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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

March 23, 2007

LIFE INSURANCE, ANNUITIES, AND QUALIFIED PLANS

1. IRS Seeks Public Comment on Information Reporting Requirements For Charities Engaged in Structured Insurance Contracts, and Congressionally Mandated Study

The IRS has issued Notice 2007-24 (2007-12 I.R.B. __), asking for public comments on temporary information reporting requirements for charities that engage in structured insurance contracts, and on the congressionally mandated study of whether it is appropriate for charities to acquire such contracts. In general, section 1211 of the Pension Protection Act of 2006 (Pub. L. 109-280) imposes new information reporting requirements on organizations (including certain government entities) to which contributions are deductible for Federal income, estate or gift tax purposes ("Specified Exempt Organization") and which acquire an interest, together with another person, in a life insurance, annuity or endowment contract ("Applicable Contract") in a reportable acquisition after August 17, 2006, but on or before August 17, 2008.

Congress imposed the information reporting requirements under section 6050V in connection with the congressionally mandated study because of concern that certain transactions involving the acquisition of life insurance contracts may be used to improperly shelter income from tax. Staff of the Jt. Comm. on Tax'n, 109th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in the 109th Congress 580 (Comm. Print 2007) In these arrangements, both an exempt organization and private investors have an interest in the contract. Generally, the exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or because of applicable State insurable interest rules. While private investors provide capital used to fund the purchase of the life insurance contracts, (sometimes together with annuity contracts), both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

In accordance with section 6050V, the IRS has issued draft Forms 8921 and 8922. Form 8921 will be used to report information to the IRS about structured transactions under which there have been reportable acquisitions of Applicable Contracts made by a Specified Exempt Organization. Form 8922

will be used to report information to the IRS about the Applicable Contracts that are part of a structured transaction required to be reported on a Form 8921.

Generally, on Form 8921, a Specified Exempt Organization would:

- Report information on the transaction itself, including information about the Specified Exempt Organization, other participants in the transaction, and the cash flows associated with the transaction.
- Assign a unique structured transaction identifier ("STI") to each transaction as provided on the Form and the instructions.
- Provide a description of the allocation formulas, interest rates, and other terms that govern the financial arrangement between the applicable exempt organization and the other participants in the transaction.
- Attach copies of documents related to the reportable acquisition, including any contracts covering the relationships between the Specified Exempt Organization and the persons other than the Specified Exempt Organization.

Generally, on Form 8922, a Specified Exempt Organization would:

- Report information on the underlying Applicable Contracts, including information about the issuers of the contracts and the individuals insured under the contracts.
- Use the STI assigned on Form 8921 that specifically relates to the underlying Applicable Contracts.
- Attach a representative copy of the Applicable Contract.

It is anticipated that more than one Form 8922 will be required with respect to a single transaction if the transaction involves more than one issuer, or more than one type of Applicable Contract.

The Treasury and the Service require that any comments on draft Forms 8921 and 8922 be received by March 16, 2007. The Treasury and the Service also request comments more generally to assist in the congressionally mandated study, especially on: (i) the purpose of transactions that are the subject of the study, other than to raise money for the applicable exempt organizations, (ii) the use of life insurance and annuity contracts by applicable exempt organizations in transactions that do not involve the participation of persons that are not tax-exempt, and (iii) in the case of an applicable insurance contract in which a charity, as defined under State law, has an interest, the appropriate treatment of amounts received by the charity as a death benefit in light of (A) the charity's role in the transaction, (B) how the charity financed the acquisition of its interest, (C) whether the charity's activities with respect to the contract are substantially related to the charity's exempt purpose or function, and (D) any other relevant factors.

Written comments relating to the congressionally mandated study should be received by August 22, 2007. Such comments should be sent to: CCPA:LPD:PR (Notice 2007-24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Alternatively, comments may be hand delivered between the hours of 8:00 a.m. and 4:00 p.m. Monday to Friday to CC:PA:LPD:PR (Notice 2007-24), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue,

NW, Washington, D.C. Comments may also be transmitted electronically via the following e-mail address: Notice.Comments@irscounsel.treas.gov.

2. IRS Issues Notice 2007-22 Providing Guidance on Rollovers From Health FSAs and HRAs to HSAs, together with Reporting Guidance

The IRS has published Notice 2007-22 (2007-10 I.R.B. 670) providing guidance on rollovers from health Flexible Spending Arrangements ("health FSAs"), and Health Reimbursement Arrangements ("HRAs") to Health Savings Accounts ("HSAs") through 2011, as allowed by amendments to section 223 made by the Tax Relief and Health Care Act of 2006 (Pub. L. No. 109-432) ("qualified HSA distributions").

