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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

September 28, 2007

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

1. Punitive Damages for Wrongful Death Action Outside Scope of Section 104 Exclusion under Section 104(c) Special Rule

In *Benavides v. Unites States*, 100 A.F.T.R. 2d 2007-5608 (5th Cir. 2007), the Fifth Circuit affirmed the district court's holding that punitive damages received in a wrongful death action were not excluded from gross income under section 104(c) because the Texas wrongful death law at issue did not limit recovery to punitive damages. Under section 104(a)(2), individuals who have received both compensatory and punitive damages may exclude from gross income the damages "other than punitive damages" (i.e., compensatory damages) received on account of personal physical injury or physical sickness. However, the court explained, because some jurisdictions allow wrongful death claimants to recover only punitive damages, Congress enacted section 104(c). Section 104(c) provides generally that the "other than punitive damages" exception to the exemption of section 104(a) shall not apply to punitive damages awarded in a civil action (1) which is a wrongful death action, and (2) with respect to which "applicable State law" provides that only punitive damages may be awarded in such an action. Under Texas law, plaintiffs may receive both compensatory and punitive damages in a wrongful death action. However, the taxpayers argued that their damages were within section 104(c) because only punitive damages were available under Texas law in a wrongful death action where the decedent was covered under the Workers' Compensation Act. Ultimately, the court rejected this argument and concluded that the reference to "applicable State law" refers to the state's wrongful death law, not the Texas wrongful death law as limited by the Texas Workers' Compensation Statute.

2. Settlement Payments Excludable from Gross Income under Section 104(a)(2)

In *Wright, et al. v. Commissioner*, T.C. Memo 2007-278, the Tax Court ruled that amounts paid by a company to one of its employees and founding shareholders under an agreement in settlement of a complaint for damages for personal injuries were excludable from gross income under section 104(a)(2), because the amounts were paid on account of personal physical injuries or sickness. The case involved tax year 1992, and thus the amendment of section 104(a) in 1996 by the Small Business Job Protection Act of 1996, Pub. L. 104-188,

providing generally that emotional distress shall not be treated as physical injury or sickness, was not in effect.

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 336- 337. In addition, 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).

In this case, the court noted that the intent of the payor, reflected in the negotiated settlement agreement, was to provide compensation for personal injuries. Accordingly, the court ruled that amounts received under the agreement were excludable from gross income under section 104(a).

3. Employer Properly Withheld on Settlement Payment to Employee as Supplemental Wages under Aggregate Method

In *Cunningham v. Blue Care Network of Michigan*, 100 A.F.T.R. 2d 2007-5958 (E.D. Mich. 2007), the district court concluded that a settlement payment to a discharged employee was properly treated as supplemental wages (rather than regular wages, as contended by the former employee) for income tax withholding purposes. The court further determined that the employer's use of the aggregate method of withholding on the gross settlement amount was consistent with the settlement agreement, which provided the employer would make appropriate tax withholdings as required by law. The court concluded that, under both the settlement agreement and IRS regulations, the employer had the option of using the aggregate procedure described in Treas. Reg. § 31.3402(g)-1(a)(6), rather than the flat-rate method provided in Treas. Reg. § 31.3402(g)-1(a)(5). The court also agreed with the employer that the former employee suffered no damages because she could easily request that the IRS refund any overpayment or apply it to her tax liability for the following tax year. The court granted the employer's motion for summary judgement and dismissed the suit.

REPORTING GUIDELINES AND FORMS

1. IRS Updates Rates for Valuing Noncommercial Flights

The IRS issued Rev. Rul. 2007-55 (2007-38 I.R.B. 604) providing Standard Industry Fare Level (SIFL) mileage rates and terminal charges for purposes of determining the value of

noncommercial flights on employer-provided aircraft under Treas. Reg § 1.61-21(g). The rates apply for the second half of 2007.

2. IRS Provides Transitional Relief and Additional Guidance Regarding Application of Section 409A to Nonqualified Deferred Compensation Plans

In Notice 2007-78 (2007-41 I.R.B. XX), the IRS provided limited extension of transition relief and additional guidance on the application of section 409A to nonqualified deferred compensation plans. Final regulations under section 409A, issued in April 2007, generally provided that a covered nonqualified deferred compensation arrangement must comply in both form and operation with the requirements of section 409A as of January 1, 2008, with good faith compliance relief expiring December 31, 2007. Notice 2007-78 generally extended the deadline for form compliance to December 31, 2008 (with certain exceptions). Thus, to the concern of many practitioners, a covered arrangement which is not in full operational compliance with the regulations or which does not comply with certain form requirements specified in Notice 2007-78 by December 31, 2007 will be in violation of section 409A as of January 1, 2008.

The notice also provided for the following:

- Guidance and additional relief addressing certain issues under section 409A and the final regulations raised by the application to employment agreements and cashout features.
- Announcement that the Treasury Department and the IRS anticipate issuing guidance containing a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of section 409A and thereby limit the amount of additional taxes due under section 409A.

