

Internal Revenue Service
Office of Federal, State and Local Governments

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FSLG Newsletter – January 2009
Internal Revenue Service

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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FSLG FISCAL YEAR 2008 ACCOMPLISHMENTS

BY JAYNE MAXWELL, CPM MANAGER

During Fiscal Year (FY) 2008, Federal, State, and Local Governments (FSLG) successfully continued two major compliance initiatives: an examination program for Federal agencies, and an examination program for large entities (those with annual payroll in excess of \$40 million). In addition, FSLG completed its first market segment project, addressing community college compliance, and initiated two others addressing compliance of housing authorities and fire districts.

With the Federal agencies, FSLG commenced 16 cases and closed 20. For large entity compliance, FSLG opened 30 cases and closed 40. These examinations focused on worker reclassification, employment taxes of fringe benefits, settlement payments, information return reporting, and other issues.

In addition to examinations, FSLG conducted 860 compliance checks. A compliance check does not examine returns or assess tax, but assesses the level of taxpayer compliance. Compliance checks continue to play an important enforcement role for FSLG. Typically, a compliance check includes Form 941, 944, 945, W-2, and the Form 1099 series.

In FY 2007, FSLG began conducting projects that adopted a market-segment approach for identifying and selecting returns for examination. These projects allow FSLG to determine trends and issues within a category of governmental entities. FSLG will use the results to plan outreach activities to improve compliance for that group. FSLG completed the first of these projects on community colleges in FY 2008 and will publish a report of its findings.

FSLG also began a market segment project on fire districts in FY 2007. The first phase of the project was focused outreach events. The second phase, conducted in FY 2008, consisted of compliance checks performed on fire districts randomly selected from each state. Although FSLG had initially planned to begin an

examination phase in FY 2009, it has decided not to pursue the examination phase, due to some recent legislative changes and the fact that most fire districts are relatively small (FSLG generally conducts examinations on entities with annual payroll of \$10 million or more). Instead, it will develop an action plan for additional focused outreach to help fire districts improve compliance; this will include phone forums, articles in industry publications, etc.

In FY2008, we conducted an exam satisfaction survey for the first time. FSLG taxpayers were asked to complete a survey that would provide feedback to assess the taxpayer's satisfaction level related a recently completed examination. Survey results indicated an overall satisfaction of 5.76 on a scale of 1 to 7 with 7 being most satisfied. The taxpayers were most satisfied with Courtesy of Specialist (6.31). The lowest satisfaction score, 5.27, was given for the length of the process. FSLG continues to explore ways to expedite the examination process without detracting from the quality or the service provided.

FSLG coordinated and conducted outreach presentations to government entities within the U.S. Territories including Guam, Commonwealth of the Northern Mariana Islands, (CNMI), U.S. Virgin Islands (USVI), and Puerto Rico and expanded its Federal Agency Outreach Seminars. FSLG began conducting outreach events in Spanish for Puerto Rico and began releasing the semiannual FSLG Newsletter in a Spanish edition to better serve these customers and reduce their tax compliance burden.

Plans for FY 2009

A central theme in the FY 2009 Work Plan is our focus on improving enforcement activity. FSLG is committed to continuing the Federal Agency and Large Entity compliance initiatives that began in FY 2005. We anticipate opening 15 examinations of Federal agencies and closing 15; for large entities, the goal is to open 30 large entity examinations and close 35.

FSLG will participate in an Employment Tax National Research Program (NRP) project to develop data to help identify sources of the tax gap related to employment taxes. The tax gap research project on employment taxes will be developed during FY 2009, as part of an IRS-wide effort. FSLG has committed to examine approximately 250 returns or 60 entities for each of three years. These audits are expected to begin in FY 2010.

In FY 2008, FSLG successfully initiated its third market segment project. The housing authority examination project will be completed in FY 2009. Findings should be published by the end of FY 2009.

In FY 2009, FSLG will begin compliance projects focused on two particular issues: Form 1099-MISC non-filers, and a project to check compliance with

classification settlement program (CSP) and other closing agreements. Most of the cases in these projects will open and close within FY 2009. As a further aid to governments, FSLG will create a questionnaire that government entities may use to conduct self-checks of their compliance. The questionnaire will be added to the FSLG page on the www.irs.gov website.

