

# Federal, State and Local Governments Newsletter

Volume 3

June 2005

# FEDERAL

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**Attn: Steve Wharton,  
Operations Manager**

**1111 Constitution Avenue NW  
Washington, DC 20224**

## MESSAGE FROM THE EDITOR: FORM W-4

BY STEWART ROULEAU, FSLG SENIOR ANALYST

On April 14, 2005, the IRS issued temporary and proposed regulations (Treasury Decision 9196) that eliminate the requirement that employers send copies of potentially questionable Forms W-4, Employee's Withholding Allowance Certificate, to the IRS.

In the past, employers were required to send to the IRS, any Form W-4 claiming more than 10 allowances or claiming exemption from withholding if \$200 or more in weekly wages was expected.

The IRS has developed a new process to use information already reported on Forms W-2 to more effectively identify workers with withholding compliance problems.

Under the provisions of the new regulations, you may receive a "lock-in letter" requiring you to limit the number of exemptions permitted to a specific employee. The new regulations require a minimum period before a lock-in letter can take effect. Currently, the lock-in letter indicates that the employer must start to withhold at the lock-in rate starting with the first pay period 60 days after the date of the letter, unless the IRS contacts the employer.

After the lock-in letter takes effect, you must disregard any Form W-4 that claims more allowances or exempt status, until the IRS notifies you to withhold based on the new Form W-4. However, if at any time, the employee furnishes a Form W-4 that claims a number of withholding allowances less than the maximum number specified in the letter, you must withhold based on that Form W-4. Employers who use electronic Form W-4 systems must make sure the employee cannot override the lock-in rate to decrease withholding via an electronic Form W-4 system.

Also, you should be aware that the jurat for the Form W-4 was revised. The employee must now certify that all information on the return is correct. Previously, the employee certified that the employee was entitled to claim exempt status or a certain number of withholding allowances. Because a Form W-4 may be in paper or electronic form, this new jurat must be used on any paper substitute statement and any electronic Form W-4. An electronic system must be updated to make this change, if it has not already been updated.

For more information about the new regulations, you can read the text at [http://www.irs.gov/pub/irs-regs/td\\_9196\\_checked.pdf](http://www.irs.gov/pub/irs-regs/td_9196_checked.pdf). You can direct questions to your local FSLG Specialist.

*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.*

## UPDATE: STUDENT FICA EXCEPTION

BY DENISE Y. BOWEN, FSLG TAX LAW SPECIALIST

In recent years, there has been significant tax controversy involving the student exception from social security and Medicare taxes (the “student FICA exception”) and its applicability to medical residents. This controversy arose following two court decisions in which the Minnesota District Court and the 8th Circuit Court of Appeals held that the medical residents at the two hospitals were students and exempt from FICA taxes. Since that time, the issue has been the subject of conflicting court rulings, ongoing litigation, and efforts by Treasury and the IRS to clarify the application of the student FICA exception through published guidance. The FSLG Newsletter first addressed this issue in March 2004.

As a result of the holdings in the Eighth Circuit, many institutions filed claims for refunds of FICA taxes paid. IRS and Treasury issued proposed regulations and a proposed Revenue Procedure on February 24, 2004, that set forth guidelines clarifying the requirements for the student FICA exception. Final regulations and a revenue procedure were issued December 21, 2004, and are detailed in this article.

The U.S. Department of Justice, on behalf of the IRS, also filed suit against a number of hospitals for the return of refunds already paid. The IRS maintains that medical residents are not students eligible for the student FICA exception. In a recent decision the Federal District Court for the Southern District of Florida granted the United States' Motion for Summary Judgment, holding that medical residents are not students and did not follow the previous court decisions of the District Court of Minnesota and 8th Circuit Court of Appeals.

### Background

Section 3121(b)(10) of the Internal Revenue Code (IRC) sets forth the conditions for the student FICA exception. It provides that employment for purposes of FICA does not include services performed in the employ of a school, college or university (SCU), or certain affiliated tax-exempt organizations in relation to the SCU (related §509(a)(3) organization), if the service is performed by a student who is enrolled and regularly attending classes at an SCU.

The student FICA exception applies to services only when both the employer status and the student status requirements are met. The employer status requirement is met if the student is employed by an SCU or a related §509(a)(3) organization. The student status requirement is met if the individual is “enrolled and regularly attending classes” at the SCU.

In recent years, a question has arisen as to whether employees performing services in the nature of on the job training are students and exempt from FICA taxes. This issue arose with respect to medical residents and interns in two cases heard by the United States District Court in Minnesota.

