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Insurance Company Information Reporting and Withholding Update

May 2005

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I. Employer Issues and Employee Benefits

A. Small Businesses May Have Simple Cafeteria Plan Option

A bill introduced on April 7, 2005, by Senator Olympia Snowe (R-ME), would provide small businesses with the opportunity to establish “simple” cafeteria plans comparable to those maintained by large companies and the government. These plans allow employees to benefit from certain nontaxable benefits, such as health insurance and flexible spending accounts, but do not have the strict participation requirements that a traditional cafeteria plan requires in order to receive tax-free treatment.

Snowe’s SIMPLE Cafeteria Plan Act of 2005 also eliminates another requirement from flexible spending plans operated under traditional cafeteria plans. The “use-it-or-lose-it” requirement would be modified so that unused funds, up to \$500, would be carried over to the following year or would be deposited into a retirement account.

B. Hearing to be Held on Calculating Withholding on Supplemental Wages

In Announcement 2005-33, released on May 6, 2005, the IRS announced that a public hearing will be held on June 9, 2005, to discuss the proposed regulations regarding the flat rate of withholding applicable to calculating supplemental wage withholding tax. The hearing will be held at 10 a.m. in the Auditorium of the Internal Revenue Service Building located at 1111 Constitution Avenue, NW, Washington, DC.

C. IRS Modifies “Use-It-or-Lose-It” Rules for Cafeteria Plans

On May 18, 2005, the IRS released Notice 2005-42, which modifies the “use-it-or-lose-it” rule for cafeteria plans. I.R.C. § 125 prohibits the deferral of compensation under a cafeteria plan. Thus, unused contributions or benefits remaining at the end of the plan year are forfeited. Notice 2005-42 permits a grace period immediately following the end of the plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during the grace period. The notice acknowledges that other areas of tax law provide similar grace periods during which time amounts paid are not deferred compensation.

D. Detailed Audit Guides Regarding Executive Compensation Issues Available Online

The IRS recently released a series of audit technique guidelines covering various executive compensation issues on its Market Segment Specialization Program website. The

newest guidelines detail audit techniques for excessive employee compensation under I.R.C. § 162(m), stock-based compensation, golden parachutes, nonqualified deferred compensation, certain transfers of compensatory stock options, fringe benefits, and split-dollar life insurance.

Although the guidelines vary in detail, most offer a precise overview of the law and the potential issues surrounding its application. Some of the guidelines offer a step-by-step guide as well as a flow chart for the auditors conducting an examination, while other guides, such as the excessive compensation guide, simply offer an auditor advice on how to tailor an initial discussion in order to begin an in-depth review of a company. The guides list documents that should be examined in addition to noting when information document requests should be issued and, if and when, those requests should be followed up with subpoenas.

The guides for nonqualified deferred compensation and fringe benefits address new Internal Revenue Code sections enacted with the American Jobs Creation Act of 2004. I.R.C. § 409A provides new rules governing nonqualified deferred compensation plans. Generally, all deferred compensation under a nonqualified deferred plan will be currently includible in gross income unless certain statutory requirements are met. The provision is effective for amounts deferred in tax years beginning after December 31, 2004, but may be applied to amounts deferred in tax years beginning before January 1, 2005, if the nonqualified deferred compensation plan under which the amount is paid was materially modified after October 3, 2004.

I.R.C. § 274(e)(2) was passed in order to reverse the decision in Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197, aff'd 255 F.3d 495 (8th Cir. 2001), which held that employer deductions for operation of a corporate aircraft were not limited by any amounts reported for personal use of the aircraft. The new provision provides that the employer's deduction is in fact limited to the amount included in the employee's income. This provision only applies to covered officials as defined by Section 16(a) of the Securities Act of 1934 and shall apply to expenses incurred after October 22, 2004.

II. Employee Business Expenses

A. Failure to Substantiate Results in Disallowed Deduction

On May 3, 2005, in Barton v. Commissioner, T.C. Memo. 2005-97, the Tax Court sustained the disallowance of Taxpayer's travel and expense deductions due to his failure to adequately substantiate the expenses with written or other records. Although I.R.C. § 274 permits taxpayers to deduct automobile, meals, and entertainment expenses, so long as such expenses are ordinary and necessary business expenses, Taxpayer did not meet the standard of strict substantiation for the expenses and the deduction was disallowed. I.R.C. § 274's strict substantiation requirement mandates that a taxpayer substantiate the amount, time, and business

purpose of the expenditure, in addition to providing adequate records or other corroborating evidence.

B. IRS Revises Publication 1542

The IRS has revised Publication 1542 (Rev. May 2005), Per Diem Rates (for Travel Within the Continental United States). The publication is no longer available in print, but is available on the IRS website at www.irs.gov/pub/irs-pdf/p1542.pdf.

