

Internal Revenue Service
Office of Federal, State and Local Governments

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FSLG Newsletter – January 2011

This is the semiannual newsletter of the office of Federal, State and Local Governments (FSLG) of the Internal Revenue Service. Our mission is to ensure compliance by Federal, state, and local governmental entities with Federal employment and other tax laws through review as well as educational programs.

For more information, visit our web site at www.irs.gov/govt. For account-related assistance, contact Customer Account Services at 1-877-829-5500. To identify a local FSLG Specialist, see the directory at the end of this newsletter.

The explanations and examples in this publication reflect the interpretation by the IRS of tax laws, regulations, and court decisions. The articles are intended for general guidance only, and are 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 may also want to consult a tax advisor to address your situation.

Federal, State and Local Governments

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REGULATIONS ELIMINATE PAPER DEPOSIT COUPONS

On August 19, 2010, IRS News Release 2010-92 announced proposed regulations (REG 153340-09) that would require all Federal tax deposits to be made using the Electronic Federal Tax Payment System (EFTPS) beginning January 1, 2011. On December 7, 2010, the IRS published [Treasury Decision 9507](#), making these regulations final. The new regulations relate to all tax types that have been paid with Form 8109, Federal Tax Deposit Coupon:

- Form 720, Quarterly Federal Excise Tax Return
- Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return (includes Form 940-PR)
- Form 941, Employer's QUARTERLY Federal Tax Return (includes Forms 941-M, 941-PR, and 941-SS)
- Form 943, Employer's Annual Federal Tax Return for Agricultural Employees
- Form 944, Employer's ANNUAL Federal Tax Return (includes Forms 944-PR, 944(SP), and 944-SS)
- Form 945, Annual Return of Withheld Federal Income Tax
- Form 1120, U.S. Corporation Income Tax Return (includes Form 1120 series of returns and Form 2438)
- Form 990-T, Exempt Organization Business Income Tax Return
- Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation
- Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- Form CT-1, Employer's Annual Railroad Retirement Tax Return

The Treasury Decision notes that the Treasury Department will no longer maintain the paper deposit coupon system after 2010. The regulations do not change existing rules for determining a depositor's status as either a monthly or semiweekly depositor for employment taxes. The regulations also do not change existing rules on whether a taxpayer can remit taxes with a return in lieu of making a deposit. For example, Form 941 filers with a deposit liability of less than \$2,500 for a return may continue to submit payment with the return.

Depositing electronically offers many advantages over the paper coupon system. It allows deposits to be made at any time, from a computer or telephone, and to schedule deposits in advance. The system also greatly reduces the possibility of errors and eliminates the need to order and retain coupons. EFTPS is pre-enrolling all taxpayers that used a coupon in the past 18 months but do not have an active EFTPS enrollment. To get up to date information or to enroll in EFTPS, visit the EFTPS website at www.eftps.gov, or call 1-800-555-4477.

For more information, see the [final regulations](#).

HELP IMPROVE THE FSLG WEBSITE

*BY MARYANN MOTZA, COLORADO SOCIAL SECURITY ADMINISTRATOR
MEMBER, ACT ADVISORY COMMITTEE*

The Federal, State, and Local Governments (FSLG) office of the Tax Exempt and Government Entities (TE/GE) Division of the IRS has a website that provides tax Information pertinent to Federal, State, & Local Governments (located at <http://www.irs.gov/govt/fslg/index.html>).

The IRS Advisory Committee on Tax Exempt and Governmental Entities (ACT), FSLG Subcommittee, is reviewing the FSLG website to assess its usefulness and value to FSLG customers. To aid us in that process, we are asking public employers and their legal and financial advisors as well as public employees to complete a brief questionnaire related to the website. The National Conference of State Social Security Administrators (NCSSSA) has graciously agreed to serve as the host website for the ACT/FSLG Subcommittee's evaluation of the FSLG website.

