FSLG NEWSLETTER VOLUME 1 SUMMER 2003

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CONTENTS

MESSAGE FROM THE EDITOR

STEWART ROULEAU, FSLG SENIOR ANALYST

Some of the most challenging and complex tax questions for government entities concern retirement plans. In this issue, we have two articles by members of IRS Employee Plans office concerning plans that are unique to public employees – section 403(b) tax-sheltered annuity plans, for employees of public schools and certain tax-exempt organizations; and section 457 “nonqualified” deferred compensation plans for state and local government employees and tax-exempt organizations.

These articles address some current issues that we hope will address questions you have about these plans. For more general information about these plans, you may want to consult IRS Publication 571, Tax Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations, or Publication 575, Pension and Annuity Income. You can also contact us with your specific questions by the methods indicated in the articles.

Please contact your local FSLG Specialist with any questions you have. A directory is included inside this newsletter.

The explanations and examples in this publication reflect the interpretation by the IRS of tax laws, regulations, and court decisions. It is intended for general guidance only, and is not intended to provide a specific legal determination with respect to a particular set of

circumstances. You may contact the IRS for additional information. You also may want to consult a tax advisor to address your situation.

IRS PUBLISHES GUIDANCE ON 457(b) ELIGIBLE GOVERNMENTAL RETIREMENT PLANS
BY DANIEL S. GARDNER- GREAT LAKES 403(b)/457 COMPLIANCE COORDINATOR

In the July 11, 2003, edition of the Federal Register, at 68 FR 41230, the Internal Revenue Service issued final regulations covering deferred compensation plans under section 457. These regulations provide the public with guidance necessary to comply with the law and will affect plan sponsors, administrators, participants and beneficiaries. The regulations apply to years beginning after December 31, 2001, and incorporate changes made to section 457 since 1982. Following is a brief overview of some of the more significant issues covered by the regulations as they affect eligible 457 governmental plans.

Funding Rules for Eligible Governmental Plans. All amounts contributed under an eligible governmental plan must be held in trust for the exclusive benefit of participants and their beneficiaries. The trust must be a written agreement that constitutes a valid trust under state law. Salary deferrals must be transferred to the trust within a reasonable period after the date that the amounts would have been otherwise paid to the participant. An example of a "reasonable period" is within 15 business days after the end of the month the deferred amount would have been paid. In general, custodial accounts (mutual funds) and annuity contracts that meet the exclusive benefit requirement are treated as satisfying the trust requirement. See Reg. 1.457-8.

Catch-Up Contribution for Individuals Age 50 or Older. Regulations clarify that governmental participants eligible for both the age 50 and special three-year, prior-to-retirement catch-up elections will be limited to the greater of the two. See Reg. 1.457-4.

Deferral of Sick, Vacation, and Back Pay. Accumulated sick, vacation, and back pay may be contributed to an eligible 457 plan if the deferral agreement is entered into before the beginning of the month the amounts would otherwise have been paid and the participant is still an employee. The regulations continue to require that the deferral agreement be made while employed but permits a deferral agreement for participants retiring or otherwise severing employment to be entered into after the beginning of the month but prior to the time the amounts would otherwise be payable. All contributions, including elective deferrals, accumulated sick, vacation, and back pay, are subject to the statutory deferral limitation for such year, including the age 50 or special catch up elections. See Reg. 1-457-4(d).

Unforeseeable Emergency Distributions. In certain circumstances, an in-service distribution is permitted from an eligible plan to satisfy an unforeseeable emergency. The distribution must be authorized under the written plan and be specifically defined. See Reg. 1.457-6(c).

Transfers to Purchase Permissive Service Credit. The regulations allow for transfers before severance from employment to a governmental defined benefit plan regardless of whether the defined benefit plan is within the same state. The amount transferred cannot exceed the actuarial value of the benefit increase and is not limited to amounts described in section 415(n) as initially suggested. See Reg. 1.457-10(b)(8).

