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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

November 30, 2007

LEGISLATION

1. House Passes Securities Basis Reporting Legislation

On November 9, 2007, the House of Representatives passed the Temporary Tax Relief Act of 2007 (H.R. 3996), a bill to that would “patch” the Alternative Minimum Tax (AMT) and extend certain expiring tax provisions. The revenue cost of these provisions is offset by a number of revenue raisers in the bill, which include changes in the taxation of partners providing investment management services and broker reporting of basis in securities transactions. Generally, the bill would mandate cost basis reporting by brokers for transactions involving the sale of a covered security. Covered securities are generally stock, debt, commodities, derivatives and other items as specified by the Treasury Secretary, which are acquired in the account or transferred to the account managed by the broker. The provision would apply to stock acquired after January 1, 2009 and to all other instruments acquired after January 1, 2011. However, Sen. Chuck Grassley, ranking member of the Committee on Finance, has issued a statement that this legislation is not agreeable to the House and Senate Republican leadership, and the White House has issued a statement saying that the President would veto the bill because he “does not believe the appropriate way to protect 21 million additional taxpayers from 2007 AMT liability is to impose a tax increase on other taxpayers.”

Despite broad-based opposition to such rules by the financial community, broker reporting provisions have been introduced in legislation proposed throughout the year, including the President’s fiscal year 2008 budget proposal. In addition, two prior bills have been introduced in the 110th Congress that focus on requiring broker reporting of a customer’s adjusted basis in securities transactions, H.R. 878 and S. 601.

2. House Passes Heroes Act: New Information Penalties Proposed

On November 6, 2007, the House of Representatives passed H.R. 3997, the “Heroes Earnings Assistance and Relief Tax Act of 2007” (the Heroes Act). The bill would provide earnings assistance and tax relief to members of the uniformed services, volunteer firefighters, and Peace Corps volunteers. The revenue cost of these items would be offset fully by new and increased penalty provisions.

The bill’s penalty provisions include an increase in information return penalties under: section 6721, relating to the failure to file correct information returns; section 6722, relating to failure to furnish correct payee statements; section 6723, relating to failure to comply with other information reporting requirements; section 6651, failure to file a return of tax; and section 6698, relating to penalty for failure

to file partnership returns. The provisions also include new section 6699, relating to failure to file S Corporation returns. For example, under the bill late information returns filed after August 1 would be subject to a third tier penalty of \$100 per return and a maximum of \$600,000 per year, up from \$50 per return and \$250,000 per year.

The bill has been placed on Senate Legislative Calendar under Read the First Time, as of November 16, 2007.

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

1. New Temporary and Proposed Regulations Issued on Information Reporting Rules for Employer-Owned Life Insurance Contracts

Treasury and the IRS have issued nonsubstantive temporary (T.D. 9364) and proposed regulations (REG-115910-07) that delegate authority to the IRS to prescribe the details of the information reporting requirements for employer-owned life insurance contracts under section 6039I. Section 6039I generally requires applicable policyholders to file a return each year showing its total number of employees, the number of employees insured with employer-owned life insurance contracts, and the total amount of insurance in force at the end of the year under these contracts, as well as other related information. In connection with these requirements, the IRS has issued Draft Form 8925, Report of Employer-Owned Life Insurance Contracts, which presumably will be finalized under the authority of the new regulations.

Section 6039I was enacted with section 101(j) as part of the Pension Protection Act of 2006. Section 101(j) generally requires businesses to treat proceeds from company-owned life insurance contracts as income, excluding as a death benefit only the premiums and other amounts it paid for the contracts, except where certain requirements are satisfied. Under the proposed regulations, Treasury and the IRS requested public comment on the need for guidance under section 101(j) concerning: (1) determination of the status of insured individuals as highly-compensated employees or highly-compensated individuals; (2) requirements a taxpayer must meet to satisfy the notice and consent requirements of section 101(j)(4); and (3) the consequences of a section 1035 exchange of an employer-owned life insurance contract.

