

FEDERAL TAX NEWS

for Colleges and Universities

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Please Note:

This issue is a combined December/January issue. Your next issue will be dated February 2010. Season's greetings to all!



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IRS Modifies Withholding Procedures On Wages Paid to Nonresident Aliens

One of the most difficult income withholding tax areas for colleges and universities relates to payments that they make to nonresident aliens. This is because the Code creates a different set of withholding rules for payments made to nonresident aliens, and institutions not only must know these rules but also be able to administratively implement them.

In the case of wage payments made to nonresident aliens, the income withholding tax requirements are essentially the same as those for U.S. citizen employees, with one major exception — a nonresident alien, unlike a U.S. citizen, is not allowed to claim the standard deduction on his or her U.S. income tax return. Because the standard deduction is built into the withholding tax tables, these tables cannot be used for nonresident aliens without making an adjustment. Several years ago, the IRS issued Notice 2005-76, which requires employers to add an amount to the wages of a nonresident alien employee solely for purposes of calculating the income tax withholding for each payroll period.

Now IRS has issued Notice 2009-91, which modifies Notice 2005-76 to account for the IRC §36A Making Work Pay Tax Credit, enacted in early 2009 as part of the American Recovery and Reinvestment Act. Like the standard deduction, nonresi-

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IRS Memo Explains How It Analyzes The Tax Status of Research Stipends

Many colleges and universities, as part of their overall scientific research activities, enter into contracts with federal government agencies, nonprofit organizations, and for-profit companies under which the institution agrees to perform certain research services in return for a fee. The institution uses the funds it receives under the research contract to compensate a variety of different individuals to work on the project, including faculty members, graduate and undergraduate students, and traditional employees.

The institution's postdoctoral fellows also may provide research services under the contract, and the question in these situations is whether the stipend payments made to the postdoctoral fellows are true fellowship payments or represent compensation for research services rendered, which would be treated as wages.

The answer to this question is important, first, because the institution is not required to withhold income tax or file reports with the IRS on fellowship payments. In addition, and of perhaps greater importance, fellowship stipends are not subject to FICA tax because the FICA tax is imposed only on wages. Thus, if the payments made to the postdoctoral fellow in connection with his or her work on

continued

the research project can be treated as *bona fide* fellowship payments, no income tax has to be withheld from the payment, no reports need to be filed with the IRS or the individual, and neither the institution nor the individual are subject to FICA tax.

But how does an institution determine whether a stipend payment made to a particular postdoctoral fellow should be treated as a fellowship payment or as wages? The IRS tackled this issue in a recent legal memorandum (ILM 200944027), which involved a state university that applied for a refund of FICA taxes that it had withheld over the past five years from stipend payments made to postdoctoral fellows to work on various research contracts.

The IRS analyzed this issue under IRC §117(c), which provides that any fellowship payment repre-

senting compensation for research services must be treated as wages. According to the memorandum, "Determining whether payments to a postdoctoral fellow under a particular research grant constitute payment for services for the purposes of §117(c), is an inherently factual matter, requiring consideration of the nature and extent of the duties imposed upon the participants, and of all other relevant facts and circumstances of the programs." The IRS went on to say that a payment is treated as compensatory under IRC §117(c) if it either

- (1) enables the recipient to pursue research primarily for the benefit of the grantor, or
- (2) represents payment for teaching, research, or other past, present, or future services by the student required as a condition for receiving the qualified scholarship or fellowship.

Distinguishes NRSA and Non-NRSA Recipients

For purposes of its analysis, the IRS divided the university's postdoctoral fellows into two groups — those who had received a National Research Service Award (NRSA) grant from the Department of Health and Human Services (HHS), and non-NRSA grantees.

With respect to the NRSA grants, the IRS noted that it has long held that, due to "the purpose of the NRSA program and the circumstances of its implementation," NRSA research grants are not payments for services and are *bona fide* fellowships for tax purposes, citing Rev. Rul. 83-93. The memorandum lists a number of factors that support this conclusion.

