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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

October 31, 2007

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

1. Disability Income Excludable Under Section 104(a)(3) Where Shareholder Reimburses Company Paid Premiums

In *Cotler v. Commissioner*, T.C. Memo 2007-283, the Tax Court ruled that disability insurance payments were excluded from the gross income of the taxpayer under section 104(a)(3). Although the premiums were paid by the employer, the court determined that the taxpayer reimbursed the employer by deduction of the premium amount from the taxpayer's shareholder loan account. Under section 104(a)(3), amounts received through accident or health insurance for personal injury or sickness are generally excluded from gross income. However, such amounts received by an employee are generally included in gross income to the extent that such amounts (A) are paid by the employer, or (B) are attributable to contributions by the employer which were not includible in the gross income of the employee. Citing *Bouquett v. Commissioner*, T.C. Memo 1994-212 in favor of a conduit-type analysis, the Tax Court rejected the IRS's argument that the bookkeeping entries and the shareholder loan receivable document did not demonstrate that the taxpayer actually reimbursed the employer for the premiums.

2. Settlement Proceeds Not Excludable Under Section 104(a)(2)

In *Hawkins v. Commissioner*, T.C. Memo 2007-286, the Tax Court ruled that amounts paid under an agreement in settlement of a complaint for damages for racial discrimination, breach of contract, breach of the covenant of good faith and fair dealing, and harrassment 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.

Generally, under section 104(a)(2), gross income 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).

In this case, the court determined that the settlement agreement indicated that the settlement proceeds were not paid on account of any physical injury or sickness because the agreement stated that the petitioner sought “wages, penalties, other damages, and attorneys’ fees,” that petitioner would be issued a Form 1099 to reflect the payment of income, and that petitioner would be required to complete a Form W-9 as a condition precedent to payment. Moreover, the Form 1099-MISC was actually issued to petitioner in this regard. Accordingly, the court sustained the IRS’s assessment and ruled that such amounts were not excludable from gross income under section 104(a).

EMPLOYEE BUSINESS EXPENSES

1. IRS Updates Rules on Business Travel Expense Substantiation

The IRS has issued Rev. Proc. 2007-63, 2007-41 I.R.B., which updates rules for determining the amount of an employee’s business travel expenses for lodging, meals, and incidental expenses that will be deemed substantiated under Treas. Reg. § 1.274-5, when the employer provides a per diem allowance. The procedure also provides an optional method for employees and self-employed individuals who are not reimbursed to compute the deductible costs paid or incurred for business meals and incidental expenses while traveling away from home.

The procedure updates the list of high-cost localities and decreases the per-diem rate for those locations from \$246 to \$237 per day (\$179 for lodging and \$58 for meal and incidental expenses). The per diem rate for other localities (i.e., not within the high-cost category) was increased from \$148 to \$152 per day (\$107 for lodging and \$45 for meal and incidental expenses). The procedure, which supercedes Rev. Proc. 2006-41, 2006-43 I.R.B. 777, is generally effective for allowances or expenses that are paid on or after October 1, 2007, with respect to travel away from home on or after October 1, 2007, subject to certain transition rules.

2. Commentators Address Proposed Regulations Under Section 274 Relating to Entertainment Use of Business Aircraft

In a September 17, 2007 letter, the National Business Aviation Association (NBAA) submitted comments to the IRS regarding recently issued proposed regulations under section 274 relating to deductions for entertainment use of business aircraft (REG-147171-05). Among other comments included in the letter, the NBAA requested additional guidance to alleviate the tax problem that companies face when using their aircraft for charitable flights, urged reconsideration of a primary purpose method of allocating flight costs, requested development of a charter rate method safeharbor, and suggested rules allowing taxpayers to use “any reasonable method” to account for deadhead flights.

REPORTING GUIDELINES AND FORMS

1. Credit Card Companies Complain That Consent Provisions in Proposed QPCA Rules are Burdensome and Unnecessary

In comment letters, credit card companies have complained about the recently proposed Qualified Payment Card Agent Program (QPCA) rules for reporting of payments of income through use of payment cards. The proposed regulations (REG-163195-05) and a proposed revenue procedure (Notice 2007-59, 2007-30 I.R.B. 135) were issued in July 2007 to revise the procedures for a payment card organization (agent) to request a determination that it is a qualified payment card agent. In response to prior comments that current regulations be modified to reflect the current electronic business operations of the industry, the new proposed revenue procedure provided that payment card organizations were allowed to provide notifications of payee status and participation electronically, if among other requirements, the payment card agent obtained certain consents from cardholder/payors and merchant/payees (consent provisions). The credit card companies took issue with these required consent provisions. At least one company objected that the proposed rules added “new burdensome and unnecessary rules regarding ‘consent’ to electronic provision of merchant data” which, if adopted, would “render the program not viable.”