The ACT/FSLG Subcommittee asks those who want to provide feedback to the IRS on its FSLG website to go to <http://www.ncsssa.org/whatsnewcombo.html> and click on the "FSLG Website Questionnaire" link, which will take you to the survey tool we are using to compile the data. Please complete the questionnaire **on or before March 1, 2011**. We know that your time is valuable, so the questionnaire is structured to only take a few minutes to complete. There is no cost to you for completing the form on-line.

To ensure the feedback we receive is as complete and thorough as possible, we suggest that, prior to completing the questionnaire, you review information contained throughout the current FSLG website. If you do not have time to review the entire website, we suggest that you, at a minimum, review the links on the left side of the home (landing) page of the website (<http://www.irs.gov/govt/fslg/index.html>), which are labeled as follows:

Federal, State, and Local Government Topics

- [About FSLG](#)
- [FSLG Newsletter](#)
- [FSLG Customer Services](#)
- [Educational Products](#)
- [FSLG Fact Sheets](#)
- [FSLG FAQs](#)
- [FSLG Toolkit](#)
- [FSLG Work Plan](#)
- [More Topics . .](#)

IRS Resources

- [Compliance & Enforcement](#)
- [Contact My Local Office](#)
- [e-file](#)
- [Forms and Publications](#)
- [Newsroom](#)
- [Frequently Asked Questions](#)
- [Taxpayer Advocate Service](#)
- [Where To File](#)

We also ask you to comment on the search feature for the FSLG website (located in the upper right of each page).

We will consider all comments and suggested changes to the site, but cannot guarantee that all recommendations will be incorporated into the final report that will be provided to the IRS during the June 2011 public meeting. No individual responses received during the evaluation process will be documented or listed under the originator's name/entity name. All data will be recorded according to a number we will assign to all evaluations we receive. Only cumulative data will be reported in the June 2011 ACT Report, which will be available later that month the [IRS website](#).

If you have questions or need further information about the website evaluation project, the ACT/FSLG Subcommittee's evaluation process, or other information pertinent to this project, please email Maryann Motza, Project Leader, at: maryann.motza@state.co.us.

Thank you in advance for your help.

Maryann Motza
Patti Phillips
Paul Carlson

FOSTER CARE AND BIOLOGICAL PARENTS

BY WANDA VALENTINE, FSLG SENIOR ANALYST

State and local governments provide programs and services to enable disabled children and adults to avoid institutionalization and to remain at home and in the community. Questions have arisen whether certain payments to biological parents for the care of their own children may be excludable from gross income as “difficulty of care payments” under section 131 of the Internal Revenue Code.

Section 131

Section 131 provides that a foster care provider may exclude “qualified foster care payments” from gross income. A qualified foster care payment must be made pursuant to the foster care program of a state or political subdivision of a state. The payer must be a state, a political subdivision of a state, or a “qualified foster care placement agency.” A qualified foster care placement agency is a placement agency that is licensed or certified - by a state, a political subdivision of a state, or an entity designated by a state or a political subdivision of a state - for the foster care program of the state or the political subdivision of the state.

In addition to payments for basic foster care, qualified foster care payments may include “difficulty of care payments.” Difficulty of care payments are compensation for providing the additional care of a qualified foster individual that is required by reason of a physical, mental, or emotional handicap of the individual, if the care is provided in the foster care provider’s home and the state has determined a need for the additional compensation.

Section 131 does not define the term “foster care” or “foster care provider.” However, the ordinary meaning of foster care excludes care by a biological parent. To “foster” means to give parental care to a child who is not one's natural or legally adopted child. In addition, section 152(f)(1)(A)(i) and (ii) of the Code distinguish between a son or daughter and a foster child. Section 152(f)(1)(A)(i) defines the term “child” to mean an individual who is a son, daughter, stepson, or stepdaughter of the taxpayer or parent; whereas, section 152(f)(1)(A)(ii) defines the term “child” to include an eligible foster child of the taxpayer, which means an individual who is placed in the home of the taxpayer by an authorized placement agency, judgment or court order. IRS Chief Counsel published a Program Manager Technical Assistance (PMTA 2010-007) on March 29, 2010, concluding that a biological parent may not qualify as a foster care provider under section 131.

