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## INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

May 25, 2007

### LEGISLATION

#### 1. Lawmakers Urged to Establish Definition for Contractor

On May 8th, in the “Hearing on the Effects of Misclassifying Workers as Independent Contractors,” witnesses testified before a joint hearing of the House Ways and Means Subcommittees on Select Revenue Measures and on Income Security and Family Support. Sigurd Nilsen, of the Government Accountability Office, testified that “no definitive test exists to distinguish whether a worker is an employee or an independent contractor.” Witnesses noted that, currently, employers have economic incentives not to classify workers as employees because, in doing so, employers avoid payment of unemployment insurance, workers’ compensation, and Social Security taxes, and escape the cost of withholding income taxes. The witnesses agreed that misclassifications of employees as contractors could be costing the federal government billions in tax revenue, and urged the lawmakers to define exactly who can be classified as an independent contractor.

#### 2. Proposed Bills Impose Excise Tax on Employers to Fund Wage Insurance Plan

Rep. Jim McDermott (D-Wash.) introduced H.R. 2202, the Worker Empowerment Act, which would impose an excise tax on employee wages paid by employers to provide workers with wage insurance. (See this publication, dated April 2007, Rep. Jim McDermott (D-Wash.) is drafting legislative proposals to aid unemployed and dislocated workers with federal funding through a new employer payroll tax.) The bill is identical to S. 1330 introduced by Sen. Charles Schumer (D-N.Y.). The legislation would impose a payroll tax to fund a “Wage Insurance Trust Fund” which would pay for reemployment adjustment assistance programs to be administered by the states. The legislation would require states to implement an unemployment assistance program providing payments to qualified individuals separated from their employers. The payments would be funded by a new excise tax under new section 3601, equal to 0.06-percent of wages paid with respect to employment.

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

#### 1. IRS Issues Final Portfolio Interest Rules For Nonresident Aliens and Corporations

The IRS has issued final regulations (T.D. 9323) under sections 871 and 881, relating to the repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments. The final regulations generally adopt, with two modifications, proposed regulations issued last year (REG-118775-06), and address section 871(h)(3) and the application of the 10-percent-shareholder test when a nonresident alien individual or foreign corporation is a partner in a

partnership that is paid interest. In addition, the final regulations implement section 5 of Notice 2006-99, 2006-46 I.R.B. 907, modifying Treas. Reg. § 1.1441-1(b)(7).

Pursuant to sections 871(a)(1)(A) and 881(a)(1)(A), U.S. source interest that is not effectively connected with a U.S. business generally is considered fixed or determinable annual or periodic (FDAP) income and is subject to tax on a gross basis. This tax generally is collected by means of withholding under sections 1441 and 1442, which require a payor of FDAP income to withhold 30-percent of the gross amount of such payment, unless the beneficial owner claims a reduced rate of tax on such interest under an applicable Code or treaty provision. See Treas. Reg. §§ 1.1441-1(b)(4) and 1.1441-6. Notwithstanding the general imposition of tax on U.S. source interest, sections 871(h) and 881(c), respectively, provide that no tax is imposed in the case of portfolio interest received by a nonresident individual or foreign corporation. However, both sections 871(h)(3)(A) and 881(c)(3)(B) provide, among other limitations, that portfolio interest does not include interest received by a 10-percent shareholder, as defined in section 871(h)(3)(B).

These regulations clarify how the portfolio interest rules apply with respect to interest paid to a partnership (or simple or grantor trust) that has foreign partners (or beneficiaries or owners). The regulations provide that when interest is paid to a partnership, the persons who “receives” the interest for purposes of the 10-percent test are the nonresident alien individual partners and the foreign corporations that are partners in the partnership.

#### *Time for applying the 10-percent shareholder test*

The final regulations provide that the 10-percent shareholder test is applied when any distributions that include the interest are made to a foreign partner and, to the extent that a foreign partner's distributive share of the interest has not actually been distributed, on the earlier of the date that the statement required under section 6031(c) is mailed or otherwise provided to such partner, or the due date for furnishing such statement. This is a modification from the proposed regulations. An example in the proposed regulations illustrated that the test is to apply on the “earliest” of when the interest is distributed, the date the statement under section 6031(b) is mailed, or the due date for furnishing the statement. The example in the final regulations is rephrased to make clear that the test may be applied on multiple dates (and not only on the date of a first partial distribution of such interest) conforming more closely to the language of Treas. Reg. § 1.1441-5(c)(2).

