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## INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

February 22, 2007

### LEGISLATION

#### **1. Finance Committee Approves Small Business Tax Relief: Punitive Damage Payments by Insurers Included in Gross Income and Insurer Reporting Required Under Section 6041**

On January 17, the Senate Finance Committee approved the “Small Business and Work Opportunity Act of 2007.” The bill includes a provision, relating to section 163(g), that denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. The bill also provides for a new section in the Internal Revenue Code relating to punitive damages compensated by insurance or otherwise. Under the provision, gross income includes any amount paid to or on behalf of a taxpayer as insurance or otherwise by reason of the other person’s liability (or agreement) to pay punitive damages. The bill also amends section 6041 so that section will apply to payments by a person to or on behalf of another person as insurance or otherwise by reason of the other person’s liability (or agreement) to pay punitive damages. As drafted, the provisions are effective for punitive damages that are paid or incurred on or after the date of enactment. The text of the Small Business and Work Opportunity Act of 2007 can be viewed at <http://finance.senate.gov/press/Bpress/2007press/prb012207leg.pdf>. On February 16, the House of Representatives voted to pass H.R. 976, the “Small Business Tax Relief Act of 2007,” which does not include the Senate’s provisions relating to punitive damages. A conference on the House and Senate bills should follow.

#### **2. President’s 2008 Budget Proposal Includes New Reporting Requirements**

The President has proposed significant law changes to improve taxpayer compliance. The provisions, released February 5th, are generally effective on or after January 1, 2008. Proposals include:

- Information reporting for payments to corporations. A business would be required to file an information return for payments aggregating to \$600 or more in a calendar year to a corporation (except a tax-exempt corporation).
- TIN certification and withholding for payments to contractors. A contractor receiving payments of \$600 or more in a calendar year from a particular business would be required to furnish to the business (on Form W-9) the contractor's certified Taxpayer Identification Number (TIN). A business would be required to verify the contractor’s TIN with the IRS, which would be

authorized to disclose, solely for this purpose, whether the certified TIN-name combination matches IRS records. If a contractor fails to furnish an accurate certified TIN, the business would be required to withhold a flat rate percentage of gross payments. Contractors receiving payments of \$600 or more in a calendar year from a particular business could require the business to withhold a flat rate percentage of their gross payments, with the flat rate percentage of 15, 25, 30, or 35 percent being selected by the contractor.

- Penalty for failure to comply with electronic filing requirements. An assessable penalty would be established for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The amount of the penalty would be \$25,000 for a corporation or \$5,000 for a tax-exempt organization.
- Basis reporting on securities sales. Certain brokers (including brokerage houses, mutual funds, asset managers and fiduciaries) would be required to report information regarding adjusted basis in connection with the sale of certain publicly traded securities, in addition to other information.
- Expanded broker information reporting. In certain circumstances, a broker would be required to make an information return regarding gross proceeds from the sale of tangible personal property.

In addition, the proposals include:

- Mandatory e-filing by all corporations and partnerships required to file Schedule M-3;
- Amendment of collection due process procedures for employment tax liabilities;
- Increased information return penalties, including failure to file penalties;
- Information reporting on merchant payment card reimbursements;
- Increased information reporting for certain government payments for property and services; and
- Expanded preparer penalties.

## **FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES**

### **Certain Qualified Settlement Fund Payments not Subject to Information Reporting and Backup Withholding, while Other Types of Payments Are**

In PLR 200704004 (Oct. 31, 2006), the IRS ruled that certain payments from a qualified settlement fund to various retailers and retail trade associations were not subject to reporting and withholding requirements. In the ruling, payments made from a qualified settlement fund (as described in section 468B and the regulations thereunder (QSF)), to compensate various retailers and retail trade associations as “calculated to account for overcharges and damages incurred by each [class member],” were “compensation for [their] destroyed or injured capital.”

