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Insurance Company Information Reporting and Withholding Update

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I. Form 1099, Backup Withholding, and Penalties

A. IRS Modifies Position on Form 1099-R Changes

In May 2004, changes were made in the instructions for the 2004 Form 1099-R Distribution Codes to be used in Box 7. Specifically, the changes related to Distribution Code 2 for premature distributions where an exception to penalty taxes applies. The "2004 Instructions for Forms 1099-R and 5498" dropped all references to the exceptions found under I.R.C. § 72(q), (t) and (v) related to substantially equal periodic payments (SEPPs). However, on August 9, 2004, the IRS posted to its website an amendment to the "2004 Instructions for Forms 1099-R and 5498," which now once again, includes under Distribution Code 2 the exceptions found under I.R.C. § 72(q), (t) and (v).

II. Life Insurance, Annuities, and Qualified Plans

A. Foreign or Puerto Rican Income from U.S. Life Insurer Is Subject to U.S. Tax

The IRS in Rev. Rul 2004-75, has determined that income received by nonresident aliens from a life insurance or annuity contract issued by a U.S. life insurance company, is U.S. source income regardless of whether the contract was issued by a foreign or Puerto Rican branch of the U.S. life insurance company. Therefore, any income received from the insurance or annuity contract is subject to U.S. tax. The revenue ruling addressed two issues. One, whether income received by a nonresident alien under a life insurance and annuity contracts by a foreign branch of a U.S. life insurance company is U.S. source income that is subject to 30% tax and withholding under I.R.C. § 871(a) and I.R.C. § 1441 and two, whether income received by a resident of Puerto Rico under life insurance and annuity contracts by a Puerto Rican branch of the U.S. life insurance company is subject to tax imposed by I.R.C. § 1.

In the first issue, because I.R.C. § 861(a) does not include rules specifying the source of income received under a life insurance or annuity contract under I.R.C. § 72, the source of such income is determined by comparison and analogy to classes of income that are specified in the statute as decided by Bank of America v. U.S., 680 F.2d 142, 147 and Howkins v. Commissioner, 49 T.C. 689. The ruling stated that income received under a life insurance or annuity contract under I.R.C. § 72 is analogous to interest on a debt obligation, dividends on a stock, and earnings and accretions on pension fund assets. Under I.R.C. § 861(a)(1) and (2), interest or dividends are U.S. source when the

corporation is domestic. In Clayton v. U.S., 33 Fed. Cl. 628 (1995), the court determined that earnings and accretions on pension fund assets was U.S. source income when the pension trust was domestic. Based on that stated analogy (for which no authority or analysis was offered), Rev. Rul. 2004-75 determined that income received by nonresident aliens under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S. source income that is subject to 30% tax withholding under I.R.C. § 871(a) and I.R.C. § 1441.

In the second issue, under I.R.C. § 933(1), an individual who is a bona fide resident of Puerto Rico during the entire taxable year may exclude income derived from sources within Puerto Rico. However, as described above, the income received from the life insurance and annuity contracts is considered U.S. source income and therefore is not eligible for the exclusion allowed under I.R.C. § 933(1). Additionally, under I.R.C. § 876, any individual who is a bona fide resident of Puerto Rico during the entire taxable year is subject to the tax imposed by I.R.C. § 1. As such, Rev. Rul. 2004-75 determined that income received by bona fide residents of Puerto Rico under life insurance or annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is subject to the tax imposed by I.R.C. § 1.

It should be noted that the life insurance industry has asked the IRS to suspend Rev. Rul. 2004-75 and to open a period of comment, as well as, to announce that any new or reinstated position will be applied only to contracts issued after the date of reinstatement.

III. Employer Issues and Employee Benefits

A. IRS to Refund Deposit Penalties; Discusses Importance of Accurate Forms W-4

To encourage employers' use of the electronic federal tax payment system (EFTPS), the IRS is offering an automatic one-time penalty refund. As explained by Thomas Burger, IRS program manager for the office of employment tax, the penalty refund offer will allow business taxpayers an opportunity to receive an automatic one-time penalty refund if they have been assessed a deposit penalty on Form 941, "Employer's Quarterly Federal Return." However, the offer is only available to those employers who are not mandated to use EFTPS and further, to qualify the employer must use the EFTPS for one year, make all Form 941 payments on time, and have previously fully paid the penalty. Additional information is available in IRS Pub. 4048.

Additionally, Burger discussed the importance of having accurate Forms W-4, "Employee's Withholding Allowance Certificate." According to Jerri Langer of the National Association of Tax Reporting and Payroll Management, questions have arisen on the difference between questionable

Forms W-4 and invalid Forms W-4. Langer elaborated, saying that an employer should treat an invalid Form W-4 as if the employee were single and claiming no allowances.

