

Internal Revenue Service
Office of Federal State and Local Governments
www.irs.gov/govt

FSLG Newsletter ~ July 2006

This is the semi-annual newsletter of the office of Federal, State and Local Governments of the Internal Revenue Service. Our mission is to ensure compliance by federal, state and local government entities with federal employment tax laws through review and educational activities as well as through educational programs.

For more information, visit our web site at www.irs.gov/govts. For account related assistance, contact the Customer Account Services at 1-877-829-5500. To identify a local FSLG Specialist, see the directory at the end of the 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 also may want to consult a tax advisor to address your situation.

Internal Revenue Service
Federal, State and Local Governments

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FY 2006 MID-YEAR RESULTS

In FY 2006, FSLG's focus is essentially the same as it was in FY 2005. With regard to our compliance activities, we continue to focus on the two strategic initiatives: the federal agency initiative and the large entities initiative. An entity is considered a large entity if it has an annual payroll in excess of \$40 million.

Under the federal agency initiative, by March 2006, we had commenced examinations of 23 federal agencies and 24 large entities. Some of the significant issues raised in these examinations and the general exam program have been: worker classification, fringe benefits, relocation payments, settlement payments, information return filings, and backup withholding.

FSLG continues to conduct compliance checks, expecting to complete 825 of them this fiscal year. This year, we decided to go back and conduct compliance checks on 125 entities on which we had conducted compliance checks in FY 2002. Each of these entities received an advisory letter from FSLG as a result of a compliance check. The purpose of the new compliance check is to determine whether an entity is in compliance with the advisory letter. The results of this initiative will be published in the January 2007 Newsletter.

In addition to its compliance activities, FSLG has also conducted about 145 outreach events with 10,673 participants. In May we held our first Phone Forum with the National Conference of State Social Security Administrators. The participants were e-mailed the text materials and joined the educational event by simply placing a telephone call to a toll free number. We plan to conduct more of these events in the future.

Finally, the FSLG web site (www.irs.gov/govt) has just added a new item called the Government Entity Toolkit. It has two parts: (a) Public Employer's Toolkit, which provides information to government entities and payroll officers working for government entities in meeting their federal employment tax obligations and (b) Government Entity Compliance Toolkit, which provides information to help government entities and their powers of attorney understand the enforcement process. This product will be updated and enhanced over time. We think you will find this to be useful.

HEALTH REIMBURSEMENT ARRANGEMENTS

HANS VENABLE, FSLG ANALYST

A Health Reimbursement Arrangement (HRA) can be a cost-effective means for a government employer to provide tax-favored health benefits to its employees. However, prior to entering into an HRA, you should be aware of the requirements of these arrangements. The IRS has recently become aware of certain plans that may not meet the requirements of an HRA.

An HRA is an employer-funded arrangement designed to reimburse employees for certain medical care expenses incurred by the employee or former employee and spouses and dependents of those employees. The tax-free treatment of such payments is based on Internal Revenue Code (IRC) sections 105 and 106. If the HRA is properly designed and operated, employer reimbursement payments are treated in the same manner as employer-provided health coverage; i.e. specifically excluded from employee gross income. See Treas. Reg. section 1.106-1 and IRC section 105(b). Usually, employer reimbursement amounts are paid directly by the employer, upon receipt of a reimbursement claim from the employee.

Example. Employee X participates in his employer's HRA. He incurs a \$200 medical expense. After providing proof of the expense to the employer, he receives a \$200 reimbursement. This is not taxable income for income tax, social security or Medicare tax, and is not reported on Form W-2.

To qualify for tax-exempt treatment of contributions to an HRA, a plan must meet the following conditions:

- (1) The plan must be funded only with employer contributions. Funding cannot be provided pursuant to salary reduction election or otherwise under a cafeteria plan described in IRC section 125. In other words, employees may not make contributions to these accounts, including arrangements that give employees the option of taking cash in lieu of contributions of unused sick or vacation leave.
- (2) The plan must provide reimbursement to the employee for medical care expenses incurred by the employee and former employees and the spouses and dependents of those employees as well as spouses and dependents of deceased employees. An HRA may reimburse only medical expenses described in IRC section 213(d). IRS Publication 502 is a good source to determine expenses which may not be allowable medical expenses.