In the first case, *Minnesota v. Chater*, the Social Security Administration (SSA) made an assessment against the state of Minnesota for FICA taxes allegedly made on payments to the medical residents. The court found that the medical residents were not employees covered under the Section 218 Agreement and were therefore not covered by FICA. The Court went on to say that even if the medical residents were covered under the 218 Agreement, then the medical residents were students and eligible for the student FICA exception. On appeal, in 1998, the 8th Circuit Court of Appeals in *Minnesota v. Apfel* affirmed the

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COMMENTS  
OR  
SUGGESTIONS?

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Court's decision and added that the social security regulations contemplate "a case-by-case examination to determine if an individual's relationship with a school is primarily for educational purposes or primarily to earn a living."

In 2003, the Mayo Clinic prevailed in a similar case in the same Federal District Court. In determining that the student FICA exception applied, the court found that the residents were employed by the Mayo Foundation and that the Foundation was a "school" under section 3121(b)(10) of the Code. The court rejected the IRS's argument that an employer's primary purpose must be education in order to qualify as a "school" under section 3121(b). The court also found that the residents qualified as students who regularly attended classes at the school.

As a result of the Apfel decision, many university medical centers, teaching hospitals and medical residents applied for and received refunds of FICA taxes paid. In response to those claims, the IRS suspended the claims while the issue was analyzed. The Office of Chief Counsel has issued four Chief Counsel Advice memos dated April 19, 2000, August 23, 2000, December 14, 2001, and January 24, 2002. Final regulations and a revenue procedure were issued December 21, 2004, applicable for services performed on or after April 1, 2005. There has also been litigation between the Justice Department, on behalf of the IRS, and hospitals on this issue.

#### **Recent Developments**

##### ***Court Rules Medical Residents are not Students***

The two Minnesota decisions, while important, do not completely resolve this issue. In the Mayo case, the court held that the Mayo Foundation meets the guidelines of being a university or university-controlled affiliate. But because much of the training during the medical residency occurs at a hospital, the issue is whether a hospital that is not associated with a university could be deemed to be an SCU.

The IRS has consistently maintained that a hospital that is not a part of the same legal entity as the SCU, and is not a related §509(a)(3) organization, does not qualify as an SCU, and is a separate common-law employer for employment tax purposes, including the student FICA exception. In the first case to address the issue of whether medical residents performing their training at academic medical centers and teaching hospitals should be categorized for employment tax purposes as students or employee, the Federal District Court for the Southern District of Florida agreed with the IRS and ruled that medical residents are not eligible for the student FICA exemption.

In *Mount Sinai Medical Center v. United States* the Department of Justice, on behalf of the IRS, sought the return of a FICA tax refund issued in 2000. Mount Sinai Medical Center is a not-for-profit teaching hospital that is not owned by a university. The IRS alleged that the refunds should not have been paid because the medical residents do not qualify under its definition of students.

The court agreed with the United States, ruled that medical residents are not eligible for the student FICA exception and granted the United States Motion for Summary Judgment. Rejecting the Eighth Circuit's opinion in the Minnesota cases, the court interpreted the legislative history of section 3121(b)(10) to conclude that Congress has always intended medical and dental interns and residents to be covered by social security. In the opinion, the court declined to follow the recent student FICA exception decisions. The court found the facts in *Minnesota v. Apfel* to be distinguishable from the Mt. Sinai case, and the holding in the Mayo case to be incorrectly decided.

## IRS issues Final Regulations and Revenue Procedure

The final regulations provide guidance for determining whether an organization is an SCU and whether an employee is a student for purposes of the student FICA exception. The following summarizes the main provisions of the regulations:

- The worker must be an employee of 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.
- 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. The regulations provide a nonexclusive list of factors to use in determining whether service or education is the predominant aspect of the relationship. These factors include:
  - The employee's course workload relative to a full-time course workload. A substantial course workload suggests the employee is a student.
  - The employee's normal work schedule and actual number of hours worked. For example, if an employee is normally scheduled to work 20 hours per week, but consistently works more than 40 hours per week, the amount of time actually worked is taken into account in determining whether or not the employee qualifies as a student.
  - Whether the employee is a professional employee. A professional employee is an employee whose primary duty consists of: (1) performing services that require advanced knowledge in a field of science or learning, (2) work requiring the consistent exercise of discretion and judgment, and (3) work that is predominately intellectual and varied in character. If an employee is a professional employee, the suggestion is that the employee is not a student.
  - If an employee is a licensed professional employee, then that fact further suggests the employee is not a student.
  - Whether the employee is eligible to receive employment benefits other than health insurance. If an employee is eligible to receive retirement and other employee benefits, then that suggests the employee is not a student.