These factors indicate that the primary purpose of an NRSA grant is to further the research training of the recipients in their individual capacities and include the following:

- ◆ The grants are tailored to the individual's training, not the university's research goals.
- ◆ There is no requirement that the research benefit the university.
- ◆ Progress reports focus on development of research skills not on research accomplishments.
- ◆ The fellows may unilaterally change the substance and focus of their research activities to maximize their individual development.

The IRS then turned its focus on the university's non-NRSA grant programs. While noting several similarities with the NRSA grants — the type of research conducted, the credentials of the fellow recipients, the

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dual nature of contract services and individual training — the IRS concluded that the non-NRSA grants “are fundamentally different in that they are for the performance of specific services determined by the [university] through the faculty sponsor rather than payments to support training and development.” The primary factors that lead the IRS to this conclusion were the following:

- ◆ The postdoctoral fellows are not hired until after the university secures the research contract.
- ◆ The fellows are assigned to discrete research projects that are defined by the project leader.
- ◆ The fellows’ appointment letters enumerate the tasks, goals, means, and time frame of the postdoctoral fellows’ duties.
- ◆ The university bases its decision to hire the postdoctoral fellows on their potential to provide services under the contract.
- ◆ The fellows are evaluated based on their substantive contributions to the research project activity.
- ◆ The research fellow can be terminated for non-satisfactory performance.
- ◆ The fellows receive more substantial fringe benefits than NRSA fellows, including, in some cases, retirement benefits.

Employee/Independent Contractor Test Applied

Finally, the IRS analyzed the non-NRSA research fellows under the tests used to distinguish employees from independent contractors — behavioral control, financial control, and the relationship established between the university and the fellow. This analysis, according to the IRS, confirmed that the non-NRSA research fellows were performing employee services for the university in connection with their work on the research contracts.

This legal memorandum is an important document in that it confirms, and for the first time explains, the reasons for the IRS’s long-standing position that NRSA grants should be treated as fellowships. In addition, it identifies and describes in great detail the many factors that are taken into account in making the often difficult determination as to whether a non-NRSA research fellowship should be treated as a *bona fide* fellowship or as compensation for research services rendered.

A copy of this memorandum can be found at www.irs.gov/pub/irs-wd/0944027.pdf. ✧

IRS Releases Audit Check Sheet on Governance Practices

While the Internal Revenue Service acknowledges that tax law does not mandate particular management structures, operational policies, or administrative practices for charities, it believes that a well-governed charity is more likely to comply with tax requirements, safeguard its assets, and serve its charitable purposes. Part VI of the revised Form 990, as well as the IRS Web page on governance (www.irs.gov/pub/irs-tege/governance_practices.pdf), underscore the IRS’ interest in governance, and now it has issued a governance check sheet for agents to use during audits.

While the check sheet is intended for examining agents, the information it seeks is a clear indicator of the policies and procedures the IRS considers to constitute good governance.

Eight-Part Form Goes Beyond 990 Information

The check sheet, which has eight parts, asks for some of the information requested on the Form 990 regarding composition and function of the governing body, conflicts of interest, and compensation, but it instructs the agent to obtain additional information as well.

Part 2, Governing Body and Management asks the examining agent to determine whether the organization has a mission statement that reflects its §501(c)(3) purposes; whether the bylaws contain composition, duties, qualifications, and voting rights for members of the governing body and officers; and what entities, such as the board or the public, have received or have access to the articles of organization and bylaws. It also asks how often a quorum of voting board members met, how frequently the full board convened, and whether these meetings met or exceeded the number specified in the bylaws.

This information enhances that required in Part VI of Form 990, which asks, among other things, the number of voting members and the number that are independent. On its governance Web page, IRS clearly states that it reviews the board composition of charities to determine whether the board represents a broad public interest and to identify the potential for insider transactions that could result in misuse of charitable assets.

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Part 3 addresses compensation and asks whether compensation arrangements for all officers, directors, trustees, and key employees are approved in advance by an authorized body with individuals who do not have a conflict of interest. It also asks whether the board relied on comparability data and whether the determinations are clearly documented. Part VI, line 15 of Form 990 asks for similar information.

Part 4, Organizational Control, like Form 990's Part VI, line 2, asks whether there are any family or business relationships among board members, officers, or key employees. It also asks whether control of the organization rests with a single or select few individuals.

