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Office of Federal, State and Local Governments

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FSLG Newsletter – July 2010

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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MEDICAL RESIDENTS AND FICA

BY STEWART ROULEAU, FSLG TAX LAW SPECIALIST (WASHINGTON DC)

News Release 2010-15

The IRS issued a news release on March 2, 2010, indicating that it would accept the position that medical residents are excepted from social security and Medicare (FICA) taxes based on the student exception for tax periods ending before April 1, 2005, when new IRS regulations went into effect.

The IRS has contacted hospitals and universities who filed FICA refund claims for these periods with additional information and instructions on how to perfect their pending refund claims. Medical residents who filed individual refund claims do not need to take any action at this time, as they will receive a communication from the IRS on this subject. Taxpayers with currently pending suits should contact the Department of Justice attorney assigned to the case. For more information, see IR News Release 2010-25.

Student FICA Exception for Tax Periods Beginning April 1, 2005

Internal Revenue Code section 3121(b)(10) provides that FICA taxes do not apply to services performed in the employ of a school, college, or university, if such service is performed by a student who is enrolled and regularly attending classes at such university. This exception is commonly referred to as the student exception.

In April 2005 the IRS issued regulations (see the FSLG Newsletter, June 2005) establishing the IRS position that for the student exception to apply, the following conditions must be met:

The employee must be employed by an SCU. An SCU is defined in the regulations as an organization that conducts educational activities as its primary function.

The employee must be enrolled and regularly attending classes at the SCU. Although all facts and circumstances must be considered in determining whether an individual is primarily a student, a full-time employee is ineligible for the student FICA exception. A full-time employee is an employee who is classified by the employer as such, or whose normal work schedule is 40 hours or more per week.

If the employee is not a full-time employee, then qualification as a student depends on all the facts and circumstances. Education, not employment, must be the predominant aspect of the employee's relationship with the employer. For more information on determining whether service or education is predominant, see TD 9167.

Whether the organization is a school, college, or university depends on the organization's primary function. In addition, whether employees are students for this purpose requires examining the individual's employment relationship with the employer to determine whether employment or education is predominant in the relationship.

Recent Developments

The validity of these regulations was challenged in Mayo Foundation for Medical Education and Research v. United States and Regents of University of Minnesota v. United States, 568 F.3d 675 (8th Cir. 2009), cert. granted, 78 U.S.L.W. 3439, 78 U.S.L.W. 3697, 78 U.S.L.W. 3700 (2010). In both cases the district courts had invalidated Treas. Reg. § 31.3121(b)(10)-2(d)(3)(iii), which provides that the student FICA exception in section 3121(b)(10) of the Code was not available to full-time employees, even where their performance of services included an educational component. The Eighth Circuit reversed these holdings, determining that the Treasury Regulation was in fact entitled to deference because section 3121(b)(10) was ambiguous or silent on the issue of whether a medical resident working for the school full time is a student enrolled and regularly attending classes. Taxpayers filed a Petition for Certiorari to the United States Supreme Court and on June 2, 2010, the Supreme Court issued an order granting the petition. Thus the case will be heard by the Supreme Court. The Court's consideration of the cases does not affect the Medical Resident FICA Refund Claim program which is limited to tax periods before April 1, 2005.

WHY EFTPS IS A GOOD FIT FOR GOVERNMENTS

BY PHYLLIS BURNSIDE, FSLG SPECIALIST (FEDERAL GROUP)

FSLG entities are encouraged to enroll in and use EFTPS (Electronic Federal Tax Payment System) to pay their taxes for several reasons. EFTPS is free and easy – easy to enroll, easy to access, and easy to use. By using EFTPS, taxpayers can save paper and simplify the tax payment process.

First, using EFTPS to pay taxes has been mandatory since 1999 for many government entities and penalties apply for failing to do so. Any entity that had total depository taxes in 2008 that were more than $200,000, or was required to use EFTPS in 2009 or any other prior year, it MUST use EFTPS to deposit taxes for 2010.

