SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050
1875 EYE STREET, N. W.
WASHINGTON, D. C. 20006-5409

(202) 331-8585
FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. JONES
SAMUEL A. MITCHELL
LYNLEE C. BAKER-GARBETT

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

July 24, 2007

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

1. IRS Provides Transitional Relief for Return Preparer Penalties Provisions

In Notice 2007-54, 2007-27 I.R.B. 12, the IRS provided guidance and transitional relief for the return preparer penalty provisions amended by the Small Business and Work Opportunity Act of 2007 (2007 Act). *See* Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28 § 8246 (2007). *See also* IR-2007-115 (June 11, 2007).

Generally, the 2007 Act amendments to section 6694 and related provisions (i) broadened the positions to which the penalty is applicable from those for which there was "not a realistic possibility of being sustained on its merits" to those for which there was "not a reasonable belief that the position would more likely than not be sustained on its merits," (ii) limited the avoidance of the penalty by disclosure to positions meeting a reasonable basis standard (where under prior law disclosure could avoid the penalty as long as the position taken was not frivolous), (iii) extended the scope of those persons to which the penalties apply from an "income tax return preparer" to preparers of all tax returns, amended returns and claims for refund, including estate and gift tax returns, generation-skipping transfer tax returns, employment tax returns, and excise tax returns, and (iv) increased the first-tier penalty (section 6694(a)) from $250 to "the greater of $1000 or 50 % of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty was imposed," and increased the second-tier penalty (section 6694(b)) for willful or reckless conduct from $1000 to "the greater of $5,000 or 50 % of the income derived (or to be derived) by the tax return preparer."

For income tax returns, amended returns, and refund claims, Notice 2007-54 provided that the standards set forth under the previous law and current regulations under section 6694 will be applied in determining whether the IRS will impose a first-tier penalty under section 6694(a). Generally, in applying transitional relief for income tax returns, amended returns or refund claims, disclosure would be adequate if made on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, attached to the return, amended return, or refund claim, or pursuant to the annual revenue procedure authorized in Treas. Reg. §§ 1.6694-2(c)(3) and 1.6662-4(f)(2). For all other returns, amended returns, and claims for refund, including estate, gift, and generation-skipping transfer tax returns, employment tax returns, and excise tax returns, the reasonable basis standard set forth in the regulations issued under section 6662, without regard to the disclosure requirements contained therein, will be applied in determining whether the Service will impose a penalty under section 6694(a).

The transitional relief applies to all returns, amended returns, and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing); to 2007 estimated tax

returns due on or before January 15, 2008; and to 2007 employment and excise tax returns due on or before January 31, 2008.

2. Disability Pension Payments Not Excludable Under Section 105(c)

In *Thomas v. Commissioner*, T.C. Summ. Op. 2007-110, the Tax Court ruled that disability pension payments based on the age and years of employment of the employee did not satisfy the exclusion requirements of section 105(c)(2), although the employee's disability triggered the payments. Under section 105(a), amounts received by an employee through accident or health insurance for personal injuries or sickness are included in the gross income of the employee to the extent that such amounts were attributable to employer contributions that were not includable in the employee's gross income, or were paid by the employer. Section 105(c) excepts amounts that (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. The Tax Court concluded that section 105(c)(2) was not satisfied in this case because the payments to the employee would have been the same regardless of the nature and severity of the particular injuries causing the disability, and cited *Hayden v. Commissioner*, T.C. Memo. 2003-184 and *Hines v. Commissioner*, 72 T.C. 715 (1979).

3. Settlement Proceeds Not Excludable Under Section 104(a)(2); Reasonable Cause Established

In *Smith v. Commissioner*, T.C. Summ. Op. 2007-106, the Tax Court ruled that amounts paid under an agreement in settlement of a complaint for damages for sexual and racial harassment, and related claims were not excludable from gross income under section 104(a)(2) because the amounts were not paid on account of personal physical injuries or physical sickness. Under section 104(a)(2), gross income generally does not include 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. To qualify for this exclusion, the taxpayer must demonstrate: (1) the underlying cause of action giving rise to the recovery is based upon tort or tort type rights; and (2) the damages were received on account of personal physical injuries or physical sickness. *See e.g.*, *Commissioner v. Schleier*, 515 U.S. 323, 337 (1995). Emotional distress is not treated as a physical injury or physical sickness, except to the extent of damages not in excess of the amount paid for medical care attributable to emotional distress. Section 104(a); *see also Prasil v. Commissioner*, T.C. Memo. 2003-100. When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such amounts are excludable, under *United States v. Burke*, 504 U.S. 229, 237 (1992).