Like line 12 of Form 990, Part VI, Part 5 of the check sheet asks whether the organization has a conflict of interest policy, but the agent also is instructed to determine whether the policy addresses recusals and annual disclosures of conflicts of interest. It also asks whether any conflicts were disclosed during the year under examination.

Part 6 asks about the institution's financial oversight, including the frequency with which board members received financial reports, whether the Form 990 was reviewed by the board or a committee; whether an independent accountant's report was prepared, and if so, whether it was discussed by the board; whether the accountant prepared a management letter, which was reviewed by the full board or a designated committee; and whether any recommendations in the management letter were adopted.

Part 7 asks whether the organization has a written policy for document retention and destruction that the organization follows. The IRS governance Web page says that, "The document retention policy should include guidelines for handling electronic files. The policy should cover backup procedures, archiving of documents, and regular check-ups of the reliability of the system." This part of the check sheet also asks whether the board contemporaneously documents and retains its meeting minutes.

Interestingly, it also asks the agent whether the examination was hindered by lack of documentation and provides choices from a drop down menu, including "Yes, did not cooperate," "Yes, documents no created," and "No hindrance."

The last section of the check sheet appears to summarize the examining agent's conclusion and principal issues regarding the primary return, although the "drop down" boxes on the check sheet are not active.

The check sheet and its instructions are posted at www.irs.gov/charities/article/0,,id=216068,00.html. ⇨

Take a First Look at the IRS Compliance Questionnaire Data

When the IRS sent its College and University Compliance Questionnaire to 400 recipients in September 2008, NACUBO and the Association of Governing Boards of Universities and Colleges (AGB) asked all respondents to send their completed questionnaires to Ernst & Young (E&Y) for analysis. Out of the 400 recipients, 146, many of which were large public institutions, submitted their completed questionnaires.

Now AGB and NACUBO have released the E&Y findings and analysis. The analysis and data are organized like the 33-page questionnaire, which was divided into four parts: (1) Organization Information; (2) Activities; (3) Endowment; and (4) Executive Compensation.

Organization Information

The organization information section runs the gamut on the type of information it requests — from the type of college or university, to the salaries and positions of the five highest paid employees, to conflict of interest policies, to whether the institution conducts distance learning activities. The E&Y analysis found that 97% of private institutions have a conflict of interest policy and 98% of the public institutions function under a state statute explicitly governing conflicts of interest for the governing body and top management officials. For full time faculty, 78% of private and 75% of public institutions have a written or statutory policy.

In response to the question on tuition discounts, more than 70% said they offered an average tuition discount of greater than 10%. One-third of the responding public universities offered discounts of greater than 20%, and 46% of private colleges said they offer discounts of greater than 30%.

Endowment

The endowment section of the questionnaire asks about how the college or university manages its endowment. For 99% of respondents, an investment policy governs how the funds are managed, and for 94%, a specific investment committee oversees the investments and approves an external endowment fund manager. Many institutions use a variety of meth-

ods, and often more than one, to monitor distributions and to ensure a donor's intent is respected. Reports (84%) and financial audits (60%) are the most frequently used methods.

Ninety-seven percent of respondents reported that their targeted endowment spending rate is 4%, and 70% reported that their spending rate is 5% or more.

On average, 45% of distributions are applied to scholarships, awards, grants, and/or loans. General university operations and general education support, including libraries, make up the next two categories, but spending is 14.7% and 13.7% respectively of the distribution. The last category that is above 10% is chairs/professorships, which on average receives 11.9% of endowment distributions.

Compensation

Throughout the questionnaire are questions regarding compensation and how it is set, with executive compensation addressed in Part 4. According to the E&Y analysis, the wording of some of the questions may have confused respondents and resulted in inconsistent responses.

Private colleges and universities indicated that a little less than 30% used outside executive compensation consultants to provide comparable data for positions, and 41% had a formal written compensation policy for at least some of the high-level officers, employees, and the board or trustees. At private colleges and universities, 53% used a process that would satisfy

RECENT DEVELOPMENTS

New Form 990 Filing Tips — Schedules A and L.

