for the purpose of pursuing a course of study" at the SCU.

To qualify for the exception, the individual's predominant relationship with the SCU must be as a student pursuing a course of study, and only secondarily or incidentally as an employee. In situations where the performance of services and pursuit of the course of study are separate and distinct activities, the extent and nature of the activities help determine whether the employment or student relationship is the predominant relationship with the SCU. However, when the services performed by the individual for the SCU are also earning the individual credit toward an ultimate educational credential, the determination of whether the employment relationship is the predominant relationship with the SCU must be based on other factors.

The proposed regulations clarify who is a student enrolled and regularly attending classes for purposes of §3121(b)(10) by defining student status. Within that definition, further clarification is provided by describing what the individual must be doing to be considered enrolled and regularly attending classes, and by providing standards for (1) determining whether an employee is pursuing a course of study, and (2) determining whether an employee's services are incident to and for the purpose of pursuing a course of study.

Proposed paragraph 2(d) provides:

> Student Status - - general rule. Whether an employee has the status of a student performing the services shall be determined based on the relationship of the employee with the organization for which the services are performed. In order to have the status of a student, the employee must perform services in the employ of a school, college, or university described in paragraph (c) of this section at which the employee is

> enrolled and regularly attending classes in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study within the meaning of paragraph (d)(3) of this section at such school, college or university. An employee who performs services in the employ of an affiliated organization described in paragraph (a)(2) of this section must be enrolled and regularly attending classes at the affiliated school, college or university within the meaning of paragraph (c) of this section in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study within the meaning of paragraph (d)(3) of this section at such school, college, or university.

Paragraph (d)(1) sets forth the requirements that must be met to be considered "enrolled and regularly attending classes". Paragraph (d)(2) defines "course of study", and paragraph (d)(3) discusses the "incident to and for the purpose of pursuing a course of study" requirement.

The requirement that students be enrolled and regularly attending classes means that the activity must include more than just providing the individual an opportunity to acquire new skills and knowledge. According to the proposed regulations, it must be inclusive of instructional activities, and led by a knowledgeable faculty member following an established curriculum for identified students. While classes can include more than traditional classroom-based instruction, faculty leadership, a set curriculum and a prescribed time frame are required. One or more courses conducted by a SCU, the completion of which fulfills the requirements to receive an educational credential granted by the SCU is a course of study.

Whether an employee's services are incident to and for the purpose of pursuing a course of study depends on all the facts and circumstances. The determination is made by comparing the educational aspect of the relationship between the employer and employee with the service aspect of the relationship. The employee's course workload is used to measure the scope of the educational aspect of the relationship, with the amount of the employee's course workload relative to a full-time course workload being a relevant factor.

The proposed regulation also provides that the services performed by the employee are not incident to and for the purpose of pursuing a course of study where an employee has the status of a career employee. A career employee is defined in Paragraph (d)(3)(ii) as follows:

> (3)(ii) Career employee status. Service of an employee with the status of a career employee are not incident to and for the purpose of pursuing a course of study. An employee has the status of a career employee if the employee is described in paragraphs (d)(3)(ii)(A), (B), (C) or (D) of this section.

Paragraph (A) references hours worked and provides that an employee has the status of a career employee if the employee regularly performs services 40 hours or more per week. Paragraph (B) provides that an employee has the status of a career employee if the employee is a professional employee. A professional employee is defined, for purposes of the student FICA exception as an employee whose primary duty consists of the performance of service requiring knowledge of an advanced type in a field of science or learning, whose work requires the consistent exercise of discretion and judgment in its performance, and whose work is predominantly intellectual and varied in character.

Paragraph (C) provides that the terms of an employee's employment could cause the employee to have the status of career employee. It sets forth a list of terms that identify career employees and the presence of any one of the terms disqualifies the individual for student status. Finally, paragraph (D) provides that an employee who must be licensed by a government entity in order to perform a certain function has the status of career employee. Examples illustrative of the principles of paragraphs (c) and (d) are contained in paragraph (e).

Conclusion

The issues addressed in the applicability of the student FICA exemption to medical residents and interns also apply to services performed by employees in other fields, particularly regulated fields, where on the job training is often required to gain licensure. The proposed guidance and examples should assist employers by reducing confusion in this area.

