Internal Revenue Service
Office of Federal, State and Local Governments

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FSLG Newsletter – July 2007

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 through 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.

Internal Revenue Service
Federal, State and Local Governments

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FISCAL YEAR 2007 MID-YEAR RESULTS

BY JAYNE MAXWELL, FSLG CPM MANAGER

In FY 2007, FSLG's focus has been essentially the same as in FY 2006. With regard to our compliance activities, we continue to focus on the two strategic initiatives: the Federal agency initiative and the large entities initiative, which addresses entities with annual payroll in excess of $40 Million.

By April of 2007, we had begun 18 examinations under our Federal agency initiative, and 28 entities under our large entity initiative. Some of the significant issues raised in these examinations and the general exam program include worker classification, fringe benefits, relocation payments, settlement payment, information return filings, and back-up withholding.

FSLG continues to conduct compliance checks, expecting to complete a total of 830 this fiscal year. FSLG has initiated an additional compliance project focusing on a specific market segment of our customer base. The primary purpose of the community college project is to measure the overall compliance of the community college market segment. Our data on the compliance levels of this market segment is minimal. The results of this project will provide information on the overall level of compliance found in this market segment and will indicate what issues exist within that market segment. Information gathered from this project will help FSLG make decisions about allocating our limited resources to address the greatest areas of non-compliance. The data can assist in development of the Workplan, ensuring our resources are being applied appropriately.

In addition to its compliance activities, FSLG has also conducted about 87 outreach events with 9,849 participants. In January, we held our second 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. In May, we held our fourth annual Federal Agency Seminar, which included presentations of a variety of technical and procedural issues to more than 100 participants representing over 100 Federal agencies. In addition to these outreach events, FSLG has initiated an outreach and education project geared towards employing organizations of firefighters, including volunteer firefighters. Our outreach efforts include outreach presentations conducted by our field specialists, and published articles addressing common areas of noncompliance in the International Association of Fire Chiefs (IACF) newsletter. The article will also appear in an issue of National Fire & Rescue Magazine.

Finally, the FSLG website has just added an updated revision of the Public Employer's Toolkit, which now includes information regarding international

issues. The Public Employer's Toolkit is one of two parts of the Government Entity Toolkit; the second part is the 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.

NEW PROVISION FOR GOVERNMENT PLAN DISTRIBUTIONS

BY STEWART ROULEAU, FSLG SENIOR ANALYST

Government entities who employ public safety employees should take note of a provision of the Pension Protection Act of 2006 (PPA '06), enacted August 17, 2006. This provision allows for special tax treatment of certain retirement plan distributions. Since enactment of this law, the IRS has released Notice 2007-7, which further explains this provision.

Exception to 10% Additional Tax on Early Distributions

Section 828 of (PPA '06), adding section 72(t)(10) to the Internal Revenue Code, provides an exception to the 10% additional tax on early distributions in the case of a distribution from a governmental defined benefit plan made to a qualified public safety employee who separates from service after reaching age 50. (The normal age requirement is 55.) Distributions made after August 17, 2006, are eligible for this treatment.

For this purpose, a "qualified public safety employee" means an employee of a State, or political subdivision of a State, whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of that governmental entity.

The payer of a distribution that qualifies for the exception to the 10% additional tax under section 72(t)(10) is permitted to use distribution code 2 (early distribution, exception applies) in box 7 of Form 1099-R, or may use distribution code 1 (early distribution, no known exception) if the payer does not know whether the recipient is eligible for this exception.

To see Notice 2007-7, click here. For more information, contact your local FSLG Specialist.

CHIEF COUNSEL GUIDANCE ON SALARY REDUCTIONS UNDER §3121(v)(1)(b)

BY DENISE Y. BOWEN FSLG TAX LAW SPECIALIST

In general, employer contributions to an employee plan are not considered wages and are not subject to social security and Medicare (FICA) tax. However, employer contributions to employee plans that are made under a salary reduction are subject to FICA. In some cases, it may not be clear whether the contributions were made under a salary reduction. On December 21, 2006, IRS issued a Chief Counsel Advisory (CCA) addressing whether an employer's contributions under Internal Revenue Code §414(h)(2), paid on behalf of employees in lieu of contributions by employees, are paid pursuant to a salary reduction under Code §3121(v)(1)(B), and are wages for FICA tax purposes.

