

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. JONES
SAMUEL A. MITCHELL
LYNLEE C. BAKER-GARBETT

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

INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

November 30, 2006

I. FORM 1099, BACKUP WITHHOLDING, AND PENALTIES

A. The IRS Announces Correction to Final Flat Rate Supplemental Wage Withholding Regulations

The IRS has announced a correction to final regulations (T.D. 9276), relating to flat rate supplemental wage withholding under sections 3401 and 3402, published in the Federal Register on July 25, 2006. The correction removes duplicative language from Example 4(i) under Treas. Reg. § 31.3402(g)-1, effective January 1, 2007. See Announcement 2006-85, 2006-45 I.R.B. 873. This correction follows a separate correction to the same regulations announced by the IRS last month in Announcement 2006-83, 2006-44 I.R.B. 822.

B. Certain Qualified Settlement Fund Payments not Subject to Information Reporting and Backup Withholding

In PLR 200645017 (Aug. 3, 2006), the IRS ruled that certain payments from a qualified settlement fund to mutual fund investors were not subject to reporting and withholding requirements. In the ruling, payments were made from a qualified settlement fund (QSF), as described in section 468B and the regulations thereunder, compensating investors for losses suffered and advisory fees paid, as well as prejudgment interest, as the result of an administrative proceeding brought by the Securities and Exchange Commission. The IRS ruled that the payments were not reportable under section 6041 because the payments were not fixed or determinable. The amounts compensating investors for loss of capital were not fixed or determinable because the QSF had no access to the investors' tax bases to calculate the amount that would constitute fixed or determinable income. The amounts compensating investors for advisory fees paid were not fixed or determinable due to lack of investor data. However, payments of pre-judgment interest were reportable under section 6041 on Form 1099-INT, and those payments made directly to qualified retirement plan participants were reportable under section 6041 on Form 1099-R. Further, the IRS ruled that the payments of pre-judgment interest and direct payments to qualified plan participants also would be subject to backup withholding under section 3406. The IRS also considered

whether the QSF was subject to reporting obligations under sections 6045 and 6049, and concluded that it was not on the basis that there was no “sale” for purposes of Treas. Reg. § 1.6045-1(a)(9), and the distributions by the QSF did not relate to deposits with brokers or obligations issued in registered form and do not otherwise meet the definition of interest for purposes of section 6049, respectively.

In a similar ruling, PLR 200645008 (Sept. 29, 2006), the IRS ruled that payments from a QSF were not reportable under section 6041 because the payments were not fixed or determinable, except that those payments made directly to qualified retirement plan participants were reportable under section 6041 on Form 1099-R, and subject to backup withholding under section 3406. Just as in the prior ruling, the IRS concluded that reporting obligations under sections 6045 and 6049 were inapplicable. See also PLR 200646010 (Sept. 29, 2006).

C. IRS Revises Publication on Backup Withholding on Missing and Incorrect Name/TIN(s)

The IRS has released revised Publication 1281 (Rev. Jul. 2006), Backup Withholding on Missing and Incorrect Name/TIN(s). The publication can be viewed on the IRS website at <http://www.irs.gov/pub/irs-pdf/p1281.pdf>.

D. IRS Issues Guidance on Entitlement to Withholding Credits

The IRS recently issued SCA 200644018 (Dec. 23, 2006), which describes the application of section 31, relating to tax withholding on wages, under circumstances in which payors made payments of amounts subject to withholding to passthrough entities and withheld amounts from those payments under section 3402. The advice assumes that the payments were made to the passthrough entity instead of directly to the individual performing services as an employee of the payor. The passthrough entities and individuals filed returns, including the section 31 withholding credit on the individuals’ Forms 1040, rather than on the federal income tax returns of the passthrough entities. Some passthrough entities and individuals attached additional forms or statements purporting to allocate the credit to the individuals. As the Forms W-2, Wage and Tax Statement, filed by payors were directed to the passthrough entities, this results in a mismatch in the accounts of the passthrough entities.

The advice states that the “recipient” of the income subject to withholding, as defined in section 31, is the person entitled to the credit. Thus, if an individual is the recipient, the individual may claim the credit even if the income was in fact paid to the passthrough entity. However, as current IRS procedures do not offer a method for ensuring that the credit is allocated to the account of the correct taxpayer, the IRS instructs payors, individuals, and passthrough entities that they may have to file amended returns (including Forms W-2 or 1099) to ensure proper treatment if they did not initially file consistent with the proper determination of the recipient.