## Conclusion

The Service continues to monitor and evaluate Mt. Sinai, Mayo, and other medical resident cases currently in litigation and cases in the Appeals Fast Track Program to develop a fair and responsible approach for resolving the pending FICA claims. The final regulations, however, provide guidance with respect to remuneration for services provided by medical residents on or after April 1, 2005.

A FULL-TIME  
EMPLOYEE  
IS  
INELIGIBLE  
FOR  
THE  
STUDENT  
FICA  
EXCEPTION.

## DEPOSITING FORM 941 TAXES

BY RHONDA KINSLEY, FSLG SPECIALIST

In general, you must deposit federal income tax withheld and both the employer and employee social security and Medicare taxes plus or minus any prior period adjustments to your tax liability (minus any advance EIC payments). The deposit rules are based on the dates when wages are paid, not on when tax liabilities are accrued for accounting purposes.

**Exception:** You may make a payment with Form 941 instead of depositing if one of the following applies.

- You report less than a \$2,500 tax liability for the quarter on line 10 of Form 941 and you pay in full with a timely filed return.
- You are a monthly schedule depositor (defined below) **and** Any deposit shortfall does not exceed the greater of \$100 or 2% of the amount of taxes otherwise required to be deposited **and** The shortfall is deposited or paid with your return by the due date of your Form 941 for the quarter in which the shortfall occurred. You may pay the shortfall with Form 941 even if the amount is \$2,500 or more.

### When To Deposit Form 941 Taxes

**Prior to the beginning of each calendar year**, you must determine which of two deposit schedules you are required to use. These two deposit schedules - monthly or semiweekly - are used to determine when you deposit social security, Medicare, and withheld income taxes. Once you determine your deposit schedule (prior to the beginning of the calendar year), you will follow the deposit rules for that deposit schedule for each pay day during that entire whole calendar year; except as otherwise instructed below.

These schedules tell you when a deposit is due after a tax liability arises (for example, when you have a payday). Your deposit schedule is not determined by how often you pay your employees or make deposits. The deposit schedule you must use is based on the tax liability that you reported on Form 941 during a four-quarter lookback period.

#### 1. Identify your lookback period.

Your deposit schedule for a calendar year is determined from the total taxes reported on line 8 of your Forms 941 in a four-quarter lookback period. (Refer to line 11 on pre-2005 versions of Form 941.) The lookback period begins July 1 and ends June 30 as shown in Table 1 below. If you reported \$50,000 or less of taxes during the lookback period, you are a monthly schedule depositor; if you reported more than \$50,000, you are a semiweekly schedule depositor.

**Note:** Determine your tax liability for the four quarters in the lookback period based on the tax liability as reported on your Form 941. If you made adjustments to correct errors on previously filed Forms 941, these adjustments do not affect the amount of tax liability for purposes of the lookback rule.

THESE  
SCHEDULES  
TELL YOU  
WHEN A  
DEPOSIT IS  
DUE AFTER A  
TAX LIABILITY  
ARISES.

If you report adjustments on your current Form 941 to correct errors on prior Forms 941, include these adjustments as part of your tax liability for the current quarter and adjust your deposits accordingly. If you filed Form 843 to claim a refund for a prior period overpayment, your tax liability does not change for either the prior period or the current period for purposes of the lookback rule.

### Lookback Period for Calendar Year 2006



#### 2. Determine your deposit period

For monthly schedule depositors, the deposit period is a calendar month. The deposit periods for semiweekly schedule depositors are Wednesday through Friday and Saturday through Tuesday.

#### 3. Deposits for a Monthly Deposit Schedule

Under the monthly deposit schedule, deposit Form 941 taxes on payments made during a month by the 15th day of the following month.

#### 4. Deposits for a Semiweekly Deposit Schedule

Under the semiweekly deposit schedule, deposit Form 941 taxes for payments made on Wednesday, Thursday, and/or Friday by the following Wednesday. Deposit amounts accumulated for payments made on Saturday, Sunday, Monday and/or Tuesday by the following Friday.

