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Insurance Company Information Reporting and Withholding Update

September 2005

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I. Form 1099, Backup Withholding, and Penalties

A. Outgoing IRS Official Discusses Problems and Penalties in Employment Taxes

Douglas Rogers, the outgoing program director for penalties and interest for the IRS spoke to the attendees of the 2005 National Association of Tax Reporting and Payroll Management conference, which was held September 18 - 21. He noted that there are more than 140 tax-related penalties, but the biggest area of interest for the IRS was related to employment taxes.

Rogers noted that unsuccessful filings are often attributable to an incorrect taxpayer identification number ("TIN") or name, an unsubmitted or incorrect Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors, misapplied tax deposits, late or insufficient tax deposits and not using the Electronic Federal Tax Deposit system when you are required to do so.

Rogers offered simple advice to ensure that filings are successful. He stated that they should have the correct employer identification number that is matched with a name, as stated on Form SS-4, Application for Employer Identification Number, accurate tax reporting, and timely tax deposits. He offered more advice in regards to the Schedule B (Form 941) explaining that the IRS wants the liability amounts, which are the amounts due that are accrued, instead of the amounts paid. This advice is also applicable to Form 945-A, Annual Record of Federal Tax Liability.

For those taxpayers that do receive a Notice of Proposed Penalty, Rogers offered the following advice. First, the taxpayer should determine that the numbers listed on the notice are indeed incorrect. Then the taxpayer should follow the solicitation requirements for name and TIN issues. If the taxpayer decides to seek a waiver or abatement of penalty, the taxpayer should provide detailed explanations containing specific information about the underlying cause of the penalty notice. He also suggested that the IRS would prefer those requests to be made in a formal letter rather than a generic form letter.

II. Life Insurance, Annuities, and Qualified Plans

A. IRS Refuses to Rule on Tax Treatment of Annuity

Despite the fact that a taxpayer requested a private letter ruling on the tax treatment of an annuity, the IRS declined to provide one until the IRS is certain that the taxpayer indeed needs a letter ruling. The IRS did offer, however, general information about the taxation of annuities.

The IRS noted that “[u]nder section 72 of the Internal Revenue Code, any amount received under an annuity contract is taxable as ordinary income except to the extent it represents a return of your previously taxed investment in the contract.” The IRS contacted the life insurance company which issued the taxpayer’s contract in question and from their general discussions about products, the IRS determined that the taxpayer may have received payments that were not annuities, and the IRS generally explained that “[a]mounts received not as an annuity are treated differently.”

III. Employer Issues and Employee Benefits

A. IRS Clarifies Reporting Requirements for Amended Cafeteria Plans

In Notice 2005-61, the IRS clarified Form W-2 reporting requirements when an employer has amended its cafeteria plan to provide a grace period for qualified dependent care assistance immediately following the end of a cafeteria plan year.

Notice 2005-42 permitted employers to amend a cafeteria plan to provide a grace period not to exceed 2 ½ months immediately following the end of a cafeteria plan year. Notice 89-111 provides employers guidance relating to the reporting requirements for dependent care assistance furnished by an employer to an employee under a qualified dependent care assistance program. If the employer sponsors a cash reimbursement arrangement, the amount to be reported on Form W-2 should be the total amount of cash reimbursement furnished to the employee during the calendar year. However, in a situation where the actual total amount of cash reimbursement is unclear at the time the Form W-2 is prepared the employer may report a reasonable estimate. The amount electively contributed by an employee for the year for dependent care is considered a reasonable amount.

Notice 2005-61 allows employers to continue to rely on Notice 89-111 and permits employers to report in Box 10 of the Form W-2 the salary reduction amount elected by the employee for the year for dependent care assistance in addition to any employer matching contributions.

IV. Employee Business Expenses

A. IRS Increases Mileage Reimbursement Rate For Last Quarter of 2005

Although the IRS normally sets mileage reimbursement rates once per year, the IRS announced on September 9 that it would make a special increase this year applicable to deductible transportation expenses paid or incurred for business, medical, or moving expense

purposes. In response to the drastic rise in gasoline prices, the IRS raised the optional standard mileage rates for the end of 2005 from 40.5 cents a mile to 48.5 cents a mile. This increase will apply to all business miles driven between September 1 through December 31.

Commissioner Mark Everson noted the rationale for the increase, "This is about fairness for taxpayers. People are entitled to deduct the real cost of operating a vehicle." Consistent with the goal for deducting the "real cost" of vehicle operation, the IRS has retained the discretion to adopt a different rate in 2006. The IRS plans to set the 2006 rate closer to January when gas prices may stabilize at a lower price.