EFTPS is provided free of charge by Internal Revenue Service and the U.S. Department of the Treasury's Financial Management Service (FMS). The system enables taxpayers to pay their Federal taxes electronically using the Internet or phone. Tax payments are initiated at least one calendar day prior to the tax due date; EFTPS then initiates a debit against the user's bank account, sends the money to Treasury and updates the records with the IRS. For federal agencies, the debit is based on the Agency Location Code, not a bank account.

Enrollment is easy with EFTPS. The government entity enrolls using the Employer Identification Number (EIN), so the personal information of individual users is not required. Online enrollments can be completed in minutes on www.eftps.gov or taxpayers can enroll by completing and mailing in the IRS Form 9779, Business Enrollment Form. A PIN and password are mailed to the enrollee address and generally received within 7 business days. Once the entity has received its PIN, it can initiate additional enrollments and request multiple user PIN/Password combinations based on individual needs.

Access is easy with EFTPS because it is available 24 hours a day, 7 days a week, by phone or internet. The website can be accessed from any computer and EFTPS uses the highest level of on-line security. To protect taxpayer information, three unique pieces of authentication are required: taxpayer identification number, personal identification number, and internet password.

EFTPS is easy to use to pay all business taxes, including excise and employment taxes. The schedule is set by the taxpayer and payments can be made daily, weekly, biweekly, monthly, and/or quarterly. A tax payment can be initiated in minutes, and because there are verification steps along the way, the user is able to check and re-check their information prior to sending it. A user-friendly, step-by-step process requires the user to input all information needed to make any federal tax payment.

EFTPS has been available for many years as a free service for individual and business taxpayers. Although not all FSLG customers are required to use EFTPS to pay their taxes, they are encouraged to do so. For more information on EFTPS visit www.eftps.gov or call the customer service line 1-800-555-4477 for state and local government entities or 1-877-333-8292 for federal agencies.

PROCEDURES FOR CORRECTING FORM 941

BY STEWART ROULEAU, FSLG TAX LAW SPECIALIST (WASHINGTON, DC)

The regulations under IRC sections 6205 and 6413 establish procedures for making interest-free adjustments to employment taxes (social security and Medicare (FICA) tax and income tax withholding (ITW)) reported on prior period

returns. The Regulations under sections 6402 and 6414 establish procedures for making claims for refund of employment taxes.

Under the previous regulations, interest-free adjustments to prior periods were made by reporting the adjustments on the employment tax return for the period the error was discovered and by attaching Form 941c, Supporting Statement to Correct Information, to Form 941. Claims for refund employment taxes were made under the previous regulations by filing Form 843, Claim for Refund or Request for Abatement, and attaching Form 941c.

Effective for errors discovered after December 31, 2008, the regulations under IRC sections 6205, 6402, 6413, and 6414 were revised (see TD 9405) and the process for making adjustments and claims for refund changed. One change to the regulations provides a "90-day rule," under which overpayment adjustments must be made at least 90 days prior to the expiration of the period of limitations on credit or refund under section 6511. The 90-day rule does not apply to the refund claim process, so employers can still file claims for refund within 90 days of the expiration of the period of limitations on credit or refund.

For errors discovered on or after January 1, 2009, corrections must be made on amended "X" series forms. The prior-period adjustment lines have been removed from employment tax returns and Form 941c and Form 843 are no longer available for use by employers. The "X" series forms are dual purpose forms used for both interest-free adjustments and claims for refund. Most government entities file Form 941; however, the rules also apply to Form 944 (an annual return for the smallest payroll employers), Form 943 for agricultural employers, Form 945 for nonpayroll withholding, and Form CT-1 for railroad employers. Since the new regulations went into effect, questions have arisen regarding the procedures to make corrections on the "X" series forms. In December 2009, the IRS issued Revenue Ruling 2009-39 to address proper procedures for making adjustments and claiming refunds of employment taxes in ten different situations. This article addresses four of the scenarios in that ruling that would commonly occur with governmental entities. These are discussed briefly below.