The IRS ruled that the payments were not reportable under section 6041 because the payments were not fixed or determinable income. The IRS stated that, if, by its nature, a payment to a taxpayer would not be an item of gross income except by application of the tax benefit rule, and the payor has no way of knowing whether the payment is income under that rule, then the payment is not “fixed or determinable” income within section 6041(a). In the ruling, the IRS noted that, based on the factual statements and representations of the ruling request, a payment to a class member was gross income only to the extent that the member derived a tax benefit from a previous deduction for the fees that were overcharged. The settlement fund affirmed that it did not know which (if any) of the class members

derived a tax benefit, or the amount of any tax benefit, and the fund could not require the class members to disclose that information.

The IRS also considered whether interest accruing over time in the corpus of the settlement fund was reportable when payments to class members were made. In the ruling, the IRS concluded that the interest is not reportable under section 6049(a) because it does not meet the definition of interest under that provision. In addition, it is not reportable under section 6041(a) because it is not fixed or determinable income. In this regard, the amounts paid into the settlement fund and the interest earned thereon are stated to be commingled and the settlement fund does not have sufficient information to determine the makeup, as between principal and interest, of the payments made to the class members.

However, the IRS concluded that the QSF must report legal fee payments of \$600 or more (in one year) to class members' attorneys, under section 6041(a). The IRS reasoned that, according to the request, the fund payments to attorneys were "on behalf of [the] Defendants." If so, the IRS concluded, in making the payments, the QSF was conducting its trade or business, and by all appearances, the payments are income to the attorneys because the amounts are either predetermined (fixed) or determinable by the settlement fund. Because the QSF is required to report the fee payments under section 6041(a), the settlement fund is not required to report the payments under section 6045(f). See Treas. Reg. § 1.6045-5(f), Ex. 9. The IRS provides that the payments should be reported on Form 1099-MISC, box 7.

In PLR 200702006 (Oct. 12, 2006), the IRS ruled that certain payments from a QSF to mutual fund investors were not subject to reporting and withholding requirements. In the ruling, payments were made from a QSF to compensate investors for losses suffered and advisory fees paid, 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 income. The amounts compensating investors for loss of capital were not fixed or determinable because the QSF had no access to any payee's tax basis, and no need or occasion to collect information on tax basis, 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 the QSF's lack of data. However, payments made directly to qualified retirement plan participants were reportable under section 6041, subject to the \$600 reporting threshold, on Form 1099-R. The IRS also considered whether the QSF was subject to reporting obligations under sections 6045 and 6049, and concluded that it was not because 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.

Further, the IRS ruled that the payments of direct payments to qualified plan participants also would be subject to backup withholding under section 3406. For purposes of meeting any obligations it may have under section 3406 as a payor of "reportable payments," the IRS ruled that the QSF need not solicit taxpayer identification numbers (TINs) from the individuals to whom it will make distributions. The QSF may obtain the TINs from the mutual funds or tax-qualified plans in which such individuals held accounts, or from transfer agents performing services for the funds or plans. See also PLR 200702008 (Oct. 13, 2006); PLR 200702009 (Oct. 13, 2006); PLR 200703009 (Oct. 12, 2006); PLR 200703010 (Oct. 12, 2006); PLR 200703034 (Oct. 12, 2006); PLR 200702048 (Oct. 12, 2006); PLR

200702010 (Oct. 12, 2006); PLR 200702012 (Oct. 6, 2006) (similar, except payments of post-judgment interest were reportable under section 6041 on Form 1099-INT, subject to any applicable exceptions in the section 6041 regulations and the \$600 reporting threshold); PLR 200702011 (Oct. 5, 2006); PLR 200703008 (Oct. 5, 2006).

## **EMPLOYEE BUSINESS EXPENSES**

### **IRS Issues Fact Sheet Describing Travel and Entertainment Expense Deduction Rules**

The IRS recently released a fact sheet, FS-2007-10, outlining the basic rules relating to travel and entertainment expense deductions. More detailed information relating to these deductions can be found in IRS publications, including Publication 463, *Travel, Entertainment, Gift, and Car Expenses*; Publication 535, *Business Expenses*; and Publication 552, *Recordkeeping for Individuals*.