B. Waiver of 60-day Time Limit of I.R.C. § 402(c) for Rollover in Various Cases

In a string of private letter rulings the IRS waived the 60-day time limit for rollovers, pursuant to I.R.C. § 402(c)(3)(B), where the Secretary may waive the requirement if “the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.”

In PLR 200427027, the taxpayer participated in a I.R.C. § 401(a) retirement plan, and on September 30, 19XX the taxpayer requested and received a complete distribution from the plan in the form of a check less the 20 percent federal withholding. Under I.R.C. § 402(f), the plan administrator within a reasonable amount of time must, supply a written explanation to the recipient of the rollover rules, including the tax consequences of a request for a complete distribution. However, the taxpayer did not receive any written or oral correspondence to that effect. On February 28, 19XX the taxpayer spoke to an investment adviser who informed the taxpayer of the 60-day limit. The taxpayer was referred to a tax advisor who created a request for a waiver from the 60-day rollover rule to the IRS. At the time of the request, the taxpayer had not cashed or rolled over the amount of the distribution.

The private letter ruling cites Rev. Proc. 2003-16, 2003-4 I.R.B. 359, which states that when determining whether to grant a waiver of the 60-day rollover requirement the IRS will consider “all relevant facts and circumstances including: (1) errors committed by a financial institution; (2) inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign county or postal error; (3) the use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and (4) the time elapsed since the distribution occurred.” As explained by the IRS in PLR 200427027, the taxpayer could not “reasonably be expected to satisfy the [60-day rollover] requirement...”

In PLR 200427028, the taxpayer received a portion of a retirement account in a divorce settlement. In anticipation of receiving the distribution, the taxpayer established individual retirement accounts (IRAs). Upon receipt of the distributions, however, the taxpayer questioned the amount withheld by the original plan. The taxpayer then consulted an attorney, who advised the taxpayer to send him the check for handling of the transaction. The attorney received the funds and did not return them until the 60-day rollover period had expired. The IRS ruled that the information provided by the taxpayer, “demonstrates an error caused by reliance on the services of [the] Attorney...” and waived the 60-day limit.

The IRS used the same argument in PLR 200427029, where the taxpayer, upon termination of his employment, relied on the faulty advice of his former employer and new employer regarding the rollover of his retirement proceeds. The employee's rollover missed the 60-day limit. Upon termination with Company A, the taxpayer was forced to sell his shares of Company A stock in the qualified plan, because being terminated he was no longer eligible to hold such stock. The taxpayer was told he had until the end of the year to rollover the proceeds of the stock sale into a new I.R.C. § 401(k) program. The taxpayer started new employment, and was told he could not make a rollover into its 401(k) program until the beginning of the next year. In January, the taxpayer was told by his employer that they would not accept his rollover because it was not in a qualified 401(k) or a Conduit IRA account. The IRS ruled that the taxpayer was able to demonstrate an "error caused by reliance" on the advice of his former and new employer and was granted a waiver to the 60-day limit.

C. Employer May Be Able to Deduct Premium for Long-term Care Insurance

A taxpayer requested a private letter ruling about the income tax consequences of long-term care insurance premium payments. The IRS responded that pursuant to 6.02 of Rev. Proc. 2004-1, they do not ordinarily issue a private letter ruling when the taxpayer's question involves a factual issue. Nor does it issue private letter rulings on whether compensation is reasonable in amount, as explained in 3.01 of Rev. Proc. 2004-3. However, the IRS did write an information letter, INFO 2004-0086, which generally provided information and assistance on the taxpayer's issues.

Under the facts in INFO 2004-0086, the taxpayer performs services for a partnership under a covenant not to compete. The partnership plans to pay the taxpayer a salary, as well as purchase a long-term care insurance policy on the taxpayer's behalf. Future employees will be eligible for the long-term care insurance policy. The taxpayer asks whether the partnership may deduct the long-term care insurance premiums in full, whether there are requirements regarding minimum salary and hours to be considered an employee of the partnership, as well as whether the taxpayer must recognize taxable income as a result of the insurance coverage.

As to the deductibility of the long-term care insurance premiums for the partnership, the IRS referred the taxpayer to I.R.C. § 162(a) which provides that a business may deduct its ordinary and necessary expenses paid or incurred during the taxable year. Under I.R.C. § 162(a)(1), employee compensation is considered an ordinary and necessary expense to the extent that the compensation is paid for services actually rendered and reasonable in relation to the services performed. There are no specific requirements for minimum salary or hours worked to determine what constitutes a reasonable

amount of employee compensation under I.R.C. § 162(a)(1). However, Treas. Reg. § 1.162-7(b)(3) defines reasonable compensation as the amount that would be paid for similar services by a similar enterprise under equitable circumstances. The IRS also referred the taxpayer to Publication 535, "Business Expenses," which has a discussion of how to determine what is reasonable and what constitutes services rendered. The tax consequences of the insured person generally are that the employer's payments for qualified long-term care insurance are excludable from the employee's income. In Publication 525, "Taxable and Non-Taxable Income," long-term care coverage is listed as non-taxable income.