Underpayment of FICA and ITW discovered in later year

An employer filed the 4th quarter Form 941 by the due date, and paid all amounts due. In February of the next year, the employer discovers an error resulted in underwithheld and underpaid FICA and ITW on wages paid in the previous quarter.

Form 941-X must be used to correct the underwithheld and underpaid FICA tax. An adjustment may not be made on the current period return. If the employer files Form 941-X by the due date of the return for the period in which it discovered the error (in this case, April 30) and pays the amount owed, the correction will be interest-free. If Form 941-X is filed timely but the amount is not

paid by the time the employer files, interest will accrue from the date Form 941-X is filed until full payment is made.

The employer may not correct the underwithheld and underpaid ITW on Form 941-X because the error was not discovered in the same year the wages were paid.

Overpayment of ITW discovered in same year wages were paid

An employer filed the 3rd quarter Form 941 by the due date, and paid all amounts due. During the 4th quarter, the employer determined that it overwithheld and overpaid ITW in the third quarter. The overpayment is repaid to the employees during the 4th quarter and the employer files Form 941-X in the first quarter of the following year.

Because the employees were repaid in the same calendar year that the wages were paid, the correction may be made using Form 941-X. The employer may not correct the error using the claim for refund process because the amount was actually withheld from the employees' wages. This is a timely adjustment under the 90-day rule.

Overpayment and underpayment of ITW for same period

The employer timely filed its 2006 4th quarter Form 941 by the date due, and paid all taxes due with the return. In December 2009, the employer ascertains that it underpaid FICA tax with respect to wages of one employee, and overwithheld and overpaid FICA tax with respect to wages of a second employee on its 2006 4th quarter Form 941.

After ascertaining the overpayment, the employer promptly reimbursed the employee from whose wages tax was overwithheld. The underpaid FICA tax must be corrected on Form 941-X using the adjustment process. Because the error relating to the overpaid FICA tax was ascertained more than 90 days before the expiration of the period of limitations on credit or refund, and because the employer reimbursed the employee in the amount of the overcollection, the employer may choose between the adjustment and refund claim processes to make the correction. Had the employer chosen to obtain the employee's consent to the filing of a refund claim instead of reimbursing the overcollected FICA, the employer would have had to use the refund claim process to correct the overpayment since the consent option is not available for the adjustment process.

Adjustment process: Form 941-X must be filed by January 15, 2010 (because of the 90-day rule). If the employer corrects both the overpayment and the underpayment on one Form 941-X, the amounts will be combined and may result in either a credit or a balance due.

Refund process: If the employer chooses to correct the overpayment using the claim for refund process (or is unable to file Form 941-X by January 15, 2010), it must file two separate Forms 941-X; one to correct the overpayment using the refund claim process, and one to correct the underpayment using the adjustment process. A refund claim and an adjustment may not be made on the same Form 941-X. The employer must file the Form 941-X reporting the overpayment by April 15, 2010 (the last day of the period of limitations on credit or refund). The employer must file the Form 941-X reporting the underpayment by January 31, 2010, and pay any amount due by the date the Form 941-X is filed. If the amount is not paid when due, interest will accrue from the date Form 941-X is filed until full payment is made. The overpayment corrected on the separate Form 941-X using the refund claim process will be refunded, plus any interest that applies, unless the employer owes other taxes, penalties, or interest. An employer may not designate an overpayment from one Form 941-X to pay an amount due on a separate Form 941-X.

Underpayment of FICA and changed filing requirement

The employer timely filed its 2007 Form 944 and timely paid all employment tax reported on the return. In February 2010, the IRS notifies the employer that its filing requirement has changed and it is required to file Form 941, rather than Form 944, for calendar year 2010 and thereafter. In May 2010, the employer ascertains that it underpaid FICA tax on its 2007 Form 944.