The IRS has issued tips and a set of frequently asked questions regarding Schedule A (Public Support and Public Charity Classification) and Schedule L (Transactions with Interested Persons) of the 2008 Form 990. **Link:** www.irs.gov/charities/article/0,,id=215112,00.html (Schedule A); www.irs.gov/charities/article/0,,id=215138,00.html (Schedule L).

Updated Compliance Guide for Section 501(c)(3) Organizations. The IRS has updated its compliance guides for IRC §501(c)(3) public charities and those exempt organizations that are neither public charities nor private foundations. **Links:** www.irs.gov/pub/irs-pdf/p4221nc.pdf (IRC §501(c)(3) public charities); www.irs.gov/pub/irs-pdf/p4221nc.pdf (non-IRC §501(c)(3) public charities and private foundations).

Employees of University's Practice Plan Subsidiary Not Treated as Concurrently Employed by Practice Plan Parent. PLR 200944016 involves a tax-exempt practice plan that is associated with a state university. The practice plan is the sole member of a limited liability company (LLC) that provides administrative and managerial services to the practice plan. The IRS ruled that the LLC will be treated as a separate corporation from the practice plan, and for purposes of applying the common paymaster rules, the employees of the LLC will not be included as employees of the practice plan for purposes of determining whether the 30% "related organization"

test of IRC §3121(s) is applicable. **Link:** www.irs.gov/pub/irs-wd/0944016.pdf.

IRS Announces Standard Mileage Rates for 2010.

In IR-2009-111, the IRS has announced the standard optional mileage rates used in computing the deductible costs paid or incurred on or after Jan. 1, 2010, for operating an automobile for business, charitable, medical, or moving purposes as follows: 50 cents per business mile; 16.5 cents per mile for medical or moving purposes; 14 cents per mile for charities. **Link:** www.irs.gov/newsroom/article/0,,id=216048,00.html.

IRS Delays (Again) Effective Date of Use of Smartcards, Etc. for Transportation Benefits.

In Notice 2009-95, the IRS says that it is delaying until Jan. 1, 2011, the effective date of Rev. Rul. 2006-57, which provides guidance to employers on the use of smartcards, debit and credit cards, and other electronic media to provide qualified transportation benefits under IRC §§132(a)(5) and 132(f). This is the third time in as many years that the IRS has delayed implementation of these rules to allow transit systems to modify their technology to make it compatible with the requirements for vouchers. **Link:** www.irs.gov/pub/irs-drop/n-09-95.pdf.

Exempt Organization Return Due Dates. The IRS has prepared a useful table setting forth the due dates of various returns and reports filed by exempt organizations. **Link:** www.irs.gov/charities/article/0,,id=210781,00.html.

UNRELATED BUSINESS INCOME ACTIVITIES UNDERTAKEN BY ONE-THIRD OF AGB/NACUBO SURVEY RESPONDENTS		
Activity	Engaged in Activity	Response All/Part UBI
Rental - facility rental	90%	34%
Bookstore	61%	26%
Food services	59%	13%
Rental - athletic facilities	55%	32%
Parking lot operations	51%	21%
Corporate sponsorships-events	51%	4%
Advertising printed publications	50%	49%
Corporate sponsorships -printed materials including publications	47%	6%
Corporate sponsorships-facilities	43%	5%
Catering services	41%	53%
Other Royalties	38%	2%
Logo Usage	38%	0%
Exclusive use contracts	34%	17%
<i>Source: Table 6, 2008 IRS Colleges and Universities Compliance Analysis</i>		

the rebuttable presumption of reasonableness of IRC §4958, which results in an automatic acceptance of the compensation. According to the AGB/NACUBO Statement, which accompanies the report, this percentage indicates that “institutions need to pay more attention to using a process intended to satisfy the rebuttable presumption procedure... .”

Faculty comprised 62% of the top five highest paid employees with an average salary of \$230,000. One interesting finding was that athletic coaches represent 13% of the highest paid employees at colleges and universities, and their average salary was \$684,000 with a median of \$404,000. However, these numbers must be read in light of who they represent. As the AGB/NACUBO Statement observes, “It is likely the 13 percent ... are almost certainly football and men’s basketball coaches at the Division I ... level.” Still, the associations flagged coaches’ salaries as an area of concern.