These are proposed regulations and are subject to change. Rev. Proc. 98-16, 1998-1 C.B. 403, which governs the payment of FICA taxes by undergraduate, graduate or professional students in the employ of certain institutions of higher education, is suspended. The IRS proposes to replace Rev. Proc. 98-16 with a new revenue procedure that is revised in limited ways to align with the proposed regulations. See Notice 2004-12, to be published in I.R.B. 2004-10 (March 8, 2004).

TAX TREATMENT OF THIRD-PARTY SICK PAY

BY KIM SAVAGE, FSLG SPECIALIST (WESTERN)

Employer fringe benefit plans frequently include a provision for sick pay. Many governmental employers now offer a pre-tax employer funded sick pay plan as an employee benefit. Both the employer and the third-party payer should be aware of special rules for reporting sick pay funded on a pre-tax basis.

A sick pay plan is a plan or system established by an employer under which sick pay is available to employees generally or to a class or classes of employees. "Sick pay" generally means any amount paid under a sick pay plan because of an employee's temporary absence from work due to injury, sickness, or disability.

It may be paid by either the employer or a third party, such as an insurance company. This discussion addresses sick pay benefits paid by third parties; it does not apply to agents of the employer, who merely make payments on behalf of the employer and assume no insurance risk.

Sick pay can include both short and long-term benefits. Sick pay does not include disability retirement, workers' compensation, employee medical expense, or payments unrelated to absence from work. Sick pay is typically subject to social security and Medicare; however, these taxes do not apply to payments made:

1. After an employee's death or disability retirement;
2. After the calendar year of an employee's death to an estate or survivor;
3. To an employee entitled to social security disability insurance benefits;
4. That exceed the applicable wage base for social security tax purposes;
5. After the sixth calendar month after the month in which the employee last worked for the employer; or
6. Attributable to employee after-tax contributions to the sick pay plan.

Special rules apply to the reporting of sick pay payments to employees made by a third party, such as an insurance company. A third party that makes payments of sick pay is liable for income tax withholding (if voluntarily requested by the employee on Form W-4S) and the employee part of the social security and Medicare taxes.

The third party is also liable for the employer part of the social security and Medicare taxes, unless the third party transfers this liability to the employer for whom the employee normally works. This liability is transferred if the third party takes **all** of the following steps:

1. Withholds the mandatory social security and Medicare taxes and voluntary Federal income tax withholding from the sick pay payments.
2. Makes timely deposits of the employee social security, Medicare, and income tax withholding taxes.
3. Notifies the employer for whom the employee normally works of the payments on which employee taxes were withheld and deposited. The third party must notify the employer within the time required for the third party's deposit of the employee part of the taxes. The third party should notify the employer as soon as information on payments is available so that an employer required to make electronic deposits can make them timely.

Whether liability has been transferred as discussed in the preceding paragraph determines who is responsible for the employer share of the taxes. If the third party does not satisfy the requirements for transferring liability for the employer's part of the social security and Medicare taxes, the third party must report the sick pay on its Form 941 and deposit or pay all the applicable Federal income and employment taxes under it's name and employer identification number (EIN) in accordance with the appropriate tax deposit schedule. The third party is responsible for preparing, providing, and filing Forms W-2 under its name and

EIN for the sick pay payments. In this situation, the employer has no tax responsibilities for sick pay.

If a third party satisfies the requirements for transferring liability for the employer part of the social security and Medicare taxes, the third party must make deposits of withheld employee social security, Medicare, and Federal income taxes in accordance with its deposit requirements under its name and EIN. The employer must make deposits of the employer part of social security and Medicare taxes under its name and EIN

For purposes of the deposit rules, the employer liability for these taxes begins when it receives the third party's notice of sick pay payments. The employer must include third-party sick pay on lines 2, 6a, and 7a of Form 941 for the quarter in which notification of the payments was received. After completing line 8 of Form 941, subtract on line 9 the employee social security and Medicare taxes withheld and paid by the third party. This amount is entered in the "Sick Pay" space included with line 9. If line 9 includes adjustments unrelated to sick pay, these amounts should be netted with the sick pay adjustment amount in the line 9 entry space on the right.