Example

County X makes payments to Parent Y, the biological mother of a disabled biological minor son, for providing 4 hours a day of nonmedical services. The payments provided to Parent Y cannot qualify as “difficulty of care payments” under section 131 of the Internal Revenue Code and are not excludable from gross income. Rather, these payments are compensation for services that are includible in the biological parent’s gross income.

CHANGES TO DRUG REIMBURSEMENTS UNDER FLEXIBLE SPENDING ARRANGEMENTS

BY STEWART ROULEAU, FSLG SENIOR ANALYST (WASHINGTON, DC)

Section 9003 of The Patient Protection and Affordable Care Act of 2010 adds section 106(f) to the Internal Revenue Code, imposing new restrictions on reimbursements for drug expenses from a health flexible spending arrangement (health FSA), or a health reimbursement arrangement (HRA).

A health FSA permits salary reduction by an employee to remain exempt from tax if used to reimburse medical expenses. The amounts placed in the FSA generally must be used within the same year they are contributed. An HRA is funded only by employer contributions and also excludes reimbursements from income if used to reimburse medical expenses. Amounts in an HRA may be carried over from year to year.

Under the new law, beginning with purchases made after December 31, 2010, only reimbursements for drugs that have been prescribed (regardless of whether they are available without a prescription) or insulin are excluded from income when paid under a health FSA or HRA. Thus, over-the-counter drugs purchased without a prescription (except for insulin) may not be reimbursed from a health FSA or HRA. The change does not affect other health care expenses, such as medical devices, eye glasses, contact lenses, co-pays and deductibles. The restriction applies even if funds were set aside in a health FSA or HRA before December 31, 2010.

Because health FSA or HRA debit cards cannot currently substantiate that over-the-counter drug expenses are prescribed, these cards may no longer be used to purchase over-the-counter drugs beginning January 1, 2011. However, the IRS will not challenge the use of these cards for over-the-counter drug expenses incurred through January 15, 2011, if the expenses otherwise comply with the debit card substantiation rules.

The same restrictions on over-the-counter drugs apply to a health savings account (HSA) or an Archer medical savings account (Archer MSA). These are accounts individuals set up with a trustee to pay for qualified medical expenses. Effective for distributions made after 2010, the new law also increases penalties from 15 to 20 percent for distributions from these accounts that are not used for medical expenses.

For more information on health FSAs or HRAs, or HSAs and Archer MSAs, see [Publication 969](#) and the [Cafeteria Plans Q&A](#) on the FSLG website. See also Notice 2010-59 on the new rules for over-the-counter drugs.

ISSUES FOR NONRESIDENT ALIEN STUDENTS AND TEACHERS

BY ROBERT CHING, FSLG SPECIALIST (NEW MEXICO)

Many government-affiliated schools, colleges and universities employ students, teachers and scholars who do not have U.S. citizenship. The correct tax treatment of these individuals can depend on several considerations, including visa status, residency, sources of income and the length of stay. These entities need to be familiar with rules governing treatment of nonresident individuals. This article provides an introduction to the topic with direction to sources for further information.

The aim of this discussion is to provide some practical guidance in identifying the problems to be addressed when an educational institution employs a foreign worker. These foreign workers are often referred to as nonresident aliens. This article addresses only employees, **not** NRAs who are treated as independent contractors. For information on aliens performing independent personal services, see [Publication 515](#).

Who is a Nonresident Alien?

Nonresident aliens (NRAs) are individuals who are NOT considered residents of the United States under §7701(b) of the Internal Revenue Code who are working for a U.S. employer. This Code section controls the determination of who is a resident alien and who is a nonresident alien for purposes of income taxation.

