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Insurance Company Information Reporting and Withholding Update

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I. Form 1099, Backup Withholding, and Penalties

A. IRS Officials Announce Withholding Compliance Initiative and Preview Upcoming Guidance

At a recent Arlington, Virginia seminar on tax reporting and withholding, IRS officials noted a current IRS compliance initiative under section 1441, and suggested withholding agents look at the audit guidelines posted on the IRS website in preparation for a potential audit and appropriate record maintenance. Officials also discussed areas of impending future guidance including the portfolio interest 10 percent test, and withholding obligations for a registered broker-dealer in the case of a ten-year offer. In addition, in an attempt to improve compliance and help withholding agents, IRS officials considered the possibility of a paperless version of Form W-8, and questioned the current three year reexecution requirement.

II. Employer Issues and Employee Benefits

A. Tax Court Lacks Jurisdiction to Review Employment Tax Liabilities

In Mars's Contractors, Inc. v. Commissioner, T.C. Memo. 2006-94, the Tax Court found that its jurisdiction does not extend to the collection of employment tax liabilities and penalties in this case, and granted the IRS's motion to dismiss for lack of jurisdiction. The court explains that its jurisdiction over collection matters under section 6330(d)(1) is limited to situations where the court has jurisdiction over the "underlying tax liability." In this case, the court determined that it does not have jurisdiction over the underlying tax liability under section 7436, relating to proceedings for determination of employment status; thus, it does not have jurisdiction over the related collection action.

B. IRS Issues Guidance Describing W-2 Wage Calculation Under Production Deduction Limitation, Section 199(b)(1) – Pre TIPRA

In Rev. Proc. 2006-22, the IRS provides guidance for calculating W-2 wages for purposes of section 199(b)(1). Section 199(b)(1) limits the section 199 deduction for income attributable to domestic production activities to 50 percent of the taxpayer's W-2 wages for the taxable year. The guidance is applicable to taxpayers who chose to apply the final regulations (T.D. 9263), published May 24, 2006, to taxable years beginning before June 1, 2006 (the effective date of the final regulations). Similar to the final regulations, Rev. Proc. 2006-22 provides three methods for calculating the W-2 wages: the unmodified box method, the modified box 1 method, and the tracking wages method.

The provisions are applicable to taxpayers only for taxable years beginning on or after January 1, 2005, and on or before May 17, 2006, the date of enactment of the Tax Increase Prevention and Reconciliation Act (TIPRA). Planned future guidance, in the form of new regulations and a new revenue procedure, will reflect the TIPRA amendment to section 199(b)(2).

C. New Jersey State Appellate Court Rules “Back Pay” Constitutes Wages – Subject to Federal and State Withholding

On May 8, 2006, in Amalgamated Transit Union Local 880 v. NJ Transit Bus Operations, Inc., N.J. Super. Ct. No. A-3139-04T5, the Superior Court of New Jersey, Appellate Division, ruled that certain “back pay” constituted wages subject to withholding under federal and state law. Section 3401 defines the term “wages” as “all remuneration . . . for services performed by an employee for his employer” The court states that the test of whether back pay is “wages” rather than a fine or penalty is whether the employees are being paid as a consequence of the existing employer-employee relationship, not whether they actually performed services for the employer for the back pay period.

The court relied upon the Supreme Court case, Soc. Sec. Bod. v. Nierotko. See Soc. Sec. Bod. v. Nierotko 327 U.S. 358 (1946). In Nierotko, the Supreme Court held that a back pay award under the National Labor Relations Act to an employee, who was wrongfully discharged for union activity and was reinstated, was treated as wages under the Social Security Act. The Supreme Court concluded that back pay for the time Nierotko was wrongfully separated from his job was clearly “remuneration” and “wages” rather than a fine or penalty for the employer’s wrongdoing. Id. at 364-65. The court noted that Nierotko focused on the employment relationship rather than whether the employee was actually working or providing services for their employers.

The court determined that the definition of wages under section 3401 is not materially different from the definition before the Supreme Court at the time of Nierotko, and was satisfied that the same analysis as to whether a back pay award is wages should apply today. In this case, the arbitrators reduced the termination of the employees to a suspension, and awarded back pay to reimburse the employees for income that they did not receive for the period during which they had been improperly prevented from performing their job duties. The employees remained employees under the terms of the collective bargaining agreement. Accordingly, the court concluded, the payments were made as a direct consequence of their employment, and thus constitute wages subject to federal and state withholding. (The court applied the same analysis for purposes of determining the state withholding issue as the federal issue.)

III. Reporting Guidelines and Forms

A. Rules for Revised Form 941 and Schedule B Issued

The IRS has released Rev. Proc. 2006-25, which provides the general rules and specifications for paper and computer-generated substitutes for the January 2006 revision of Form 941, Employer's Quarterly Federal Tax Return, and Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors. Changes pursuant to January 2006 revisions include:

- Form 941 and Schedule B (Form 941) have six-digit Form ID codes instead of the four-digit codes used in 2005.
- The 2006 revision of Schedule B (Form 941) now includes a calendar year designation area near the top of the form.
- There are new 6x10 grid layouts for the 2006 revisions.

The IRS states that forms should not be submitted to the IRS for specific approval. However, if a taxpayer would like clarification as to any specification, the IRS advises the taxpayer to:

- (1) Submit a letter citing the specification;
- (2) State its understanding of the specification;
- (3) Enclose an example (if appropriate) of how the form would appear if produced using its understanding; and
- (4) Send the request to Internal Revenue Service, Attn: Substitute Forms Program, SE:W:CAR:MP:T:T:SP, IR-6406, 1111 Constitution Avenue, N.W., Washington, DC 20224, including its name, complete address, phone number, and, if applicable, an email address.

The IRS notes that the taxpayer should allow at least 30 days for a response.

Software developers and form producers are asked to send a blank copy of their substitute Form 941 and Schedule B (Form 941) in pdf format to Victor.V.Martin@irs.gov, to assist the IRS in preparing to scan these forms.

IV. Other Matters

A. 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 2007. 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 approximately 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, sections will be based not only on an applicant's qualifications, but also on the segment that he or she will represent.

Nominations are due on or before July 14, 2006. Applicant information is available on the IRS website at <http://www.irs.gov/efile/article/0,,id=156491,00.html>.

V. Ask the Experts . . .

Scribner, Hall & Thompson's upcoming June issue of the *Insurance Company Information Reporting and Withholding Update* will feature a new "Ask the Experts" section giving readers the opportunity to ask "hypothetical" information reporting and withholding questions, and receive a response from the authors. One question and answer will be featured each month. Questions can be submitted to Lynlee Baker-Garbett by email at Lbaker@scribnerhall.com or by calling 202-331-8585.

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This newsletter 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 newsletter 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 newsletter's discussion with regard to the tax issues in question and a taxpayer's good faith reliance on the newsletter will be determined under applicable provisions of the law and regulations (§ 10.35(f)).

For additional information on any of the topics in this Update, please contact Lynlee Baker-Garbett at Scribner, Hall & Thompson, LLP.