E. IRS Updates Accuracy-Related Penalty Guidance

The IRS has issued Rev. Proc. 2006-48, 2006-47 I.R.B. 934, which identifies circumstances under which the disclosure on a taxpayer’s return with respect to an item or a position is adequate for

purposes of reducing the understatement of income tax under section 6662(d), and avoiding the preparer penalty under section 6694(a). However, the revenue procedure does not relate to any other penalty provisions (including the disregard provisions of the section 6662 accuracy-related penalty, which are subject to an exception for adequate disclosure).

Changes from Rev. Proc. 2005-75, 2005-50 I.R.B. 1137 include an expansion of Section 4.02(3) concerning a difference in book and income tax reporting by adding new Schedules M-3 for Forms 1065, *U.S. Return of Partnership Income*, 1120-L, *U.S. Life Insurance Company Income Tax Return*, 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*, 1120S, *U.S. Income Tax Return for an S Corporation*, which reconcile net income (loss) in the financial statements to that shown on an entity's return.

This revenue procedure applies to any return filed on a 2006 tax form for a taxable year beginning in 2006, and to any return filed on a 2006 tax form in 2007 for a short taxable year beginning in 2007.

F. IRS Issues Corrections to Instructions for Form 1099R and Instructions for Form 5498

The IRS has corrected the 2006 Instructions for Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., and Form 5498, IRA Contribution Information. In a notice posted on the IRS website, the following corrections were listed with respect to editions downloaded before November 10, 2006:

- On page R-2, IRA Revocation and Account Closure, the first sentence should read: "If a traditional or Roth IRA is revoked during its first 7 days (under Regulations section 1.408-6(d)(4)(ii)) or is closed at any time by the IRA trustee or custodian pursuant to its resignation due to a failure of the taxpayer to satisfy the Customer Identification Program requirements described in Section 326 of the U.S. Patriot Act, the distribution from the IRA must be reported."
- On page R-5, under Loans Treated as Distributions, items 3 and 4 of the number list should read: "3. The loan must be repaid in substantially level installments (at least quarterly), and 4. The loan amount does not exceed the limits in section 72(p)(2)(A) (maximum limit is equal to the lesser of 50% of the vested account value of \$50,000)."
- On page R-6, under Box 2a, Taxable Amount, Traditional IRA or SEP IRA, the first paragraph should read: "Generally, you are not required to compute the taxable amount of a traditional IRA or SEP IRA nor designate whether any part of a distribution is a return of basis attributable to nondeductible contributions. Therefore, report the total amount distributed from a traditional IRA or SEP IRA in box 2a. This will be the same amount reported in box 1. Check the 'Taxable amount not determined' box in box 2b."

- On page R-6, under Box 2a, Taxable Amount, Traditional IRA or SEP IRA, the third paragraph should read: "For a distribution of contributions plus earnings from an IRA before the due date of the return under section 408(d)(4), report the gross distribution in box 1, only the earnings in box 2a, and enter Code 8 or P, whichever is applicable, in box 7. Enter Code 1 or 4, if applicable."

In addition, the IRS notes with respect to qualified charitable distributions, section 1201 of the Pension Protection Act of 2006 allows certain account holders to direct a tax-free distribution to a qualified charity from a traditional IRA or Roth IRA. However, the trustee is not responsible for knowing if that charity is one described under section 408(d)(8). Therefore, taxpayers should follow the general rules for reporting distributions where the recipient is age 70 ½ or older, enter code 7 in box 7 of Form 1099-R for these distributions, and not use code F.

The corrected version of the 2006 Instructions for Forms 1099-R and 5498 (Rev. October 2006) is available for download (PDF version) at <http://www.irs.gov/pub/irs-pdf/i1099r.pdf>.

II. LIFE INSURANCE, ANNUITIES, AND QUALIFIED PLANS

IRS Provides Situational Guidance on Use of Smartcards and Debit Cards for Transportation Benefits

In Rev. Rul. 2006-57, 2006-47 I.R.B. 911, the IRS has provided guidance to employers on the use of smartcards, debit or credit cards, or other electronic media to provide qualified transportation fringes under sections 132(a)(5) and 132(f). The ruling identifies three situations with respect to which it provides guidance.

