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FSLG RELEASES REVISED EDITION OF PUBLICATION 963 BY STEWART ROULEAU, FSLG SENIOR ANALYST

The Office of Federal, State, and Local Governments has completed an on-line revision of Publication 963, Federal-State Reference Guide.

Publication 963, last revised in 2002, is a comprehensive guide to social security, Medicare, and retirement plan coverage for government employers. The first edition appeared in 1997, as a joint effort of the Internal Revenue Service, the Social Security Administration, and the National Association of State Social Security Administrators. It contains a thorough discussion of Section 218 of the Social Security Act and how it applies to different governmental entities in various situations, with many illustrations of the application of coverage rules. The publication also discusses employment tax and fringe benefit issues of interest to government entities, and provides information and points of contacts for the Internal Revenue Service, the Social Security Administration, and the National Association of State Social Security Administrators.

Although the IRS does not plan to make printed copies available for distribution, any or all of Publication 963 can be downloaded from the FSLG web site, www.irs.gov/govts. The on-line format will enable FSLG to make updates to the information periodically, and will allow taxpayers immediate access to these updates. Numerous links are provided in the text to related web pages and sources.

A limited number of printed copies of the 2002 edition remain available from the National Distribution Center. You can order it by calling 1-800-829-3676. While most of the information in the 2002 edition is correct, you should check the 2005 revision for changes, particularly to procedures and contact information.

NEW IRS ADVICE ON TAXABILITY OF GIFT CARDS BY MARILEE BASARABA, FSLG SPECIALIST (PACIFIC)

Many employers give employees birthday or holiday gifts. These gifts take a variety of forms including a turkey, a ham, a gift basket, or a coupon to purchase a turkey or a ham at a local grocery store. In recent years, the gift card has been a popular alternative because it provides

employees with more choices and greater convenience. Some employers believe that gift cards are not taxable and qualify as excludable from income as a de minimis fringe benefit because they meet the example of “traditional birthday or holidays gifts of low fair market value”, or because they are non-negotiable (restricted to only certain items; the redemption time is limited; and any unused portion is forfeited). However, Federal tax law does not view giving an employee a turkey or a ham as the equivalent of giving an employee a gift card to purchase a turkey or a ham. A recently issued Tax Advice Memorandum (TAM) in 2004 clarifies the tax law and discusses this issue.

In order for a fringe benefit to be excludable as a de minimis fringe benefit, it must be a property or service that is small in value, infrequent, and administratively impracticable. The TAM determined that an employer-provided thirty-five dollar holiday gift coupon that is redeemable at several local grocery stores is not excludable from income as a de minimis fringe benefit. The IRS findings states that the gift coupon operates in the same way as a gift certificate which is considered a cash equivalent. Cash equivalents are never excludable as a de minimis fringe benefit.

The example in Reg. §1.132-6(a) of holiday gifts is limited to property; it does not include cash (except for special rules that apply to transit passes and/or occasional meal money). The same regulation states that cash is not excludable even when it is provided to purchase a property or service that, if provided in kind, would be excludable as de minimis. The example given in the regulation refers to an employer providing cash to purchase a theater ticket to the employee; whereas, if the employer gave the employee the theater ticket it would be excludable as a de minimis fringe benefit.

The Service holds that the “statute provides the basis for the exclusion”, wherein the regulations describe examples of fringe benefits that are potentially excludable assuming all of the other requirements of the statute are met. Because gift cards, certificates, and/or coupons are considered cash equivalents, they do not meet the statute requirements to be excludable. Furthermore, the value of the coupons was determinable and the frequency to individual employees was ascertainable - all requirements that must be met in order for the coupons to be excluded from income.

The TAM does not address a dollar threshold to establish a standard for the meaning of “small in value.” However, we can look at other tax law for guidance. A 1959 revenue ruling states that the value of a turkey or a ham is considered nominal or small in value. A 2000 legal memorandum states that non-monetary recognition awards having a fair market value of \$100 did not qualify as de minimis fringes and are considered wages.