The final regulations also provide that the 10-percent shareholder test is applied with respect to a nonresident alien individual or foreign corporation that is a beneficiary of a simple trust or an owner of a grantor trust at the time that a withholding agent, absent any exceptions, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest.

#### *Elective retroactive application*

The final regulations generally provide that the provisions relating to the 10-percent shareholder test apply to interest paid after April 12, 2007. However, the regulations also permit taxpayers to choose to apply the provisions to interest paid in any taxable year that is not closed by the period of limitations, provided that the taxpayer consistently applies the provisions to all relevant partnerships during such years.

*Repeal of interest and penalties provision in the case of no underlying tax liability*

These final regulations retroactively eliminate, in accordance with Notice 2006-99, the rule in Treas. Reg. § 1.1441-1(b)(7)(iii) that imposed interest and penalties based on hypothetical underpayments of tax when in fact no tax is ultimately due (e.g., because, although the payor did not obtain proper documentation before payment, the payee was ultimately determined to be entitled to a treaty exemption), for payments made after December 31, 2000. The examples illustrating this rule in Treas. Reg. § 1.1441-1(b)(7) were also removed. (For further discussion, see ASK THE EXPERT, below.)

**2. Tax Court Holds Discrimination Settlement Not Excluded Under Section 104(a)(2), and Imposes Penalties**

In Connelly v. Commissioner, T.C. Memo 2007-98, the Tax Court ruled that payments to the taxpayer under the settlement of a discrimination claim were improperly excluded payments from gross income, and imposed penalties on the taxpayer because such payments were not paid on account of personal physical injuries or physical sickness under section 104(a)(2).

Generally, section 104(a)(2) excludes from gross income “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.” The flush language of section 104(a) specifies that “emotional distress shall not be treated as a physical injury or physical sickness.”

In Commissioner v. Schleier, 515 U.S. 323 (1995), the court held that damages are excludable from income under section 104(a)(2) if they meet a two-pronged test. First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is “based upon tort or tort type rights,” and second, the taxpayer must show that the damages were received “on account of personal injuries or sickness.” Id. at 335- 337.

The court noted that under the flush language of section 104(a), amounts paid for medical care attributable to emotional distress, however, may be treated as damages received on account of personal physical injuries or physical sickness. In Connelly, the taxpayer provided evidence that 21 months after the signing of the settlement agreement, she was referred to a psychiatrist with a diagnosis of anxiety disorder and “panic attack,” but the taxpayer failed to prove any connection between the discrimination charges and the disorder. Moreover, the court reasoned, even if it were to assume that there is a causal relationship between the event and the disorder, the taxpayer did not show that any of the amounts paid were for the cost of her medical care.

Citing Commissioner v. Duberstein, 363 U.S. 278, 286 (1960), the court noted that the ultimate character of the proceeds depends on the payor’s “dominant reason” for making the payment. The court determined that here, the intent of the payor is evidenced in the settlement agreement. By referring to the amounts as income to be reported on Form 1099, and by making the statement that the agreement included the settlement of all claims without specific allocation to any particular claim, the payor demonstrated that its dominant reason for the payment was not as damages on account of physical injury or physical sickness.

Accordingly, the court held that the settlement amounts were not paid “on account of personal injuries or sickness” and are not excludable from gross income under section 104(a)(2). In addition, the court imposed an accuracy-related penalty under section 6662(a), and penalties under section 6651(a)(1) for failure to file a timely return.

### **3. Ninth Circuit Affirms that Civil Rights Settlement Not Excluded Under Section 104(a)(2); Attorney’s Fee Also Included in Income**

In Allum v. Commissioner, the Ninth Circuit affirmed the Tax Court’s holding that payments to the taxpayer for a violation of the taxpayer’s civil rights and to the taxpayer’s attorney under a contingent fee arrangement were not paid on account of physical injury or sickness under section 104(a)(2). See also Allum v. Commissioner, T.C. Memo 2005-177.