One of the primary areas of outreach and education will be Internal Revenue Code Section 3402(t), which requires that Federal and state agencies, and any other governmental entities with annual payments (excluding payroll) of \$100 million or more withhold 3% from any payments made to any person providing property or services, beginning in 2011. FSLG will continue over the next two years to meet with Federal agencies and state and local governments affected by Section 3402(t) to discuss the proposed regulations, obtain suggestions and comments and to provide education on the final regulations when issued.

FSLG will continue to partner with the Social Security Administration as its major external partner in issues relating to social security coverage and Section 218 Agreements. It will also maintain and increase activities with other stakeholders, such as the National Conference of State Social Security Administrators (NCSSSA). Stakeholders will be involved in the development of outreach products and with other actions to maximize the benefits of customer education efforts.

NEW WITHHOLDING REQUIREMENT FOR GOVERNMENTS BEGINNING 2011

BY STEWART ROULEAU, FSLG TAX LAW SPECIALIST

Section 3402(t) of the Internal Revenue Code requires Federal, state, and local government entities to withhold 3 percent from payments for property or services, deposit the withholding with the IRS, and report the payments and the withholding to the IRS and to the payees. Withholding is required for payments made after December 31, 2010.

On December 5, 2008, the IRS issued proposed regulations relating to withholding under section 3402(t). The proposed regulations provide guidance primarily on what government entities need to do to comply with the new withholding requirements so they can make timely preparations.

Which Government Entities Are Required To Withhold

The following are subject to the new requirement:

1. The entire U.S. government, including all Federal agencies, the executive branch, the legislative branch and the judicial branch.

2. All states including the District of Columbia (but not including Indian tribal governments).
3. All political subdivisions of a state government, or every instrumentality of such subdivisions, unless the instrumentality makes annual payments for property or services of less than \$100 million.

Generally, withholding is required on all payments to all persons providing property or services to the government, including individuals, trusts, estates, partnerships, associations, and corporations. Withholding is required at the time of payment, and applies to payment in any form (cash, check, credit card or payment card). If the government entity fails to withhold the tax required under section 3402(t), it becomes liable for the payment of the tax.

Payment Threshold

The proposed regulations create a payment threshold of \$10,000 and provide that payments below the threshold are not subject to withholding. The regulations also include an anti-abuse rule that payments of \$10,000 or more may not be divided into payments of less than \$10,000 solely for the purpose of avoiding the withholding requirements.

Exceptions from the 3 Percent Withholding Requirement

The proposed regulations provide the following exceptions from the withholding requirements:

1. Payments otherwise subject to withholding, such as wages.
2. Payments for retirement benefits, unemployment compensation, or social security.
3. Payments subject to backup withholding, if the required backup withholding is actually performed.
4. Payments for real property.
5. Payment of interest.
6. Payments to other government entities, foreign governments, tax exempt organizations, or Indian tribes.
7. Payments made under confidential or classified contracts, as described in IRC 6050M(e)(3).
8. Payments made by a political subdivision of a state, or instrumentalities of a political subdivision of a state that make annual payments for property or services of less than \$100 million.
9. Public assistance payments made on the basis of need or income. However, assistance programs based solely on age, such as Medicare, are subject to the requirements.
10. Payments to employees in connection with service, such as retirement plan contributions, fringe benefits, and expense reimbursements under an accountable plan.

11. Payments received by nonresident aliens and foreign corporations.
12. Payments made by Indian tribal governments.
13. Payments in emergency or disaster situations.

Exception for Small Entities

Subdivisions of a state, or instrumentalities of a subdivision of a state are exempt from the withholding requirement if its total annual payments for property and services (not including wages) are less than \$100 million. The proposed regulations provide a simple rule for determining whether an entity makes annual payments less than \$100 million. In general the entity looks to its accounting year ending with or within the second preceding calendar year. For example, if total payments for the entity's 2009 accounting year exceed \$100 million, the withholding requirement will apply in 2011.

Payments by Payment Administrator

Under the proposed regulations, a government entity may use a payment administrator in making payments. A payment administrator is a person that acts with respect to a payment solely as an agent for the government entity by making the payment on behalf of the government entity to the person providing the property or service to, or on behalf of, the government entity. If a payment administrator is used, the payment subject to withholding occurs when the payment administrator pays the person providing property or services. The government entity is liable for the withholding and reporting associated with the payment regardless of whether the government entity or its payment administrator makes the payment for property or services. This liability is not transferred to any other party.