The employer must correct the underpayment of FICA tax using the adjustment process. Because the employer is correcting an error on a previously filed Form 944, it must file a Form 944-X, to make the correction; the "X" form filed must correspond to the return being corrected. The employer must file Form 944-X by January 31, 2011, the due date of the return for the return period in which it ascertained the error, and pay the amount owed by the time it files Form 944-X. If the employer timely files Form 944-X but does not pay by the time it files, interest will accrue from the date Form 944-X is filed until payment is made.
For the explanation of procedures for other situations, and more general information on the adjustment and claim for refund processes, see Revenue Procedure 2009-39 and Publication 15, Employer's Tax Guide (Circular E).

PROPOSED REGULATIONS ALLOW AUTHORIZATION OF IRC 3504 AGENT FOR FUTA

BY WANDA VALENTINE, FSLG SENIOR ANALYST (WASHINGTON, DC)

The IRS and Treasury have issued Proposed Regulations (Federal Register, Volume 75, number 8, issued January, 13, 2010) under section 3504 to permit

certain employers to designate third parties to act as their agent for FUTA tax purposes.

Background

Currently, Federal, state and local governments administer programs that provide home health care and other personal services to the elderly and disabled in their homes. The programs authorize the use of certain intermediaries, who are screened by the government agencies administering the programs, to serve as agents to disburse payments to service providers on the service recipient's behalf. The individuals receiving the care are commonly known as the "home care service recipients" and are usually considered the common-law employers of the individuals providing the care for federal employment tax purposes. However, these home care service recipients often designate the intermediary to act as their agent under Section 3504 of the Internal Revenue Code (the Code) for purposes of fulfilling their employment tax obligations incurred for the service care providers in their homes. The service recipient usually completes Form 2678, Employer/Payer Appointment of Agent, to designate the intermediary as his or her agent at the time of enrollment with the intermediary.

These intermediaries can be public, private or nonprofit entities and organizations. Designating the intermediary as an agent generally reduces administrative burden on the home care service recipient, who might not otherwise be able to meet the employment tax obligations. The designated agents can report, file and pay income tax withholding and Federal Insurance Contributions Act (FICA) tax on behalf of multiple service recipients on a single return. However, under current regulations, the service recipient cannot designate the intermediary as an agent to pay Federal Unemployment Tax Act (FUTA) tax.

Employment Tax liabilities for Domestic Services

An employer is generally defined as a person for whom an individual performs services as an employee. An employer is generally required to withhold income tax and FICA taxes from their employees' wages and is separately liable for the employer's share of FICA taxes and FUTA taxes. The employer is also required to file employment tax returns, file and furnish Forms W-2 to employees, and generally to make tax deposits.

The employment tax obligations for domestic services provided in or about a private home of the employer are somewhat modified. The employer is not required to withhold income taxes on wages paid for domestic services; but, under a voluntary agreement, may withhold income taxes from one or more domestic employees. The employer is only liable for FICA taxes with respect to

domestic services when wages exceed a designated dollar threshold amount. The FICA wage threshold for domestic services is revised annually; for 2010, it is $1,700. The threshold applies separately to each employer and with respect to each individual employee.

An employer is liable for FUTA taxes for domestic services if the employer paid aggregate wages of $1,000 or more (for all domestic employees) in any calendar quarter in the current or prior year. The employer is required to pay FUTA tax in an amount that, combined with credit for state unemployment contributions, equals 6.2 percent of each employee's wages, but only on the first $7,000 of wages paid to that employee in a year.

Proposed Changes to Section 3504 Regulations

Section 3504 of the Code authorizes the IRS to designate an agent to act on behalf of the employer, but all provisions of law applicable with respect to employers, including penalties, are applicable to the agent and remain applicable to the employer. Accordingly, both the employer and the agent can be held liable for employment tax obligations undertaken by the agent. Under the current regulations under section 3504, an employer can designate an agent to withhold, report and pay income tax withholding and FICA tax, but not FUTA tax.