The employer retains the responsibility for reporting the sick pay on Forms W-2 and W-3 under the transferred liability option. To ensure the employer has the complete, correct, and timely information needed to incorporate the sick pay payments and taxes into its employees' Forms W-2, the third party must furnish the employer with a statement by January 15 of the year following the year of sick pay payment containing all information needed by the employer. In addition, the third party must prepare and file a "third-party sick pay recap" Form W-2 and W-3 for sick pay payments reported on employer Forms W-2 and W-3. These recap forms provide a means of reconciling the wages shown on the third party's Forms 941 for the calendar year and do not reflect sick pay paid to individual employees. Detailed instructions for completing these recap forms appear in section 6 of Publication 15-A, *Employer's Supplemental Tax Guide.*

However, the employer and third party may choose to enter into a legally binding agreement designating the third party to be the employer's agent for purposes of preparing and filing Forms W-2 reporting sick pay. If such an agreement is executed, the third party prepares and files the actual Forms W-2 for each employee who receives sick pay from the third party. The employer, and not the third party, should prepare and file the "third-party sick pay recap Forms W-2 and W-3 to reconcile its actual Forms W-2 and W-3 filed with its Forms 941 for the year.

For additional information, see section 6 of IRS Publication 15-A.

PAY ADVANCES AND EMPLOYENT TAXES

BY CLARK FLETCHER, FSLG SPECIALIST (PACIFIC)

State and local governments use various payroll methods and periods to make wage payments to employees. These methods and periods may be set by statute or contract, or by any other means available to the employer. One common practice that may cause confusion is offering employees draws or advances against their normal pay. Governmental employers may have a policy that limits the amount of the draws, sets the cut-off date for requesting a draw, or establishes some form of standard practice for processing and issuing an employee advance prior to the end of the payroll period. In each case, it is important to be aware of how these practices may affect your employment tax responsibilities.

Are draws or advances taxable wages to the employee?

The general rule for constructive receipt of income under Internal Revenue Code (IRC) section 451 states that any item of income shall be included in the gross income for the taxable year received by the taxpayer. Regulation 1.451-2 establishes that the taxpayer need not have actual possession of income if the income is credited to his account, set apart, or otherwise made available so that he or she may draw upon it at any time without substantial restrictions or limitations, or that he or she could have drawn upon it during the taxable year if notice of intention to withdraw had been given. This is the constructive receipt principle. The employment tax regulations (under sections 3121, 3401, and 3402) define wages as all remuneration paid for employment unless specifically excluded. These regulations further stipulate that the name by which remuneration for employment is designated is immaterial. The regulations state that wages are paid and received at the time of payment to the employee (actual receipt) or when credited to the account of or set apart for an employee (without substantial restrictions or limitations). It is clear from the language in Regulation 1.451-2 and in the employment tax regulations that the definition of wage income is intended to mirror the definition of constructive receipt of income. Therefore, if an employee has receipt of a draw, the draw must be recognized as wage income. The following rulings illustrate this principle.

How has the IRS ruled on advance payments previously?

Revenue Ruling 68-239 discusses advance payments that are paid to salesmen against unearned salary, commissions, or other remuneration for which they are to perform services and concludes that advances are wages at the time of payment. However, Revenue Ruling 68-337 makes the distinction that when advances are paid to employees and acknowledged by a note or letter of indebtedness, the advances are treated as loans. This would rarely be the case for government employers, however, as most governmental employers are prohibited from lending money to their employees.

Is an employer required to withhold from draws or advances?
An employer is required to collect tax by deducting and withholding the taxes from the employee's wages when actually or constructively paid. The employment tax regulations define constructively-paid wages in terms similar to Regulation 1.451-2. Unless a payment qualifies as a loan, as described above, or is exempt from wages by some other statute, withholding is required. The definition of wages as income and the requirement to withhold from wages eliminate any doubt that the principle of constructive receipt of income applies equally to employment taxes and income taxes.

Does the payment of advances change the payroll period?
An employer's payroll period means the period of service for which a payment of wages is *ordinarily* made to the employee. The income tax withholding regulations also state that it is immaterial whether wages are always paid at regular intervals. The regulation cites the example of an employer who establishes a calendar week payroll period and makes a mid-week payment (for services already rendered) to an employee. The calendar week payroll period is not affected by this mid-week wage payment. Therefore, the actual pay date has no bearing on the established payroll period.