## **REPORTING GUIDELINES AND FORMS**

### **1. Supreme Court Refuses to Review Holding that Early Retirement Severance Payments Are Subject to FICA Taxes; IRS Modifies Litigating Position**

The Supreme Court has refused to review the Sixth Circuit's holding in Appoloni v. United States, 97 A.F.T.R. 2d 2006-2828 (6th Cir. 2006), that early retirement incentive payments made to tenured public school teachers were FICA wages. The holding had appeared to conflict with North Dakota State University v. United States, 87 A.F.T.R. 2d 2001-2522 (8th Cir. 2001), where the Eighth Circuit Court of Appeals held that payments made to tenured university professors pursuant to an early retirement program were not "wages" for FICA purposes.

In Appoloni, the Sixth Circuit Court of Appeals ruled that early retirement incentive payments to tenured public school teachers "easily fall within the definition of FICA wages as 'all remuneration for employment'" under section 3121. *Id.* at 2006-2836. In its opinion, the Sixth Circuit stated that it has held consistently that where a payment arises out of the employment relationship, and is conditioned on a minimum number of years of service, such a payment constitutes FICA wages. The opinion reasoned that, in this case, to qualify for a payment, the teachers were required to serve a minimum number of years that exceeds the number of years required to obtain tenure, which indicated that the payments were for services performed as opposed to the relinquishment of tenure rights. The fact that the teachers also gave up tenure rights was not determinative because the relinquishment of tenure rights was incidental to the teacher's agreement to retire early. The court also likened the payments to the relinquishment of seniority rights, rights to bring suit, and other types of rights in exchange for a severance payment that each constitute FICA wages.

#### *IRS Issues Revised Action on Decision - North Dakota State University*

Separately, the IRS issued a revised action on decision with respect to North Dakota State University that modifies its litigating position. See AOD 2007-001. On December 31, 2001, the IRS issued a non-acquiescence with respect to the decision in North Dakota State University, but acknowledged that it would follow the decision within the Eighth Circuit with respect to cases that had

exactly the same facts. In the recent AOD, the IRS continued its nonacquiescence and modified its litigating position in light of the intervening Rev. Rul. 2004-110, 2004-2 C.B. 960. Rev. Rul. 2004-110 modified and superseded Rev. Rul. 58-301, upon which North Dakota State University was based. Rev. Rul. 2004-110 provides that an amount paid to an employee as consideration for the cancellation of an employment contract and relinquishment of contract rights is ordinary income and wages for purposes of FICA, the Federal Unemployment Tax Act (FUTA), and Federal income tax withholding. Rev. Rul. 2004-110 applies to payments made on or after January 12, 2005.

As a result, under AOD 2007-001, the IRS will follow North Dakota State University within the Eighth Circuit only with respect to cases that have exactly the same facts and only with respect to payments were made before January 12, 2005. The IRS states that it will continue to litigate cases in the Eighth Circuit involving early retirement payments but otherwise having different facts from North Dakota State University regardless of when the payments were made, and will continue to take the position that early retirement payments made to tenured professors are remuneration for services subject to FICA taxes in all cases in other circuits.

## **2. IRS Rules State Agency's Issuance of Two-Party Check Not Sufficient to Impose Employer Status Under Section 3401(d)(1)**

In TAM 200704031 (Jan. 26, 2007), the IRS ruled that the State was not an employer pursuant to section 3401(d)(1) when it made payments jointly to a common law employer and a day care aide employee via a two-party check. Under the facts of the ruling, a state agency administered a program in accordance with the Child Care and Development Block Grant Act of 1990, as amended and codified at 42 U.S.C. Chapter 105 (2000) (the "Child Care Act"), which offers federal funding to provide low-income families with the financial resources necessary to afford quality child care. Under the program, the day care aide was the common law employee of the parent. However, to ensure conformity with the Child Care Act, the agency issued two-party checks payable jointly to the parent and the day care aide. The two-party checks were mailed to the parent at the parent's home address. The agency neither furnished nor filed any Forms 1099 or Forms W-2 reporting the amounts paid to the day care aides for the years at issue. Additionally, the agency never treated day care aides as employees of the State for any purpose.