So, if an employer provides a turkey, a ham, or other property of nominal value to employees, the value of these items is not considered wages or salary and is excludable from income. But if an employer provides gift cards, certificates, or coupons to purchase a turkey, ham, or other nominal value property, these are considered wages and are subject to income and employment taxes (even when the card restricts the items purchased, the time to use the coupon, and any unused portion is forfeited) because cash equivalents do not meet the de minimis fringe benefit requirements.

NEW NOTIFICATION REQUIREMENT FOR STATE AND LOCAL GOVERNMENT NEW HIRES BY EDIE LEE, SOCIAL SECURITY ADMINISTRATION

Section 419(c) of the Social Security Protection Act of 2004 (PL 108-203) contains a provision requiring state and local government employers to provide a statement to employees hired January 1, 2005, or later in a job not covered under social security. The statement explains how a pension from that job could affect future social security benefits to which they may become

entitled.

Form SSA-1945, Statement Concerning Your Employment in a Job Not Covered by Social Security, is the document that employers should use to meet the requirements of the law. The SSA-1945 explains the potential effects of two provisions in the social security law for workers who also receive a pension based on their work in a job not covered by social security. The Windfall Elimination Provision can affect the amount of a worker's social security retirement or disability benefit. The Government Pension Offset Provision can affect a social security benefit received as a spouse or an ex-spouse.

Under the Windfall Elimination Provision, a worker's social security retirement or disability benefit is figured using a modified formula when he/she is also entitled to a pension from a job where he/she did not pay social security tax. As a result, the worker will receive a lower social security benefit than if he/she was were not entitled to a pension from this job. Under the Government Pension Offset Provision, any social security spouse or widow(er) benefit to which a person becomes entitled will be offset if he/she also receives a Federal, state or local government pension based on work where he/she did not pay social security tax. The offset reduces the amount of a person's social security spouse or widow(er) benefit by two-thirds of the amount of his/her pension.

For more detailed information about the new legislative requirement, and to view a copy of Form SSA-1945, see www.socialsecurity.gov/form1945. This website also contains links to more detailed information about the Windfall Elimination Provision and the Government Pension Offset Provision.

TREATMENT OF EMPLOYER-PROVIDED LODGING BY KATHERINE DEES, FSLG SPECIALIST (WESTERN)

Providing free or discounted housing to an employee may be an important recruitment tool for employers. This benefit may enable employers to attract employees who would otherwise be unavailable. For example, many rural school districts have a problem attracting and maintaining quality teachers. To accomplish this, they frequently offer teachers free or discounted housing as incentives. However, this may lead to a taxable fringe benefit.

Fringe benefits are fully taxable under Internal Revenue Code (IRC) Section 61, unless specifically excluded by law. In general, the amount that must be included in the employee's gross income is the amount by which the fair market value (FMV) of the benefit exceeds the amount the employee paid after taxes for the benefit, less any amount the law excludes. In general, this rule applies to employer-furnished housing.

Example 1: A school district gives a teacher "free" housing. Based on comparable property in the area, it has a fair rental value of \$600 per month. Based on these facts, the school should be including \$600 in the teacher's income per month.

Example 2: A school district gives a teacher "discounted" housing. Based on comparable property in the area, it has a fair rental value of \$400 per month. The teacher is paying the school \$250 per month to rent the house. Based on these facts, the school should be including \$150 in the teacher's income per month.

There are no specific required techniques for establishing the FMV, but common methods would include checking the local newspaper and finding the FMV of comparable rental property or calling a realtor and getting comparable rental value on similar real estate. The employer must determine the value of the fringe benefits provided to the employee no later than January 31 of the following year in order to report the value on the employee's Form W-2. Employer - provided "noncash" taxable fringe benefits are subject to all payroll taxes, including Federal income tax,

social security and Medicare (FICA), and Federal unemployment tax (FUTA).