In Situation 1, Employer A provides its employees transportation benefits in an amount not to exceed \$105 for each month in 2006 (the amount of the fringe benefit which may be excluded from gross income and wages for 2006). A uses smartcards which are plastic cards that among other features contain a memory chip that stores the value of the card. The amount stored on the smartcard may not be used to purchase anything other than fare media for X, a transit system. A makes monthly payments to X on behalf of its employees who participate in the program, which X then allocates electronically to each employee's smartcard as instructed by A. A does not require employees to substantiate their use of smartcards. In the revenue ruling, the IRS concludes that the smartcard qualifies as a transit system voucher under Treas. Reg. § 1.132-9(b), Q/A - 16(b)(2), distributed in kind by A to its employees because the value stored on the smartcards is usable only as fare media for transit system X, and the amount allocated to each employee's smartcard is within the amount specified by section 132(f)(2)(A). Accordingly, the IRS ruled that the value of the fare media provided by A to its employees through use of the smartcards is excluded from the employees' gross income as a qualified transportation fringe benefit within the meaning of section 132(a)(5) without requiring the employees to substantiate their use of the smartcards.

In Situation 2, Employer B provides its employees transportation benefits in an amount not to exceed \$105 for each month in 2006 (the amount of the fringe benefit which may be excluded from gross income and wages for 2006). Debit card provider P provides debit cards that may be used by employers to provide transportation benefits to their employees. The debit cards are restricted for use only at merchant terminals at points of sale at which only fare media for transit system Y is sold. B uses these debit cards as a mechanism to provide transportation benefits to its employees who participate in the transportation benefit program. B makes monthly payments to P on behalf of its employees who participate in the program, which P then allocates electronically to each employee's terminal-restricted debit card as instructed by B. B does not require employees to substantiate their use of the debit cards. In the revenue ruling, the IRS concluded that the terminal-restricted debit card qualifies as a transit system voucher under Treas. Reg. § 1.132-9(b), Q/A - 16(b)(2), because it can be used only at merchant terminals at points of sale at which only fare media for transit system Y can be purchased, and the amount allocated to each employee's debit card is within the amount specified by section 132(f)(2)(A). Accordingly, the IRS ruled that the value of the fare media provided by B to its employees through use of the terminal-restricted debit cards is excluded from the employees' gross income as a qualified transportation fringe benefit within the meaning of section 132(a)(5) without requiring the employees to substantiate their use of the debit cards.

In Situation 3, Employer C provides its employees transportation benefits in an amount not to exceed \$105 for each month in 2006 (the amount of the fringe benefit which may be excluded from gross income and wages for 2006). Debit card provider Q provides debt cards that may be used by employers as a mechanism to provide transportation benefits to their employees. Q restricts the use of the debit card to merchants that have been assigned a merchant category code (MCC) indicating that the merchant sells fare media. The cards are restricted for use at merchants that have been assigned MCCs indicating that the merchant sells fare media for some or all of the following categories: local and suburban commuter passenger transport; passenger railway; bus lines, excluding charters and tours; and transportation service (not elsewhere identified). The merchant may or may not sell other merchandise. The MCCs were developed by S, which is a debit/credit card network. S determines and updates the MCC assigned to a particular merchant based on information provided by the merchant. C uses the MCC-restricted debit cards provided by Q as a mechanism to provide transportation benefits to its employees. A voucher or similar item exchangeable only for a transit pass is not otherwise readily available for purchase by C for direct distribution to C's employees within the meaning of section 132(f)(3). In the revenue ruling, the IRS concluded that the debit card provided by C to its employees does not qualify as a transit system voucher under Treas. Reg. § 1.132-9(b), Q/A - 16(b)(2), because it is possible that it can be used to purchase items other than transit passes. Because a voucher or similar item exchangeable only for fare media is not readily available to C for direct distribution to its employees, section 132(f)(3) permits C to provide qualified transportation benefits in the form of cash reimbursements for transit pass expenses, but only if the reimbursements are provided under a bonafide reimbursement arrangement. The ruling then describes the specific circumstances under which the reimbursements will be treated as made under a bonafide reimbursement arrangement.

In Situation 4, the facts are the same as in Situation 3, except the IRS demonstrates facts under which C's reimbursements are not treated as provided under a bonafide reimbursement arrangement. In this situation, C's employees certify that the card will be used only for transit passes, and written on each debit card is the statement that the card is to be used only for transit passes. At no time do C's employees substantiate to C the amount of the fare media expenses that have been incurred. In the revenue ruling, the IRS concluded that the arrangement does not qualify as a bonafide reimbursement arrangement under Treas. Reg. § 1.132-9(b), Q/A-16(c) because it provides for advances rather than reimbursements and because it relies solely on employee certifications provided before the expense is incurred. The IRS states that those certifications, standing alone, do not provide the substantiation of expenses incurred necessary for there to be a bona fide reimbursement arrangement, and the amounts C provides to its employees through the use of the debit cards are included in the employees' gross income and wages.