Rolled-In Asset Distribution Restrictions. Regulations require that eligible rolled-in assets be held in a separate account and may not be distributed until a participant is eligible under section 457. See Reg. 1.457-10(e). Additional guidance regarding the treatment of rolled-in assets is a part of the 2003-2004 IRS Business Plan.

Excess deferrals. A plan may self-correct and continue to maintain eligible status if the excess, along with any allocable income, is distributed as soon as is administratively practical after the plan determines that excess exists. Excess deferrals are included in taxable income in the year deferred with allocable income taxable in the year distributed. See Reg. 1.457-4. For information regarding withholding and reporting requirements applicable to eligible 457(b) plans, see Notice 2003-20, 2003-19 I.R.B. 894.

For more information about 457 retirement plans and a complete copy of the 457 final regulations and Notice 2003-20, please visit the Employee Plans web site at www.irs.gov/ep. You can call us toll free with your questions at (877) 829-5500 or e-mail us at RetirementPlanQuestions@irs.gov.

403(b) AUDITS: LAW REQUIRES BROAD COVERAGE FOR ELECTIVE DEFERRALS

BY ANDY CUSHING, IRS MID-ATLANTIC 403(b)/457 COORDINATOR

A recurring issue involving 403(b) plans of many public school and university systems is the requirement of universal eligibility with respect to the right to make elective deferrals. The requirement of universal eligibility states that all employees must be permitted to make elective deferrals of more than $200 per year to the plan. The only exceptions are where the excluded employees are:

1. Covered by another plan offering elective deferrals such as a 401(k) or 457 plan, or another 403(b) arrangement.
2. Nonresident aliens
3. Students regularly attending classes at a school, college or university.

4. Normally scheduled to work less than 20 hours per week.

Of all the above exceptions, #4 has caused the most concern. This article will discuss some fact patterns that have, in the past, resulted in a violation of this requirement.

Pattern 1. Employees are excluded based on a predetermined classification. Often these classified employees are not eligible for other employer provided benefits. Many employer benefits are available only to employees who are expected to work 1000 hours or more over the course of a year. This is a standard established by the Employee Retirement Income Security Act (ERISA) that is not applicable to 403(b) deferrals. Part-time employees may never work more than 1000 hours over the course of a year, but may average 20 or more hours per week during the periods they are actually employed. These employees should be given the opportunity to make elective deferrals to the 403(b) plan even though they may not be eligible for other employer provided benefits.

Pattern 2. Employees are initially hired to work less than 20 hours per week, but changing workload demands cause them to exceed 20 hours. Although there is no hard and fast rule as to when an employee must be considered to "normally" work in excess of 20 hours per week; a safe and easily measurable system would be to keep a rolling average of the number of hours worked. If employees begin to average 20 or more hours per week, they should be offered the opportunity to participate in the plan.

Pattern 3. Employees are hired as part-time, but no record is kept of actual hours worked. This frequently occurs with adjunct, part-time or substitute faculty, but can occur in any field where a contract employee is hired to perform specified duties, and there is no fixed period during which all of the duties are normally performed. In such instances, the employer must make a reasonable attempt to measure the responsibilities of an equivalent full-time employee within that line of business or profession. An employee performing approximately one-half the duties of an equivalent full-time employee would be considered to work 20 or more hours per week and should be given the opportunity to make elective deferrals. For example, if a full-time faculty member normally teaches 4 courses per semester, then an adjunct faculty member who teaches 2 or more courses would be considered to be employed for 20 or more hours per week and should be permitted to make elective deferrals to the plan.

Pattern 4. An employee is hired for more than one position with the same employer, and normally works less than 20 hour per week in each position. If the combined hours worked in each position equals or exceeds 20 hours per week, the employee is entitled to make elective deferrals to the plan. If the employee appears on separate payroll systems, then controls

should be established to determine the total number of hours worked by the employee.