- (3) The plan may provide reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period may be carried forward to increase the maximum reimbursement amount in subsequent coverage periods. Each medical expense submitted for reimbursement must be substantiated. Reimbursement payments to an employee which occur irrespective of whether qualifying medical expenses have been incurred will cause all medical reimbursement payments during the year to be included in the employees' gross income, and subject to employment taxes under IRC sections 3401(a), 3121(a), and 3306(b).
- (4) The plan cannot allow any cash-out of unused amounts, and no taxable or nontaxable benefit may be provided other than reimbursement of medical expenses.

The following are common questions and answers with regard to HRAs:

Can an employee designate a part of his or her salary to be contributed into an HRA and receive pre-tax benefits from FICA and income tax?

No, this is commonly described as a salary reduction, which is not permitted in an HRA.

Can an employer contribute unpaid sick, vacation, and other leave to an HRA annually, or at termination or retirement of the employee?

Possibly. However, if the employee is provided an option to receive cash in lieu of the contribution of leave, then it is considered a salary reduction, which is not allowed in an HRA. If no employee is allowed to choose to take cash in lieu of the contribution of leave, then it may be allowed because the contribution is considered made by the employer. See [Revenue Ruling 2005-24](#).

At the death of an employee or retiree, can the HRA pay cash for any unused amounts?

No. Disbursements can only be made for medical reimbursements; unused amounts can never be paid in cash.

If an employer made contributions for an employee who dies, what happens to the contributions?

It depends upon how the arrangement (agreement between the employer and employee) was structured. HRA contributions may only be distributed for medical reimbursements and those reimbursements may be made only to current or former employees, the employee's spouse, or dependents, or

spouses or dependents of deceased employees. Any unused portion not distributed is forfeited.

Can administrative expenses be paid out of the HRA?

No, only medical expenses can be paid out of an HRA.

Are there other programs designed to give individuals and employers tax advantages to offset health care costs?

Yes. There are several different programs; each has different incentives and restrictions. Two of these are Health Savings Accounts (HSA) and Flexible Spending Arrangements (FSA). Both of these permit employer contributions and pre-tax salary reductions. [Publication 969](#), Health Savings Accounts and Other Tax-Favored Health Plans, provides additional information about these and other health care reimbursement plans.

You may want to consult the following IRS guidance on HRAs:

IRS [Notice 2002-45](#) addresses allowable medical expenses under an HRA.

IRS [Revenue Ruling 2002-41](#) addresses year-to-year carryover.

IRS [Revenue Ruling 2003-43](#) addresses reimbursements and accounting for expenses.

IRS [Revenue Ruling 2004-45](#) addresses interaction between HRAs and benefits under flexible spending arrangements.

IRS [Revenue Ruling 2005-24](#) addresses four scenarios involving cash reimbursements under health retirement plans. (An article on this ruling appears on the FSLG [web site](#).)

See also related IRS Revenue Rulings [2002-3](#) & [2002-80](#).

Recently, the IRS has commenced examinations of government employers that have established plans for employees and former employees that appear to not meet the requirements of an HRA as discussed above.

If you are approached by a vendor offering a health benefit plan that allows for both elective pre-tax employee contributions of cash or leave, and the accumulation of assets from year to year, or provides for cash disbursement of pre-tax contributions, exercise caution. The plan may not be entitled to treatment as an HRA. Consult the IRS published guidance above or your FSLG Specialist.

REQUESTING A PRIVATE LETTER RULING

BY WANDA VALENTINE, FSLG ANALYST

A private letter ruling (PLR) is written advice issued to a taxpayer by the IRS in response to a taxpayer's request for advice on a particular tax issue. The ruling generally interprets and applies the tax law to a particular tax issue and the taxpayer's specific set of facts. A PLR is written in response to a written request submitted by a taxpayer and is binding on the IRS as long as the taxpayer has fully and accurately described the facts and circumstances. The taxpayer can rely on the PLR as it relates to the taxpayer's specific facts and circumstances. Taxpayers may not rely on a private letter ruling for another taxpayer.

When To Request a PLR or Other Types of Guidance

You can request or seek oral guidance at any time from an IRS customer service representative, through the IRS departmental web sites, field office or Service Center when preparing a tax return or seeking general tax information. If you have a general question, for example, about how to complete an information return, you would not request a private letter ruling. You can call customer service, research IRS publications, web sites and prior published guidance for general tax information. However, oral advice is advisory only, and is not binding on the IRS.

Most taxpayers will never need to request an IRS private letter ruling. But if you have a large dollar amount of tax involved and/or a tax issue that is unclear, you should consider requesting a PLR to seek clarification. For example, you may want a ruling whether an entity is an instrumentality of a state or local government, or you may have a question about the qualifying status of your government retirement plan. The private letter ruling will provide you with legal advice, and you will be able to rely on this advice.