The court determined that neither the settlement agreement nor the record indicated that the settlement proceeds were paid on account of any physical injury or sickness. Accordingly, the court sustained the IRS's assessment and ruled that such amounts were not excludable from gross income under section 104(a). However, the court also concluded that the taxpayer was not liable for the accuracy-related penalty under section 6662(a), based on the reasonable cause exception under section 6664(c) and Treas. Reg. § 1.6664-4(b)(1). The court determined that the taxpayer established reasonable

cause for failing to report the settlement proceeds as income and that he acted in good faith regardless of whether he received the Form 1099-MISC in connection with the proceeds, in light of the taxpayer's termination from employment, eviction resulting in temporary homelessness, health issues, and the technical nature of the law as to the exclusion of income under section 104, in addition to the experience, knowledge, and education of the taxpayer.

EMPLOYEE BUSINESS EXPENSES

1. IRS Issues Proposed Regulations on Deductions for Entertainment Use of Corporate Owned Aircraft

The IRS has issued proposed regulations (REG-147171-05) relating to deductions for entertainment use of business aircraft under section 274. The regulations are proposed to apply to any taxable year beginning on or after the date of publication of the rules as final regulations. However, prior to being published in final form, taxpayers may generally rely on the proposed rules or the rules provided in Notice 2005-45, 2005-24 I.R.B. 1128. Highlights from the proposed regulations include: (i) an optional flight-by-flight method in addition to the occupied seat hour or mile allocation method of Notice 2005-45; (ii) an election to use the straight-line depreciation in determining the amount of deduction disallowance; (iii) clarification of rules for deadhead flights; and (iv) the limited application of the proposed rules to entertainment activities under section 274(a)(1)(A).

2. IRS Rules Awards Qualify as Performance-based Compensation for Purposes of Section 162(m)

In PLR 200724011 (Feb. 21, 2007), the IRS ruled that awards based on certain multi-year performance goals received under a compensation plan for key employees were performance-based compensation within the meaning of section 162(m)(4)(C) and Treas. Reg. § 1.162-27(e), relating to the requirements for qualified performance-based remuneration. (The plan provided shares, options to buy, and units representing shares of the taxpayer's common stock.) Although section 162(m)(1) disallows, in the case of any publicly-held corporation, deduction for applicable employee remuneration with respect to any covered employee in excess of $1,000,000, section 162(m)(4) provides an exception for certain performance-based compensation. Thus, the result of the ruling was that no part of the deduction would be disallowed under section 162(m), provided that all of the requirements of Treas. Reg. § 1.162-27(e)(4) (shareholder approval requirement) were met, including Treas. Reg.§ 1.162-27(e)(4)(vi) (disclosure requirement).

REPORTING GUIDELINES AND FORMS

1. Treasury and IRS Publish Final Regulations to Ease Reporting Requirements and Facilitate Electronic Filing for Corporations, Controlled Groups, and Shareholders

The Treasury and IRS have published final regulations that simplify, clarify and, in some cases, eliminate reporting burdens relating to certain corporate transactions, including redemptions, liquidations and reorganizations. T.D. 9329. For example, where reporting was previously required by every shareholder of a corporation, many provisions have been changed so that reporting is required only by

significant shareholders. Although the precise terminology varies by provision, the term "significant" generally refers to a 5% shareholder (by vote or value) in the case of a publicly traded corporation, and a 1% shareholder (by vote or value) in the case of a non-publicly traded corporation.

The regulations also clarify that a foreign insurance corporation that elects to be treated as a domestic insurance corporation under section 953(d) is required to file with its return a copy of its annual statement (or pro forma annual statement if the insurance company is not required to file the NAIC annual statement) under Treas. Reg. § 1.6012-2(c)(1) or (2), as a domestic life or nonlife insurance company, respectively.

The final regulations generally adopt the rules published as temporary and proposed regulations on May 30, 2006 (T.D. 9264, REG-134317-05) with no substantive changes, and remove the temporary regulations. The regulations (except for certain provisions relating to consolidated returns) generally apply to any taxable year beginning on or after May 30, 2006, with an election to apply the rules before that date under certain circumstances. (A clerical correction to the final regulations was published, effective June 29, 2007.)