2. IRS Continues to Focus on Worker Misclassification in Effort to Narrow Tax Gap

On September 28, 2007, at a meeting of the Employment Taxes Committee of the American Bar Association’s Section of Taxation in Vancouver, IRS officials discussed cited worker classification issues and data mining as high priorities for the IRS. Mary C. Gorman, assistant division counsel (prefiling), Small Business/Self-Employed Division, Office of Chief Counsel, stated that the IRS has increased worker classification monitoring in an effort to narrow the tax gap and increase Form 1099 taxpayer compliance. Gorman explained that the data mining projects include the Employment Tax Examination Program reviewing databases (for example, Form 1099 filings) to look for inconsistencies in taxpayer reporting information, and the Cash Bank reporting System, where the IRS will review cash reports to see if there are patterns that resemble payrolls. The Government Accountability Office has estimated that misclassification of workers could be reducing federal revenues by up to \$4.7 billion annually.

3. DC Bar Tax Section Panel Discusses Open Issues in Recently Proposed Cafeteria Plan Regulations

On September 25, 2007, at a District of Columbia Bar Tax Section luncheon, IRS and Treasury officials discussed the recently issued proposed regulations under section 125 on cafeteria plans (REG-142695-05). Several significant issues under the proposed regulations were discussed at the luncheon. Kevin P. Knopf, an attorney-advisor at Treasury, stated that no corrections program will be included in the final regulations because such a program would be outside the scope of the regulation process. Knopf noted that practitioners had been asking whether military differential pay or disability benefits could be put toward cafeteria plan benefits the same way that the proposed regulations allowed

employees to put severance pay toward cafeteria plan benefits. Knopf responded that although such provisions are not included in the proposed regulations, he would be interested in seeing justifications for using other types of payments in cafeteria plans, and comments relating to how people would make such an election.

OTHER MATTERS

IRS Announces New Online EIN Application Process: EINs Generated in Minutes

The IRS has announced that taxpayers can now request an Employer Identification Number (EIN) through a Web-based system that instantly processes requests and generates identification numbers in real time. *See* IR-2007-161. “This new and improved online application will reduce the time it takes taxpayers to get an EIN,” said Richard Morgante, Commissioner of the IRS Wage & Investment Division. “Essentially they can get one while they wait — within minutes.”

A taxpayer accesses the Internet EIN system at <https://sa1.www4.irs.gov/modiein/individual/index.jsp> and enters the required information. If the information passes the automatic validity checks, the IRS issues a permanent EIN to the taxpayer. If the information does not pass the validity checks, it is rejected. The taxpayer then has an opportunity to correct the information and resubmit the application. When the EIN application process is complete, a taxpayer has the option to view, print and save his or her confirmation notice, as opposed to waiting for the IRS to mail it.

ASK THE EXPERT

We understand that the annual IRS Information Reporting Program Advisory Committee (IRPAC) meeting is this month. What types of issues is IRPAC working on?

Yes, at the IRPAC annual public meeting on October 24, 2007, IRPAC discussed a number of issues:

- Data security concerns;
- Clean Renewable Energy Bonds and Gulf Tax Credit Bonds;
- Taxation and reporting of excess inclusion income;
- Reporting mortgage insurance premiums on Form 1098 in 2007;
- Form 1042-S Instructions—reporting of return of capital;
- Form W-8 (BEN, ECI, IMY, EXP) and corresponding instructions for country abbreviations;
- Form W-8 BEN Instructions—reverse hybrid entities as beneficial owners;
- Form 1042 Instructions—reporting subsequently determined underreporting;
- Reporting of undistributed earnings to a foreign partner on Form 1042;

- Substitute Form W-8 statement above signature line;
- TIN Matching;
- Creation/modification of Schedule R (Form 941), Allocation Schedule for Aggregate Form 941 Filers;
- Revised Form 2678, Employer/Payer Appointment of Agent;
- Barter Exchange backup withholding and "B" notice requirements for name-TIN mismatches;
- Expansion of the definition of broker under section 3405;
- Legislation affecting the Form 990-T and the Form 990;
- The re-designed Form 990, Return of Organization Exempt from Income Tax;
- Filing requirements regarding foreign corporations;
- Reporting issues related to the Pension Protection Act (PPA);
- Form 5500, Form W-9, Form 1099A and Form 1099C; and
- Form 944 regulations and their impact.

Details will be provided in next month's report.

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