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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

January 31, 2008

LEGISLATION

6.2 Percent FUTA Tax Extended Through December 31, 2008

On December 19, 2007, the President signed into law the *Energy Independence and Security Act of 2007* (the 2007 Energy Act). Section 1502 of the 2007 Energy Act extends the additional 0.2 percent FUTA surtax to wages paid through December 31, 2008. Thus, the FUTA tax rate is currently 6.2 percent.

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

1. Eleventh Circuit Affirms Tax Court: Sale of Rights to Future Lottery Payments Ordinary Income

In *Womack v. Commissioner*, 100 A.F.T.R.2d 2007-7103, the Eleventh Circuit affirmed the Tax Court's determination that the lump sum payments for the sale of future annual lottery payments by two couples constituted ordinary income. The court cited *P.G. Lake, Inc. v. Commissioner*, 356 U.S. 260 (1958), for the underlying proposition that capital gain treatment isn't available for lump sum consideration that is essentially a substitute for what would otherwise be received at a future time as ordinary income. The Eleventh Circuit noted that its conclusion is consistent with the four other circuits that have addressed the same issue and reached the same conclusion, albeit different reasoning.

2. IRS Official Warns: Corporations May Be Overlooking Section 1441 Withholding Obligations

On January 17, 2008, at the Foundation for Accounting Education's annual international taxation conference, Barry Shott, deputy commissioner (international) in the IRS Large and Mid-Size Business Division warned corporations that they may be overlooking withholding tax obligations under Treas. Reg. § 1.1441-7(a). Under Treas. Reg. § 1.1441-7(a)(1), a person is considered a withholding agent for purposes of section 1441 and its related provisions if the person has control, receipt, or custody of any amounts subject to withholding. Every withholding agent must file an information return, *Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding*, to report amounts paid during the preceding calendar year. Shott explained that tax executives may not be checking with their accounts payable office for fixed, determinable, and periodic payments (FDAPPs) that trigger withholding requirements. IRS examination of payments is now part of the basic audit plan for revenue agents

examining Form 1120 corporate tax filings. Shott urged companies voluntarily to disclose noncompliance and stated that voluntary disclosure is always better for the taxpayer than having problems found on audit. Shott also noted that the IRS will consider reasonable cause arguments for the failure to file Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and Form 1042S, *Foreign Person's U.S. Source Income Subject to Withholding*, and failure to make deposits of withholding tax.

REPORTING GUIDELINES AND FORMS

1. IRS Reissues Excess Per Diem Payment Auditing Guidance In Connection With Rev. Rul. 2006-56

On January 14, 2008, the IRS Small Business/Self-Employed Division reissued an expired Interim Guidance Memorandum (SBSE-04-1106-049, reissued as SBSE-04-0108-003) to provide administrative guidelines to examiners who are auditing a taxpayer's treatment of excess per diem payments, i.e., whether the taxpayer has satisfied the requirements under Treas. Reg. § 1.62-2 relating to excess payments (allowances paid to an employee in excess of federal per diem rates) so that business expenses can be treated as paid under an accountable plan for purposes section 62.

The memorandum reiterates that most taxpayers who were not in compliance regarding the treatment of excess per diem payments, as described in Rev. Rul. 2006-56, 2006-46 I.R.B. 874, needed time to update or secure accounting software enabling them to compute the proper amount of additional wages. In Rev. Rul. 2006-56, the IRS ruled that where the taxpayer's expense allowance arrangement routinely results in payment of excess allowances, the taxpayer's failure to track the excess allowances, and its routine payment of excess allowances that are not repaid or treated as wages, evidence a pattern of abuse under Treas. Reg. § 1.62-2(k). Accordingly, the IRS ruled that even if the taxpayer's expense allowance arrangement otherwise meets the business connection, substantiation, and return of excess requirements of an accountable plan for the allowances paid to the taxpayer's employees up to the amount that may be deemed substantiated, all payments made under taxpayer's expense allowance arrangement are treated as paid under a nonaccountable plan. Thus, the ruling provided that the taxpayer must include all amounts paid under the arrangement to reimburse employees' meals and incidental expenses, not just the excess allowances, in the employees' wages on Forms W-2 and treat all these amounts as wages for the withholding and payment of employment taxes.

The memorandum states that for taxable periods ending on or before December 31, 2006, absent egregious circumstances or evidence of intentional noncompliance, the examiner should not treat a plan as a nonaccountable plan solely because excess per diem payments were not treated as wages. Instead, the examiner should treat only the excess amounts over the federal per diem limit as wages. However, for periods ending after December 31, 2006, the examiner will determine whether the plan is abusive based on the extent of the excess payments that are not treated as wages and on whether a system for tracking excess payments is being utilized. The memorandum provides criteria for making these determinations.