2. IRS Publishes Guidance on Whether Substantially Nonvested Stock was Transferred in Connection With Services Under Section 83

In Rev Rul. 2007-49 (2007-31 I.R.B. XX), the IRS has provided guidance on the application of section 83 in the context of three different scenarios:

Situation 1: The treatment of substantially nonvested stock subject to section 83 where restrictions imposed on substantially vested stock cause the substantially vested stock to become substantially nonvested. The ruling concluded that the imposition of new restrictions had no effect for purposes of section 83 because the substantially vested shares of stock were already owned by the transferee for purposes of section 83; thus, there was no “transfer.”

Situation 2: The treatment of substantially nonvested stock subject to section 83 where a service provider exchanged substantially vested stock for substantially nonvested stock in a reorganization described in section 368(a). In addition, the transferee timely filed an election under section 83(b) with respect to the substantially nonvested stock received in the merger. The ruling concluded that because the substantially vested stock was exchanged for stock that was subject to a restriction causing the shares to be “substantially nonvested,” the substantially nonvested shares were treated as having been transferred in connection with the performance of services, and thus, were subject to section 83. The “amount paid” for the stock under section 83 on the transfer of the substantially nonvested shares was the fair market value of the substantially vested stock exchanged therefor. Thus, the transferee did not need to report any taxable income from the transfer stock under the section 83(b). The transferee would not include any amount in compensation income in the taxable year when the stock became substantially vested because of the prior section 83(b) election, and the transferee’s basis in the stock would continue to be the amount paid for the stock, i.e., the fair market value of the substantially vested stock.

Situation 3: The treatment of substantially nonvested stock subject to section 83 where a service provider exchanged substantially vested stock for substantially nonvested stock in a taxable stock acquisition. The ruling concluded that because the transferee disposed of the substantially vested stock in a section 1001 exchange, the transferee recognized capital gain on the disposition of the substantially vested stock. Because the substantially vested stock was exchanged for stock that was subject to a restriction causing the shares to be "substantially nonvested," the substantially nonvested shares were treated as having been transferred in connection with the performance of services, and thus, were subject to section 83. As in the second situation, the "amount paid" for the stock under section 83 was the fair market value of the substantially vested stock exchanged therefor. Thus, when the transferee made an election under section 83(b) with respect to the substantially nonvested stock, the transferee did not need to report any additional amount of income. The transferee would not include any amount in compensation income when the stock became substantially vested because of the prior section 83(b) election. Upon the ultimate sale of the substantially nonvested stock, the transferee would recognize as capital gain the amount by which the amount received exceeded the transferee's basis in the shares, i.e., the fair market value of the substantially vested shares exchanged therefor. If no section 83(b) election had been made, the transferee would include the fair market value of the substantially nonvested shares, less the basis of the shares, in gross income as compensation at vesting under section 83(a), and the transferee's basis in the substantially nonvested shares would be increased accordingly, prior to the subsequent sale.

3. IRS Issues Guidance on Employment Tax Consequences of Employer Contributions to Nonexempt Employees' Trust

In Rev. Rul. 2007-48, 2007-30 I.R.B. XX (amplifying Rev. Rul. 74-299,1974-1 C.B. 154), the IRS addressed the income and employment tax consequences to employees, the employer, and the trust, where an employer contributed to a nonexempt employees' trust subject to the provisions of 402(b), on behalf of highly compensated employees (participants). With respect to the employment tax consequences, the ruling provided guidance on determining the amount and timing of the payment of wages for purposes of Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax as well as federal income tax withholding.

For FICA and FUTA purposes, the ruling concluded that when an employer contributed to a nonexempt employees' trust on behalf of a highly compensated employee, the FICA and FUTA taxation of such contributions depended on whether the employee's interest in the contribution was vested at the time of contribution. If the contribution was vested at the time of contribution, then the amount of the contribution was subject to FICA and FUTA taxes at the time of contribution and the employer was liable for the payment of FICA and FUTA taxes on such amounts. *See, e.g.*, Rev. Rul. 67-351, 1967-2 C.B. 86. If the contribution was not vested at the time of contribution, then the amount of the contribution and the earnings thereon were subject to FICA and FUTA taxation at the time of vesting. *See, e.g.*, Rev. Rul. 79-305, 1979-2 C.B. 350. With respect to contributions and earnings thereon that became vested after the date of contribution, the nonexempt employees' trust was considered the "employer" under section 3401(d)(1) with respect to such amounts as they become vested. *See also* Treas. Reg. § 31.3401(d)-1(f).