For college and university presidents, 38% of public institutions report compensation between \$200,000 and \$300,000, and 27% of private institutions reported compensation about \$100,000 higher. Compensation

came in the form of base salary, contributions to employee benefit plans, contributions to life, disability, and long-term care insurance, and contributions to 403(b) plans.

Unrelated Business Income

The questionnaire asks about 47 different types of activities that could generate unrelated business income. The 13 activities listed in the table to the left were undertaken by more than one-third of the respondents.

The AGB/NACUBO statement observes the following with regard to concerns that tax-exempt organizations are not paying the fair amount of tax: “Our job is to demonstrate not just how these rules work, but how they compare to the tax burdens that fall on the business sector. Indeed, there are ample data to suggest that unrelated business income taxes from nonprofits and corporate income taxes paid by small businesses are comparable.”

The complete NACUBO/AGB report is posted on the NACUBO Web site — <http://tinyurl.com/ybguqac>. ✧

Nurse Allowed to Deduct MBA Educational Expenses

As a general rule, when an individual incurs tuition and other education-related expenses, the expense is viewed as primarily personal and therefore nondeductible. But what if the person is working as an employee, and the education arguably helps maintain or improve his or her employment skills? Should the person be allowed to deduct the education expenses as a trade or business expense deduction under these circumstances?

The IRS regulations under IRC §162 address this issue and say that a deduction for educational expenses is allowed if the education either

- (1) maintains or improves the skills required by the individual in his employment, or
- (2) meets the express requirements of the person’s employer or applicable law necessary for the person to retain his job.

But, the regulations say, if the education serves to qualify the person for a new trade or business, the expenses are not deductible because the education is primarily personal in nature. (See Treas. Reg. §1.162-5(a)(1) and (2); (b)(3)).

It was against this background that the Tax Court considered a case involving a woman who had worked as a registered nurse for more than 20 years at a variety of different hospital jobs before enrolling in an MBA program in health care management. She received her MBA degree in April 2008 and, shortly thereafter, obtained a job at another hospital as a performance manager coordinator. While the job qualifications for this job did not require an MBA degree, the hospital said that one is "preferred." She claimed her educational expenses as a business deduction on her income tax return. The IRS audited her return and denied these deductions.

Court Says MBA 'Helpful'

The controversy ended up in the Tax Court where the IRS argued, first, that she would never have been hired for her current job without her MBA degree and therefore, the degree qualified her for the new trade or business of working at this hospital. The court disagreed, finding that the MBA degree was helpful but not a prerequisite for employment and that, given her extensive nursing background and performance, she would likely have been hired without the degree.

'New Trade or Business' Test Requires Objective Inquiry

The IRS next argued that, as a general matter, the MBA degree qualified her for a new trade or business. The court addressed this issue by noting that the "new trade or business" determination is an objective inquiry that is made by analyzing the tasks and activities that the person was able to perform before the education, in comparison to those she was qualified to perform after the education.

The court further noted that an MBA degree, unlike others such as law or medicine, does not automatically qualify the person for a new trade or business; rather, the determination must be made by looking at all of the facts and circumstances of the particular case.

Here, the court said, the nurse had essentially engaged in the same employment duties for over 20 years before obtaining her MBA degree and that her duties at the hospital were essentially the same after she obtained the degree. Therefore, the court rejected the IRS position and held that her MBA expenses were fully deductible.

A link to this case, *Singleton-Clark v. Commissioner*, T. C. Summary Op. 2009-182, can be found at www.ustaxcourt.gov/InOpHistoric/Singleton-Clarke.Sum.wpd.pdf. ✧

Nonresident Alien Withholding

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dent aliens are not eligible to claim this tax credit. To account for this, in Notice 2009-91, the IRS said that beginning with wages paid on or after Jan. 1, 2010, in addition to standard deduction-related adjustment, employers also must determine an additional amount of withholding to offset the effect of the Making Work Pay Tax Credit having been built into the withholding tables.