Generally, to qualify for favorable treatment, by plan year end:

- The plan must be amended;
- The employee must elect the rollover;
- The year-end balance must be frozen, and funds must be transferred by employer within 21/2 months after the end of the plan year and result in a zero balance in the health FSA or HRA.

Under a special transitional rule, relief is provided for amounts remaining at end of 2006:

- There is no requirement to freeze the year-end balance in the health FSA or HRA, and
- The amendment, election, and transfer must be completed by March 15, 2007.

The notice also includes reporting guidance for employers. Generally, employers must report employer contributions to an HSA in box 12 of Form W-2 with code W. (Employer contributions to an HSA that are not excludable from the income of the employee also must be reported in boxes 1, 3, and 5.)

Notice 2007-22 provides that amounts transferred through a "qualified HSA distribution" are not reported in box 12 of Form W-2. The notice also states that employers are not responsible for reporting whether an employee receiving a qualified HSA distribution remains an eligible individual during the testing period. However, employers must report qualified HSA distributions as rollover contributions to the HSA trustee, and the HSA trustee must report the qualified HSA distribution as a rollover contribution on Form 5498-SA, *HSA, Archer MSA, or Medicare Advantage MSA Information*. The 2007 Form 5498-SA has been temporarily removed from www.irs.gov. The IRS states that it is revising the form to reflect changes required by the Tax Relief and Health Care Act of 2006.

Notice 2007-22 modifies Rev. Rul. 2006-36 (2006-36 I.R.B. 353), Rev. Rul. 2005-24 (2005-16 C.B. 892), Rev. Rul. 2003-102 (2003-2 C.B. 559), Notice 2002-45 (2002-2 C.B. 93), Rev. Rul. 2002-41 (2002-2 CB 75), and Rev. Rul. 69-141 (1969-1 C.B. 48), with respect to Code Sec. 106(e): qualified HSA distributions. Notice 2005-86 (2005-2 C.B. 1075) is modified as of Dec. 20, 2006.

3. IRS Announces Updated Specifications for Filing Archer MSA Summaries

In Announcement 2007-15 (2007-8 I.R.B. 596), the IRS details major changes in filing procedures for Form 8851, *Summary of Archer MSAs* (Medical Savings Accounts). Form 8851 is filed by trustees and custodians of an Archer MSA to report the total number of Archer MSAs established, the total number of previously uninsured account holders, the total number of excludable account holders, and the names and social security numbers of account holders. The report will be used to furnish information about Archer MSAs to Congress and to determine when the maximum number of Archer MSAs allowed by law (750,000, excluding previously uninsured account holders) is reached.

Rev. Proc. 2001-31 (2001-1 C.B. 1170), which detailed prior filing requirements, will be revised at future date, but the revised version will not be available by the due date of the return, March 20, 2007. Filers can use this announcement along with Rev. Proc. 2001-31 to file Form 8851 electronically. The major changes detailed in Announcement 2007-15 are:

- The name of the Martinsburg Computing Center was changed to Enterprise Computing Center - Martinsburg (ECC-MTB).
- The due date for filing Forms 8851 was changed to March 20, 2007. This date is effective for both filing periods, January 1, 2005 through June 20, 2005 and January 1, 2006 through June 20, 2006. A separate transmission is required for each filing period.
- ECC-MTB no longer accepts magnetic media for the filing of Forms 8851. The only acceptable method for those with over 250 forms is electronic filing via the Filing Information Returns System (FIRE) at http://fire.irs.gov. For more information regarding the FIRE system, refer to Publication 3609, *Filing Information Returns Electronically*, which can be downloaded from http://www.irs.gov. Filers of Form 8851 must call ECC-MTB toll-free at 1-866-455-7438, ext. 3 for log-on instructions.

If you have questions concerning the filing of Form 8851, you may contact the IRS ECC-MTB toll-free at 866-455-7438. The 2007 Form 8851 can be accessed online at http://www.irs.gov/pub/irs-pdf/f8851.pdf.

REPORTING GUIDELINES AND FORMS

1. IRS Rules Plan is Supplemental Unemployment Benefit Plan – Payments Not FICA or FUTA Wages

In PLR 200709056 (March 2, 2007), the IRS ruled that an employee benefit plan for laid-off workers established pursuant to an agreement between a company and a union of employees was a supplemental unemployment benefit (SUB). The ruling described the resulting FICA and FUTA tax treatment of payments under the plan.

