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Division of Social Security

Finance & Administration Cabinet
Division of Social Security
P.O. Box 557
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Scholarships may require withholding

Scholarships are unique in the federal employment tax realm. The basic requirement for a scholarship grant to be tax free, known as a "qualified" scholarship, is that the person receiving the scholarship must be a candidate for a degree at an educational institution.

A qualified scholarship can be for any amount that is used under the terms of the grant for:

- * Tuition and enrollment fees required to attend an educational institution, or
- * Fees, books, supplies and equipment that are required for the courses at the educational institution. These must be required of all students in the same course of instruction.

Any amount received for incidental expenses is not a tax free, qualified scholarship. Incidental expenses include expenses for room and board, travel, research and clerical help. They also include expenses for equipment and other items that are not required for either enrollment or attendance at an education organization, or in a course of instruction.

The part of any scholarship, including tuition reduction, that represents payment for past, present or future services or duties must be included as income and would be subject to the withholding of all applicable employment taxes. This applies even if all candidates for a degree are required to perform the service to receive the degree. Also to be included as income are any studies or research performed that primarily benefit the grantor of the scholarship.

Generally, the question is whether the work performed under a scholarship primarily benefits the recipient or the grantor. If it is the recipient who benefits from the work, the grant is excludable. If the grantor primarily benefits from the recipient's efforts, then the grant is subject to federal employment taxes.

Such a determination is not often easily defined. For example a program was partially funded by (the then) Department for Health, Education and Welfare and the stipend received by a participant was not excludable. The work performed was designed to improve the quality of education in a city. The local public school system, as grantor, was regarded as the primary beneficiary.

WE HAVE MOVED

The Division of Social Security has moved to Suite 101 of the Bush Building located at 403 Wapping St., Frankfort, 40601. The DOSS' telephone number (502/564-3952) remains the same, as does its FAX number (502/564-2124).

The division is now on-line to accept E-mail. The network address is The Finance and Administration Cabinet and the Bush Building is our mail box.

On the other hand, a native Alaskan was entitled to exclude the monthly stipend received from a state education agency. The taxpayer was enrolled in a program designed to encourage native Alaskans to enter the teaching profession and obtain the services of the program's participants after they graduated. Although the taxpayer functioned as a teacher's aide, the primary purpose of the stipend was to provide training, as the recipient was not obligated to accept employment with the Alaskan school system upon confirmation of a degree.

Other examples:

* A recipient of a \$5,000 qualified scholarship under a federal program is required to perform future service as federal employee. The \$5,000 scholarship represents payment for services and the \$5,000 must be included in the recipient's gross income as wages.

* A recipient of a \$10,000 scholarship from a state agency under the condition of agreeing to work for the state agency after graduation. The recipient has no previous relationship with state agency. The \$10,000 represents payment for future services and the \$10,000 scholarship must be included in the recipient's gross income as wages.

NOTE—When reporting non-qualified scholarship grants, Forms W-2 must be used, not Form 1099-MISC.

Agencies Must Make Calls on Contractor/Employee Status

One of the main duties of the Division of Social Security is the monitoring of personal service contracts between the Commonwealth and individuals (not corporations) to ensure the proper treatment of the state's FICA responsibility. It is the state agencies, however, that must make the initial call on whether a contract holder should be considered an employee.

Agencies should review their contracts and apply the Internal Revenue Service's common-law "control" test to determining whether an individual holding a personal service contract is an employee or an independent contractor. (Copies of the common-law "control" test are available from the Division of Social Security.) If the contractor is considered to be an employee, then all state and federal employment taxes must be withheld. These "employees" may be paid via the UPPS. Contact the UPPS support staff (502/564 6883) for more information.

The personal service contract holders deemed to be "employees, can also be paid outside the UPPS. Forms DOA-27 and DOA-40 (Receiving Report) must be completed fully when paying and withholding taxes under personal service contracts. Enter "***PSCP YMT" in the vendor number field on the DOA-40. The DOA-40, DOA-27 and any necessary backup should be sent to the Division of Account, Finance and Administration Cabinet.

An agency will, occasionally, find a contract that does not appear to fall into either the employee or contract category. These contracts should be submitted to the Division of Social Security which will, in turn, work with the Internal Revenue Service to reach a ruling.

This procedure requires both the state agency and the contractor to each complete a Form SS-8 and return both forms to the DOSS. Any determination arrived at through this process is final.

Experience has shown that most decisions arising from benefit claims will usually designate the former contractor as an employee, despite the fact the state did not consider the contractor as an employee and paid no FICA contributions. The result was that the agency must pay retroactive FICA contributions for both the state and the contractor, plus substantial interest and penalties.

Under the common-law control test, an individual will be an independent contractor where the state does not either actually exercise or have the right to exercise control over the manner in which the services are performed. Although the state may control the results to be accomplished, it cannot control the method by which that result is achieved.

If an employer-employee relationship exists under the common-law test, it is of no consequence that the employee is designated as a consultant, agent or independent contractor, how the employee is compensated or the FICA status designation marked on the contract.

DOA-27 Payroll Vouchers and Requests for Refund on Payroll

- * Enter the social security number for employees listed on these forms.
- * Complete the company number field by entering the cabinet and department numbers.
- * Be sure to check the appropriate payment type: P-1 employee, Non P-1 employee or Non P-1 employee other.
- * Use the new Request for Refund on Payroll form (revision date 8/1/93).
- * Make sure both the social security and medicare taxable wage and tax withheld fields are completed.

Address Changes Needed by DOSS

It is important to both our clients and the Division of Social Security that we maintain a high level of communication. For this reason, a form that will assist you in notifying the division of any address change accompanies the spring '96 Division of Social Security information release.

If there has been a change as to who should receive our information releases or where they should be sent, please complete the accompanying form and return it to the Division of Social Security at:

Postal

DOSS

P.O. Box 557

Frankfort, KY 40602-0557

Messenger

DOSS

101 Bush Bldg.

403 Wapping St.

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