The revenue ruling is effective January 1, 2008. However, employers and employees may rely on the revenue ruling with respect to transactions occurring prior to January 1, 2008.

III. EMPLOYER ISSUES AND EMPLOYEE BENEFITS

IRS Guidance Emphasizes Employers Need to Track Expense Per Diem Allowances

In Rev. Rul. 2006-56, 2006-46 I.R.B. 874, the IRS ruled that where the taxpayer's expense allowance arrangement routinely results in payment of excess allowances, the taxpayer's failure to track the excess allowances and its routine payment of excess allowances that are not repaid or treated as wages, evidence a pattern of abuse under Treas. Reg. § 1.62-2(k). Accordingly, the IRS ruled that even if the taxpayer's expense allowance arrangement otherwise meets the business connection, substantiation, and return of excess requirements of an accountable plan for the allowances paid to the taxpayer's employees up to the amount that may be deemed substantiated, all payments made under taxpayer's expense allowance arrangement are treated as paid under a nonaccountable plan. Thus, the taxpayer must include all amounts paid under the arrangement to reimburse employees' meals and incidental expenses, not just the excess allowances, in the employees' wages on Forms W-2 and must treat all these amounts as wages for the withholding and payment of employment taxes.

Under section 62(a)(2)(A), for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement. Generally, under section 62(c) and Treas. Reg. § 1.62-2(c)(1), an arrangement will be treated as a reimbursement or other expense allowance arrangement if it meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. With regard to the substantiation requirement, a portion of the per diem allowance may be deemed substantiated under the regulations, but employees must continue to actually substantiate the elements of time, place, and business purpose relating to the travel expenses. See Rev. Proc. 2005-67, sections 4.04 and 7.01. For purposes of

the return of excess requirement, under Treas. Reg. § 1.62-2(f)(2) an arrangement that provides a per diem allowance is treated as satisfying the requirement of returning amounts in excess of expenses so long as the allowance is reasonably calculated not to exceed the amount of the employee's expenses and the employee is required to return any portion that relates to days of travel not substantiated.

If the business connection, substantiation and excess requirements are satisfied, all amounts paid under the arrangement are treated as paid under an accountable plan. See Treas. Reg. § 1.62-2(c)(2). However, the portion of the allowance that exceeds the amount deemed substantiated will be treated as paid under a nonaccountable plan, pursuant to Treas. Reg. § 1.62-2(c)(5). Under Treas. Reg. § 1.62-2(c)(4), amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. Conversely, amounts paid under the arrangement treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes, pursuant to Treas. Reg. § 1.62-2(c)(3) and (5). Significantly, where the facts and circumstances evidence a pattern of abuse of the rules of section 62(c) and the regulations thereunder, including the rule to treat excess allowances as wages, all payments made under the arrangement are treated as wages. See Treas. Reg. § 1.62-2(k).

Based on the facts of the ruling, the taxpayer did not receive actual substantiation for the meals and incidental expenses covered by the allowances, and the taxpayer neither required repayment of the excess allowances nor treated the excess allowances as wages for purposes of withholding and payment of employment taxes and reporting on Forms W-2. In fact, the taxpayer did not include any mechanism or process that tracked allowances and would permit it to determine when the allowances paid to its employees exceeded the amount that may be deemed substantiated. As a result, the IRS further concluded that under Treas. Reg. § 1.62-2(k), the taxpayer's arrangement evidenced a pattern of abuse. Accordingly, all payments under the plan, not just the excess amounts, were included in the employees' gross income, were reported as wages or other compensation on the employees' Form W-2, and were subject to withholding and payment of employment taxes. See Treas. Reg. § 1.62-2(c)(5), and (h)(2). The ruling is accompanied by a news release, IR-2006-175 (Nov. 9, 2006), in which the IRS states that the ruling was necessary to avoid abuse of tax-free reimbursement rules.

IV. EMPLOYEE BUSINESS EXPENSE

A. 2007 Reimbursement Rate for Business Mileage Set

In Rev. Proc. 2006-49, 2006-47 I.R.B. 936 and IR-2006-168 (Nov. 1, 2006), the IRS announced the optional standard mileage rate is 48.5 cents per mile for business miles driven, effective January 1, 2007. The rate reflects an increase of 4 cents from the 2006 rate described in Rev. Proc. 2005-78, 2005-51 I.R.B. 1177. 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 20 cents per mile, reflecting an increase of 2 cents per mile. The rate for charitable use

during 2007 will remain at 14 cents a mile, a statutory rate not adjusted for inflation. Special enhanced rates for Hurricane Katrina related charitable activities expire after December 31, 2006, and are removed for 2007. See Rev. Proc. 2006-49 for additional information and limitations on the use of the standard mileage rates.