The CCA describes a situation in which an employer pays the employee mandatory contributions to a Retirement System from funds used to pay employees' salaries, without a salary reduction or offset, and in addition to annual salary increases. The CCA concludes that the contributions were not paid pursuant to a salary reduction, and are not wages subject to FICA taxation. The situation is described in detail below.

Facts

The employer is a public school district. Statutes A and B require the employer and eligible employees, respectively, to participate in the Retirement System. Participation in the Retirement System is mandatory and employees may not elect out of the Retirement System.

The total contribution to the Retirement System is a percentage of each employee's salary. Statute A requires the employer to contribute a percentage of each employee's salary to the Retirement System, and Statute B requires each employee to contribute a percentage of salary to the Retirement System. Statute B also authorizes the employer to pay all employee contributions made after a specified date, "in order to be treated as employer contributions for the sole purpose of determining tax treatment under [Code §414(h)]."

Under Statute B, the employer has the option of paying employee contributions with or without a reduction in the employee's cash salary. In this case, the employer pays the employee contributions from the source of funds used to pay the employee's salary, but does not withhold the contributions from the employee's salary. Rather, after making its contribution, the employer pays the employee's salary without reduction or offset for the amount designated as an employee contribution. The employer makes a supplemental contribution to the Retirement System in an amount equal to the designated employee contribution in satisfaction of the employee's obligation under Statute B.

In each of the years in which the employer initiated contributions pursuant to Statute B, it increased the employees' compensation in an amount consistent with historical salary increases. The employer did not withhold or pay FICA taxes with respect to amounts it contributed to the Retirement System pursuant to Statute B.

Background

Code §414(h)(1) provides that a contribution to a qualified plan shall not be treated as having been made by an employer if it is designated by the plan as an employee contribution. Code §414(h)(2), however, provides an exception for qualified plans established by a federal, state or local government. Code §414(h)(2) states that "where the contributions of employing units are designated (by the plan) as employee contributions, but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions." Code §414(h) generally codifies earlier administrative rulings and judicial decisions regarding the tax treatment of amounts designated as employee contributions.

Under Code §3121(a) the term “wages” for FICA tax purposes means all remuneration for employment unless specifically excepted. Code §3121(a)(5)(A) is an exception to wages, providing that wages do not include any payment made to, or on behalf of, an employee or his beneficiary from or to a qualified plan, unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust.

The Social Security Amendments of 1983 added Code §3121(v)(1)(B), which originally provided that "any amount treated as an employer contribution under Code §414(h)(2)" would be subject to FICA taxation. However, Congress intended to include in wages for FICA tax purposes only those amounts that would have been included in wages had the employer made the contribution pursuant to a salary reduction. As a result, the Deficit Reduction Act of 1984 modified the Code to impose FICA taxes only on "any amount treated as an employer contribution under Code §414(h)(2) where the pickup referred to in such section is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise)."

Analysis and Conclusion

Chief Counsel’s analysis focused on whether the employer contributions under Code §414(h)(2) were paid pursuant to a salary reduction under Code §3121(v)(1)(B), and consequently, are wages for FICA tax purposes.

For purposes of Code §3121(v)(1)(B) the term “salary reduction” relates to amounts treated as an employer contribution under Code §414(h)(2) that would have been included in wages for FICA tax purposes, but for the employer contribution. A salary reduction occurs if the amounts included in wages for FICA tax purposes (without regard to Code §3121(v)(1)(B)) are less than they otherwise would have been, but for the employer contribution.

The amounts that would have been included in wages for FICA tax purposes, but for the employer contribution, are determined based on the facts and circumstances that determine the employee’s compensation under the

employment relationship. Only by determining what the employee's total salary would have been but for the employer contribution is it possible to determine whether the employer contribution is made pursuant to a salary reduction or a salary supplement.

Under a salary reduction, the employer pays the employer contribution with funds derived from the employee's original salary and pays the employee an amount equal to the salary increase. Thus, notwithstanding the salary increase, the amounts included in wages for FICA tax purposes (without regard to §3121(v)(1)(B)) are less than they otherwise would have been but for the employer contribution.