IV. Reporting Guidelines and Forms

A. Insurers Relieved of Filing Forms 1099-H

In Notice 2004-47, the IRS effectively relieved health insurance providers of the responsibility of filing Forms 1099-H, Health Coverage Tax Credit (HCTC) Advance Payments, unless the health insurance provider chooses to prepare the form. Instead, the IRS HCTC Program's transaction center will take over the filing of Forms 1099-H required by I.R.C. § 6050T. Under I.R.C. § 6050T the providers are required to file information returns with the IRS reporting the advance payments the providers receive from the Treasury Department, and to furnish the insured an information statement showing the information filed with the IRS.

Currently the Treasury Department is administering the HCTC program by using a customer contact center and a transaction center. The transaction center will collect the insured's portion of the premium and forward the total premium including the advance payment to the health insurance providers through health plan administrators. As stated by Notice 2004-47, since the transaction center will know the amount of the advance payments, and the identity of the individuals who benefit from the payments, it is "in the interest of sound tax administration to allow such health insurance providers to use the transaction center to satisfy their information reporting obligations under I.R.C. § 6050T and not require the providers to file information returns..."

B. IRS Issues Guidance on Determining How Payment Card Transactions Are Reported and How to Request QPCA Status

On July 14, 2004, the IRS simultaneously released two revenue procedures, Rev. Proc. 2004-42 and Rev. Proc. 2004-43, on payment card information reporting. The two procedures make it easier to determine whether a transaction is subject to reporting requirements and for payment card organizations to gain authority to act on behalf of merchants and cardholders. The release of the two

procedures was coordinated with the July 12 release of final and temporary regulations (T.D. 9136) on the information reporting and backup withholding requirements of payment cards, which are issued by banks and used much like credit cards.

Rev. Proc. 2004-42 establishes a procedure for payment card organizations to request a determination that they are a Qualified Payment Card Agent (QCPA) for information reporting and backup withholding purposes. A QCPA may act on behalf of cardholders to solicit, collect, or validate merchant data including taxpayer identification numbers (TINs), and to furnish merchant data to the cardholders on behalf of the merchant. Following this procedure relieves the cardholders from certain TIN solicitation requirements for payments made through a QCPA.

To become a QCPA, the payment card organization must send an application to the IRS detailing, among other things, account opening procedures along with the documents the organization uses, and the organization's systems and controls related to the activities associated with being a QCPA. Additionally, the payment card organization must establish that it has authorization from the cardholders to solicit, collect, and validate merchant names and TINs, as well as authorization from the merchants to furnish their names and TINs to cardholders. To establish this the payment card organization is required to send written notices to both the cardholders and merchants.

Rev. Proc. 2004-43 provides an optional procedure that payors (cardholders) may use in determining whether payment card transactions are reportable under I.R.C. § 6041 or I.R.C. § 6041(a). Additionally, this procedure may be used to determine whether payment card transactions are reportable for purposes of the IRS TIN Matching Program under I.R.C. § 3406. Generally, this procedure allows a payment card organization to assign Merchant Category Codes (MCCs) to merchants according to whether they predominantly furnish services (reportable transactions) or goods (non-reportable transactions), and as defined by the revenue procedure. The payment card organization then notifies payors that use its payment card of the MCCs. The payor may then rely on the MCC assigned to a merchant in determining whether a payment card transaction is subject to reporting under I.R.C. § 6041 or I.R.C. § 6041(a).

C. IRS Publications Relating to TIN, EIN Rules

The IRS posted two publication explaining rules and requirements for usage of taxpayer identification number (TINs) and employer identification numbers (EINs). Publication 1586, "Reasonable Cause Regulations and Requirements for Missing and Incorrect Name/TINs" was revised in July 2004, and should provide information on basic TIN procedures and policies including how to obtain a TIN, and how employers can avoid penalties for incorrect or incomplete TIN information

returns. However, the publication was added to the IRS website with errors, and subsequently is scheduled to be back up by August 30, 2004.

Publication 1635, "Understanding Your EIN" was also revised in July 2004, and provides information on avoiding common EIN problems. The booklet generally covers what entities need EINs, and provides information on what returns each type of business must file. While it does not cover entity classification elections, it does not that special ruled may apply when Form 8832, "Entity Classification Election" is filed.