Publication 15 Explains Calculation

The specific steps to follow for each modification are set forth in the 2010 edition of Publication 15 (on page 16). Step 1 requires the employer to add a certain amount to the nonresident alien's wages for the payroll period. The chart that follows is reproduced from Publication 15 and sets out the amounts added to the wages for each type of pay period. For example, if the individual is paid on a biweekly basis, the employer adds \$78.85 to the employee's wages.

AMOUNT TO ADD TO NONRESIDENT ALIEN EMPLOYEE'S WAGES FOR CALCULATING INCOME TAX WITHHOLDING ONLY	
Payroll Period	Add Additional
Weekly	\$ 39.42
BiWeekly	78.85
Semimonthly	85.42
Monthly	170.83
Quarterly	512.50
Semiannually	1,025.00
Annually	2,050.00
Daily or Miscellaneous (each day of payroll period)	7.88
<i>Source: IRS, Pub. 15, Circular E, Employer's Tax Guide (2010), p. 16</i>	

In Step 2, the employer determines the tax from the tax tables used for other employees. In Step 3, the employer uses the same figure calculated in Step 1 but reduces it by the value of the claimed withholding allowance (usually one). It then uses the tables for the nonresident alien withholding adjustment (Pub. 15, page 70) and determines the amount of additional tax to withhold. In Step 4, the employer adds the two withholding adjustments from Step 2 and in Step 3,

and this is the amount to withhold during each pay period.

Let's look at an example. Brittany, a nonresident alien is paid \$600 every two weeks (bi-weekly) for her services to University A. Because she is paid bi-weekly the university must add \$78.85, as specified in the table on p. 16 of Publication 15, to the \$600 to calculate her withholding. This amount is not reported as wages; it is only used for the adjustment. Brittany, who is single, claims one withholding allowance, and University A uses the wage bracket method to determine withholding. First, the university adds the wage of \$600 and the adjustment amount, \$78.85, for a total of \$678.85. For Step 2, the university finds in the standard bi-weekly tax tables that the withholding is \$36. According to Step 3, the university next reduces the \$678.85 by the value of the withholding allowance (\$140.38 for biweekly payroll) and subtracts \$140.38 from \$678.85, which equals \$538.47. Using the tables on p. 70 of Publication 15, which are specifically for nonresident alien withholding adjustments for the Making Work Pay Credit, the university determines that it must add \$15.40 to the adjustment for the stan-

dard deduction. Thus, for each bi-weekly pay period, University A withholds \$51.40 (\$36 + \$15.40) from Brittany's pay check.

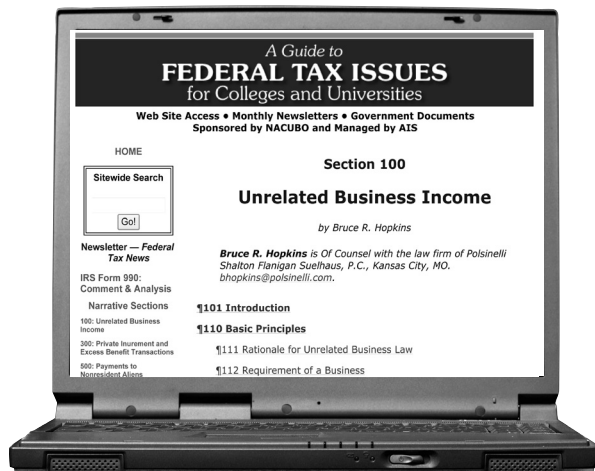
Note that because of treaty provisions, the withholding adjustments do not apply to nonresident alien students from India.

Supplemental Instructions for W-4 Issued

The IRS also issued Notice 1392, which sets forth supplemental instructions for nonresident aliens to follow when completing Form W-4, "Employee's Withholding Allowance Certificate." The notice modifies the current instructions to explain the restrictions on a nonresident alien's filing status, the limited number of personal exemptions allowed, and the adjustments that must be made because the nonresident alien cannot take either the standard deduction or the Make Work Pay credit.

Notice 2009-91 is posted at www.irs.gov/irb/2009-48_IRB/ar10.html. Publication 15 (2010) is posted at www.irs.gov/pub/irs-pdf/p15.pdf?portlet=3. Notice 1392 is posted at www.irs.gov/pub/irs-pdf/n1392.pdf. ✧

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