What To Include in the PLR Request

When requesting a PLR, you must consult Revenue Procedure 2006-1. It contains a checklist of the items you must submit with your request. Every letter ruling request must contain the name, address, telephone numbers and taxpayer identification numbers of all interested parties. The request must also include a complete and detailed statement of facts and analysis of facts as related to the tax issue in question. All supporting documentation must be included with any and all written requests. The request should be sent with the applicable user fee to:

Ruling Request Submission
Internal Revenue Service
Attn: CC: PA:LPD:DRU
P.O. Box 7604

Ben Franklin Station
Washington, DC 20044

When a PLR Cannot Be Requested

A private letter ruling will ordinarily not be issued to a taxpayer in the following situations:

- The issue is under examination, in pending litigation, or is being considered by Appeals.
- The issue involves worker status. (Generally you may request these types of determinations on [Form SS-8](#).)
- The ruling request is made by an association or group other than the taxpayer.
- The request is made by a foreign government.
- The issue is frivolous or fraudulent.
- The request is based on an alternative plan or hypothetical situation.
- The request does not address the tax liability or reporting obligation of the taxpayer.
- The requestor asks for a ruling on the federal tax consequences of proposed legislation.
- Release of published guidance on the same tax issue is pending.

If any of the above circumstances exist, you should not request a private letter ruling.

Fees

A general fee schedule for requesting rulings is outlined in Revenue Procedure 2006-1. The standard fee for a private letter ruling is currently \$10,000. However, there are no fees for federal agencies or instrumentalities of the United States requesting a private letter ruling. Generally, the user fee will not be refunded unless the Internal Revenue Service declines to rule on all of the issues raised in the ruling request.

There are certain circumstances in which a taxpayer can pay a reduced fee. Reduced fee schedules and exemptions are determined by the IRS and reviewed appropriately using program guidelines in the current revenue procedure.

Additional information and specific guidelines or other types of guidance requests are also outlined in [Revenue Procedure 2006-1](#) which you can review on the site www.irs.gov. This revenue procedure for requesting a letter ruling is updated annually and is always the first revenue procedure listed in the Internal Revenue Bulletin for each calendar year.

WHAT IS A COMPLIANCE CHECK?

BY SUSAN SERRANO, FSLG ANALYST

One of the primary objectives of Federal, State and Local Governments (FSLG) is to ensure that all governmental entities comply with federal employment tax laws. A *compliance check* is one method used by FSLG Specialists to educate governmental entities about their federal reporting requirements, which helps to ensure future voluntary compliance.

A compliance check is a review of employment tax information returns and forms, such as Forms 941, 1099, W-2, and W-4, that IRS requires governmental entities (public employers) to file or maintain. A compliance check does not directly relate to determining a tax liability for any particular period. It is neither an investigation, under Internal Revenue Code (IRC) Section 7605(a), nor an audit, under Section 530 of the Revenue Act of 1978.

To determine whether a governmental entity is adhering to recordkeeping and information reporting requirements, an FSLG Specialist may ask governmental employers whether they understand or have questions about the filing requirements for these forms. They may also ask about policies, procedures and processes used to ensure proper reporting of worker payments and filing of IRS forms.

The FSLG Specialist will not ask to examine books and records during a compliance check. The Specialist will not ask questions regarding tax liabilities, such as the reason for treating workers as independent contractors or employees. Typically these types of questions are asked during an examination to determine a government entity's correct tax liability.

If, during a compliance check, the FSLG Specialist identifies areas of noncompliance and the governmental entity acknowledges that it did not meet the IRS reporting requirements, the FSLG Specialist may ask the entity to self-correct by filing voluntarily. If the entity does not voluntarily file the forms, the FSLG Specialist may initiate an examination. Should a FSLG Specialist decide an audit is appropriate, he or she will notify the governmental entity in writing by issuing an examination appointment letter, prior to asking any questions that relate to tax liability.

Because compliance checks are not examinations, compliance checks can be conducted as often as facts and circumstances warrant. The limitations on reopening examinations provided by IRC Section 7605(b) do not apply, and a *compliance check* does not afford the governmental entity protection under Section 530 of the Revenue Act of 1978. (Section 530 provides a safe haven for the employment tax treatment of workers based on taxpayer reliance on a prior audit.)

