

SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. BROWN
SAMUEL A. MITCHELL

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

Writer's Direct Dial: (202) 434-9169

Writer's Email Address:

jgouker@scribnerhall.com

Insurance Company Information Reporting and Withholding Update

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I. Life Insurance, Annuities, Qualified Plans

A. IRS Releases Schedules M-3 for Insurance and S Corporations

On December 13, the IRS released draft Schedules M-3 and instructions for corporations that file Forms 1120PC, 1120L and 1120S. Once finalized, these schedules will be used by property and casualty insurance corporations that have total assets of \$10 million or more, starting with tax years ending on or after December 31, 2006. Schedules M-3 require affected companies to provide a detailed reconciliation between financial accounting net income and taxable income. The draft forms are available on the web at www.irs.gov on the corporations page. The IRS and Treasury plan to meet with affected groups to discuss the new schedule and instructions and is requesting that comments be submitted by February 10, 2006. It is expected that the Schedule M-3 will be finalized this coming summer.

B. IRS Announces Safe Harbors for Valuing Annuities Relating to Roth IRA Conversions

In Rev. Proc. 2006-13, the IRS provides for safe harbor methods, which are permitted to be used in determining the fair market value of an annuity contract for purposes of determining the amount includible in gross income as a result of the conversion of a traditional IRA to a Roth IRA.

Under I.R.C. § 408(d) and A-7 of § 1.408A-4 of the regulations, any amount that is converted from a traditional IRA to a Roth IRA is includible in gross income as a distribution for the taxable year in which the amount is distributed or transferred from the traditional IRA. Temporary regulations were released in August 2005 which provide for the amount to be included in income in the year in which the conversion occurs. The Treasury and IRS both noted that the valuation determination of annuities may be difficult under the temporary regulations. Therefore, pursuant to Rev. Proc. 2006-13, modified valuation methodology is permitted as a safe harbor for determining the fair market value of annuity contracts related to Roth IRA conversions until further guidance is issued.

II. Employer Issues and Employee Benefits

A. Settlement Proceeds from Employment Discrimination Case are Subject to Withholding as Wages

In Jack A. Rivera v. Baker Concrete, No. 03-17261 (9th Cir. Dec. 13, 2005), the Ninth Circuit affirmed a district court judgment that settlement proceeds from an employment

discrimination case filed on the basis of race and national origin represented lost wages, not compensation for personal injuries. Therefore, the proceeds were subject to wage withholding.

B. Rev. Rul. 2005-74 Clarifies Tax Issues Involved with Worker Relocation Sales

In Rev. Rul. 2005-74, the IRS explained when a sale of a home occurs for federal tax purposes when an employer is involved in helping a relocating employee sell their old home. The revenue ruling focused on situations where an employee sells a home to an employer through the employer's agent, a relocation management company, which is followed by a separate sale of that home by the employer to a third party buyer or a sale of the home from the employee to the third party buyer facilitated by the employer through the relocation management company.

The revenue ruling provides examples of three typical transactions that may arise in this situation. Determining whether a sale has actually occurred will be judged by the facts and consequences of the situation. Historically, the courts have considered the following items in determining the burdens and benefits of ownership: whether legal title passes among parties, whether an equity was acquired in the property, whether any contracts created an obligation on the seller to execute and deliver a deed and an obligation on the purchaser to make payments, whether the right of possession is vested in the purchaser, which party pays property taxes, which party bears the risk of loss or damage to the property, and which party receives the profits from the operation and sale of the property.

III. Employee Business Expenses

A. 2006 Reimbursement Rate for Business Mileage Set

In Rev. Proc. 2005-78, the IRS set the optional standard mileage rate for 2006 at 44.5 cents per mile for business miles driven effective January 1, 2006. This rate marks a decrease of 4 cents in the rate set for the period of September 2005 through December 2005. The revenue procedure also set the standard mileage rates for deducting the costs of operating an automobile for charitable, medical or moving purposes. The rate for medical or moving purposes is now 18 cents per mile driven. For charitable activities other than for activities related to Hurricane Katrina relief, the standard mileage rate is 14 cents per mile driven. For Hurricane Katrina related charitable activities, the rates will be 32 cents per mile for deduction purposes and 44.5 cents per mile for reimbursement purposes.

IV. Insurance Agents

A. Insurance Commissions are Subject to Self-Employment Tax

In Gregg R. Gilbert et ux. v. Commissioner, T.C. Summ. Op. 2005-176, the Tax Court issued a summary opinion holding that renewal commission payments made after Gilbert's employment relationship with Conseco terminated are subject to self-employment tax in accordance with I.R.C. § 1402(k). These payments are not exempted from self-employment tax, because "the payments are 'tied to the quantity [and] quality of the taxpayer's prior labor', and these commission payments derive from the 'carrying on' of petitioner's business as an independent insurance agent."