In contrast, for income tax withholding purposes, the rule for determining the amount and timing of the payment of wages subject to income tax withholding followed the rule in section 402(b)(4) for determining the amount and timing of gross income rather than the FICA and FUTA rule. The ruling concluded that the participant must include in gross income as compensation under section 402(b)(4)(a) the participant's vested accrued benefit (other than the participant's investment in the contract) as of the end of the taxable year of the trust ending with or within the taxable year of the participant. Similarly, the wages for federal income tax withholding purposes were in the amount of the employee's vested accrued benefit on the last day of the taxable year of the nonexempt employees' trust and were treated as paid for federal income tax withholding purposes on that same date. The nonexempt employees' trust was the employer for federal income tax withholding purposes within the meaning of section 3401(d)(1) with respect to the highly compensated employee whose gross income is determined under section 402(b)(4)(A), regardless of whether contributions made for the benefit of the employee were vested at the time of contribution. Thus, the employees' trust was responsible for all federal income tax withholding with respect to such wages paid to the employee. Distributions of benefits from the nonexempt employees' trust to the employee or for the employee's benefit were included in determining the vested accrued benefit of the employee at the end of the trust's taxable year, which was subject to federal income tax withholding at the end of the trust's taxable year.

4. Treasury Official Addresses ABA Request for Section 409A Corrections Program, and Timing of Section 409A Reporting and Withholding Guidance

On June 21, at the American Law Institute-American Bar Association executive compensation conference, Daniel Hogans, attorney-advisor in the Treasury Office of Tax Policy, commented on a June 14 letter from the Section of Taxation of American Bar Association to Acting Commissioner of Internal Revenue Kevin Brown. The letter asked the IRS to adopt a limited short-term corrections program to address inadvertent violations of section 409A, and cited section 7121 and the Pension Protection Act as two areas of authority that might enable the IRS to initiate such a program. Hogans responded that nonqualified deferred compensation plans have been administered through the IRS Chief Counsel's office, which has a small staff and is without resources to handle a corrections program. He also noted that the statute is self-implementing, raising the question of the IRS's authority to grant waivers or other relief generally associated with a corrections program. Hogans said that the ABA letter provided many good recommendations and "food for thought," but there is no near-term solution.

At that same conference, Hogans also addressed future guidance on reporting and withholding to replace Notice 2006-100 and guidance on funding to replace Notice 2006-33, which expires at the end of 2006. He stated that the items are "must do" items to be dealt with before the end of the year.

5. IRS Advises Employers, Payers and Agents to Use New Appointment Form

In IR-2007-121, the IRS recommended that employers, payers and their agents begin using a new, improved version of the agent appointment form immediately, to avoid delays in having the IRS approve the agent appointments. The Form 2678 is a request for approval to have an agent file returns and make deposits or payments of employment or other withholding taxes or revoke an existing appointment. New Form 2678, *Employer/Payer Appointment of Agent*, is available at

http://www.irs.gov/pub/irs-pdf/f2678.pdf. All versions of Form 2678 dated before May 2007 are obsolete.

6. IRS Issues Rev. Proc. 2007-42 Updating Form 941 and Schedule B Substitute Specifications

The IRS has released Rev. Proc. 2007-42, 2007-27 I.R.B. 15 (superceding Rev. Proc 2006-25, 2006-21 I.R.B. 926) which provided the general rules and specifications for paper and computer-generated substitutes for the January 2007 revision of Form 941, Employer's Quarterly Federal Tax Return, and Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors. This revenue procedure will be reproduced as IRS Publication 4436, General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941).

7. IRS Updates Guidance for Form W-2 and Form W-3 Substitutes

The IRS has issued guidance regarding the preparation and use of substitute forms for Form W-2,Wage and Tax Statement, and Form W-3, Transmittal of Wage and Tax Statements, for wages paid during the 2006 calendar year. *See* Rev. Proc. 2007-43, 2007-27 I.R.B. 26 (superceding Rev. Proc 2006-55, 2006-52 I.R.B. 1151). The revenue procedure will be reproduced as the next revision of IRS Publication 1141, *General Rules and Specifications for Substitute Forms W-2 and W-3*.

8. IRS Eliminates Form 550 Schedule P, *Annual Return of Fiduciary Benefit Trust*

The IRS has released Announcement 2007-63 (2007-30 I.R.B. XX) on the elimination of Schedule P, *Annual Return of Fiduciary Benefit Trust*. The IRS has determined that the continued use of a Schedule P of the Form 5500 in connection with the filing of a plan's Form 5500 is no longer necessary. The elimination of Schedule P is effective beginning with the 2005 plan year for Form 5500-EZ filers. For all other Form 5500 series filers, the elimination of Schedule P is first effective for the 2006 plan year. For plan years in which the Schedule P is eliminated, the Service will treat the plan's filing of a return from the applicable Form 5500 series as if the filing constitutes a return of the plan's employee benefit trust for purposes of section 6501(g)(2). Thus, the Service will not assess income taxes with respect to an employee benefit trust later than the limitations periods specified in section 6501 for the assessment of tax related to the Form 5500 filed by the plan to which the trust relates.