2. New Proposed Regulations Would Require Tax Withholding under Section 1441 on Distributions to Foreign Shareholders

Treasury and IRS have issued proposed regulations (REG-140206-06) which would require a U.S. financial institution (withholding agent) to set aside in an escrow account 30 percent (or the applicable treaty withholding rate) of the amount of certain corporate distributions in redemption of stock that is publicly traded (section 302 payment). Special rules apply in the context of a qualified intermediary, withholding foreign partnership, or withholding foreign trust.

Under the proposed regulations, once amounts are set aside in escrow, the withholding agent is then required to provide a written statement to the foreign beneficial owner, including the information necessary for the beneficial owner to make a determination under section 302 of the extent that the

distribution is a distribution in exchange for stock and the extent it is a dividend to which section 301 applies. In the written explanation provided to the foreign beneficial owner, the withholding agent must request that the beneficial owner provide a written certification to the withholding agent within 60 days as to whether the distribution is either a dividend or a payment in exchange for stock (the "certification").

If, within the 60-day period, the withholding agent receives the certification that the section 302 payment is a payment in exchange for stock, the withholding agent must credit the account with the amount set aside to the beneficial owner, and the entire amount paid (including the amount initially set aside) must be reported as capital gains on Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*. If, within the 60-day period, the withholding agent receives a certification that the payment is a dividend, the withholding agent must treat the amount set aside as tax withheld as of the time it receives the certification, and must deposit that amount pursuant to the applicable regulations. The entire amount paid is then reported on Form 1042-S as dividends.

Currently, under Treas. Reg. § 1.1441-3(c), a corporation making a distribution with respect to its stock to a foreign shareholder, as well as any intermediary (such as a broker) paying such a distribution, is required to withhold on the entire amount of the distribution, unless it elects to reduce the amount of withholding under Treas. Reg. § 1.1441-3(c). However, the election is only available to the extent the payment represents a distribution in part or full payment in exchange for stock, as opposed to a dividend. Thus, a withholding agent cannot avail itself of this election unless it knows the extent that the distribution represents a payment in exchange for stock under section 302(a). Generally, this determination is based on information that the withholding agent does not have, e.g., information from each participating shareholder regarding actual and constructive ownership of stock. The new regulations have been proposed because Treasury and the IRS believe that the discretion permitted by the current regulations, and the resulting different treatment of similar transactions, is not appropriate.

REPORTING GUIDELINES AND FORMS

1. IRS Issues 2007 Guidance for Reporting and Withholding under Section 409A, Suspend Deferral Reporting for 2007

Notice 2007-89, modifying Notice 2005-1, 2005-2 I.R.B. 274, provides guidance for employers and payers on reporting and wage withholding requirements for calendar year 2007 under section 409A. The new Notice generally reflects an extension to 2007 of the guidance provided in Notice 2006-100, 2006-51 I.R.B. 1109, applicable to 2005 and 2006 tax years.

Notice 2007-89 permanently waives for calendar year 2007 requirements for deferral reporting requirements by employers and payers under section 6041 and section 6051. Thus, an employer is not required to 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, and a payer is not required to report to a nonemployee the total amount of deferrals for the year under a nonqualified plan in box 15a of Form 1099-MISC. However, an employer still is required to 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. In addition, 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. (Notice 2006-100 provided guidance with respect to service providers for 2005 and 2006.)

Guidance for service providers is also provided in the new Notice. Service providers must report as income and pay taxes due on amounts includible in gross income under section 409A for 2007. *See* Notice 2007-89, section IV. If the service provider fails to report and pay taxes due as provided in the notice for 2007, the IRS may assert additional income taxes, penalties and interest.

Background

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 there is a section 409A violation, 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 for benefit of a person under a nonqualified plan if a Form 1099-MISC or a Form W-2 otherwise is not required to be filed for the person. With respect to inclusion reporting, section 3401(a) was amended by 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 gross income. *See* section 6041(g)(2).

Notice 2005-1

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

Notice 2006-100

Notice 2006-100, modifying Notice 2005-1, permanently waived employers' and payers' deferral reporting requirements under section 6041 and section 6051 for calendar years 2005 and 2006. See also Notice 2005-94, 2005-2 C.B. 1208.