The Tax Court had looked beyond the settlement agreement, from which it could not clearly discern why the settlement amount was paid, to the allegations in the taxpayer’s complaint to determine whether the “civil rights claims” were claims for personal physical injuries. The Tax Court concluded that although the complaint also included general allegations that the taxpayer suffered emotional and physical damage as a result of the alleged violations and sought compensatory and punitive damages, it contained no specific allegations of personal physical injury or physical sickness.

The Tax Court also concluded that the taxpayer’s argument, that the payment related to the loss of his business license and that such loss is a personal physical injury under section 104(a)(2), was also unsupported by the record. Even if it assumed that the payment was attributable to the license, the court reasoned that the taxpayer’s interest in his license was a property interest, and recovery for “business or property” was separate and distinct from recovery for personal injury. Accordingly, the court concluded that no portion of the settlement payment was compensation for a personal physical injury or physical sickness and petitioner is not entitled to exclude the payment from gross income under section 104(a)(2).

The court further concluded that the portion of the settlement paid to the taxpayer’s attorney under a contingency fee arrangement was included in gross income, citing Commissioner v. Banks, 543 U.S. 426, 125 S. Ct. 826 (2005). In Banks, the Supreme Court held that a contingent fee agreement between an attorney and a client should be viewed as an anticipatory assignment to the attorney of a portion of the client’s litigation recovery and that, “as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.” Id. at 430.

### **4. IRS Broadening Scope of Withholding and Reporting Compliance Initiatives**

The IRS is broadening the scope of its withholding and reporting compliance initiatives, in part by increasing the number of examinations of withholding and reporting agents, IRS officials stated at a tax reporting and withholding seminar in Washington. The officials noted that the IRS will focus not only on interest and dividends, but also on royalties, rents and other payments across various industries. Kathy Robbins, director of field operations in the IRS Office of Financial Services Industry, called the recent section 1441 voluntary compliance program a “very successful cooperation effort” that revealed many multinational companies were not aware of their withholding and reporting obligations. Carl Cooper, IRS Office of Chief Counsel, said the IRS is interested in developing the capacity to allow Form

W-8, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*, to be filed electronically. The IRS also announced that it expects to issue proposed regulations in the next several months that will outline a process of checking Form W-8 against a third-party database from credit rating agencies, banks, financial institutions, and other public and private sources.

## **LIFE INSURANCE, ANNUITIES, AND QUALIFIED PLANS**

### **1. IRS Rules Recalculation of IRA Annual Payments Results in 10-Percent Penalty**

In PLR 200716032 (Jan. 23, 2007), the IRS ruled that a taxpayer's proposed recalculation of an annual payment from an Individual Retirement Plan (IRA) would be treated as a modification to a series of substantially equal periodic payments under section 72(t)(4) that would result in imposition of the 10-percent penalty tax for premature distributions under section 72(t)(1). The taxpayer in the ruling retired in 2004 at age 50, rolled his retirement plan account balance into an IRA, and began to receive payments from the IRA in a series of substantially equal periodic payments determined under the fixed amortization method, without recalculation.

#### *Background*

Section 72(t)(1) imposes a 10-percent penalty tax on the portion of early distributions from qualified retirement plans (including IRAs) includible in gross income. However, section 72(t)(2)(A)(iv) provides that this tax shall not apply to distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and beneficiary.

Notice 89-25 (1989-1 C.B. 662), as modified by Rev. Rul. 2002-62 (2002-2 C.B. 710), provides three methods of determining substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv), which include the fixed amortization method. The fixed amortization method provides that the annual payment for each year is determined each year by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate. Under this method, the annual payment is the same amount in each succeeding year.

However, if the series of periodic payments is subsequently modified within five years of the date of the first payment, or, if later, age 59 ½, the exception to the 10-percent penalty tax under section 72(t)(2)(A)(iv) does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount, determined under regulations, which (but for the section 72(t)(2)(A)(iv) exception) would have been imposed, plus interest. See section 72(t)(4).