Under Code Sec. 119(a), the gross income of an employee does not include the value of lodging furnished for the convenience of the employer, but only if the employee is required to accept the lodging on the business premises of his employer as a condition of his employment. Clearly, an understanding of these terms is essential to determining whether lodging is excludable in any given case. Each of the terms will be covered in detail below.

In general, only lodging furnished to employees "in kind" is excludable. Treas. Reg. 1.119-1(e) states that to be excludable, lodging must be furnished directly to the employee. Therefore, cash allowances or employer reimbursements for lodging purchased by the employee are not excludable. Examples of the in-kind requirement are illustrated in Private Letter Rulings (PLRs) 9801023 and 9824001 where the IRS held that housing allowances (in one instance paid by a private school to its headmistress and in the other instance paid by a hospital to residents) were not excludable because the value of lodging is only excludable if provided in-kind. (Note that letter rulings address a specific situation, and may not be cited as precedent.)

Special rules apply in the case of qualified campus lodging furnished to faculty. These requirements are covered below.

For the Convenience of the Employer: Lodging will be regarded as furnished for the convenience of the employer if it is furnished for a "substantial noncompensatory business reason." Basically, that means that the employer must have a good business reason for providing the lodging other than to provide additional pay.

Business Premises of the Employer: The value of lodging furnished to an employee is excludable only if furnished on the employer's business premises. The term "business premises" has been the source of extensive litigation. This may be due to the rather vague definition of the term in the regulations. Under Treas. Reg. 1.119-1(c)(1), the business premises of the employer is "the place of employment of the employee."

Some court cases have addressed this point and may help illuminate a situation. In *Dole*, the Tax Court held that the term should mean either the living quarters that constitute an integral part of the employer's business property or premises on which the company conducts some of its business activities. In *Anderson*, the Sixth Circuit Court of Appeals held that the employer's business premises is the location where either the employee performs a significant portion of his duties or the premises where the employer conducts a significant portion of his business. In this case, the court ruled that the lodging that was located only two blocks from where the employee worked did not meet the requirements of Code Sec. 119 because no duties were performed at the home.

In PLR 8938014, the IRS ruled that lodging provided across the street from the employer did not meet the exclusion test because the employees did not perform significant duties nor did the employer conduct significant business there. Similar reasoning was used in PLR 9404005 where an apartment building located near the campus of a private school was not on the business premises of the school because the apartment was not an integral part of the school's business property.

The exclusion may be allowed if the employee performs substantial services for the employer at that location, regardless of the fact that the location is not the regular office or work site. In *Adams*, the lodging furnished to the chief executive officer was considered to be on the employer's business premises because the officer often performed substantial services in the home that benefited the employer, including entertaining members of the business community. Rev. Rul. 90-64 demonstrates that if the employee is furnished lodging on the employer's physical business premises, it is not necessary for the employee to perform services within the lodging to obtain the exclusion.

Condition of Employment: Lodging must also be accepted as a condition of employment in order to be excludable, which means that an employee must be required to accept the lodging in order to enable him or her to properly perform the duties of his or her employment. Lodging is deemed to meet this requirement when, for example, the employee must be available for duty at all times or because the employee could not perform the services required of him or her unless he or she was furnished the lodging. If the employee has the choice of accepting or rejecting the lodging, no exclusion will be allowed. A statement that the lodging is required by the employer is not sufficient evidence for the condition to be met. The lodging must be necessary in order for the employee to properly do his or her job or the employee must be on call at all times. However, it is not necessary for the employee to show that his or her duties would be impossible to perform without the provision of the lodging. This requirement may be satisfied if the employer-furnished lodging provides significant benefits or rewards to the employer or in some other manner facilitates job performance.

