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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

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LEGISLATION

1. Proposals Require Reporting of Employer-Provided Health Insurance

President's Fiscal 2008 Budget Proposal

The President's fiscal 2008 budget proposal included the imposition of a standard deduction for health insurance which drew criticism from payroll administrators attending the American Payroll Association in Washington on March 23. Present law provides a tax subsidy for employer-paid health insurance that is generally proportional to the size of the health insurance premium. Under the proposal, health insurance would be considered taxable income above a certain threshold, but a standard deduction of \$15,000 for families (\$7,500 for individuals) would be created for all taxpayers. Those deductions would increase subject to the Consumer Price Index, but are not expected to rise as quickly as healthcare costs. The administrators expressed numerous concerns about the plan, including the employer's responsibility in determining the value of its healthcare plan.

Healthcare Disclosure Act of 2007

Separately, Representative Jim Cooper (D-Tenn.), introduced H.R. 847, the Healthcare Disclosure Act of 2007, which if enacted, would require that amounts paid for employer-provided coverage under accident or health plans to be included on W-2 forms.

2. Proposed Payroll Tax to Aid Unemployed

Rep. Jim McDermott (D-Wash.) is drafting legislative proposals to aid unemployed and dislocated workers with federal funding through a new employer payroll tax. An aid noted that there was no timetable for introduction of the bill.

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 200712004 (Dec. 12, 2006), the IRS ruled that certain payments from a qualified settlement fund (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 profit disgorgement and civil penalties, as the result of an administrative proceeding brought by the Securities

and Exchange Commission. The administrative proceeding related to misleading and incorrect assurances that certain providers of variable annuity products would seek to prevent market timing of mutual funds in which purchasers of these products invested.

The IRS ruled that the payments were not reportable under section 6041 because the payments were not fixed or determinable income, except in the case of payments made directly to participants in tax-qualified retirement plans. The amounts compensating investors were not fixed or determinable because the QSF had no knowledge as to the annuity starting dates of injured investors, and no authority to compel disclosure of that information. The QSF would have needed such information in order to calculate the amount of income chargeable to any given investor. In some cases, the QSF would have also needed information as to the investor's investment in the annuity contract. Payments made directly to qualified retirement plan participants, however, 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 to participants in tax-qualified plans 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 variable annuity providers, mutual funds or tax-qualified plans in which such individuals invested, or from transfer agents performing services for these providers, funds or plans. See also 200712005 (Dec. 12, 2006) (similar).

EMPLOYEE BUSINESS EXPENSES

1. IRS Announces Benefit Valuation Rates for Flights on Employer Provided Aircraft

The IRS has issued Rev. Rul. 2007-17 (2007-13 I.R.B. 805), announcing the Standard Industry Fare Level ("SIFL") cents-per-mile rates and the terminal charges in effect for the first half of 2007 under Treas. Reg. § 1.61-21(g). Treas. Reg. § 1.61-21(g) provides a rule for valuing noncommercial flights on employer-provided aircraft for purposes of the taxation of fringe benefits under section 61. Treas. Reg. § 1.61-21(g)(5) provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the SIFL formula by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in Treas. Reg. § 1.61-21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are reviewed semi-annually.

For flights taken in the first half of 2007, the terminal charge rose to \$37.92 (from \$37.85 for the second half of 2006). The SIFL rates are \$.2075 per mile up to 500 miles (up from \$.2071 per mile for

the second half of 2006); \$.1582 per mile from 501-1500 miles (up from \$.1579 per mile for the second half of 2006); and \$.1521 per mile over 1500 miles (up from \$.1518 per mile for the second half of 2006).

2. IRS Updates Publication 1542: Per Diem Rates (for Travel Within the Continental United States)

The IRS released Publication 1542 (rev. March 2007), *Per Diem Rates (for Travel Within the Continental United States)*. Publication 1542 is for employers who pay a per diem allowance to employees for business travel away from home within the continental United States, on or after October 1, 2005, and before January 1, 2008. It gives the maximum per diem rate employers can use without treating part of the per diem allowance as wages for tax purposes. The publication can be viewed at <http://www.irs.gov/pub/irs-pdf/p1542.pdf>.

REPORTING GUIDELINES AND FORMS

1. IRS Web Page Provides Employment Tax Resource

The IRS has posted resources on a web page that provide employment tax guidance. The page includes subjects such as frequently asked tax questions and answers, independent contractors vs. employees, employment tax publications, tax-related responsibilities for employers, and employment tax notices and news releases. The page can be viewed at <http://www.irs.gov/businesses/small/content/0,,id=98942,00.html>.

2. IRS Updates Directions for Corporations Required to E-file

The IRS updated guidance for corporations required to e-file: *Tax Year 2006 Directions for Corporations Required to e-file* (rev. 03-20-07). Major changes from prior guidance include updated rules on filing mixed returns. The changes can be viewed at <http://www.irs.gov/businesses/corporations/article/0,,id=163357,00.html>

OTHER MATTERS

Treasury and IRS Issue Update to Priority Guidance Plan

On March 12, the Treasury and IRS issued an update to the 2006-2007 priority guidance plan originally released August 15, 2006. Proposed rules that are awaiting final regulations include:

- Final regulations under section 403(b) regarding tax-favored annuities purchased by section 501(c)(3) organizations or public schools. Temporary rules (T.D. 9159) were published November 16, 2004, under section 3121, relating to the definition of a salary reduction agreement and providing guidance to employers purchasing section 403(b) annuities, and

- Final regulations under section 3402(f) relating to Form W-4. Temporary rules were published on April 14, 2005 (T.D. 9196). The regulations related to Form W-4, *Employee's Withholding Allowance Certificate*, which provided guidance for submissions to the IRS, notifications on the maximum number of withholding exemptions allowed, and the proper use of substitute forms.