If you have more than one pay date during a semiweekly period and the pay dates fall in different calendar quarters, you will need to make separate deposits for the separate liabilities. For example, if you have a pay date on Wednesday, March 30, 2005 (first quarter) and another pay date on Friday, April 1, 2005 (second quarter), two separate deposits would be required even though the pay dates fall within the same semiweekly period. Both deposits would be due Wednesday, April 6, 2005 (three banking days from the end of the semiweekly deposit period).

#### 5. Deposits on Banking Days Only

If a deposit is required to be made on a day that is not a banking day, the deposit is considered timely if it is made by the close of the next banking day. In addition to federal and state bank holidays, Saturdays and Sundays are treated as nonbanking days.

Semiweekly schedule depositors have at least three banking days to make a deposit. That is, if any of the three weekdays after the end of a semiweekly period is a banking holiday, you will have one additional banking day to deposit. For example, if a semiweekly schedule depositor accumulated taxes for payments made on Friday and the following Monday is not a banking day, the deposit normally due on Wednesday may be made on Thursday (allowing three banking days to make the deposit).

**6. \$100,000 Next-Day Deposit Rule**

If you accumulate a tax liability (reduced by any advance EIC payments) of \$100,000 or more on any day during a deposit period, you must deposit the tax by the next banking day, whether you are a monthly or a semiweekly schedule depositor.

Once you accumulate at least \$100,000 in a deposit period, stop accumulating at the end of that day and begin to accumulate anew on the next day. For example, Fir City is a semiweekly schedule depositor. On Monday, Fir City accumulates taxes of \$110,000 and must deposit this amount on Tuesday, the next banking day. On Tuesday, Fir City accumulates additional taxes of \$30,000. Because the \$30,000 is not added to the previous \$110,000 and is less than \$100,000, Fir City must deposit the \$30,000 by Friday (following the semiweekly deposit schedule).

If you are a monthly schedule depositor and accumulate a \$100,000 tax liability on any day, you become a semiweekly schedule depositor on the next day and remain so for at least the rest of the calendar year and for the following calendar year.

**7. Additional Information**

For more information on depositing Form 941 taxes, see **Publication 15, Employer's Tax Guide** or call your FSLG Specialist listed in this newsletter.

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**FEDERAL, STATE AND LOCAL GOVERNMENTS CONTACTS**

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Alabama	Judy Nichols John Givens	(251) 340-1781 (251) 340-1761	
Alaska	Gary Petersen	(907) 456-0317	
Arkansas	Jan Germany	(501) 324-5328	253
Arizona	Kim Savage	(928) 214-3309	5
California	Phyllis Garrett	(213) 576-3765	
Colorado	Karen Porsch Chuck Sandoval	(719) 579-0839 (303) 446-1156	231
Connecticut	Phyllis Burnside	(401) 525-4205	
Delaware	Kevin Mackesey	(302) 856-3332	12
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Massachusetts	Mark A. Costa	(617) 320-6807	
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Mississippi	John Givens Robert Lettow	(251) 340-1761 (318) 869-6312	
Missouri	Joe Burke Sharon Boone	(636) 940-6389 (417) 841-4535	

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New Hampshire	Bob Westhoven	(207) 784-6988	
New Jersey	Pat Regetz	(908) 301-2119	
New Mexico	Toni Holcomb	(505) 527-6900	232
New York	Martin Boswell Fran Reina	(315) 233-7302 (315) 793-8171	
North Carolina	Clifford Brown	(803) 253-3523	
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Oregon	Marilee Basaraba Sue Ann Jansen	(503) 326-5030 (503) 326-5057	
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South Carolina	Clifford Brown	(803) 253-3523	
South Dakota	Al Klamam Rhonda Kingsley	(701) 227-0133 (701) 239-5400	261
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Washington	Clark Fletcher	(425) 489-4042	
West Virginia	Michael Durland	(540) 887-2600	18
Wisconsin	Ruthann Watts	(262) 513-3520	
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 present. For more information about upcoming events that FSLG may be participating in, visit [www.irs.gov/govts](http://www.irs.gov/govts) or contact your local FSLG Specialist.

**National Association of Counties  
Annual Conference and Exposition  
July 15-19, 2005  
Honolulu, HI  
Naco.org**

**National Association of State Budget Officers  
Annual Meeting  
July 17-20, 2005  
Baltimore, MD  
Nasbo.org**

**National Association of College and University Business Officers  
Annual Meeting  
July 9-12, 2005  
Nacubo.org**

**National Conference of State Social Security Administrators  
Annual Conference  
July 24-27, 2005  
Denver, CO  
Ncssa.org**