Credit Card Payments

Under the proposed regulations, when a government entity or its payment administrator uses a credit card or payment card to pay a person for providing property or services, payment occurs at the point of sale when the government credit card or payment card. Thus, withholding is required at the point of sale and not when the government entity pays the credit card company. The government entity is liable for the withholding and reporting associated with the payment, and this liability is not transferred to any other party.

How To Report Withheld Tax

Withholding is required at the time of payment. Payments subject to the withholding requirement must be shown on [Form 945](#), Annual Return of Withheld Income Tax. These amounts are subject to the deposit rules for that form. The deposit rules are discussed in ([Publication 15](#)), (Circular E, Employer's Tax

Guide). All amounts withheld must be reported by the government entity on Form 1099-MISC, Miscellaneous Income, at the end of the calendar year. Amounts withheld may not be applied as a credit against the employment tax liabilities of the payee. The payee will include withheld amounts in total withholding on the individual or business tax return. The proposed regulations provide an explanation of the timing of credit for the withholding to be taken when the recipient operates under a fiscal tax year.

Transitional Rules

The proposed regulations provide that generally the withholding requirement do not apply to payments under contracts existing on December 31, 2010. The proposed regulations also provide that government entity will not be liable for interest and penalties with respect to the failure to pay the tax on payments for property and services made before January 1, 2012 if the entity made a good faith effort to comply with the withholding requirements.

The office of Federal, State and Local Governments (FSLG) will continue to provide information on these provisions, as it becomes available, on its website. To see the Proposed Regulations, click [here](#).

MILITARY DIFFERENTIAL AND COMBAT ZONE BONUS PAY *BY WANDA VALENTINE, FSLG SENIOR ANALYST*

The Heroes Earnings Assistance and Relief Tax Act of 2008 (Heroes Act) made significant changes to the treatment of military differential pay and combat zone bonus pay. This will change the way employers report these payments beginning in 2009.

Military Differential Pay

Differential pay is defined as any payment made by an employer to an individual during the period during which the individual is called to active duty in the uniformed services for a period of more than 30 days, and represents part or all of the wages the individual would have received from the employer if the individual were performing service for the employer.

Prior to the Heroes Act, military differential pay was not treated as wages and qualified plans were not required to treat differential pay as compensation for purposes of the limitations on benefits and contributions. Employers previously reported military differential payments in box 3 of Form 1099-MISC. However, the Heroes Act redefines military differential pay as wages for all payments made after December 31, 2008.

Changes in Information Return Reporting and Withholding

The Heroes Act includes changes in reporting requirements for military differential pay and tax treatment of bonuses paid the military personnel in a combat zone. Section 105 of the Heroes Act amends section 3401 of the Code to make military differential payments subject to income tax withholding. Section 3401(h)(2) has been added to include the definition of differential wage payments.

Military differential pay is subject to Federal income tax withholding for all amounts paid after December 31, 2008. These payments should be reported in Box 1 of Form W-2. However, these payments will not be subject to social security or Medicare withholding, and are not entered in box 3 or box 5.

These payments are also defined as compensation for retirement plan purposes.

Combat Zone Bonus Pay

Under the Heroes Act any bonus payments paid by a state or local government to active or former military personnel for service in a **combat zone** payments made before, on, or after June 17, 2008. will be excluded from the recipient's gross income. Bonus payments are distinguished from military differential payments and are not included in income reported on Forms W-2. The bonus payments are defined in Section 112 of the Heroes Act as payments made "by a State or political subdivision to any member or former member of the uniformed services of the United States or any dependent of such member only by reason of such member's service in a combat zone."

Visit the FSLG website or contact your local FSLG Specialist if you have questions about these provisions.

CORRECTING EMPLOYMENT TAXES ERRORS IN 2009

BY WANDA VALENTINE, FSLG ANALYST

Background

The Form 94X Adjusted Employment Tax Returns Project was initiated in response to requests from employers and the payroll community to reduce employers' burden when making employment tax adjustments. In response to this request, the Form 94X Project has developed a new set of multi-purpose forms which will reduce burden for correcting errors on employment tax returns discovered on or after January 1, 2009. Beginning with the first quarter Form 941 for 2009, employers will no longer be able to make prior period adjustments

for errors discovered on or after January 1, 2009, on a current period return, but will instead use the new "X" forms. These "X" forms will be used to make adjustments, claim refunds, or request abatements of employment taxes.