3. Treasury and IRS Issue Final Regulations on Employment and Excise Taxation of Disregarded Entities

The Treasury and IRS issued final regulations on the employment and excise taxation of disregarded entities (T.D. 9356), generally adopting the proposed regulations (REG-114371-05). The final regulations provide that a disregarded entity is treated as "a separate entity" for purposes of employment taxes and related reporting requirements but clarify that "the separate entity" is treated as a corporation for these purposes. In addition, the final regulations provide that disregarded entities are treated as separate entities for purposes of certain excise taxes reported on Form 720, "Quarterly Federal Excise Tax Return;" Form 730, "Monthly Tax Return for Wagers;" Form 2290, "Heavy Highway Vehicle Use Tax Return;" and Form 11-C, "Occupation Tax and Registration Return for Wagering;" excise tax refunds or payments claimed on Form 8849, "Claim for Refund of Excise Taxes;" and excise tax registrations on Form 637, "Application for Registration (For Certain Excise Tax Activities)."

In response to comments, the preamble clarifies that section 3306(c)(8) (providing FUTA exception from employment status for certain charity employees) continues to apply to services performed for a disregarded entity that is owned by an organization described in section 501(c)(3). Thus, a disregarded entity owned solely by a section 501(c)(3) organization will not be subject to FUTA tax on wages it pays its employees. Also in response to comments, the preamble states that the regulations do not apply to reportable payments under section 3406, relating to backup withholding. Thus, the owner of the disregarded entity is responsible for any backup withholding that is required with respect to reportable payments made by the disregarded entity, but considered made by the owner. The final regulations also clarify that an individual owner of a disregarded entity will continue to be treated as self-employed for tax purposes under the Self-Employment Contributions Act, and not as an employee of a disregarded entity for employment tax purposes.

Notably, the Treasury and IRS refused, however to adopt commentators' suggestion that Notice 99-6 (1999-1 C.B. 321) be retained. Notice 99-6 had provided that employment taxes and other employment tax obligations with respect to employees of a disregarded entity could be satisfied with either of two methods. The first method had allowed a single member owner to calculate, report, and pay the employment taxes of the LLC's employees under the owner's own name and employee identification number (EIN). The second method had allowed the disregarded LLC separately to calculate, report, and pay the employment tax obligations incurred with respect to employees of the LLC under the name and EIN of the LLC.

The employment tax provisions of these regulations apply to wages paid on or after January 1, 2009. However, the excise tax provisions of these regulations apply to liabilities imposed and actions required or permitted in periods beginning on or after January 1, 2008.

OTHER MATTERS

TIGTA Report Makes Recommendations on IRS Matching Taxpayer Data to Existing Accounts; Treasury Inspector General for Tax Administration Comments on IRS Response

Treasury Inspector General for Tax Administration, J. Russell George, stated on September 11, 2007, that he was confounded by the IRS's disagreement with the recommendations of the report of the Treasury Inspector General for Tax Administration (TIGTA) finding the efforts on matching of taxpayer data to existing accounts insufficient and costing potentially billions of dollars in tax revenue. TIGTA recommended that the IRS consider enforcement options such as extra research to resolve cases of incorrect taxpayer identification numbers (TINs). The Report stated that by using data systems to research manually statements with incorrect TINs reporting over $60,000 in earnings, TIGTA was able to correct and validate successfully 50 percent of the statements in a sample of 620 statements and match them to the

proper taxpayer accounts. However, the IRS said that it did not plan to manually research such cases due to cost-benefit concerns. For the TIGTA report, *see* TNT Doc. 2007-20828.

ASK THE EXPERT

> **Based on items in last month's INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE, it seems that Congress is scrutinizing intensely efforts to curb worker misclassification. What is behind this scrutiny and is legislation being proposed in this regard?**

Yes, last month we reported several instances in which Congress has been scrutinizing IRS and Department of Labor efforts to curb worker misclassification. The intense focus on worker misclassification is predominantly tied to the Government Accountability Office's estimate that misclassification of workers could be reducing federal revenues by up to $4.7 billion annually. On September 13, 2007, Senators Obama (D-Ill.), Durbin (D-Ill.), Kennedy (D-Mass.) and Murray (D-Wash.) introduced the "Independent Contractor Proper Classification Act of 2007" (S. 2044). The bill is aimed at restricting the classification safe harbor of section 530 of the Revenue Act of 1978, "to close its use as a tax loophole," in the language of the bill. (Section 530 provides that if an employer consistently treats a worker as an independent contractor, the employer is protected from the employment tax liability that would result from reclassification of the worker as an employee, as long as the employer had some reasonable basis for treating the worker as a non-employee.) The bill would allow the IRS to make a determination that a worker is an employee, with prospective effect for employment tax purposes. The bill also is intended to strengthen employment laws and require greater cooperation between the IRS and the Department of Labor in enforcement efforts. The Independent Contractor Proper Classification Act of 2007 can be viewed at
http://thomas.loc.gov/cgi-bin/query/D?c110:1:./temp/~c110xKOPLV::

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