2. Credit Card Companies Complain that Consent Provisions in Proposed QPCA Rules Are Burdensome and Unnecessary

At a November 7, 2007 hearing on proposed regulations relating to information reporting and backup withholding for payment card transactions (REG-163195-05), representatives of Visa USA and Mastercard Worldwide discussed the recently proposed Qualified Payment Card Agent Program (QPCA) rules for reporting payments of income through use of payment cards. In particular, consistent with written comments reported in a prior edition of this newsletter, witnesses took issue with the consent rules of the proposed regulations. The proposed regulations and a proposed revenue procedure (see 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. Paula Porpilia, speaking on behalf of Visa USA, stated that "since it is our understanding that QPCA notice must be sent only once, we find it difficult to understand why a QPCA would send one written communication to secure permission to send another letter electronically." Thus, Visa USA requested clarification that the notice needs to be sent only once. Porpilia also expressed concern that a merchant must give consent for its data to be sent to a cardholder electronically. Porpilia explained in part that the merchant has no standing to dictate any term of the relationship between the cardholder and the issuer or card organization, including the method of communication between the cardholder and its agents. An unofficial transcript of the hearing is available from Tax Analyst electronically. See 2007 TNT 221-21.

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

On November 6, 2007, worker misclassification was again at the forefront of information withholding and reporting news with the IRS announcement of a new initiative, the *Questionable Employment Tax Program*, and a webcast dedicated to worker classification. See IR-2007-184. As the first part of the initiative, the IRS and more than two dozen state workforce agencies have entered into exchange agreements to share the results of employment tax examinations. The agreements provide a centralized, uniform means for the IRS and state employment officials to exchange data, thereby leveraging resources and encouraging businesses to comply with federal and state employment tax requirements. The November Tax Talk Today program webcast, "What's Hot in Employment Taxes: Independent Contractor or Employee?" was the setting for a discussion on worker classification issues. Bill Conlon, director of specialty programs at the IRS assured the audience that the IRS is "not trying to force employers to recategorize all their workers as employees rather than independent contractors." If you missed the program, the webcast is accessible for viewing via archive for 12 months at Tax Talk Today, <http://www.taxtalktoday.tv/>.

4. IRS Revises Form W-9, Request for Taxpayer Identification Number and Certification

On October 24, 2007, the IRS published a revised Form W-9 (Rev. October 2007), *Request for Taxpayer Identification Number and Certification*. Changes include the reference on page 2, to the “Exempt payee” box which now states as follows: “If you are exempt from backup withholding, enter your name as described above and check the appropriate box for your status, then check the ‘Exempt payee’ box in the line following the businesses name, sign and date the form.” In addition, the word recipients on pages 2 and 3 was replaced with the word “payees.”

5. Third Circuit Reverses Lower Court: Early Retirement Payments to Tenured Faculty Subject to FICA Tax

On November 2, 2007, in *University of Pittsburgh v. United States*, 100 A.F.T.R. 2d 2007-6504 (3rd Cir. 2007), the Court of Appeals for the Third Circuit reversed the district court and held that because tenure is a form of compensation for past services, payments offered as a substitute for tenure are compensation and therefore taxable as wages subject to FICA taxation. The court determined that relinquishment of tenure rights, while a condition precedent to the payments, was not the primary consideration that employees offered. Rather, a number of facts indicated that the payments were primarily in consideration for employees’ past service.

The Third Circuit’s decision is consistent with the Sixth Circuit of Appeals in *Appoloni v. United States*, 97 A.F.T.R. 2d 2006-2828 (6th Cir. 2006). In *Appoloni*, the court ruled that early retirement incentive payments to tenured public school teachers “easily fall within the definition of FICA wages as ‘all remuneration for employment’” under I.R.C. § 3121. *Id.* at 2006-2836. The Third Circuit noted that the circuits are currently split on this issue and cited *North Dakota State University v. United States*, 87 A.F.T.R. 2d 2001-2522 (8th Cir. 2001), a case in which the Eighth Circuit Court of Appeals held that payments made to tenured university professors pursuant to an early retirement program were consideration for relinquishment of contractual tenure rights and not “wages” for FICA purposes.

