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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

June 20, 2007

LEGISLATION

Senate Finance Committee Considers Legislation Expanding Employment Tax Reporting

At the American Bar Association Section of Taxation meeting on May 11, 2007, a Senate Democratic aide said the Finance Committee is looking at legislative provisions that could expand employment tax reporting requirements. However, the time frame of such a proposal is unclear.

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 200722004 (Feb. 20, 2007), 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, as described in section 468B and the regulations thereunder, in settlement of an administrative proceeding brought by the Securities and Exchange Commission to compensate investors for losses suffered, as well as prejudgment interest, from improperly failing to disclose certain information.

The IRS ruled that the loss compensation was not reportable under section 6041 because the payments were not fixed or determinable. The amount of compensation for loss of capital which was income depended on each investor's basis, which was not known to the QSF due to limitations on its data collecting authority. However, payments of pre-judgment interest were reportable under section 6041 on Form 1099-INT (subject to any applicable exceptions under the section 6041 regulations and the \$600 reporting threshold), and those payments made directly to qualified retirement plan participants were reportable under section 6041 on Form 1099-R. The IRS determined that the QSF was not subject to reporting obligations under section 6045 because there was no "sale" for purposes of Treas. Reg. section 1.6045-1(a)(9), nor under section 6049 because the distributions by the QSF did not relate to deposits with brokers or obligations issued in registered form and thus did not meet the definition of interest for purposes of section 6049.

Further, the IRS ruled that the payments of pre-judgment interest and direct payments to qualified plan participants also would be subject to backup withholding under section 3406. The IRS ruled that for purposes of meeting any obligations it may have under section 3406 as a payor of "reportable payments," the QSF need not solicit taxpayer identification numbers (TINs) directly 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 200722025 (Feb. 20, 2007) (similar).

EMPLOYEE BUSINESS EXPENSES

IRS Issues Guidance Clarifying Definition of “Covered Employee” Under Section 162(m)(3)

In Notice 2007-49, the IRS provides guidance clarifying the definition of “covered employee” under section 162(m)(3), relating to certain excessive employee remuneration. Section 163(m)(1) restricts the amount of deduction that a publicly held corporation is allowed to take for covered employee compensation exceeding \$1 million in a taxable year. The definition of “covered employee” under section 162(m)(3) and Treas. Reg. section 1.162-27(c)(2)(ii) had mirrored Securities and Exchange Commission (SEC) rules which were amended on September 8, 2006.

Section 162(m)(3) defines a “covered employee” as any employee of the taxpayer if, (A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or (B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the four officers with the highest compensation for the taxable year (other than the chief executive officer). Treas. Reg. section 1.162-27(c)(2)(ii) provides that whether an individual is the chief executive officer or among the four highest compensated officers (other than the chief executive officer) is determined pursuant to the executive compensation disclosure rules under the Securities Exchange Act.

The definition of covered employee in section 162(m)(3) mirrored the definition of named executive officers under the old disclosure rules. Under the old SEC disclosure rules, named executive officers consisted of, in relevant part, (i) all individuals serving as the registrant’s chief executive officer or acting in a similar capacity during the last completed fiscal year (“CEO”), regardless of compensation level; and (ii) the registrant’s four most highly compensated executive officers (other than the CEO) who were serving as executive officers at the end of the last completed fiscal year.

Under the amended SEC disclosure rules, named executive officers consist of, in relevant part, (i) all individuals serving as the registrant’s principal executive officer or acting in a similar capacity during the last completed fiscal year (“PEO”), regardless of compensation level; (ii) all individuals serving as the registrant’s principal financial officer or acting in a similar capacity during the last completed fiscal year (“PFO”), regardless of compensation level; and (iii) the registrant’s three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year. Thus, while the amended disclosure rules continue to require disclosure for five executive officers, two executives are now covered by the rules based on their positions, and three are covered by the rules based on their level of compensation.

Therefore, the IRS advised that officials will interpret the term “covered employee” for purposes of section 162(m)(3) to mean: any employee of the taxpayer if, as of the close of the taxable year, such employee is the principal executive officer (within the meaning of the amended disclosure rules) of the taxpayer or an individual acting in such a capacity, or if the total compensation of such employee for that

taxable year is required to be reported to shareholders under the Securities Exchange Act by reason of such employee being among the three most highly compensated officers for the taxable year (other than the principal executive officer or the principal financial officer). Accordingly, the term “covered employee” for purposes of section 162(m)(3) does not include the principal financial officer (within the meaning of the amended disclosure rules) for whom disclosure is required under the Securities Exchange Act, unless that officer is among the four employees with the highest compensation.

REPORTING GUIDELINES AND FORMS

1. IRS Enforcement Initiatives Target Employer Expense Reimbursement and Worker Misclassification

On May 23, 2007, Joe Tiberio, acting program manager for employment tax policy at the IRS, told participants at the American Payroll Association Meeting that the features of employer business expense reimbursement arrangements are the focus of another IRS effort to ensure that such payments are legitimate business expenses under a true accountable plan arrangement, and not some other type of taxable compensation. Tiberio noted that reimbursements made under nonaccountable plans are considered wages subject to employment tax.