### **2. IRS Rules Section 1035 Inapplicable to Nonqualified Annuity With Indirect Transfer of Cash Value by Endorsement of Proceeds**

In Rev. Rul. 2007-24 (2007-21 I.R.B. XX), the IRS ruled that if a taxpayer receives a check from a life insurance company under a non-qualified annuity contract, the endorsement of the check to a second company as consideration for a second annuity contract does not qualify as a tax-free exchange under section 1035(a)(3). Instead, the amount received is taxable to the extent set forth in section 72(e). The IRS noted that neither section 1035 nor the regulations thereunder make any special provision for the

purchase of an annuity contract with amounts distributed to the policyholder under another contract. Further, in this case, because the annuity contract was a non-qualified contract, no rollover provision, such as section 403(a)(4), applied. The IRS concluded that section 1035 did not apply because there was no actual exchange of contracts, the taxpayer did not assign the first contract to the second company, and cash value was not directly transferred from the first company to the second company.

### **3. IRS Issues Final Regulations Under Section 402A on Designated Roth Accounts, Including Reporting and Recordkeeping Requirements**

The IRS has issued final regulations under section 402A (T.D. 9324) relating to Designated Roth Accounts. The regulations provide detailed guidance on the taxation of distributions from designated Roth accounts under section 401(k) and section 403(b) plans. The regulations also include additional reporting requirements for recipient plans upon acceptance of an indirect rollover of designated Roth contributions, but such reporting is not required until the IRS issues the necessary forms.

#### *Reporting by plan administrator (or other responsible party)*

Just as in the proposed regulations (REG-146459-05), the final regulations provide that the administrator of a plan with a designated Roth account (or other responsible party), is responsible for tracking the 5-taxable-year period for each employee and the amount of designated Roth contributions made on behalf of such employee. In the case of a direct rollover to a designated Roth account under another eligible plan, the plan administrator or other responsible party is required to provide the administrator of the recipient plan (the plan accepting the eligible rollover distribution) with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of such distribution attributable to basis, or that the distribution is a qualified distribution. If the distribution is not a direct rollover to a designated Roth account under another eligible plan, the plan administrator or responsible party must provide to the employee, upon request, this same information, except the statement need not indicate the first year of the 5-taxable-year period. The statement is required to be provided within a reasonable period following the direct rollover (or employee request), but in no event later than 30 days following the direct rollover (or employee request). The plan administrator or other responsible party for the recipient plan is permitted to rely on these statements. This reporting requirement is satisfied if this information is provided on a statement attached to the check issued to the employee. Otherwise, generally, the same reporting requirements apply to plans with designated Roth accounts as apply to other plans, i.e., a contribution to and a distribution from a designated Roth account must be reported on Form W-2 and Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, respectively, in accordance with the instructions thereto.

#### *Reporting by recipient plan*

If any portion of a distribution that is rolled over to a designated Roth account by the distributee rather than by direct rollover, the plan administrator of the recipient plan must notify the IRS of its acceptance of the rollover contribution to the extent that a portion of a distribution is includible in income (determined without regard to the rollover). However, no such reporting is required until the IRS releases relevant forms and instructions. Such instructions will specify the address to which the notification must be sent and will require the following information: (1) the employee's name and social

security number; (2) the amount rolled over; (3) the year in which the rollover contribution was made; and (4) such other information as the Commissioner may prescribe in order to determine that the amount rolled over is a valid rollover contribution.

#### *Reporting by employee*

Generally, an employee has no reporting obligation with respect to designated Roth contributions under a section 401(k) or a section 403(b) plan. However, an employee rolling over a distribution from a designated Roth account to a Roth IRA should keep track of the amount rolled over in accordance with the instructions to Form 8606, "Nondeductible IRAs."

## **REPORTING GUIDELINES AND FORMS**

### **1. Final Regulations Under Section 409A on Nonqualified Deferred Compensation Plan Rules; ABA Provides Comments For Future Reporting Guidance**

The Treasury has issued final regulations on the treatment of nonqualified deferred compensation plans and arrangements under section 409A (T.D. 9321). The final regulations generally implement the rules provided in the proposed regulations published on September 30, 2005 (REG-158080-04), but include revisions reflecting numerous comments received from the public. Published along with the regulations was Notice 2007-34 (2007-17 I.R.B. 996), which includes additional guidance regarding the application of section 409A to split-dollar life insurance arrangements and provides that certain amendments of such arrangements to comply with section 409A will not be treated as a material modification triggering loss of grandfathered status.