These new forms will provide a more accurate process for making and tracking adjustments and for claiming refunds or requesting abatements of employment taxes. The new stand-alone forms will replace the complex Form 941c, Supporting Statement to Correct Information. The 2009 employment tax returns are being revised to eliminate the lines for prior period adjustments due to the new processes.

Forms

The new "X" forms will be user-friendly and allow the employer to make easy and accurate corrections. Each stand-alone form will correspond to, and relate line-by-line with the employment tax return it is correcting. The new "X" forms include Forms 941-X, 943-X, 944-X, 945-X and CT-1X. They will correspond as follows:

Return previously filed	Corresponding 94X series form
Form 941, Employer's QUARTERLY Federal Tax Return (PDF)	Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund
Form 943, Employer's Annual Federal Tax Return for Agricultural Employees (PDF)	Form 943-X, Adjusted Employer's Annual Federal Tax Return for Agricultural Employees or Claim for Refund
Form 944, Employer's ANNUAL Federal Tax Return (PDF)	Form 944-X, Adjusted Employer's ANNUAL Federal Tax Return or Claim for Refund
Form 945, Annual Return of Withheld Federal Income Tax (PDF)	Form 945-X, Adjusted Annual Return of Withheld Federal Income Tax or Claim for Refund
Form CT-1, Employer's Annual Railroad Retirement Tax Return (PDF)	Form CT-1X, Adjusted Employer's Annual Railroad Retirement Tax Return or Claim for Refund

The full series of "X" forms will be available in early 2009 for use in correcting errors on employment tax returns discovered on or after January 1, 2009.

The IRS is also in the process of revising Form 941 and other employment tax returns for the 2009 tax year to eliminate prior period adjustment lines which will no longer be needed after the implementation of the series of new "X" forms.

Process

Under the new process, when an employer (or agent withholding income tax on Form 945) discovers an underpayment or overpayment error on a previously filed Form 941, 943, 944, 945, or CT-1, it will now use the new corresponding "X" form to make corrections. The IRS will make both the tax and wage corrections to the tax period being corrected, resulting in a more accurate account.

Employers correcting an overpayment on a previously filed employment tax return will be able to choose to make an adjustment and have any overpayment amount applied as a credit to the period in which the “X” form is filed, or to claim a refund of the overpayment.

Employers correcting an underpayment must use the corresponding “X” form to make an adjustment. The “X” form must be filed by the due date of the return for the period in which the employer discovers the error in order to get interest-free treatment. Amounts owed must be paid by the time the “X” form is filed.

Payments can be made by using EFTPS or by sending a check. For certain forms, credit card payments may be accepted.

Employers can also use the adjustment process to correct underpayments resulting from the failure to file a return for a prior period because the employer failed to treat any individuals as employees.

More information

The Form 941-X and Instructions will be available online from the [Forms and Publications page](#) of IRS.gov on or about January 5, 2009. The remaining forms, which correspond to annual returns, are scheduled for release in February of 2009. Look for more information about the new adjustment and claim for refund processes and forms on IRS.gov in early January. The final regulations were published in IRB 2008-32 as [T.D. 9405](#).

NEW REVISION OF PUBLICATION 963 *BY STEWART ROULEAU, FSLG TAX LAW SPECIALIST*

In November, FSLG released a new edition of Publication 963, Federal-State Reference Guide. This publication is updated annually and is designed specifically for officials of local government entities, employees, practitioners, and others who may work on tax matters with governments.

Publication 963 was first published in 1995 as a joint effort of the IRS, Social Security Administration, and National Association of State Social Security Administrators (NCSSSA). Its primary focus was on the explanation of rules for social security coverage under Section 218, reflecting the cooperative role of the three organizations in administering these rules. However, the publication also addresses general employment tax issues in the public sector, as well information reporting, fringe benefits, public retirement plans, social security provisions, and other topics related to Federal tax.

Publication 963 contains information not readily available in depth from other sources. It is recommended for all public employers, and especially for those

responsible for administering Section 218 Agreements. The latest edition can be accessed at the FSLG [website](#).

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