The employer's contributions did not reduce or offset any amounts due and owing to the employees. Thus, under the facts and circumstances determining the employee's compensation, the employer did not pay contributions under Code §414(h)(2) in lieu of current or future compensation that would have been included in wages for FICA tax purposes but for the employer contribution.

The fact that the employer could have further increased the employees' compensation in lieu of making an employer contribution does not support the determination that the employer would have further increased the employees' compensation, but for the employer contribution. Only if the employer would have increased the employees' compensation are the amounts relevant in determining whether the employer made the contributions pursuant to a salary reduction.

The mere possibility of a salary increase, unsupported by the facts and circumstances determining the employee's compensation, does not demonstrate that the employer contributions were made pursuant to a salary reduction under §3121(v)(1)(B). Similarly, the fact that Taxpayer pays the employee contributions from the source of funds used to pay the employee's salary does not demonstrate that the amounts would have been currently included in wages for FICA tax purposes, but for the employer contribution.

FIREFIGHTERS AND EMERGENCY WORKERS

(Adapted from the FSLG web site)

FSLG receives many inquiries asking whether any special tax rules apply to firefighters. Firefighters are generally treated in the same manner as all other workers, however, the Internal Revenue Code provides an exception from social security and Medicare taxes for certain emergency workers.

The law provides that wages paid to certain employees hired by federal, state, or local governments to respond to an emergency are not subject to social security and Medicare taxes. In order for this exemption to apply the employee must be

hired to perform serves on a temporary basis on account of a storm, snow, earthquake, flood, or similar emergency.

To be an emergency worker for this purpose, the employee must have been hired specifically to perform services in connection with the emergency and is not intended to become a permanent employee. The exemption applies only with respect to wages paid for services performed related to the emergency for which the employee was hired. How long the employee remains employed on an emergency basis depends upon the facts and circumstances of the case. If a temporary employee becomes permanent, the employee is subject to general rules for social security and Medicare coverage.

Long-term or permanent federal, state, or local government employees who perform services in emergency situations, such as municipal firefighters, are not eligible for this exception. Even if such employees work part-time, intermittently, or additional time because of an emergency situation, their wages are subject to the regular rules for social security and Medicare coverage. They may be subject to mandatory social security coverage, covered under a section 218 Agreement through their state Social Security Administrator, or exempt from social security because they participate in a public retirement system. For more information, see Publication 963, *Federal State Reference Guide*.

If firefighters receive compensation for services performed, regardless of the form it takes, how it is paid, or is cash or some other benefit, these amounts are treated as wages subject to withholding and tax unless a specific exclusion applies. For a further discussion, including treatment of reimbursement for expenses, see Publication 963 or section 5 of Circular E, Employer's Tax Guide (Publication 15).

The following questions and answers provide guidance on how the emergency exception is to be applied:

Q-1. Are wages paid by a local government to temporary employees hired to clean up hurricane debris exempt from social security and Medicare taxes under the emergency exemption?

A-1. Yes. The wages are exempt from social security and Medicare taxes under the emergency exemption because the employees were hired on a temporary basis to perform services in response to an emergency.

Q-2. A local government requires its police officers to work overtime to enforce a curfew imposed following a hurricane. Are the overtime wages paid by the local government exempt from social security and Medicare taxes under the emergency exemption?

A-2. No. The police officers were not newly hired on a temporary basis to perform services in response to an emergency. Their overtime wages are subject to the regular rules for social security and Medicare coverage.

Contact FSLG with any questions you have regarding federal tax rules that apply to government employees.

CORRECTING FRINGE BENEFIT REPORTING: AN EXAMPLE

BY NICHOLAS C. MERRILL, JR., ACCOUNTING DIVISION MANAGER, STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS, AND STEWART ROULEAU, FSLG SENIOR ANALYST

Errors in reporting fringe benefits are among the most common discovered in an IRS examination, and confusion about proper reporting of employee personal vehicle use is a very common situation. In this article, we attempt to illustrate a common situation where a vehicle benefit is reported incorrectly. We explain the error, how it should be corrected with the IRS, and the procedures for correcting for other reporting purposes.