The final regulations do not render Notice 2005-1 (2005-2 I.R.B. 274) obsolete, Q&A-24 through Q&A-38, relating to information reporting and withholding, which remain effective as modified by any other applicable guidance. However, the Preamble states the intention to issue further guidance, including such transition guidance as may be appropriate with respect to the reporting and withholding requirements. In addition, the Treasury notes that it is continuing to study the request by commentators that a service recipient be permitted to rely upon a representation of an independent contractor that the independent contractor meets the exclusion requirements, presumably under Treas. Reg. § 1.409A-1(f)(2), so that a service recipient will know whether it is subject to the reporting requirements with respect to amounts deferred subject to section 409A.

#### *Section 409A – Generally*

Section 409A(a), added by the American Jobs Creation Act of 2004 (the "2004 Jobs Act") (Pub. L. No. 108-357, § 885 (2004)), provides generally that amounts deferred after 2004 under a nonqualified deferred compensation plan ("Nonqualified Plan"), to the extent the amounts are not subject to a substantial risk of forfeiture and were not previously included in income, are currently includible in gross income, unless certain requirements are met. The requirements impose restrictions on distribution elections, including timing and acceleration of distributions. Amounts includible in gross income under section 409A are also subject to an additional 20-percent tax and interest. Section 409A(a)(1)(B); section 409A(b)(4).

*Reporting issues*

In connection with the enactment of section 409A, the 2004 Jobs Act requires annual reporting of all compensation deferred under the plan for the year regardless of whether such compensation is includible in gross income pursuant to section 409A(a)(1)(A). As a result, reporting and withholding obligations consist of two-parts: inclusion reporting, when section 409A requirements are not met, and deferral reporting. With respect to deferral reporting, the 2004 Jobs Act added sections 6041(g)(1) and 6051(a)(13) to require that all deferrals for the year under a Nonqualified Plan be separately reported on a Form 1099, or Form W-2. However, neither section 6041(g)(1) nor section 6051(a)(13) requires the reporting of deferrals under a Nonqualified Plan that benefit a person with respect to whom a Form 1099-MISC or a Form W-2 is not required to be filed. With respect to inclusion reporting, section 3401(a) was amended under the 2004 Jobs Act to provide that the term “wages” includes any amount includible in the gross income of an employee under section 409A. For purposes of reporting nonemployee compensation, section 6041 was also amended to require that amounts includible in gross income under section 409A that are not treated as wages must be reported as income under that provision. See section 6041(g)(2).

The Treasury and IRS first provided reporting guidance with respect to section 409A in Notice 2005-1, issued on December 20, 2004. Notice 2005-1 imposed the following reporting and withholding requirements:

- An employer must report to an employee the total amount of deferrals for the year under a Nonqualified 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.
- A payer must report to a nonemployee the total amount of deferrals for the year under a Nonqualified Plan in box 15a of Form 1099-MISC. See Q&A-30.
- A payer must report amounts includible in gross income under section 409A and not treated as wages under section 3401(a) as nonemployee compensation in box 7 of Form 1099-MISC. A payer must also report such amounts in box 15b of Form 1099-MISC. See Q&A-35.

Transitional relief with respect to the 2005 and 2006 reporting requirements was later provided in Notice 2005-94 (2005-2 I.R.B. 1208), and Notice 2006-100 (2006-51 I.R.B. 1109).

*ABA tax section reporting comments*

The American Bar Association Tax Section (ABA) has submitted comments to the Treasury, dated April 25, 2007, concerning issues under section 409A not addressed in the final regulations, including calculation and timing of income inclusion, and reporting and withholding. With respect to reporting on Forms W-2 and 1099, the ABA recommended that regulations provide that:

- Deferrals relating to services provided while a service provider was an employee be reported to the service provider on Form W-2, not Form 1099-MISC, even where those deferrals occur after the service provider is no longer an employee.
- When deferred compensation relating to services provided while a service provider was an employee becomes includable in gross income under section 409A and subject to withholding, those amounts be reported to the service provider on Form W-2, and not Form 1099-MISC, even where reporting is required after the service provider is no longer an employee.

The ABA comment letter explains that the clarification of whether amounts are reported on Form W-2 or instead on Form 1099-MISC is important because in a number of circumstances a service provider who earned compensation subject to section 409A while an employee will no longer be employed at the time amounts are includable in gross income under section 409A. In addition, the approach recommended logically ties the form to be used for reporting with the service provider's status when the services were provided, and is consistent with the treatment for FICA purposes of amounts paid to a former employee for services performed while an employee.