In addition to modifying the business mileage rate, Announcement 2005-71 revised the medical and moving mileage rates by increasing the deduction from 15 cents per mile to 22 cents per mile for miles driven for the last quarter of 2005. The mileage rate for charitable contributions was not altered in this announcement and remains at 14 cents per mile.

V. Reporting Guidelines and Forms

A. IRS Updates Specifications for Paper Substitutes for Forms W-2 and W-3

In Revenue Procedure 2005-65, the IRS updated its specifications for the private printing of paper and laser-printed substitutes for Form W-2, Wage and Tax Statement, and Form W-3, Transmittal of Wage and Tax Statements, for tax year 2005. This revenue procedure supersedes Revenue Procedure 2004-54.

The IRS has eliminated magnetic media as a filing method; the last year for filing Forms W-2 on tapes and cartridges was 2004, and 2005 marks the last year to file Forms W-2 on 3 ½ diskette. The IRS will also release Publication 1141, General Rules and Specifications for Substitute Forms W-2 and W-3, only for downloading via the IRS website. Payee statements may be furnished electronically so long as employees consent.

Other changes include the addition of three new codes, Q, Y, and Z, for box 12 of the Form W-2. The 2005 instructions will provide further details about the use of those codes. Additionally, the IRS made editorial changes and attempted to eliminate any redundancies.

B. Revenue Procedure Details Rules for Electronic Filing

The IRS released Revenue Procedure 2005-60, which details the obligations of authorized e-file providers as well as other e-file participants to the IRS. The revenue procedure lists 20 returns which may be filed under the e-file program. Those returns include: Forms 1040 and

1040A, U.S. Individual Income Tax Return, Form 1120, U.S. Corporation Income Tax Return, Form 1120S, U.S. Income Tax Return for an S Corporation and Form 990, Return of Organization Exempt from Income Tax, among others. However, this revenue procedure does not cover providers of information returns that are filed under the FIRE (Filing Information Returns Electronically) Program.

Authorized IRS e-file providers must comply with the regulations in this revenue procedure. Publication 3112, IRS e-file Application and Participation, explains the procedures governing the process to become an authorized IRS e-file provider.

VI. Other Matters

A. IRS Offers Relief to Taxpayers in Areas Affected by Hurricanes

On September 15, the IRS announced that 401(k) plans and other similar employer-sponsored retirement plans may make loans and hardship distributions to the victims of Hurricane Katrina and members of their families. Announcement 2005-70 was designed to relax rules and regulations required for loans and hardship distributions. To qualify for the relief under this announcement, the hardship withdrawals must be made after August 29, 2005 and before March 31, 2006.

The announcement serves to specifically include Hurricane Katrina as a hardship. Furthermore, the announcement requires employers to amend plans, which do not provide for loans or hardship distributions. These amendments must be done no later than December 31, 2005. Additionally, the IRS has relaxed certain procedural requirements for plan administrators, such as documentation and verification requirements. The Department of Labor announced that it will not treat any person complying with this announcement as having violated the provisions of Title I of the Employee Retirement Income Security Act. Generally hardship distributions are includible in gross income and are subject to a 10% penalty for early withdrawals. Congress is currently considering legislative relief for this tax.

The IRS requested on September 21 for any taxpayer affected by the hurricane to identify themselves by writing "Hurricane Katrina" in red ink at the top of any form or document filed with the IRS. Deadlines have been extended until February 28, 2006 to file tax returns and pay any taxes due as a result of The Katrina Emergency Tax Relief Act of 2005, which was signed on September 23.

Additionally, the Service has also granted tax relief to those taxpayers affected by Hurricane Rita. Many of the relief provisions similarly apply to victims of Hurricane Rita. The

IRS has requested that those affected identify themselves by writing “Hurricane Rita” in red ink at the top of any form or document filed with the IRS. For any questions regarding tax initiatives for the hurricane affected areas, the IRS has established a special disaster hotline, 1-866-562-5227.

IRS Circular 230 Disclosure:

This memorandum is provided solely for informational purposes and is not intended to furnish legal advice with respect to the reader’s particular factual circumstances. In accordance with § 10.35 of IRS Circular 230 requirements, you are advised that any discussion of tax issues in this memorandum is not intended or written to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction or matter addressed herein. The persuasiveness of this memorandum with regard to the tax issues in question and a taxpayer’s good faith reliance on the memorandum will be determined under applicable provisions of the law and regulations (§ 10.35(f)).