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Insurance Company Information Reporting and Withholding Update

November 2004

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I. Life Insurance, Annuities, and Qualified Plans

A. Proposed Regs Issued for I.R.C. § 403(b) Annuity Contracts

On November 15, 2004, the IRS issued proposed regulations, which would provide updated guidance for I.R.C. § 403(b) annuity contracts of public schools and I.R.C. § 501(c)(3) tax-exempt organizations. The proposed regulations would update the current regulations (issued in 1964) to reflect the existing state of the law, with respect to similar salary reduction contribution arrangements, such as I.R.C. § 401(k) plans. If issued in final form, the proposed regulations would supercede or obsolete other I.R.C. § 403(b) administrative guidance, such as revenue rulings and notices issued by the IRS. The proposed effective date is taxable years beginning after December 31, 2005, subject to certain transition rules.

A public hearing is scheduled for February 15, 2005. Comments are due by February 14, 2005. Outlines of discussion topics for the scheduled public hearing are due by January 25, 2005.

B. Temporary Regs Issued Defining “Salary Reduction Agreement” for Certain Exempt Organizations Purchasing I.R.C. § 403(b) Annuity Contracts for Employees

On November 15, 2004, the IRS issued temporary regulations, which define the term “salary reduction agreement” for purposes of I.R.C. § 3121(a)(5)(D). Temp. Treas. Reg. § 31.3121(a)(5)-2T provides guidance to public educational institutions and I.R.C. § 501(c)(3) tax-exempt organizations that purchase I.R.C. § 403(b) annuity contracts on behalf of employees. Under this temporary regulation, the term salary reduction agreement explicitly includes I.R.C. § 403(b) annuity contracts. Temp. Treas. Reg. § 31.3121(a)(5)-2T is effective November 16, 2004, and expires on November 16, 2007.

II. Employer Issues and Employee Benefits

A. Settlement Payments Received Pursuant to Separation Agreement are Not Excludable from Gross Income Under I.R.C. § 104(a)(2)

On November 3, 2004, the United States Tax Court held that the payments received by an employee, pursuant to a separation agreement, were not excludable from gross income under I.R.C. § 104(a)(2). Ndirika v. Commissioner, T.C. Memo. 2004-250. The Tax Court found that the employee

did not establish that the payments were received on account of personal physical injuries or physical sickness, as required by statute and caselaw.

Under the facts in Ndirika, the employee was provided an opportunity to voluntarily resign in lieu of termination. The employee and employer subsequently entered into a separation agreement, whereby the employee was to receive \$93,750 in severance pay, in the form of salary continuation, as well as \$15,000 in a lump sum supplemental severance payment. The employer reported these amounts to the IRS on Form W-2 as wages, tips, and other compensation. The employee took the position that the payments were excludable from gross income under I.R.C. § 104(a)(2) as payments received on account of personal physical injuries or physical sickness.

The Tax Court found that the separation agreement treated the payments as salary continuation severance payments and, as such, the payments were includible in the employee's gross income.

B. Amended Definition of Dependent Under I.R.C. § 152 Does Not Affect Definition of Dependent for Purposes of I.R.C. § 106

On November 17, 2004, the IRS published Notice 2004-79, which clarified that the definition of dependent under I.R.C. § 152, as amended by the Working Families Tax Relief Act of 2004 (WFTRA), does not affect the definition of dependent for purposes of I.R.C. § 106.

I.R.C. § 106(a) excludes from gross income accident or health plan coverage provided to an employee by an employer. Treas. Reg. § 1.106-1 extends this exclusion to employer-provided coverage of an employee's dependents, as defined in I.R.C. § 152. Because dependent is defined in Treas. Reg. § 1.106-1, rather than in I.R.C. § 106, the WFTRA did not amend I.R.C. § 106.

However, the WFTRA amended I.R.C. § 105(b), which excludes from gross income direct or indirect reimbursements by an employer for an employee and the employee's dependents, as defined in I.R.C. § 152. The amendment provides that whether an individual is a dependent for purposes of I.R.C. § 105(b) will be determined without regard to the amended provisions of I.R.C. § 152.

The Notice stated that Congress did not intend to change the definition of dependent for purposes of I.R.C. § 106 when it amended I.R.C. § 152. Rather, Congress intended to retain the definition of dependent for purposes of I.R.C. § 106, as it did for I.R.C. § 105(b). The Notice further stated that revision of Treas. Reg. § 1.106-1 is necessary to reflect the intent of Congress. Once revised, Treas. Reg. § 1.106-1 will provide that the meaning of dependent, as used in I.R.C. § 105(b), shall apply to I.R.C. § 106, effective for taxable years beginning after December 31, 2004. Until such revision is made, taxpayers may rely on Notice 2004-79 and "exclude from gross income the value of

employer-provided coverage for an individual who meets the definition of a qualifying relative, except that the individual's gross income equals or exceeds the exemption amount.”

III. Employee Business Expenses

A. IRS Releases 2005 Standard Mileage Rates

On November 17, 2004, the IRS published Rev. Proc. 2004-64, which lists the 2005 optional standard mileage rates for employees, self-employed individuals, and other taxpayers, to use in computing the deductible costs of operating an automobile for business, charitable, medical or moving expense purposes. The new standard mileage rates are effective January 1, 2005, and consist of the following: 40.5 cents per mile for business miles (3 cent increase from 2004), 14 cents per mile for charitable use miles (unchanged from 2004), and 15 cents per mile for medical and moving miles (1 cent increase from 2004).