The Proposed Regulations would amend the employment tax regulations under section 3504 and allow a home care service recipient to designate an agent under section 3504 to report, file and pay all employment taxes, including FUTA taxes, with respect to wages paid for home care services rendered to the home care service recipient. The proposed change would allow the agent to file a single FUTA tax return for multiple home care service recipients as currently allowed for agents with respect to income tax withholding and FICA tax.

The proposed regulations define the home care service recipient as an individual who is an enrolled participant in a program administered by a federal, state, or local government agency that provides federal, state, or local government funds to pay, in whole or in part, for the home care service. Status as a home care recipient applies until the end of the calendar year in which the participant ceases to be enrolled in the program.

The Proposed Regulations also define home care services to include health care and personal attendant care services rendered to a home care recipient in his/her home or local community. Services provided outside the home may qualify as home care services for purposes of these Regulations as long as the services are provided within the service recipient's local community.

Because Section 3504 provides that all provisions of the law apply to the employer and agent, the agent can report state unemployment contributions (paid on behalf the home care service recipient's behalf) as a credit against the

FUTA tax on its aggregate FUTA tax return. The agent can report the credit, whether the state unemployment contributions are made under the name and state identification number of the home service recipient or the agent.

Effective Date

The regulations are proposed to apply to wages paid beginning January 1 of the calendar year following the date of the publication of final regulations. However, taxpayers may rely on the Proposed Regulations immediately and may apply them to any year for which there was a valid agent designation under Section 3504.

More information

The text of the Proposed Regulations can be viewed here. General information on employment tax rules can be found at www.irs.gov.

SECTION 218 AGREEMENTS – AN OVERVIEW

A Section 218 Agreement is a written agreement between a state and the Social Security Administration (SSA), to provide social security and Medicare coverage, or Medicare-only coverage, for state and local government employees. These arrangements are called “Section 218 Agreements” because they are authorized by Section 218 of the Social Security Act.

In 1939, the Old-Age, Survivors, and Disability Income program was created. The funding mechanism for the social security program was officially established in the Internal Revenue Code as the Federal Insurance Contributions Act (FICA). The IRS is responsible for the collection of this tax. In 1950, legislative changes allowed for voluntary agreements to include public employees in social security. In 1991, mandatory social security coverage began for public employees not covered by a Section 218 Agreement or a public retirement system.

All 50 states, Puerto Rico, the Virgin Islands, and approximately 60 interstate instrumentalities have Section 218 Agreements with SSA. Because of the voluntary nature of Section 218 Agreements, the extent of social security coverage varies from state to state. At the state level, most public employees participate in social security. The following table includes the major historical developments since state and local employees first became eligible for social security coverage in 1951.

Section 218 Key Dates

January 1, 1951 - Beginning this date, states could voluntarily elect social security coverage for public employees not covered under a public retirement system by entering into a Section 218 Agreement with SSA.

January 1, 1955 - Beginning this date, states could extend social security coverage to employees (other than police officers and firefighters) covered under a public retirement system.

July 1, 1966 - Beginning this date, employees covered for social security under a Section 218 Agreement are automatically covered for Medicare.

August 20, 1983 - Beginning this date, coverage under a Section 218 Agreement cannot be terminated unless the governmental entity is legally dissolved.

April 1, 1986 - Employees hired on or after this date are mandatorily covered for Medicare, unless specifically excluded by law. For state and local government employees hired before April 1, 1986, Medicare coverage may be elected under a Section 218 Agreement.

July 2, 1991 - Beginning this date, most state and local government employees became subject to mandatory social security and Medicare coverage, unless they are (1) members of a public retirement system, or (2) covered under a Section 218 Agreement.

For more detailed information about Section 218 Agreements or social security and Medicare taxes, see Publication 963, Federal-State Reference Guide. For information about whether a section 218 Agreement applies to your entity, contact your state Social Security Administrator (a list is available at www.ncsssa.org). For information about social security benefits, contact the Social Security Administration (www.ssa.gov).

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