ASK THE EXPERT

In last month’s edition, we promised to provide details of the IRS Information Reporting Program Advisory Committee (IRPAC) annual public meeting held on October 24, 2007. At that meeting, IRPAC discussed several information reporting provisions in the President’s fiscal year 2008 budget proposal and provided recommendations as follows:

Require basis reporting on security sales

The President’s proposals include a provision to expand information reporting requirements when securities are sold. Under the proposal, brokers and other financial institutions would be required to report the adjusted basis of securities sold, as well as holding period and gain or loss on the sale (collectively referred to as basis reporting).

IRPAC recommends that Treasury and the IRS develop a comprehensive strategy for implementing basis reporting in concert with various stakeholders, including the securities and mutual fund industries, as well as return preparers. This strategy should include the following components:

- Due to the lead time needed to modify systems and business practices, basis reporting should be required only after a reasonable amount of time has lapsed after Treasury and the IRS issue guidance by way of Treasury regulations, IRS forms, or other authoritative pronouncements.
- Leaders from Treasury and the IRS should continue substantive meetings with the Senate Finance Committee and industry representatives to coordinate legislation, regulatory guidance and the development of IRS forms to accommodate basis reporting.
- Treasury should allow a reasonable transition period during which penalties would not be imposed on brokers and other financial institutions that make good faith efforts to transform their business practices and systems to comply with new basis reporting requirements.
- Treasury and the IRS should consider the comments made by various trade organizations, such as the Securities Industry and Financial Markets Association (SIFMA), the Investment Company Institute (ICI), the American Bankers Association (ABA) and other key industry organizations. These trade organizations are well-positioned to provide sound technical and practical advice since their members (securities brokers, mutual fund companies, et. al.) will be responsible for generating and reporting the majority of basis information returns under the proposed regime.

Require information reporting on merchant payment card reimbursements

The President proposes to require the Secretary of the Treasury to promulgate regulations to expand information reporting requirements by mandating that payment card processors report gross annual reimbursements to merchants. With respect to this proposal, IRPAC recommends that the IRS should address industry concerns about how such a reporting requirement would be met, whether the benefits of this requirement outweigh the costs, and whether the IRS has the capability to use the information in the manner it has identified.

Require a certified Taxpayer Identification Number from contractors

The Bush administration and Treasury have proposed:

- Requiring a contractor receiving payments from a business of \$600 or more to provide a Form W-9 certifying the recipient contractor's TIN.
- Requiring the payer business to verify the TIN with the IRS, presumably through the IRS TIN matching program.
- Requiring the payer business to withhold a flat rate percentage of the gross payments as income tax withholding if the contractor fails to provide a valid TIN.
- Providing an option to each contractor receiving \$600 or more in payments from a business to require the payer business to withhold tax from its gross payments at a flat percentage rate of 15%, 25%, 30%, or 35%, whichever is selected by the contractor.

In connection with these requirements, IRPAC's recommendation included:

- The proposed January 1, 2008 effective date should be postponed to a date that follows by at least 18 months the date of issuance by Treasury of detailed regulations and guidance. Sufficient lead-time is necessary to allow affected businesses to develop reliable TIN verification procedures and withholding and reporting systems;
- The proposed January 1, 2008 effective date also should be postponed to a date that follows by at least 6-9 months the issuance by the IRS of the reporting requirements relative to the reporting specifications to be applied, the form to be used, etc. (If the reporting issue and protocol will be incorporated into the regulations referenced above the 18 months is sufficient for both.);
- The dollar threshold for applying the TIN/Withholding requirement should be raised to \$2,000 or perhaps \$5,000 in the interest of minimizing the potentially large burden this new requirement would place on payer businesses;
- There should be further study of the potentially large burden this will place on payer businesses before a TIN/ Withholding requirement is imposed to improve tax compliance; and
- Any reporting or withholding penalties should not be applied until after the issuance of final regulations with respect to this proposal.

Require information reporting on payments to corporations

Currently, Form 1099-MISC is required to be filed for payments made to noncorporate service providers. Congress is now recommending that these filing requirements be expanded to payments made to corporations for services provided. IRPAC recommended that the Form 1099-MISC filing requirements not be expanded to corporate service providers.

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