Rev. Proc. 2004-64 supercedes Rev. Proc. 2003-76 for mileage allowances paid to an employee on or after January 1, 2005, for transportation expenses paid or incurred by an employee on or after January 1, 2005, and for purposes of computing allowable transportation deduction expenses paid or incurred on or after January 1, 2005.

B. Publication 1542 Rereleased by IRS

The IRS has rereleased Publication 1542, Per Diem Rates (For Travel Within the Continental United States). The maximum federal per diem rates, effective October 1, 2004, are listed in Table 4 of the publication.

IV. Reporting Guidelines and Forms

A. IRS Updates Specifications for Magnetic or Electronic Filing of Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding

On November 8, 2004, the IRS published Rev. Proc. 2004-63, which updates the specifications for electronic and magnetic filing of Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. Rev. Proc. 2004-63 supercedes Rev. Proc. 2003-83, and will be reprinted as the current revision of Publication 1187. This revenue procedure must be used to prepare current and

prior year information returns filed beginning January 1, 2005, and received by IRS/ECC-MTB or postmarked by December 31, 2005.

For electronic filing, withholding agents may use the FIRE (Filing Information Returns Electronically) System. The IRS now offers an internet connection at <http://fire.irs.gov>. The FIRE System will be unavailable for submissions from December 23, 2004 through January 4, 2005, due to system upgrading.

For magnetic filing, withholding agents may use IBM 3480, 3490, 3490E, 3590, 3590E compatible tape cartridges, or 3½ inch diskettes. However, effective tax year 2006, processing year 2007, withholding agents may no longer submit 3½ inch diskettes.

Noteworthy changes for the current tax year (2004) include complete revision of Part B, Electronic Filing Specifications, as well as changes to the Transmitter 'T' Record, the Withholding Agent 'W' Record, the Recipient 'Q' Record, the Reconciliation 'C' Record, and the End of Transmission 'F' Record. Also, editorial changes have been made throughout the publication.

B. Panel Speaks on 2004 Year End Payroll Issues

On November 9, 2004, Tax Talk Today aired a web cast featuring a panel of payroll and government experts. The topic was Payroll Prep for the Year End.

One year end issue was the need to ensure the accuracy of information reported on Form W-2, Employee Wage and Tax Statement. Ten percent of the Forms W-2 filed with the SSA for 2003 contained mismatches of employee names and social security numbers. For 2004, employers should ensure Form W-2 accuracy by verifying the information through the SSA database. However, if a 2004 Form W-2 requires correction, employers now may file Form W-2c, Corrected Wage and Tax Statement, electronically through the SSA's website.

Employers may electronically file up to 20 Forms W-2. Greater than 60 percent of 2003 Forms W-2 were electronically filed. Employers who electronically filed for 2003, and who will electronically file for 2004, should make sure that the year on their batch submissions is changed to 2004. If an employer files electronically, the employer will receive a Form W-3, Transmittal of Wage and Tax Statements, which should comport with the fourth quarter wage and tax figures on Form 941, Employer's Quarterly Tax Return, filed with the IRS. Employers also are urged to verify check dates so that the first 2005 check is not actually paid in 2004.

Another year end issue was the revision of Form 941, which is effective beginning in 2005. The revised form provides separate boxes for each quarter, which eliminates a problem that arose when, instead of using an original Form 941, an employer used a copy of a previous Form 941 that already had a quarter designated, but failed to designate the appropriate quarter. Also, with respect to Form 941, it is the date withholding liability occurs, rather than the date withheld taxes are deposited, that belongs on Schedule B (Form 941).

C. Changes to 2004 E-Filing Programs and Redesigned Forms

On November 15, 2004, the Council for Electronic Revenue Communication Advancement sponsored a conference at which IRS officials discussed e-filing program changes and redesigned forms.

Changes to the e-filing programs for 2004 Form 1065, U.S. Partnership Return of Income, and 2004 Form 1041, U.S. Income Tax Return for Estates and Trusts, allow additional forms to be filed electronically with each of these forms. With electronically filed Form 1065, taxpayers also may e-file Form T, Form 970, and Form 8886. With electronically filed Form 1041, taxpayers also may e-file Form 8082, Form 8275, Form 8275-R, and Form 8886, as well as a preparer's note, an election explanation, and a regulatory explanation.

Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return, have been redesigned. Form 940 was redesigned in an effort to make the form easier to scan and to embed a 2-D code. Form 940 became eligible for e-filing in 2004, and the redesigned form should be available for tax year 2006. The redesigned Form 941 must be used by all e-filers beginning April 15, 2005.

Also discussed at the conference, were e-filing statistics. Over a two year period, there was a 75 percent increase in e-payments, and an 80 percent increase in balance-due Form 1040 returns, with 60 percent of balances due electronically paid. The IRS hopes to expand the capabilities of the electronic federal tax payment system.

D. New Code on 2005 Form W-2 for I.R.C. § 409A Income Deferrals

On November 22, 2004, the IRS published Announcement 2004-96, which advises employers of a new code (i.e., "Code Y- Deferrals under a section 409A nonqualified deferred compensation plan") for use on 2005 Form W-2, Box 12. Code Y will identify annual deferrals of income under a nonqualified deferred compensation plan.

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I.R.C. § 409A was added by the American Jobs Creation Act of 2004, and is effective after December 31, 2004. Employers will be required to report annual deferrals under a nonqualified deferred compensation plan on each employee's Form W-2, in Box 12, using Code Y. Code Y has been added to the 2005 Form W-2, and the 2005 Instructions for Forms W-2 and W-3.

This Update is provided solely for informational purposes and is not intended to furnish legal advice with respect to a reader's particular factual circumstances. For additional information on any of the topics in this Update, please contact Stephanni Hemmi at Scribner, Hall & Thompson, LLP.