Treas. Reg. § 31.3401(a)-1(b)(4) specifically provides that, for purposes of federal income tax withholding, any payments made by an employer to an employee on account of dismissal (i.e., involuntary separation from the service of the employer) constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments. A similar rule

applies in the context of FICA and FUTA taxes. H.R. Rep. No. 1300, 81st Cong., 1st. Sess. 124 (1949), 1950-2 C.B. 255, 277, and 300. See also Rev. Rul. 90-72, (1990-2 C.B. 211), Rev. Rul. 71-408 (1971-2 C.B. 340), and Rev. Rul. 75-44 (1975-1 C.B. 15).

In Rev. Rul. 56-249, the Service created an administrative exception for SUB pay, and subsequent revenue rulings broadened the scope of Rev. Rul. 56-249, but only to the extent that the plans in question are "similar in all material details" or are "substantially the same" as the plan in Rev. Rul. 56-249. In Rev. Rul. 90-72, the IRS ruled that SUB pay is excluded from "wages" for FICA and FUTA tax purposes only if the receipt of SUB pay is actually linked to the receipt of state unemployment compensation (i.e., the plan payments satisfy the plan's design and purpose of supplementing the receipt of state unemployment compensation). Furthermore, it holds that lump-sum payments are not linked to state unemployment compensation since the amount of the benefit received is the same regardless of the length of the individual's unemployment. Therefore, to qualify as SUB pay for FICA and FUTA tax purposes, payments under a plan must be specifically designed to supplement state unemployment benefits and, under the terms of the plan, the employee must be unemployed and must meet the requirements necessary to receive state unemployment compensation benefits.

In PLR 200709056 the private ruling, the IRS determined that the plan was a SUB plan because it was similar in all material respects to the plan described in Rev. Rul. 56-249, as modified by Rev. Rul. 90-72; i.e., the plan was designed to supplement state unemployment benefits, and the benefits were linked to the receipt of state unemployment compensation. As a result, the following rulings applied to the various categories of payments under the plan:

- Benefits paid to laid-off employees receiving State unemployment benefits and no other compensation from the Company were not wages for FICA and FUTA tax purposes.
- Benefits were not wages for FICA and FUTA tax purposes where paid to laid-off employees who were ineligible to receive State unemployment benefits because the employee did not have sufficient employment to be covered under the State system, the employee exhausted the duration of State unemployment benefits, or the employee did not met the requisite waiting period (provided the employee otherwise would become eligible and receive State benefits once the waiting period expired).
- The FICA and FUTA exclusion also extended to the de minimis amount of benefits paid pursuant to the plan that were not tied to State unemployment benefits (i.e., benefits paid to full-time students and laid-off workers receiving medical disability payments).
- Benefits were not excluded if made to employees disqualified from receiving State unemployment benefits due to outside earnings or earnings as a supplemental worker. Due to the "very small number of occurrences" under this category, the IRS determined that it would not affect treatment of the benefits described above.

The taxpayer in the private ruling did not request a ruling with regard to the tax treatment of benefits paid under the plan to employees who volunteered to be laid off.

2. IRS Rules on Timing of Deferred Compensation Accrual

In Rev. Rul. 2007-12 (2007-111 I.R.B. __), the IRS ruled that an accrual basis taxpayer may treat its FICA and FUTA tax ("payroll tax") liability as incurred in Year 1, regardless of whether the

compensation to which the liability relates is deferred compensation that is deductible under section 404 in Year 2, if the all events test and recurring item exception of section 461 are otherwise met.

Previously, in Rev. Rul. 69-587 (1969-2 C.B. 108), the IRS concluded that, under the all events test of section 461, an accrual method employer generally may not deduct payroll taxes payable with respect to bonuses and vacation pay accrued but unpaid at year-end until the taxable year in which the bonuses and vacation pay are paid. In Rev. Rul. 96-51 (1996-2 C.B. 36), the IRS concluded that, under the all events test, an accrual method employer may deduct in Year 1 its otherwise deductible payroll taxes imposed on year-end wages properly accrued in Year 1 but paid in Year 2, provided the employer satisfies the requirements of the recurring item exception in Treas. Reg. § 1.461-5 with respect to those taxes. However, the IRS stated that Rev. Rul. 96-51 does not address the application of section 404 because the year-end wages in that ruling were paid before the fifthteenth day of the third calendar month after the end of Year 1.