Exclusion for Certain Faculty Housing

Under Code Sec. 119(d), the value of qualified campus lodging furnished to an employee of an educational institution is not taxable to the employee if the rent is adequate. Specifically, the employee/faculty member must include in income the excess of the lesser of (1) 5% of the appraised value of the qualified campus lodging, or (2) the average of the rentals paid by individuals other than employees or students of the institution, for comparable lodging furnished by the institution, over the rent paid by the employee for the qualified campus lodging. Per the 1986 Act Conference Committee Report, the appraisal must be made by a qualified appraiser. The appraisal may not be made by the educational institution, or any of its officers, trustees, or employees. Qualified campus lodging is defined as (1) located on, or in the proximity of, a campus of the educational institution and (2) furnished to the employee by, or on behalf of, the educational institution for use as a residence. An educational institution is defined as an organization that normally maintains a regular faculty and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly conducted.

FICA and FUTA Taxation of Lodging

Employer provided lodging that is excludable from an employee's gross income under Code Sec. 119 is also excludable for FICA and FUTA tax purposes.

For more information, contact an FSLG Specialist. A directory is provided at the back of this newsletter.

IRS REVISES FORM FOR TAX-EXEMPT BONDS BY MICHAEL MURATORE, TEB TAX LAW SPECIALIST

Significant revisions were recently made to the form used by municipalities and other issuers of tax-exempt bonds to make arbitrage related payments. The revised Form 8038-T, Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate, will streamline the process for issuers and will help the IRS identify potentially abusive transactions. The revised form was issued February 1.

Arbitrage is the profit that results from investing the proceeds of tax-exempt bonds in higher yielding taxable securities. Tax law generally requires a rebate of arbitrage profits to the U.S. Treasury.

The new form reduces the number of items to be completed by a full 20% and includes instructions re-written in a more useful, plain-language manner. In addition, a new section

requests information related to various items such as qualified administrative costs, guaranteed investment contracts and the amount of proceeds used to redeem bonds was added. These new items will assist in spotting potentially abusive bond issues.

The effort to revise Form 8038-T began by soliciting input from practitioners that use the form. Many of the comments received were incorporated in the revisions, including a change requested by several commentators related to the report number. Other significant revisions include new sections for late payments and qualified zone academy bonds and elimination of a number of outdated questions related to seldom used elections.

The comments of the Commissioner and Director, Tax Exempt Bonds, with respect to the revised form were published in several news stories including articles disseminated by the Wall Street Journal and Bond Buyer.

If you have further questions about Form 8038-T or Tax Exempt Bonds, contact Michael Muratore at 202-283-9771.

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Publication 963 is a comprehensive guide to social security, Medicare, and retirement plan coverage. Federal, State and Local Governments Customer Assistance
 Call toll-free for general information and account assistance:
 Customer Account Services
 (877) 829-5500

Access the Web site of Federal, State and Local Governments
www.irs.gov/govts

For a written response, send correspondence to:
 Internal Revenue Service
 Federal, State and Local Governments T:GE:FSL

Attn: Steve Wharton,

Operations Manager
1111 Constitution Avenue NW
Washington, DC 20224

Comments or Suggestions?

We welcome your comments and your suggestions for information you would like to see in this newsletter.

Please contact us through our website at www.irs.gov/govts.

Calendar of Events

The following upcoming national events may be of interest to you. FSLG representatives may be present. For more information, contact the hosting organization.

National State Auditors Association
Annual Conference
Wrightsville Beach, NC
June 8-11, 2005
www.nasact.org

Federal Agency Seminar
Washington, DC
June 8, 2005
www.irs.gov/govts

Federation of Tax Administrators
Annual Meeting
San Antonio, TX
June 12-15, 2005
www.taxadmin.org

Center for State and Local Taxation
Summer Tax Institute
June 20-23, 2005
Davis, California
www.iga.ucdavis.edu/summertax.html

Government Finance Officers Association
Annual Conference
San Antonio, TX
June 26-29, 2005
www.gfoa.org