Correction: If you discover that your plan does not offer the right to make elective deferrals to all eligible employees, it is important to make corrections as soon as possible. In many cases, correction can be accomplished without notifying the IRS or paying any penalties. For additional guidelines on correcting eligibility failures see Revenue Procedure 2003-44. This document is available online at www.irs.gov.

FEDERAL EXCISE TAX REFUND GUIDELINES FOR FUEL USED BY STATE AND LOCAL GOVERNMENTS

BY PATRICK SCHMUCKER, SBSE EXCISE TAX AGENT AND JANIE SMITH, FSLG SPECIALIST

Generally, Federal excise taxes are imposed on certain fuels, including gasoline and diesel fuel. The tax is imposed at the time of purchase.

The Secretary of the Treasury has provided guidelines whereby gasoline suppliers at their option can sell gasoline and diesel fuel tax-free to state and local governments or the District of Columbia. A local government includes any political subdivision of a State. An Indian tribal government is treated as a state only if the fuel is used in an activity that involves the exercise of an essential tribal government function.

In order to qualify for tax-free treatment, the state or local government must purchase the fuel for its own exclusive use. State and local government entities may benefit from Internal Revenue Code Section 4221 (a) (4). This section exempts these entities from the Federal motor fuel excise taxes. Since there are separate regulations governing gasoline and diesel fuels, we will address these regulations governing each fuel separately.

Gasoline

State and local government entities using gasoline for legitimate governmental functions have the option of purchasing the fuel tax-free from a fuel retailer who qualifies as a gasoline wholesale distributor. If fuel is to be purchased tax-free, a certificate of ultimate purchaser must be signed annually and given to the distributor. The certificate is usually provided by the distributor and serves as proof for the entity to certify that the fuel will be used solely by the government entity purchasing the gasoline.

If the gasoline is purchased from a fuel retail distributor and includes the fuel tax, the buyer can complete Form 8849, Claim For Refund of Excise Taxes, to make

a claim for refund. The law requires that records be maintained to establish both the type and quantity of fuel purchased. Since there are different Federal fuel taxes on gasoline and gasohol, it is important that the records substantiate the fuel type (i.e. gasoline or gasohol) as well as the quantity purchased. Note that the amount of any gasoline purchased tax-free cannot be included on a Form 8849 claim, as the tax was never paid.

Diesel Fuel

Diesel fuel can also be purchased tax-free from a registered ultimate vendor. The status of registered ultimate vendor is given to petroleum distributors as warranted under the Internal Revenue Service guidelines. The guidelines require that a petroleum distributor file Form 637, Application For Registration. Form 637 guidelines require that if diesel fuel is to be purchased tax-free, an annual exemption certificate must be presented to the ultimate vendor registrant.

It is important to note that while the Internal Revenue Code and Regulations allows a state and local government entity to purchase diesel tax-free from any registered ultimate vendor, the regulations prohibit the filing of Form 8849 in order to obtain a refund for excise tax paid on diesel fuel purchases. Accordingly, state and local government entities should determine which fuel supplier could offer this option. Therefore, if the state and local government entity has purchased diesel fuel tax-paid, a refund must be requested from the registered ultimate vendor.

Further information regarding Federal excise tax on motor fuel can found in Publication 510, Excise Taxes for 2003, Publication 378, Fuel Tax Credits and Refunds, as well as Form 8849, Claim For Refund of Excise Taxes and its accompanying instructions. Form 8849, Schedule 1, addresses the non-taxable use of fuels in general. These forms and publications are available through the IRS Web Site at www.irs.gov and by phone ordering at 1-800-829-3676. For additional customer service please contact us at 877-829-5500.