In general, section 404 applies to compensation paid or accrued by an employer on account of any employee under a plan deferring the receipt of such compensation. An employer's liability for payroll taxes does not represent compensation paid or accrued by an employer on account of any employee. Therefore, the IRS reasoned that section 404 does not control the deductibility of an employer's liability for payroll taxes, even if the payroll tax liability relates to a deferred compensation liability subject to the deduction rules of section 404. As a result, the IRS concluded that section 404 does not alter the timing of the accrual of the taxpayer's FICA and FUTA tax liability under section 461. Rev. Rul. 2007-12 revoked Rev. Rul. 69-587 (1969-2 C.B. 108) and amplified Rev. Rul. 96-51 (1996-2 C.B. 36).

The IRS also noted that a change in treatment of payroll tax liabilities associated with deferred compensation to comply with this revenue ruling would be a change in method of accounting within the meaning of sections 446 and 481 and the regulations issued thereunder. Accordingly, a taxpayer that wants to change its treatment of payroll taxes associated with deferred compensation to comply with Rev. Rul. 2007-12 revenue ruling must obtain the consent of the Commissioner under section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i).

ASK THE EXPERT

How do the reporting obligations relating to penalty relief for rank-and-file employees with backdated stock options generally dove-tail with the reporting obligations with respect to the exercise of the backdated options, without regard to section 409A- 20% tax and interest?

In Announcement 2007-18 (2007-9 I.R.B. 625), the IRS announced a program that, under certain circumstances, permits employers to pay the additional taxes arising under section 409A from an employer's exercise in 2006 of certain backdated and mispriced stock options and stock appreciation rights (stock rights) issued by the employer. Generally, the program:

- Requires employers to notify the IRS no later than February 28, 2007 of their intent to participate, and to notify affected employees within 15 days of providing the notification to the IRS.
- Applies only to discounted stock rights exercised during 2006.

- Applies only to employees and former employees who are/were non-insiders.
- Requires full payment by the employer of the applicable section 409A taxes arising from the exercise of the stock right.
- Provides relief for the employees from the requirement to pay the section 409A taxes.
- Requires treatment of the employer's payment of the employee's section 409A taxes as an additional payment of compensation to the employee in the employee's taxable year in which the payment is made.

Pursuant to Notice 2006-100 (2006-51 I.R.B. 1109), issued on November 30, 2006, service recipients (employers) generally are required to report amounts includible under section 409A for 2006 on a timely filed form W-2 or Form 1099, as applicable. In addition, service providers (employees) are required to report amounts includible under section 409A for the service provider's 2006 tax year and to pay any taxes due in accordance with the requirements of Notice 2006-100.

If an employer complies fully with the required provisions of Announcement 2007-18 with respect to an exercise of a stock right by an employee, the employer will not be required to report the section 409A inclusion amount with respect to such stock right exercise in box 12 of Form W-2 using code Z. If an employer complies fully with the required provisions with respect to an exercise of a stock right by an employee, but has already reported the section 409A inclusion amount with respect to such exercise of a stock right by an employee in box 12 of Form W-2 using Code Z, the employer may provide a corrected Form W-2c that does not report the section 409A inclusion amount in box 12 of Form W-2c using Code Z, and such employer will not be subject to any penalties under section 6721 or section 6722. Nothing in this Program relieves the employer of any information reporting requirements with respect to an employee or an exercise of a stock right that was not identified in the employer's further submission.

However, payments made on behalf of an employee or former employee to cover section 409A taxes are wages for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Federal income tax withholding purposes for the employee's taxable year in which the payment is made. Such wages, as well as any additional wages resulting from the employer's payment of the employee's share of FICA tax and income tax without withholding such amounts from the employee, must be reported on Form 941, *Employer's Quarterly Federal Tax Return*, and in box 1, 3 and 5 of the employee's Form W-2, *Wage and Tax Statement*, for the year in which the payment is made. See Rev. Rul. 58-113 (1958-1 C.B. 362) and Rev. Proc. 81-48 (1981-2 C.B. 623), for methods of computing gross wages when paying FICA and Federal income tax withholding on behalf of an employee.

Nothing in this announcement or program affects the employer's obligation to report the amount that would be required (without regard to section 409A) to be included in income and wages due to the exercise of a stock right, and to withhold and pay the applicable employment taxes, or the employee's obligations to include such amounts in income and pay Federal taxes on them. Thus, the program does not affect an employer's obligation to report the compensation income and wages arising from the exercise of the stock right on the Form W-2, in Box 1, 3 and 5, and to apply the appropriate employment taxes, nor does it affect an employee's obligation to report such compensation income on the Form 1040 and pay the applicable income tax (other than the additional section 409A taxes).

The program has been sharply criticized by practitioner's because the initiative offers no significant incentive to the employees or their companies to participate. Companies are not currently liable for the tax. By participating, the employer would be acting to save the employees from handling the issue on an individual basis.

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