Guidance projects awaiting upcoming release include:

- Contributions to welfare benefit funds; and
- Reserves for post-retirement medical and life insurance benefits under section 419A.

Guidance on split-dollar life insurance under section 409A, also included on the plan, was just recently released (T.D. 9321).

ASK THE EXPERT

We've been hearing a lot about worker misclassification lately, what is the IRS doing in this regard?

There have been numerous news items within the last several weeks relating to worker misclassification. For example, on March 27, witnesses testifying in front of the Subcommittee on Workforce Protections, a House Education and Labor subcommittee, stated that employers who misclassify workers as independent contractors rather than employees cost the federal government billions in tax revenue annually, and deprive workers of essential protections under federal and state labor laws. In response to a question from Rep. Joe Wilson (R-S.C.), Catherine Ruckelshaus, a lawyer with the National Employment Law Project in New York, stated that legislative action is not needed now regarding the tests used to determine whether a worker is an employee or independent contractor "if current laws are properly enforced."

IRS Agency-wide Strategy

The IRS appears to be taking steps to address the issue. At a March 23 American Payroll Association Summit in Washington, IRS Small Business/Self-Employed Division Chief (Employment Tax), John Tuzynski, announced that the IRS is developing an agency-wide strategy to combat abusive employment tax practices (in an effort to reduce the tax gap). These efforts include a continued focus on companies' improper classification of workers as independent contractors, not subject to employer withholding requirements, rather than as employees. According to Tuzynski, the IRS is also beginning to examine more employers that submit high percentages of Forms W-2 triggering "no-match" notices with the Social Security Administration.

IRM Update: Corporate Officer Classification and Compensation

In addition, on March 22, 2007, the IRS issued a memorandum that provided interim guidance and affirmed existing audit practices regarding employee classification in the context of corporate officer compensation. See Memorandum for Employment Tax Territory Managers. Group Managers and

Specialists, dated March 22, 2007, *available at* www.irs.gov/pub/foia/ig/sbse/sbse-04-0307-012.pdf. The purpose of the document was to provide guidance and clarify instances where sections 3509 (relating to determination of employer's liability for certain employment taxes), section 7436 (relating to proceedings for determination of employment status), and section 501 of the Revenue Act of 1978 (which provides relief from employment tax liability, notwithstanding the actual relationship between the taxpayer and the individual performing the services, under certain circumstances) apply in officer compensation cases.

Section 3509 and "intentional disregard"

Section 3509 provides for reduced rates for income tax withholding and the employee portion of FICA when an employer fails to deduct and withhold those taxes because it treated the employee as "not being an employee." However, these reduced rates will not apply in cases of "intentional disregard." In the memorandum, the IRS emphasized to examiners that the rules in section 3509 could apply where an officer is classified as something other than an independent contractor, and stated:

Although IRM 4.23.8.5 specifically mentions independent contractor, Section 3509 could apply in any situation where the worker is being treated as other than an employee, for example, an officer who performs services, receives no compensation, and takes his earnings as corporate distributions. However, a taxpayer is not entitled to the reduced rates of Section 3509 if the taxpayer intentionally disregarded the employment tax requirements. Thus, in the case of a corporation treating an officer as other than an employee, if there is intentional disregard, the taxpayer will not be entitled to the reduced rates of Section 3509.

Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 provides relief from employment taxes where: (1) the taxpayer did not treat the individual as an employee, (2) required federal tax returns reflect the taxpayer's treatment of the individual as a non-employee, (3) the taxpayer had a reasonable basis for not treating the individual as an employee, and (4) the taxpayer did not treat any individual in a substantially similar position as an employee. The IRS reminded examiners to address section 530 in officer compensation cases, and noted that the taxpayer will have difficulty overcoming the reasonable basis requirement because officers who perform services for the corporation are employees by statute under section 3401(c), section 3121(d)(1), and 3306(i).

Section 7436

Section 7436 provides Tax Court jurisdiction to review certain employment tax determinations. As originally enacted, section 7436 authorized the Tax Court only to review determinations by the Service that a taxpayer's workers should be classified as employees for purposes of subtitle C (which governs employment taxes), or that the taxpayer for whom the services were performed was not entitled to treatment under section 530(a) of the Revenue Act of 1978. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1454(a) (1997). Section 7436 was later amended to authorize the Tax Court also to determine the proper amount of employment tax in determining worker status and section 530 treatment. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 314(f) (2000).

Section 7436(a) requires that the determination(s) involve an actual controversy and that the determination(s) be made as part of an examination. In the memorandum, the IRS states that where a taxpayer did not treat the corporate officer as an employee, there is an “actual controversy,” despite the fact that an officer of a corporation is specifically defined as an employee for employment tax purposes. See Sections 3401(c), 3121(d)(1) and 3306(i). When a corporate officer performs services for a corporation and the corporation does not treat the officer’s compensation as wages, a controversy regarding whether the officer is an employee exists, whether the corporation treats the officer as an independent contractor, partner, lessee, or recipient of royalty, dividend, or loan payments. As a result, in any officer compensation case where the corporation does not treat the officer’s compensation as wages (i.e., does not file Form W-2 for the officer), the provisions of section 7436 must be followed, and following normal appeal procedures, a Notice of Determination of Worker Classification must be issued.

The guidance is effective immediately, and the Internal Revenue Manual 4.23.8.5 will be updated to reflect the changes.

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