Federal, State and Local Governments Contacts

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	Fred Darbonnier	(916) 974-5614	
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Vermont	Fran Reina	(315) 793-8171	
Virginia	Eugenia Bahler	(703) 285-2350	138
	Michael Durland	(540) 887-2600	18
Washington	Clark Fletcher	(425) 489-4042	
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	Ruthann Watts	(262) 798-8386	
Wyoming	Dwayne Jacobs	(307) 672-7425	33

CALENDAR OF EVENTS

The following upcoming national events may be of interest to you. FSLG representatives may be at these events. For more information, contact the organization.

National Association of Government Defined Contribution Administrators, Inc.
Annual Conference
Nashville, TN
September 20-25, 2003
nagdca.org

Association of School Business Officials International
Annual Meeting and Exhibits

Charlotte, NC
October 31-November 4, 2003
asbo.org

National Association of Counties
Health, Human Services and Workforce Conference
Miami, FL
November 6-9, 2003
naco.org

Form W–4, Employee's Withholding Allowance Certificate

BY HANS VENABLE, FSLG PROGRAM ANALAYST

When you hire an employee, you must have the employee complete a Form W-4, *Employee's Withholding Allowance Certificate*. Form W–4 tells you, as an employer, how many withholding allowances to use when you deduct Federal income tax from the employee's pay. Form W-4 includes detailed instructions, and a worksheet to help the employee figure his or her correct number of withholding allowances.

Form W–4 is also used by an employee to tell you not to deduct any Federal income tax from his or her wages. To qualify for this exempt status, the employee must have had no tax liability for the previous year and must expect to have no tax liability for the current year. However, if the employee can be claimed as a dependent on a parent's or another person's tax return, and has income exceeding $750 that includes more than $250 of nonwage income, such as interest on a savings account, the employee cannot claim to be exempt. Employees who claim exemption from withholding must complete a new Form W-4 by February 15th each year to continue claiming exempt status.

After the employee completes and signs the Form W-4, you should keep it in your files. This form serves as verification that you are withholding Federal income tax according to the employee's instructions. Do *not* send it to the IRS.

However, if you receive a Form W-4 on which the employee claims more than 10 withholding allowances, or claims exemption from withholding and his or her wages would normally be expected to exceed $200 per week, you must send a copy of that Form W-4 to the IRS with your next employment tax return along with a cover letter giving your name, address, EIN, and the number of forms included. If you want to submit the Form W-4 earlier, you can send a copy of the Form W-4 to the IRS. The IRS will send you further instructions if it determines that you should not honor one or more Forms W-4.

You should inform your employees of the importance of submitting an accurate Form W-4. An employee may be subject to a $500 penalty if he or she submits, with no reasonable basis, a Form W-4 that results in less tax being withheld than is required. There is no penalty if your employee doesn't claim enough withholding allowances and has too much withheld.

You should keep blank Forms W-4 on hand so you can provide them to your current and new employees. An employee may want to change the number of withholding allowances or his or her filing status on Form W-4 for any number of reasons, such as marriage, an increase or decrease in the number of dependents, or an increase or decrease in the amount of itemized deductions or tax credits anticipated for the tax year. Any of these reasons could affect the employee's tax liability. If you receive a revised Form W-4 from an employee, you must put it into effect no later than the start of the first payroll period ending on or after the 30th day from the date you received the revised Form W-4.

The IRS Website has a calculator that employees can use to help them calculate the number of allowances to claim on the Form W-4 . The web address is: www.irs.gov/individuals/article/0,,id=96196,00.html.

If an employee fails to give you a properly completed Form W-4, you must withhold Federal income tax from his or her wages as if he or she were single and claiming no withholding allowances.

For additional information, refer to Publication 15 (PDF), *Circular E, Employer's Tax Guide*, Publication 505 (PDF), *Tax Withholding and Estimated Tax*, and Publication 919 (PDF), *How Do I Adjust My Tax Withholding*.

FAQ: PAYMENTS TO FIREFIGHTERS AND EMERGENCY WORKERS

Many questions have been raised recently concerning situations involving firefighters. The following questions provide the official IRS position with respect to some of these issues.