D. IRS Provides Guidance on Filing Employment Tax Forms in Certain Acquisitions

The IRS released Rev. Proc. 2004-53, which explains both the standard and alternate procedure for preparing and filing Form W-2, "Wage and Tax Statement," Form 941, "Employer's Quarterly Federal Tax Return," Form W-4, "Employee's Withholding Allowance Certificate," and Form W-5, "Earned Income Credit Advance Payment Certificate," in certain acquisitions. Rev. Proc. 2004-53, which supersedes Rev. Proc. 96-60, is applicable when an employer (successor) acquires substantially all of the property used in a trade or business of another employer (predecessor), or used in a separate unit of a trade or business of a predecessor, and in connection with or immediately following the acquisition (but within the same calendar year), the successor employs individuals who prior to the acquisition were employed in the trade or business of the predecessor.

Rev. Rul. 2004-53 includes guidance on the new Schedule D (Form 941), "Report of Discrepancies Caused by Acquisitions, Statutory Mergers, or Consolidations" that is being developed by the IRS. The new Schedule D (Form 941) may be used in both the standard and alternative methods to explain the discrepancies between Forms W-2 (Copy A) and Forms 941 in the totals of social security wages, Medicare wages and tips, social security tips, federal income withheld, and advanced earned income credit (EIC) payments caused by an acquisition or merger. The new Schedule D (Form 941) replaces the statement which served the same function as described in Rev. Proc. 96-60. For both methods, if the Form 941 is filed electronically, the Schedule D (Form 941) must be filed separately on paper until the IRS creates electronic specifications for Schedule D (Form 941).

E. Rules and Specifications for Forms W-2 and W-3

In Rev. Proc. 2004-54, the IRS released the new rules and requirements of the IRS and Social Security Administration (SSA) for reproducing paper substitutes for Forms W-2, "Wage and Tax Statement" and Forms W-3, "Transmittal of Wage and Tax Statement," for wages paid during the 2004 calendar year. Changes to note include several changes to the dimensions of Forms W-2 and

Forms W-3, including the red-ink Forms W-2 and W-3, the Privacy Act and Paperwork Reduction Act Notice has been moved to the back of Copy D of Form W-2, and electronic payee statements (Copies B, C, and 2 of Form W-2) which may be furnished if employees give their consent.

F. Update Specifications for Magnetic and Electronic Filing of Forms 1098, 1099, 5498, and W-2G

The IRS has released updated specifications for magnetic and electronic filings of Forms 1098, 1099, 5498, and W-2G in Rev. Proc 2004-50. This revenue procedure must be used for the 2004 tax year information returns, as well as information returns for years prior to 2004 that are filed beginning January 1, 2005, and postmarked by December 1, 2005. The IRS now offers a web connection for electronic filing through the IRS Martinsburg Computing Center (IRS/MCC) at <http://fire.irs.gov>. The FIRE system will be down from December 23, 2004 until January 4, 2005 for upgrading, and will not be able to accept submission during that time.

There were programming changes to the old procedures, most notably is the complete revision of Part B, Electronic Filing Specifications, in light of the new online filing system offered through IRS/MCC. Additionally, several forms have been revised including Form 1099-B, 1099-CAP, and 1099-DIV. These revisions may impact taxpayers' ability to correct prior year forms. Taxpayers required to make corrections electronically or magnetically to any of these forms for tax year 2003 or earlier, should contact the Information Reporting Program Customer Service Section for instructions at 1-866-455-7438.

V. **Other Matters**

A. Treasury's Priority Guidance Plan

The Treasury Department has released its 2004-2005 Priority Guidance Plan. Several items included in the Plan may affect the withholding and reporting obligations of insurance companies, including the following:

- o Guidance regarding information reporting under I.R.C. § 6041 for commissions paid to insurance agents
- o Final regulations under I.R.C. § 6045(f) regarding the reporting of gross proceeds to attorneys

B. Technical Guidance from IRS Now Available Through E-mail

The IRS will make technical guidance available through e-mail to interested tax professionals. Subscribers will receive notice of IRS revenue rulings, revenue procedures, announcements and notices, as well as links to the text. Interested individuals may sign up online at the IRS website, www.irs.gov, by clicking on “The Newsroom” and “e-News Subscriptions,” then choose “IRS Guidewire.”

C. IRS Seeks Comments on Need for Guidance on Options Granted Under Employee Stock Purchase Plans

In Notice 2004-55, the IRS and Treasury stated that it had received questions on whether the proposed regulations regarding incentive stock options are to be interpreted consistently with I.R.C. § 423, concerning options granted under an employee stock purchase plan. The IRS invited public comment as to whether the I.R.C. § 423 should be amended, and if so, what issues should be addressed or concerned. The notice included a list of specific questions the IRS had received, and encouraged comments on those issues as well as any others in which I.R.C. § 423 should be clarified or amended. Comments are due by October 1, 2004, and may be submitted by mail, by hand, or electronically at Notice.Comments@irs.counsel.treas.gov.