## **2. IRS Enhances FIRE System for 2007 and Working to Create Back-up System**

At an April 25, 2007 tax reporting and withholding seminar in Washington, Frank Montaro, senior manager for IRS Electronic Tax Administration, described enhancements to the IRS Filing Information Returns Electronically (FIRE) system. The IRS has enhanced the FIRE system, used to process more than one billion information returns every year, by including electronic versions of forms for business filing extensions. Reporting and withholding agents can use the system to file Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding), Form 1098 (Mortgage Interest Statement), Form 5498 (IRA Contribution Information), Form 8027 (Employer's Annual Information Return of Tip Income and Allocated Tips), Form 8809 (Application for Extension of Time To File Information Returns), and W-2G (Certain Gambling Winnings), in addition to Form 1099s. The IRS is looking at other forms that could be added to the system, including Form 1042. The enhanced system also includes e-mail notification that a transmitter's files have been accepted by the IRS. If the files are corrupted, there is a 30-day window for corrections, and the system provides a prompt every three weeks thereafter to the extent corrections are not made. Mr. Montaro also stated that the IRS currently has no backup for the FIRE system but is working to put such a system in place by 2008. In addition, practitioners were reminded that beginning in the tax year 2006, the IRS will no longer accept diskettes for transmitting files, and in tax year 2008, the IRS will no longer accept magnetic cartridges for information returns.

## **OTHER MATTERS**

### **1. Former IRS Commissioner Richardson Meets with Treasury To Discuss Third-Party Information Reporting Regarding Online Commerce**

In a letter to the Treasury, former IRS Commissioner Margaret Richardson thanked the Treasury for a meeting to discuss third-party information reporting in the context of online commerce, including eBay. In the letter, Richardson explained that eBay is not a broker or middleman but simply an on-line

venue that allows buyers and sellers to agree to make sales. Richardson stated that a venue such as eBay is not party to information about actual sales and suggested that an information reporting system based on credit card payments would be less flawed than a system of reporting by the venue based on incomplete information. See Individual Comments on Third-Party Information reporting for Online Commerce, 2007 TNT 80-24.

## **2. Sixth Circuit Upholds Check-the-box Regulations and Holds Sole Member of LLCs Liable For Unpaid Taxes**

In Littriello v. United States, 99 A.F.T.R.2d 2007-2210, a case of first impression, the Sixth Circuit affirmed a district court opinion upholding the validity of the check-the-box regulations, and held that the sole member of multiple limited liability companies (LLCs) was liable for unpaid employment taxes owed by the LLCs. Because the taxpayer was the sole owner of the LLCs and had not elected to have the businesses treated as “associations” (i.e., corporations) under Treas. Reg. §§ 301.7701-3(a) and (c), the LLCs were “disregarded” as separate taxable entities and, instead, were treated for federal tax purposes as sole proprietorships of the taxpayer under Treas. Reg. § 301.7701-3(b)(1)(ii).

The taxpayer contended that the check-the-box regulations (i) exceeded the authority of the Treasury to issue regulatory interpretations of the Internal Revenue Code; (ii) conflicted with the principles enunciated by the Supreme Court in Morrissey v. Commissioner, 296 U.S. 344 (1935); and (iii) disregarded the separate existence of an LLC under Kentucky state law. The district court rejected the taxpayer’s arguments and found that the regulations were a reasonable interpretation by the IRS of a tax statute, section 7701, that was otherwise ambiguous. The district court upheld the regulations under a “Chevron” analysis and held the taxpayer individually liable for the amounts assessed by the IRS. See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

Before the Sixth Circuit, the taxpayer also contended that the regulations did not apply to employment taxes, an argument that relied, at least in part, on proposed amendments to the entity-classification regulations that were not proposed until after the appeal in this case was filed. If the proposed amendments had been in place when the tax deficiencies in this case arose, single-member LLCs such as the taxpayer’s would have been treated as separate entities for employment tax purposes, although not for other federal tax purposes. The taxpayer argued that the proposed amendments should be taken as reflecting the Treasury Department policy as applied to this case.