B. IRS Corrects Updated Rules on Business Travel Expense Substantiation

Last month we reported that the IRS issued Rev. Proc. 2006-41, 2006-35 I.R.B. 331, updating and providing rules for determining the amount of an employee's ordinary and necessary business expenses for lodging, meals, and incidental expenses incurred while traveling that will be deemed substantiated under Treas. Reg. § 1.274-5 when a payor provides a per diem allowance.

The procedure updates the list of high-cost localities, and increases the per-diem rate for those locations to \$246 per day (\$188 for lodging and \$58 for meal and incidental expenses) from \$226. The per diem rate for other localities not falling within the high-cost category was increased to \$148 per day (\$103 for lodging and \$45 for meal and incidental expenses) from \$141. The procedure, which supercedes Rev. Proc. 2005-67, 2005-42 I.R.B. 729, is generally effective for allowances or expenses that are paid on or after October 1, 2006, with respect to travel away from home on or after October 1, 2006, subject to certain transition rules.

In Announcement 2006-96, the IRS announced the following correction: For purposes of the high-low substantiation method, Martha's Vineyard is a high-cost locality from June 1, 2007, through August 31, 2007.

V. OTHER MATTERS

Online Transcript Delivery System Access to Be Expanded to Withholding Agents

Based on recommendations from the Information Reporting Program Advisory Committee (IRPAC), online transcript delivery system access is expected to be expanded to withholding agents, according to Robert Foley, chairman of the IRPAC Large and Midsize Business subgroup. In addition, Enterprise Computing Center at Martinsburg is expected to begin sending B-Notices for independent contractors and 972CG civil penalty notices via CD-ROMs. The IRPAC subgroup has also recommended that the IRS consider substantially revising Form W-8Ben, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, and perhaps the rest of the Form W-8 series due to high error rates. Further, the IRPAC subgroup announced that it expects to soon publish questions and answers relating to nonresident aliens' withholding responsibilities for withholding agents making payments to foreign vendors and related service providers.

VI. ASK THE EXPERTS

What is the status of forthcoming Treasury and IRS guidance on reporting and withholding obligations under section 409A?

IRS and Treasury officials recently addressed employer reporting and withholding obligations under section 409A at the American Bar Association Section of Taxation's fall meeting in Denver, and the American Bar Association Joint Committee on Employee Benefits' Compensation for Executives and Directors meeting in New York. Under section 409A, relating to inclusion in gross income of deferred compensation under nonqualified deferred compensation plans, employers must report and withhold on deferred compensation amounts included in income. Officials describe the reporting and withholding obligations as consisting of two-parts: inclusion reporting, when there is a section 409A violation, and deferral reporting. Daniel Hogans, an attorney with the Department of Treasury, indicated that employers should be prepared to report the 2006 amounts includible in gross income under Code Z. However, with respect to Code Y reporting obligations, IRS Compensation Branch Senior Counsel William C. Schmidt indicated that reporting of nonqualified deferred compensation plan deferrals, imposed under Notice 2005-1, 2005-2 I.R.B. 274, and later suspended under Notice 2005-94, 2005-52 I.R.B. 1208 may once again be deferred.

Notice 2005-1 imposes the following reporting and wage withholding requirements with respect to deferred amounts:

- An employer must report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 12 of Form W-2 using code Y. See Q&A-29.
- An employer must report amounts includible in gross income under section 409A and in wages under section 3401(a) in box 1 of Form W-2 as wages paid to the employee during the year. An employer must also report such amounts in box 12 of Form W-2 using code Z. See Q&A-33.

Notice 2005-94, subsequently suspended employer and payer Code Z and Code Y reporting and wage withholding requirements for deferrals of compensation under section 409A for the calendar year 2005. However, the IRS noted that future published guidance may require the filing of corrected information returns and furnishing corrected payee statements for calendar year 2005.

On September 29, 2005, the IRS issued proposed regulations regarding the application of section 409A. See 70 Fed. Reg. 58930 (Oct. 4, 2005). The proposed regulations incorporate and expand on the guidance provided in Notice 2005-1. Final regulations under section 409A are expected to be published before 2007. See TPR HP-128 (Oct. 4, 2006). Treasury Officials have noted that final regulations also will provide guidance or clarification regarding section 457(f) plans golden parachute gross-ups and other reimbursement arrangements, performance-based plans, and possibly additional plan categories, among other issues.

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