If it is determined that an individual is a resident alien, then he or she is subject to the same tax treatment applied to other resident individuals.

If the individual is determined to be an NRA, then you must consider both the Code provisions and applicable tax treaties. For information on specific tax treaties, see [Publication 901](#), U.S. Tax Treaties.

What records should be kept if an individual is an NRA?

An institution must identify all foreign student and teachers who are not immigrating to the U.S. These foreign students and teachers have been admitted to the U.S. temporarily for the specific purpose of studying or training. All documentary evidence such as:

- Visas
- Copies of passports
- Form 8233, Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual
- I-94, Arrival-Departure Record
- I-20 A-B/ID, Certificate of Eligibility for Nonimmigrant (F-1) Student Status)
- Communications with the US Citizenship and Immigration Services (USCIS), etc.

The IRS does not make determinations related to immigration or legal status, but addresses the classification of individuals as resident or nonresident aliens, and the correct application of the tax law based on that determination. If your institution has no NRA employees, you do not need to address the rules discussed in this article.

Employment and Student Visas

When you have identified the NRAs, you should determine whether any of the NRAs at the institution are receiving compensation as employees of your institution. For this purpose, compensation for employment may include cash payments, as well as compensation in the form of a scholarship, grant or tuition reduction.

A “qualified scholarship” is exempt from gross income under Internal Revenue Code section 117. In addition to establishing the purpose and use of the funds provided to the individual, you need to determine whether a portion of the amounts received represents payment for teaching, research or other services required of the recipient (see Regulation §1.117-6(d)). The exclusion from gross income under §117 does **not** apply to any portion attributable to services. Such amounts should be treated as wages; see Regulation §1.117-6(d)(4).

If the NRA has an F, J, Q or M visa, and is performing services **that carry out the purpose of the visa**, then the wages are **not** subject to social security or Medicare taxes (FICA). See §3121(b)(19). Notwithstanding the limitations of §3121(b)(19), an NRA student’s wages may be exempt from social security or Medicare taxes under the broader student worker exemption of §3121(b)(10).

However, if the NRA is a postdoctoral student/fellow, he or she may **not** be able to claim the student exemption from FICA for certain education-related services

provided under §3121(b)(10). See [Revenue Procedure 2005-11](#) and the article “Medical Residents and FICA” in [July 2010 FSLG Newsletter](#).

If the scholarship is not exempt under §117 and is **not** awarded in exchange for services, the payment may be reportable on Form 1042-S (see §871(c)) and could be subject to 14% or 30% withholding (see §1441(b)).

What steps should be taken, and when, for NRA employees?

In the case of NRA employees, the following should be considered:

- Students and teachers on a valid F, J, Q or M visa must apply for a social security number (Form SS-5) and **not** for an ITIN on Form W-7.
- Form W-4 should be completed with marital status “Single” and claiming one exemption (an exception applies for residents of Canada, Mexico, and Korea; see [Publication 15](#)). Nonresident Alien” should be written above Line 6 of W-4.
- In addition to regular income tax withholding, an amount applicable to NRAs must be added by the employer (see section 9 of [Publication 15](#) and [Notice 2009-91](#) for details).

However, if the NRA is a postdoctoral student/fellow, he or she may **not** be able to claim the student exemption from FICA for certain education-related services provided under §3121(b)(10). See [Revenue Procedure 2005-11](#) and the article “Medical Residents and FICA” in [July 2010 FSLG Newsletter](#).

These are some of the salient issues for NRA student and teacher employees. For more information refer to the following resources:

- [Publication 15](#), Circular E (also Publication 15-A).
- [Publication 515](#), Withholding of Tax on Nonresident Aliens
- [Publication 901](#), US Tax Treaties.
- Rev. Proc. 88-24, Withholding at less than the statutory rate.
- Rev. Proc. 89-67, Scholarship or grant.

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