The Sixth Circuit concluded that “because the further development of permissible alternatives is part of the administering agency’s function under Chevron, the proposed regulations do not in any way undermine the District Court’s determination that the current regulations are reasonable and valid.” Further the Sixth Circuit stated that “plainly, an agency does not lose its entitlement to Chevron deference merely because it subsequently proposes a different approach in its regulations.”

### **ASK THE EXPERT**

**What prompted the recent elimination of the provision of Treas. Reg. § 1.1441-1(b)(7)(iii) that had imposed an interest charge under section 6601 on a withholding agent for an amount of tax that had not in fact been imposed?**

It appears that comments at the IRS Financial Services Industry Conference in New York on October 12, 2006, prompted the revision of Treas. Reg. § 1.1441-1(b)(7)(iii), generally effective for payments made after December 31, 2000. Prior to amendment, Treas. Reg. § 1.1441-1(b)(7)(iii) provided:

A withholding agent that has failed to withhold other than based on appropriate reliance on the presumptions described in paragraph (b)(3) of this section or in §1.1441-4(a) (2)(i) or (3) is not relieved from liability for interest under section 6601. Such liability exists even if there is no underlying tax liability due. The interest on the amount that should have been withheld shall be imposed as prescribed under section 6601 beginning on the last date for paying the tax due under section 1461 (which, under section 6601, is the due date for filing the withholding agent's return of tax). The interest shall stop accruing on the earlier of the date that the required withholding certificate or other documentation is provided to the withholding agent and to the extent of the amount of tax that is determined not to be due based on documentation provided, or the date, and to the extent, that the unpaid tax liability under section 871, 881 or under section 1461 is satisfied. Further, in the event that a tax liability is assessed against the beneficial owner under section 871, 881, or 882 and interest under section 6601(a) is assessed against, and collected from, the beneficial owner, the interest charge imposed on the withholding agent shall be abated to that extent so as to avoid the imposition of a double interest charge. However, the withholding agent is not relieved of any applicable penalties. See section 1464.

(Emphasis added.) In addition, prior to amendment, Treas. Reg. §1.1441-1(b)(7)(v) set forth two examples that illustrated the operation of this rule.

As amended, Treas. Reg. § 1.1441-1(b)(7)(iii) now provides:

For payments made after December 31, 2000, if a withholding agent fails to deduct and withhold any tax imposed under sections 1441 or 1442, and the tax against which such tax may be credited under section 1462 is paid, then the amount of tax required to be deducted and withheld shall not be collected from the withholding agent. However, the withholding agent is not relieved from liability for interest or any penalties or additions to the tax otherwise applicable in respect of the failure to deduct and withhold. See section 1463. Further, in the event that a tax liability is assessed against the beneficial owner under section 871, 881, or 882 and interest under section 6601(a) is assessed against, and collected from, the beneficial owner, the interest charge imposed on the withholding agent shall be abated to that extent so as to avoid the imposition of a double interest charge.

(In addition, the examples set forth in Treas. Reg. §1.1441-1(b)(7)(v) prior to amendment were removed.)

At the IRS Financial Services Industry Conference in New York on October 12, 2006, the IRS defended the government's imposition of interest and penalties on withholding agents where the agent gives a taxpayer the benefit of a reduced withholding rate without having proper documentation, but no additional tax liability is ultimately imposed, in accordance with Treas. Reg. § 1.1441-1(b)(7)(iii) as then in effect (interest was imposed under section 6601 when no underlying tax liability had in fact been imposed). John Topping, IRS associate technical advisor in the IRS Large and Midsize Business Division, stated that the examiner had no choice in assessing interest in light of the underlying regulations.

Subsequently, in Notice 2006-99 (2006-46 I.R.B. 907), section 5, the IRS and the Treasury announced the intention to issue regulations retroactive to January 1, 2001, removing the rule in Treas. Reg. § 1.1441-1(b)(7)(iii), and the accompanying examples illustrating the rule in Treas. Reg. § 1.1441-1(b)(7)(v). The IRS and the Treasury also stated the intention, in the new regulations, to clarify that, like interest, penalties that are computed based on underpayments of tax will not be imposed when no tax has in fact been imposed. Taxpayers were instructed that they may rely on this notice until the regulations removing the rule are finalized. The regulations were ultimately revised in T.D. 9323, to read as quoted above.

*IRS Circular 230 Disclosure:*

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