The IRS is also targeting worker misclassifications. At the American Bar Association Section of Taxation meeting on May 12, 2007, John Tuzynski, IRS chief of employment tax stated that worker classification cases will be a major focus in 2008, and noted that the IRS has entered into data-sharing agreements with several state workforce agencies to refer employment tax cases for audit. The IRS has entered into a partnership with the Department of Labor, the National Association of State Workforce Agencies, the Federation of Tax Advisors, and workforce agencies that administer state employment and unemployment taxes in California, Michigan, New Jersey, and North Carolina. In connection with these partnerships, the IRS is training state workforce agency examiners. To accommodate taxes from workers that have been misclassified, the IRS is creating new Form 8919. Current Form 4137, *Social Security and Medicare Tax on Unreported Tip Income* will then only be used for workers who are paying employment tax on allocated tips.

2. Joint Committee on Taxation Releases Document Describing Worker Classification for Federal Tax Purposes

The Joint Committee on Taxation released a document relating to the present law and background of worker classification for federal tax purposes. See Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes* (JCX-26-07), May 7, 2007. The document is available online at <http://www.house.gov/jct/x-26-07.pdf>.

3. Insurance Agent Not Liable for Tax on Commissions Paid to Third Party

In *Cirbo v. Commissioner*, T.C. Summary Opinion 2007-85, the Tax Court held that commission checks issued by an insurance company that were payable to an insurance agent

would not be treated as income to the agent. The agent contended that the commissions related to applications signed by the agent on behalf of the third party. The commissions related to policies sold prior to the effective date of an assignment of commissions from the agent to the third party, but the commission checks were issued after that date. In addition, the checks were deposited into the account of the third party and the third party paid taxes on the commissions. However, the insurance company filed Form 1099-MISC reporting the commissions paid to the insurance agent.

Generally, the Commissioner's determinations are presumed correct, and taxpayers bear the burden of proving otherwise. *See* Tax Court Rule 142(a)(1); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

However, under section 6201(d), the burden of production may shift to the Commissioner where an information return, such as a Form 1099, serves as the basis for the determination of a deficiency. Under section 6201(d), if a taxpayer asserts a reasonable dispute with respect to any item of income reported on a third-party information return and the taxpayer has fully cooperated with the Secretary, the Secretary shall have the burden of producing reasonable and probative information concerning that deficiency in addition to the information return.

In this case the Tax Court determined that the burden shifted to the IRS, and the IRS failed to satisfy that burden. Accordingly, the court held that the agent was not liable for the deficiency or related penalties.

ASK THE EXPERT

How likely is it that Congress will enact broker basis reporting requirements in the near term?

Legislation requiring brokers to report basis in connection with securities transactions is rumored almost certain to be enacted in some form during the 110th Congress. Recently, Senate Finance Committee staff released for public comment a bipartisan staff proposal on basis reporting of securities transactions. The proposal, similar to a proposal in the President's fiscal 2008 budget plan, is intended to address concerns regarding the extent of capital gains and losses that are misreported, and to reduce the incidence of misreporting.

Under the proposal, with respect to any applicable security (acquired by purchase or by other means such as gift or inheritance), every broker required to report to the IRS a customer's gross proceeds under section 6045(a) also would be required to include the customer's adjusted basis and information necessary to determine the customer's holding period in that security. The broker also would be required to include this information in the statement to the customer under present-law section 6045(b).

An "applicable security" is defined broadly to include any one of the following securities if market quotations for the security are readily available on an established securities market on the date of

the acquisition of the security: a share of stock in a corporation; a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; a note, bond, debenture, or other evidence of indebtedness; an interest rate, currency, or equity notional principal contract; and other items as described in section 475(c)(2). An applicable security also includes (whether or not market quotations are readily available on an established securities market) any interest in a regulated investment company under section 851; any interest in a real estate investment trust under section 856 that is subject to registration with the Securities and Exchange Commission; and any other financial instrument designated in Treasury regulations.

In addition to broker reporting requirements, the proposal would impose significant new reporting requirements when actions undertaken by issuers of applicable securities affect the basis of those securities. However, such requirements may be waived if the issuer makes certain required information publicly available as provided by the Secretary.

Significantly, the proposal would also change section 1012 basis computation rules from the first-in-first-out, specific identification, and average cost basis rules to an account-by-account method. Under the account-by-account method, the basis of any applicable security for which basis and holding period reporting is required is determined based on the customer's holding of that security in the same account and not by reference to any shares of that security that the customer may hold in an account with another broker.

The technical explanation and draft proposal are each available online at <http://finance.senate.gov/Public/052507pc.pdf>, and <http://www.finance.senate.gov/Public/052507pca.pdf>, respectively. Comments should be submitted no later than June 30, 2007. Public comment can be submitted by email to basisreporting_comments@finance-dem.senate.gov or in writing to Russ Sullivan, Democratic Staff Director, and Kolan L. Davis, Republican Staff Director, at the Senate Finance Committee, 219 Dirksen Senate Office Building, Washington, DC 20510.

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