Note: A governmental entity may refuse to participate in a compliance check, without penalty. However, the FSLG Specialist has the option of opening a formal investigation, whether or not the governmental entity agrees to participate in a compliance check.

If you have questions about what to expect in a compliance check, contact your local FSLG Specialist. A directory appears at the end of this publication.

WHAT YOU NEED TO KNOW ABOUT DISCLOSURE LAWS

BY STEWART ROULEAU, FSLG SENIOR ANALYST

You are probably aware that the law protects your tax return information from disclosure to other parties by the Internal Revenue Service. Section 6103 generally prohibits the release of tax information by an IRS employee. However, there are important exceptions that you should be aware of.

IRC 6103(d) provides that return information may be shared with state agencies responsible for tax administration. The state agency must request this information in writing, and the request must be signed by an official designated to request tax information.

IRC 6103(i)(1) provides that, pursuant to court order, return information may be shared with law enforcement agencies for investigation and prosecution of non-tax criminal laws.

IRC 6103(k)(6) allows the IRS to make limited disclosures of return information in the course of official tax administration investigations to third parties if necessary to obtain information that is not otherwise reasonably available.

IRC 6103(l)(1) provides that return information related to taxes imposed under chapters 2, 21, and 24 may be disclosed to the Social Security Administration (SSA) as needed to carry out its responsibilities under the Social Security Act. Chapter 2 relates to self-employment income and does not normally concern employers. Chapter 21 concerns social security and Medicare (FICA) tax, and chapter 24 deals with income tax withholding.

The IRS may therefore share information with SSA about social security and Medicare tax liability if necessary to establish the taxpayer's liability. This provision does not allow the IRS to disclose your tax information to SSA for any other reason. SSA employees who receive this information are bound by the same confidentiality rules as are IRS employees. Therefore, they generally cannot disclose the information to state social security administrators, state officials or other Federal agencies.

IRC 6103(e)(6) and (c) provide for disclosures to powers of attorney and other designees. If you are notified of an audit by the IRS, you may want to have someone other than the authorized officer of your entity represent you or participate in the meeting. You may bring any individual you wish into the discussion, in person or by telephone. You may give oral consent to speak with a third party if necessary to resolve a federal tax matter. However, oral consent does not substitute for a power of attorney or a legal designation, and the discussion is limited to the issue for which the consent is given. To officially establish a legal representative, you must provide consent using one of the following forms:

Form 2848

Use this form if you want someone to represent you before the IRS. An individual named on a Form 2848 is authorized to take actions on your behalf, including signing returns and making agreements with the IRS. Form 2848 may be used to designate only those admitted to practice before the Service.

Form 8821

Use this if you want someone to inspect or receive your confidential tax information. It can be sent to an accounts management center that handles your return, or directly to the office handling a matter. You can designate any periods or types of tax for the appointee to receive return information about you.

Both of these forms allow disclosure of information to the third party only for the tax years listed on them. You may send either of these forms to the IRS service center indicated on the form instructions, or, for handling a specific tax matter, you may mail or fax it directly to the office you are working with. A copy should be brought by your representative to any meeting with the IRS to discuss your return.

The powers granted by these forms can be revoked at any time. See the instructions on the forms for details on the procedures.

If you have a section 218 Agreement to provide social security coverage for your employees, you may wish to have the state social security administrator (SSSA) consulted or otherwise involved in the examination. The SSSA is not considered an official responsible for the administration of state or Federal tax laws under section 6103; therefore, there is no provision in the law allowing the IRS to disclose tax information to your SSSA. If you are reviewing an issue with the IRS involving section 218 social security coverage, you may wish to have the SSSA or a representative participate in the discussion. If you want the IRS to be able to communicate directly with the SSSA, you should complete one of the forms discussed above.

If you have questions about the disclosure laws or your rights or options in the course of an IRS examination, ask the examining agent or contact FSLG.

Calendar of Events

National Association of Counties
Annual Conference and Exposition
August 4-8, 2006
Cook County, IL
naco.org

National Association of State Budget Officers
Annual Meeting
July 16-19, 2006
Lexington, KY
nasbo.org

National Association of State Social Security Administrators
Annual Conference
July 23-26, 2006
Williamsburg, VA
ncsssa.org

Please send any comments or questions about this newsletter to the Editor at Stewart.G.Rouleau@irs.gov.

Directory of FSLG Contacts

<u>State</u>	<u>Specialist</u>	<u>Telephone Number</u>	<u>Ext.</u>
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