Employee Use of Employer Vehicle

In general, employee use of an employer vehicle for personal use is a taxable fringe benefit. This applies to an employer-provided vehicle that does not qualify as a nonpersonal use vehicle and is used by the employee for personal use, including commuting.

It is the employer's responsibility to determine the actual value of this fringe benefit and to include the taxable portion in the employee's income.
In order to determine the correct amount, Regulations 1.61-21(d) provides specific guidance, including three methods for determining the value of the benefit:

- Lease-valuation rule
- Cents-per-mile rule
- Commuting valuation rule

Each of these rules has specific requirements and may be optional, mandatory, or unavailable in certain situations.

In this example, City A maintains several vehicles for use by employees in their official duties. In some cases, employees are allowed to use the vehicle for personal use. All of the following apply to the vehicle:

- The vehicle was a standard passenger vehicle, and not a qualified nonpersonal use vehicle.

- The personal use was not for commuting and did not meet the de minimis test, discussed in Publication 15-B.
- In 2005, it was driven 2,000 miles per year for all use.
- The vehicle was first placed in service in 2005, with a fair-market value of $16,500.

Original Reporting

In 2006, Employee X drove the vehicle for 400 miles for personal use, or 20% of the total use of 2,000 miles. To figure the taxable amount, the employer used the cents-per-mile rule. Multiplying the 400 miles of personal use by the standard mileage rate of .445, a total of $178 was computed for the value. This amount was included in the employee's wages on Form W-2 for 2006, and on Form 941, line 2. The income tax withheld was shown on line 3, and the total social security and Medicare tax of $27.23 ($178 x .153 combined employer and employee tax rate) was included in the amount shown on line 5, and deposited properly.

Correct Reporting

To value the personal use of a vehicle under the cents-per-mile rule, certain requirements must be met. Because the vehicle was not driven 10,000 miles by all employees in 2005, it does not qualify for the cents-per-mile rule. In addition, the vehicle had a value in 2006 of more than $15,000, so it would not eligible for the cents-per-mile rule regardless of the miles driven. The value of the personal use of the vehicle must be determined using the lease valuation rule, discussed in Publication 15-B.

The lease valuation table in Regulation 1.61-21(d) and in Publication 15-B indicates that it has an annual lease value of $4,600. The correct calculation of the taxable fringe benefit is as follows:

$4,600 is multiplied by the percentage of personal use (20%) for a total of $920.

In addition, the employer provided all the fuel that was used in the vehicle. The Regulations state that 5.5 cents per mile should be added to this amount and included in the taxable employee benefit. 400 miles x 5.5 cents = $22.50.

The total of $920 + $22.50, or $942.50, should have been included on the employee's Form W-2 as wages, subject to income tax, social security and Medicare.

As a result of the examination, the employee's wages were corrected to include this $942.50. The difference between this amount and the amount originally reported ($178) is $764.50. City A paid additional social security and Medicare tax of $116.96 on this amount, as follows:

7.65% (employer share) x $764.50 = $58.48, plus
7.65% (employee share) x $764.50 = $58.48

City A filed Form W-2c for Employee X (and for any others for whom there are adjustments) showing an increase in wages of $764.50 for 2006 in boxes 1, 3, and 5 and additional tax in boxes 4 and 6. Form W-3c was used as a transmittal form for all Forms W-2c filed by City A.

See Circular E for a complete explanation of reporting adjustments for a prior year.

Other Corrections

City A also participates in a Public Employees' Retirement System (PERS). According to the PERS plan document, employee and employer retirement contributions must be made on all forms of remuneration received by the employee, including vehicle usage income. The increase in employee taxable wages resulting from the additional value of personal vehicle use is subject to employee and employer retirement contributions. City A must notify the PERS of the original reporting error and provide the corrected payroll information, along with the required employee and employer retirement contributions. The additional income from the vehicle use will also be used in the calculation of the employee's average final compensation for retirement benefit purposes, in accordance with the PERS plan document.

If you have questions about correcting the Federal tax reporting, contact an FSLG Specialist in your area. Contact state officials concerning state tax reporting or your public retirement system.

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