Under section 3401(d), the term "employer" generally means the person for whom an individual performs any service, of whatever nature, as the employee of such person. Under section 3401(d)(1), however, if the person for whom the individual performs the services does not have control of the payment of the wages for such services, the term "employer" means the person having control of the payment of such wages.

The IRS applied the exception in section 3401(d)(1) narrowly, and cited Westover v. William Simpson Const. Co., 209 F.2d 908 (9th Cir. 1954), Century Indemnity Company v. Riddell, 317 F.2d 681 (9th Cir. 1963), and Southwest Restaurant Systems, Inc. v. United States, 607 F.2d 1237 (9th Cir. 1979) for the proposition that the courts have consistently emphasized two requirements for the application of section 3401(d)(1): first, the common law employer must not have legal control of the payment of the wages, and second, a third party must have "sole and legal control" of the payment of the wages.

The IRS concluded that the parent had a legal right to control disbursement of the proceeds of the check. The IRS noted that under the State Code an instrument made payable to two or more persons not alternatively (e.g., a two-party check) is payable to all of them and may be negotiated, discharged, or enforced only by all of them. Thus, unless endorsed by the parent, a two-party check was a restricted payment that constituted neither the actual nor the constructive receipt of wages by the day care aide. Similarly, the payments were neither set apart for the day care aid without any substantial limitation or restriction nor within the day care aide's own control and disposition.

### **3. IRS Releases Updated Publication Guidance to Employers**

The IRS has revised Publication 15 (Rev. Jan. 2007), *Circular E, Employer's Tax Guide (Including 2007 Wage Withholding and Advance Earned Income Credit Payment Tables)*. The revised Publication 15 can be viewed online at <http://www.irs.gov/pub/irs-pdf/p15.pdf>. The IRS has also revised Publication 15-A (Rev. Jan. 2007), *Employer's Supplemental Tax Guide (Supplement to Publication 15 (Circular E), Employer's Tax Guide)*. Revised Publication 15-A can be viewed online at <http://www.irs.gov/pub/irs-pdf/p15a.pdf>.

### **4. IRS Corrects Instructions for Form 1040, Schedule B**

The IRS has announced in a web notice that it has corrected the 2006 Instructions for Schedule B (Form 1040), Interest and Ordinary Dividends to correct the web site location of Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. Form TD F 90-22.1 can be viewed at <http://www.irs.gov/pub/irs-pdf/f90221.pdf>. The corrected version of the 2006 Instructions for Schedule B (Form 1040) is available at <http://www.irs.gov/pub/irs-pdf/i1040sa.pdf>.

### **5. IRS Updates Guidance for Substitute Forms**

The IRS has issued Rev. Proc. 2007-15 (2007-3 I.R.B. 300, superceding Rev. Proc. 2005-69, 2005-44 I.R.B. 864) which provides requirements for reproducing paper substitutes and for furnishing substitute recipient statements for Forms 1096, 1098, 1099, 5498, W-2G, and 1042-S. Rev. Proc. 2007-15 will be reproduced as the next revision of Publication 1179.

The IRS has also released revised Publication 1141 (Rev. Dec. 2006), *General Rules and Specifications for Substitute Forms W-2 and W-3*. See also Rev. Proc. 2006-55, 2006-52 I.R.B. 1151 (reprinted as Publication 1141), superceding Rev. Proc 2005-65, 2005-38 I.R.B. 564. Revised Publication 1141 is available online at <http://www.irs.gov/pub/irs-pdf/p1141.pdf>.

## **ASK THE EXPERT**

### **Is the insurance industry currently represented on the Information Reporting Program Advisory Committee (IRPAC)?**

Erica L. Dinner, Director, Tax Information Reporting at Hartford Life Insurance Company, has been an IRPAC member since 2006, and her appointment is slated to expire next year. Although the IRS recently appointed eight new members to IRPAC, the newly appointed members do not include another representative from the insurance industry.

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