9. IRS Updates Filing Requirements for Reporting Agent Authorizations

Rev. Proc. 2007-38, 2007-25 I.R.B. 1442 (superceding Rev. Proc. 2003-69, 2003-2 C.B. 403) provided updated requirements for filing Form 8655, *Reporting Agent Authorization* which allows taxpayers to designate a reporting agent to perform specified tax-related acts on their behalf. For example, the Form 8655 may authorize a reporting agent to sign and electronically file Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, Form 941, Employer's Quarterly Federal Tax Return, or Form 944, Employer's Annual Federal Tax Return. In addition, Form 8655 may authorize a reporting agent to make federal tax deposits and other federal tax payments. Changes from prior rules include an expansion of the acts that may be authorized to include the signing and filing of

other forms, e.g., Form 944, Employer's ANNUAL Federal Tax Return, and making related deposits and payments.

OTHER MATTERS

Study calls for FICA Reform to Soften Impact of Globalization

On June 26, 2007, the Financial Services Forum released a study on U.S. workers in the global economy (*Succeeding in the Global Economy: A New Policy Agenda for the American Worker*), calling for significant changes to employment taxes under the Federal Insurance Contributions Act (FICA). The study recommends either fully integrating FICA taxes into the income tax or making the tax more progressive. The report was authored by Grant Aldonas of the Center for Strategic and International Studies, Robert Lawrence, professor of international trade and business at Harvard University, and Matthew Slaughter, professor of international economics at Dartmouth University, and is available online at http://www.financialservicesforum.org.

ASK THE EXPERT

In the context of deductions for entertainment use of business aircraft under section 274, what is the difference between the flight-by-flight method provided in the recently proposed regulations and the occupied seat hour or mile allocation method provided in Notice 2005-45?

As noted above, the IRS has issued proposed regulations (REG-147171-05) relating to deductions for entertainment use of business aircraft under section 274. The flight-by-flight method and the occupied seat hour or mile method are two methods used to allocate expenses to entertainment flights provided to specified individuals which are disallowed, except to the extent of the amount treated as compensation to the specified individual, or reimbursed.

Under the flight-by-flight method in the proposed regulations, generally, all of the expenses for the taxable year for the aircraft are divided by the number of flight hours or miles for the taxable year to arrive at a cost per hour or mile. Expenses are then allocated to a flight based on the flight hours or miles of that flight. The expenses allocated to a flight are then allocated to the passengers on the flight per capita.

Under the occupied seat hour or mile method, generally, the hours or miles flown by an aircraft for the taxable year are multiplied by the number of occupied seats to arrive at the total occupied seats hours or miles. Then the expenses are aggregated to determine the total expenses paid or incurred during the year with respect to an aircraft. Total expenses are then divided by total occupied seats hours or miles to determine the cost per hour/mile.

Results under these two methods can differ significantly. For a simplified example, assume 10 flights during the taxable year, each flight a round trip of 1,000 miles. Nine flights are flown for business use with only one passenger, and one flight is flown by 10 passengers for personal/entertainment use. Under the occupied seat hour or mile method, 9,000 seat-miles (9 trips of 1,000 miles x 1 seat for the only passenger) are for business, while 10,000 seat-miles (1 trip x 10 seats) are for

personal/entertainment use, and over half of the expenses related to the aircraft for the taxable year would be personal/entertainment use. However, under the flight by flight method, only 1,000 flight miles (1 trip of 1,000 miles) are for personal entertainment, while 9,000 flight miles (9 trips of 1,000 miles) are for business. Thus, under this method, only 1/10th of the total expenses would be personal/entertainment use.

IRS Circular 230 Disclosure:

This newsletter is provided solely for informational purposes and is not intended to furnish legal advice with respect to the reader's particular factual circumstances. In accordance with § 10.35 of IRS Circular 230 requirements, you are advised that any discussion of tax issues in this newsletter is not intended or written to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction or matter addressed herein. The persuasiveness of this newsletter's discussion with regard to the tax issues in question and a taxpayer's good faith reliance on the newsletter will be determined under applicable provisions of the law and regulations (§ 10.35(f)).