Are volunteer firefighters employees?

To determine whether a firefighter is an employee, use the same criteria as you would apply to other workers. It also does not matter whether workers are called “volunteers.” Any worker who receives compensation for services performed subject to the will and control of an employer is a common-law employee. For more information on determining whether a worker is an employee, see Publication 15-A, Employer’s Supplemental Tax Guide, or Publication 963, Federal-State Reference Guide (available on the FSLG web site). If the worker is

a common-law employee, the amounts paid, whether in cash or in some other form, are subject to withholding for income, social security and Medicare taxes.

Are firefighters subject to social security and Medicare tax?

Under section 3121 of the Internal Revenue Code, all employees are subject to social security and Medicare taxes unless an exception applies. Most government workers are covered either under these statutory provisions, or by a section 218 Agreement between the employing government and the Social Security Administration to provide social security and/or Medicare coverage for certain groups of workers. This agreement may provide specific coverage rules for firefighters. As of July 2, 1991, all public employees who are not covered by a section 218 Agreement or a qualifying public retirement plan are subject to mandatory social security and Medicare taxes.

Who is an emergency worker?

Under Internal Revenue Code section 3121(b)(7)(F)(iii), an exception is provided from social security and Medicare coverage for a worker “serving on a temporary basis in case of fire, storm, snow, earthquake, flood, or other similar emergency.” This exception is provided only for temporary workers who respond to unforeseen emergencies. It does not apply to workers who work on a recurring, routine, or regular basis, even if their work involves situations that may be considered emergencies.

How are expense reimbursements to firefighters treated?

Reimbursements to firefighters, or any workers, are not subject to tax and withholding if they are made under an accountable plan. An accountable plan must (1) require workers to substantiate actual business expenses, (2) allow no reimbursements for unsubstantiated expenses, and (3) require that any amounts received that exceed substantiated expenses be returned within a reasonable period. Any amounts paid for reimbursement that do not meet these conditions are considered made under a nonaccountable plan and are treated as regular wages. Therefore, a per diem amount that does not reimburse documented expenses is includible in income and subject to income, social security and Medicare taxes. It does not matter whether the amount is paid as reimbursements, a per diem, or under a point system.

Is the value of special benefits or incentives provided to volunteer firefighters taxable?

Taxable income includes any economic or financial benefit conferred on an employee. Unless Federal tax law provides an exclusion from income, social security, or Medicare taxes for a particular benefit provided, it is reportable as wages and subject to withholding.

TAX EXEMPT BONDS ESTABLISHES KNOWLEDGE SHARING GROUP
BY JOSEPH GRABOWSKI, SENIOR TEB ANALYST

Tax Exempt Bonds (TEB) has established a Knowledge Sharing Group on Tax Exempt Bond Returns. The group will utilize the knowledge and experience of TEB personnel to review the TEB returns, instructions and related processing functions to determine whether changes and improvements are needed.

The goal of the group will be to improve the overall information reporting on tax-exempt bonds by ensuring that information is being requested in a clear and concise manner and that the return instructions provide bond issuers a clear understanding and description of the return items.

The group will be comprised of individuals from TEB Outreach, Planning and Review (OPR) and the field, with the Manager, OPR, Clifford Gannett, serving as an advisor to the group. Initially, the group will be considering filing errors occurring on the Forms 8038 to determine whether instructions are clear and adequate. Other items that will be considered include reporting on lease/installment arrangements, lines of credit and commercial paper transactions.

TEB encourages the members of the bond community to submit any suggested revisions to returns and instructions they feel necessary. Suggested revisions can be mailed to the Manager, TEB OPR, at: 1111 Constitution Ave. N.W., Washington, D.C., 20224, T:GE:TEB:O. Suggestions may also be sent by Fax to 202-283-9797. If you would like more information on this program, you may also call Joe Grabowski at 202-283-9781.

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