III. Reporting Guidelines and Forms

A. Tax Benefit Doctrine Does Not Apply to Certain ‘Rebates’

In PLR 200519002, released May 13, 2005, the IRS ruled that state-sponsored rebates on food and beverage were includible in gross income, and that filing an information return under I.R.C. § 6041 was required. Taxpayer provided rebates for property, sales, and food and beverage taxes in an effort to attract businesses. The rebates for property and sales taxes were not considered income regardless of the tax benefit doctrine because the tax benefit of the rebate could not be determined by Taxpayer. The rebates on food and beverage were not truly rebates because the tax was imposed directly on the purchaser, not the business; therefore, the rebate is actually just a payment of money to the business and would be considered income.

B. IRS Implements New Initiatives

The IRS, in an attempt to facilitate communication between the home office and field auditors for employment taxes, has instituted an organizational change. This change will permit the Service to address Form 941 nonfilers on a national rather than regional level. There are an estimated 2.8 million Form 941 nonfilers.

Additionally, the IRS will redesign 2006 Form 940, Employer’s Annual Federal Unemployment Tax Return, in an effort to make the form ‘plain and simple.’ The redesigned form will be optically scanned and easier to fill out, and the instructions will be easier to understand. The Service is also planning to create Form 944, which will serve as an annual version of Form 941. Form 944 would be utilized by very small employers with a minimal employment tax liability.

C. Rules for Revised Form 941 and Schedule B Issued

In an effort to clarify the rules and specifications for the January 2005 revisions of Form 941 and Schedule B, the IRS released Revenue Procedure 2005-21. The new rules are designed

to enable the IRS to utilize scanning technology as well as facilitate the completion of these forms. The revenue procedure contains general requirements for the forms as well as rules for reproducing the paper forms. Taxpayers are permitted to use their own versions of Form 941 and Schedule B; however, it must completely conform to the specifications of the IRS. If the form does not completely conform, a taxpayer will risk the possibility that it will be returned. Forms that do not completely conform may be used so long as a taxpayer receives prior approval from the IRS.

D. Dial-Up Service To End

The IRS will discontinue access to its dial-up system for electronically filing information returns on June 26, 2005. After that date, taxpayers who previously used the dial-up system must use the web-based system, which is available at <http://fire.irs.gov>. This move was prompted by limitations of the dial-up system, whereby information was sent via modem to a dedicated IRS computer system. In deciding to terminate the dial-up service, the IRS further noted the inefficiency and difficulty of supporting both the web-based and dial-up systems.

E. Change of Hearing Date for Proposed Regulations on U.S. Source Income Paid to Foreign Persons

The hearing date for the proposed regulations to amend the regulations under I.R.C. §§ 1441 and 1442, relating to income tax withholding on certain U.S. source income paid to foreign persons, has been changed from July 13, 2005, to July 20, 2005 at 10:00 a.m. Comments must be received by June 29, 2005, instead of June 22, 2005, and outlines of oral comments must be submitted by June 29, 2005, instead of June 8, 2005.

IV. Other Matters

A. Taxpayer's Claim Barred by Anti-Injunction Act

On March 29, 2005, in Bennett v. United States, W.D. Va., No. 7:04CV00705, a district court judge dismissed a taxpayer's claim that the IRS improperly requested Taxpayer's employer to disregard Taxpayer's W-4 and withhold federal income taxes as if Taxpayer had claimed single filing status with zero allowances. Taxpayer's claim was dismissed on the grounds that Taxpayer failed to exhaust his administrative remedies and that his claim was barred by the Anti-Injunction Act. The court noted that Taxpayer had not suffered any real injury because he can file his income tax return and receive a refund for any amounts withheld in excess of his tax liability.

B. Common Fund Attorneys' Fees are not Includible in Class Action Members' Gross Incomes

In PLR 200518017, issued May 6, 2005, the IRS ruled that members of a class action lawsuit are not required to include in gross income attorneys' fees paid pursuant a settlement agreement. The ruling concluded that the attorneys' fees would be "awarded by the court having jurisdiction over the action under the 'common fund doctrine,'" as opposed to being paid pursuant to a standard retainer or other fee agreement, and that the fees would not fall within the scope of Old Colony Trust Co v. Commissioner, 279 U.S. 716 (1929), which held that third party payments in satisfaction of a taxpayer's debt are includible in the taxpayer's gross income because the taxpayer receives the economic benefit of the payment.

C. IRPAC Nominations Sought by IRS

The IRS seeks nominations of individuals to serve on its Information Reporting Program Advisory Committee (IRPAC) for terms beginning in January 2006. The committee consists of up to twenty-three members, who serve three year terms. The current panel consists of seventeen members. Committee terms are staggered, so that only one-third of the committee membership will expire each year. The IRS intends to fill the committee with a diverse group to represent all taxpayers; therefore, selections will be based not only on an applicant's qualifications, but also on the segment that he or she will represent.

Nominations are due by June 30, 2005. Application information is available on the IRS website at <http://www.irs.gov/taxpros/article/0,,id=138089,00.html>.