Revenue Ruling 65-231 addresses the determination of the proper payroll period to be used for withholding tax purposes when making a lump-sum payment of accrued wages. It states that since a school *ordinarily* pays wages to its' teachers semimonthly, the withholding should be based on a semimonthly payroll period. An employee can have only one payroll period with respect to wages by any one employer. Therefore, if Municipality A creates, in the normal course of operations, a calendar month payroll period, the period for determining the withholding is based upon the monthly payroll period. It may seem, then, that if a governmental employer establishes a monthly payroll period and makes advances to its employees during the payroll period, then the withholding tax obligation does not arise until the payroll period closes. This conclusion is incorrect, however, because setting a payroll period determines the *basis* for determining the withholding of employment taxes from an employee; it does not supersede the principle of constructive receipt, and does not establish when payroll funds are paid or when the withholding taxes are due.

Does allowing employee advances defer the withholding of employment taxes or other deduction amounts until the "regular" payroll period ends? If advance payments to employees are considered wages for employment tax purposes, then the employers would be obligated to withhold employment taxes from these payments and to deposit the withheld taxes at the prescribed time for that pay date. Additionally, a new payroll period may be created, which would establish a different basis for income tax withholding.

Revenue Ruling 66-376 discusses the mode or time of collection of withholding taxes when advance wage payments have been made. In the case reviewed in this ruling, an employer ostensibly establishes a four-week payroll period but makes advance wage payments, in approximately one-half of the net monthly wages, to its employees at the end of the second week of each payroll period.

The ruling determined that a biweekly payroll period had been established when the advance wage payments were paid and, therefore, the employer is obligated to withhold and deposit the employment taxes. The regularity with which the advances were paid established a common payroll and business practice, so that even if there is no written policy allowing for employee advances, ***the facts and circumstances dictate the true payroll period.*** The amount of the advances is immaterial because the issue in the Regulations and Revenue Rulings is when wages are actually paid, in keeping with the principle of constructive receipt of income.

How are advances for travel or other employee expenses treated? If payments are made in advance for anticipated expenses, they are not subject to withholding if they are made under an accountable plan. For more information on the requirements of an accountable plan, see Publication 15 (Circular E), *Employer's Tax Guide.* Advances for expenses not made under an accountable plan are treated as wages and subject to withholding as described above.

What are the consequences of a new payroll period being established? If Municipality A establishes a policy that allows advance wage payments to be paid to its employees on a regular basis and, in fact, does make advance wage payments, then a "new" payroll period is created for those employees and the obligation to collect and deposit the employment taxes is imposed upon the employer. The basis for withholding of income taxes on the employees who receive advance wage payments would be determined by the payroll period in which the advances (or wages) were paid.

If you have questions about when employment taxes are due, contact the FSLG Specialist in your area. A list of Specialists appears at the back of this newsletter.

NEW TAX EXEMPT BONDS PUBLICATION FOR 501(C)(3) BONDS

BY JOSEPH GRABOWSKI, SENIOR TEB ANALYST

The Office of Tax Exempt Bonds, a part of IRS Tax Exempt and Government Entities (TE/GE) Operating Division, has announced the release of its new Tax-Exempt Bonds for 501(c)(3) Charitable Organizations Guide, (Publication 4077), is available on the IRS website at www.irs.gov/bonds. A printed version will be available later in March.

The publication provides an overview for state and local government issuers and 501(c)(3) charitable organizations of the general post-issuance rules under the Federal tax law that generally apply to municipal financing arrangements commonly known as 501(c)(3) bonds. The guide provides information on:

- Filing requirements;
- Qualified use of proceeds;
- Private business use, issuance costs;
- Management and service contracts;

- Arbitrage and yield restriction rules;
- Federal guarantees prohibition;
- Refundings; and
- Educational and outreach services available.

The guide 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.

To learn more about VCAP and the other TEB programs available, visit the site at www.irs.gov/bonds or contact Clifford Gannett, Manager of Tax Exempt Bonds Outreach Planning and Review at 202-283-9798, or Joseph Grabowski at 202-2839781.

CALENDAR OF EVENTS

National Association of State Comptrollers
Annual Conference
Indianapolis, IN
March 18-20, 2004
nasact.org

Federation Tax Administrators
Annual Conference
Providence, RI
June 6-9, 2004
taxadmin.org

Government Finance Officers Association
Annual Convention
Milwaukee, WI
June 13-16, 2004
gfoa.org

Federal Agency Seminar
FSLG
Washington, DC
June 23, 2004
irs.gov/govts