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Insurance Company Information Reporting and Withholding Update

April 2005

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I. Employer Issues and Employee Benefits

A. IRS Receives Comments on Proposed Regulations for Flat Rate Withholding on Supplemental Wages

The IRS has received comments on proposed regulations that would amend the rules for flat rate withholding on supplemental wages. The proposed regulations were issued on January 5, 2005, and reflect statutory changes over the past 10 years, including the American Jobs Creation Act of 2004, which subjects supplemental wages, in excess of \$1 million for the calendar year, to mandatory withholding at the maximum rate of tax, currently 35%.

In a comment letter dated April 5, 2005, the National Association of Tax Reporting and Payroll Management (NATRPM) requested transition relief from underwithholding penalties through calendar year 2006 for good faith compliance efforts, default treatment as supplemental wages when it is unclear whether wages are supplemental or regular, clarification on treatment of post-employment wage payments that would have been supplemental wages prior to termination, and clarification on the application of the supplemental wage rate in the context of payroll tax examinations. The NATRPM commented that the payroll community faces administrative and system-conversion challenges in complying with the new withholding requirements. The NATRPM also requested a public hearing on the proposed regulations.

In a comment letter dated April 11, 2005, Tax Executives Institute (TEI) recommended that the effective date of the regulations be deferred until the later of January 1, 2006, or six months following the release of final regulations, as opposed to the proposed effective date of publication of the final regulations in the Federal Register. TEI commented that employers will need the extra time to bring their payroll systems up to date to ensure compliance with the new rules once effective. TEI also recommended interim relief permitting a reasonable, good faith effort to comply with withholding obligations that includes a waiver of reporting and withholding penalties and interest, and a waiver of employer or other payer withholding tax liability. TEI further recommended that, in order to ease the burdens imposed on employers, rules of administrative convenience should be adopted, such as applying the 35% rate after total compensation exceeds \$1 million to ease the difficulty of distinguishing regular wages from supplemental wages, applying the 35% rate to the entire payment or to additional supplemental wage payments once the \$1 million threshold is met to ease the difficulty of applying split withholding rates to a single payment of supplemental wages, and permitting third-party payers to apply the maximum withholding rate to cumulative supplemental wages measured on a stand-alone basis.

In a comment letter dated April 11, 2005, KPMG recommended an exclusion from the definition of supplemental wages, and from the calculation of the \$1 million threshold, for disqualifying

dispositions of statutory options. KPMG commented that although there is no withholding obligation for disqualifying dispositions under I.R.C. § 421(b), as amended by the American Jobs Creation Act of 2004, it is not clear how such disqualifying dispositions are to be treated because statutory options are not specifically excluded from I.R.C. § 3401(a), and items that are not wages under I.R.C. § 3401(a) are not subject to the \$1 million threshold and the mandatory flat rate withholding requirements. KPMG alternatively recommended that if disqualifying dispositions are not excluded from the definition of supplemental wages, such disqualifying dispositions should be disregarded for purposes of calculating the \$1 million threshold.

B. Wages Paid to H-3 Visa Holder Subject to FICA, FUTA, and Income Tax

In a recently released information letter, dated March 21, 2005, the IRS responded to a general information request regarding the taxation of wages paid to an H-3 visa holder (i.e., a nonresident alien temporarily staying and working in the U.S. as a trainee in certain training programs). Info 2005-0062. The letter stated that wages paid to an H-3 visa holder are subject to FICA, FUTA, and income tax. The obligation to withhold FICA, FUTA, and income tax is imposed on the withholding agent, who is personally liable for any tax required to be withheld. The withholding agent is the individual, corporation, partnership, trust, association, or any other entity that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding.

C. Payments from Employer-Provided Medical Arrangements that Provide for Reimbursement of Other than Medical Care Expenses are Not Excludable from Gross Income

On April 5, 2005, the IRS published Rev. Rul. 2005-24, which held that payments made under an employer-provided reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits are not excludable from gross income under I.R.C. § 105(b). The ruling stated that, whether or not an employee has incurred medical expenses during the year, if an employee is entitled to receive payment irrespective of whether any medical expenses have been incurred, none of the payments are excludable from gross income under I.R.C. § 105(b). Rev. Rul. 2005-24 also applies to employer-provided reimbursement arrangements that are limited only to retired employees, and arrangements that cover active employees or both active employees and retirees.

Rev. Rul. 2005-24 amplifies Notice 2002-45, and is effective for plan years beginning after December 31, 2005.

D. Summary of Report on Tax Compliance Options Released

On April 12, 2005, the Joint Committee staff released a summary of the January 27, 2005, Joint Committee on Taxation report entitled "Options to Improve Tax Compliance and Reform Tax Expenditures." One option, pertaining to the inconsistent FICA tax treatment of salary reduction amounts, provides for inclusion in FICA wages salary reduction amounts used to provide benefits under a cafeteria plan or to provide qualified transportation fringe benefits, similar to the manner in which salary reduction contributions to employer-sponsored retirement plans are included in FICA wages.

E. Proposal Would Increase Excludable Amounts for Employer-Provided Transit and Van Pooling Benefits

On April 19, 2005, the Joint Committee on Taxation released its Description of the Chairman's Modification to the Provisions of the "Highway Reauthorization and Excise Tax Simplification Act of 2005." One proposal would increase the maximum dollar amount of excludable employer-provided transit and van pooling benefits from \$105 per month (for 2005) to \$155 per month, indexed for inflation after 2008. The maximum amount of excludable qualified parking would remain at \$200 per month. The proposal would be effective for taxable year beginning after December 31, 2005.

II. Reporting Guidelines and Forms

A. New Regs Issued on Submission of Questionable Forms W-4

On April 14, 2005, the IRS issued final and temporary regulations, which amend the procedures for submitting copies of Form W-4, Employee's Withholding Allowance Certificate, to the IRS. T.D. 9196. Under the regulations, employers are no longer required to submit certain questionable Forms W-4 to the IRS (i.e., forms on which an employee claims more than 10 exemptions, or claims complete exemption from withholding for the taxable year). Rather, submission of copies of Form W-4 will be required only upon written notice to the employer from the IRS, or if directed in published guidance (e.g., revenue procedure or notice). The regulations also allow employers to prepare and use a substitute withholding exemption certificate if the substitute form is accompanied by the Form W-4 instructions, tables, and worksheets.

The regulations are effective April 14, 2005. The text of the temporary regulations is the text of simultaneously issued proposed regulations. A public hearing is scheduled for July 26, 2005. Written or electronic comments must be received by July 5, 2005.

B. IRS Publishes General Rules and Specifications for Production of Substitute Forms 941

On April 18, 2005, the IRS published Rev. Proc. 2005-21, which provides the general rules and specifications for production of paper and computer-generated substitutes of revised Form 941, Employer's Quarterly Federal Tax Return, and Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors. Rev. Proc. 2005-21 provides the measurements and printing specifications for Form 941 and Schedule B (Form 941) so that substitute forms will conform to scanning requirements.

Rev. Proc. 2005-21 will be reproduced as IRS Publication 4436, General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941).

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.