V. Reporting Guidelines and Forms

A. IRS Suspends Reporting and Withholding Requirements Relating to Deferrals of Compensation under I.R.C. § 409A for Calendar Year 2005

The IRS released Notice 2005-94, which provided for the suspension of employer and payer reporting and wage withholding requirements relating to deferrals of compensation under I.R.C. § 409A for calendar year 2005. Future guidance may require an employer or payer to file a corrected information return and to furnish a corrected payee statement reporting any previously unreported amounts includible in gross income under I.R.C. § 409A. The IRS will not assert penalties against service providers in certain circumstances, but interest will continue to accrue. Although practitioners are relieved for the delay in implementing the new deferral reporting rules, some are anxious about the timing of the release of guidance for 2006. Payroll groups have requested that guidance be issued early in 2006, so that employers can properly prepare to implement the new rules.

B. IRS Issued Final Regulations on Inversion Transaction Reporting

Aiming to help curb abusive corporate inversions, the IRS issued final regulations (T.D. 9230) requiring information reporting by a corporation if control of the corporation is acquired or the corporation has a substantial change in capital structure, and the corporation or any shareholder is required to recognize gain under section 367(a) and the related regulations. The final regulations essentially adopt the 2003 temporary regulations with some slight revisions. Reporting is now limited only to transactions in which the reporting company or any shareholder is required to recognize gain under section 367(a). Additionally, these final regulations alter the definition of "acquisition of control of a corporation" and the definition of "change in capital structure." The final regulations became effective December 5, 2005. The IRS noted that it is

still mulling over ideas for applying I.R.C. § 6043A and related reporting rules to transactions not covered under these final regulations.

C. IRS Updates Requirements for Substitute Tax Forms and Schedules

The IRS released Rev. Proc. 2005-74 on December 9, 2005, which specifies requirements for substitute tax forms and schedules. The revenue procedure provides guidelines to be followed in order to receive approval for the use of substitute forms and schedules by the IRS. The IRS will only accept quality substitute forms that are consistent with the official forms and do not have an adverse impact on its processing. Forms W-2 and W-4 are not covered by this revenue procedure. The following types of forms are covered by Rev. Proc. 2005-74: worksheets as they appear in instruction packages, applications for permission to file returns electronically and forms used as required documentation for electronically filed returns, powers of attorney, over-the-counter estimated tax payment vouchers and forms and schedules relating to partnerships, exempt organizations and employee plans. Rev. Proc. 2005-74 supersedes Rev. Proc. 2004-62.

D. IRS Issues Final Regulations on Treatment of Disability Payments for FICA Purposes

The IRS issued final regulations (T.D. 9233) regarding the treatment of payments made on account of sickness or accident disability under a worker's compensation law for purposes of the Federal Insurance Contributions Act (FICA). The regulations became effective December 15, 2005 and adopt without changes the proposed regulations published on March 11, 2005. Thus, under the final regulations, qualifying accident disability or sickness payments to an employee or an employee's dependents under a statute similar in nature to a workers' compensation law will not be subject to FICA for the first six months that the employee is out of work, because the regulations treat those payments as made under workers' compensation statutes.

VI. Other Matters

A. Request to Enjoin Withholding Dismissed in Fourth Circuit

In Matthew J. Bennett v. United States, Doc. 2005-24324 (Dec. 1, 2005), the Fourth Circuit affirmed the district court's dismissal of Bennett's request to enjoin the withholding of federal income tax from his wages. The complaint was dismissed since it was not filed in a timely manner.

B. IRS Simplifies Foreign Withholding Rules

In Rev. Proc. 2005-77, the IRS changed the final withholding foreign partnership and withholding foreign trust agreements which were contained in Rev. Proc. 2003-64 by eliminating the relatedness requirement. The previous rule required a withholding trust or partnership to be a trustee or a general partner in the organization to which it wanted to extend simpler treatment. The IRS revised the relatedness rule after receiving many comments from taxpayers and ultimately deciding that the requirement was unnecessary. By eliminating the rule, the IRS hopes to facilitate compliance as well as make it easier to receive the kind of documentation that the IRS truly needs from complex structures, such as tiered partnerships and trusts.

C. IRS Issues Rules Casting Greater Scrutiny on Acceptance Agents who Assist Foreign Taxpayers in Obtaining TINs

In Rev. Proc. 2006-10, the IRS provided guidance as to qualifications for acceptance agents who help foreign individuals get U.S. tax identification numbers. In order to ensure that the acceptance agents are qualified, the revenue procedure explains that applicants may be required to undergo suitability checks. The suitability checks include a thorough background investigation which reviews, among other things, the applicant's tax filing history, credit check, and an FBI background check. Additionally, acceptance agents' agreements will expire every four years and agents will have to periodically reapply to retain their acceptance agent status.

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)).