2. IRS Issues Fact Sheet On Employment Taxes and Classifying Workers

The IRS recently issued the final 2007 fact sheet on employment taxes and classifying workers (FS-2007-27). In the fact sheet, the IRS reminds businesses that they need to make correct employee-independent contractor determinations to assure that reporting, withholding and tax obligations are satisfied. For example, an employer must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an “employee.” In contrast, a business generally does not have to withhold or pay any federal taxes on payments to an “independent contractor.”

The IRS also explains that it is a common misconception that someone working part time or earning less than \$600 per year should be classified as an independent contractor. Rather, part time status and the number of hours worked are generally not factors that determine whether a worker is an employee or independent contractor.

Businesses use several factors to determine how to classify its workers, including the degree of control the business has over its workers. Generally, the more control the business has over a worker, the more likely it is that the worker is an employee rather than an independent contractor. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and type-of-relationship.

1. Behavioral control

Behavioral control relates to whether the business has a right to direct and control how the worker performs the task for which she is hired. In general, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that the employer has the right to control the details of how the services are performed. Such details include:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

2. Financial control

Financial control looks at whether a worker has the ability to affect financial decisions. Important questions to ask include:

- Does the worker have a significant investment in assets or tools?
- Are there unreimbursed expenses that the worker has to bear herself?
- Are the worker’s services available to the public?

- What is the method of payment; is the worker paid whether the work is done or not, or is the worker paid only if she finishes the job? An independent contractor can realize a profit or loss on a job.
- Can the worker make business decisions that affect his bottom line?

3. *Type of relationship*

The type-of-relationship factor looks to whether there is a contract between the worker and the business and how it is worded; whether the worker gets any type of benefits – vacation and sick pay, pension plan, and health or life insurance; and how permanent is the relationship, e.g., whether it continues indefinitely or only for a specific project or period. Also, does the worker have his own business, which he markets to others?

The IRS fact sheet also lists important employer resources:

- If requested, the IRS can make the worker classification determination for a business. Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, can be used to request that the IRS make the proper worker classification determination. <http://www.irs.gov/pub/irs-pdf/fss8.pdf>
- The IRS's archived Tax Talk Today November 2007 Webcast, "What's Hot in Employment Taxes: Independent Contractor or Employee?" focuses exclusively on worker classification issues.
 - Publication 15-A, Employer's Supplemental Tax Guide. http://www.irs.gov/pub/irs-pdf/p15a_05.pdf
 - Publication 1779, Independent Contractor or Employee brochure. <http://www.irs.gov/pub/irs-pdf/p1779.pdf>
 - Publication 1976, Independent Contractor or Employee? Section 530 Employment Tax Relief Requirements. <http://www.irs.gov/pub/irs-pdf/p1976.pdf>

3. **IRS Provides Interim Guidance Relating to Information Reporting Requirements For Statutory Stock Options Under Section 6039**

In Notice 2008-8, 2008-3 I.R.B. 276, the IRS announced that Treasury and the IRS intend to issue regulations that prescribe rules on the information return requirements contained in section 6039 (concerning returns required in connection with certain options), as amended by section 403 of the Tax Relief and Health Care Act of 2006. Treasury and the IRS expect that the forthcoming regulations generally will retain the existing rules contained in Treas. Reg. § 1.6039-1, relating to the information statements to be provided to employees, and generally require that the same information be included in the information returns filed with the IRS. Treasury and the IRS also expect that the new regulations will be effective retroactively to January 1, 2007. Because regulations under section 6039 have not yet been issued, the IRS is waiving the obligation to make an information return for 2007 stock transfers governed

by section 6039. However, the Notice states that corporations should continue to furnish to employees the information required by, and in accordance with, existing Treas. Reg. § 1.6039-1, with respect to such stock transfers.

4. IRS Develops New Form For Misclassified Workers

The IRS has developed a new form for employees who have been misclassified as independent contractors by an employer. Form 8919, *Uncollected Social Security and Medical Tax on Wages*, will now be used in place of Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, for misclassified workers beginning with the 2007 tax year. (Form 4137 should continue to be used in connection with unreported tip income, however.) By filing Form 8919, taxpayers who meet one of several criteria indicating employee status will be ensured that Social Security and Medicare taxes will be credited to his or her social security record. The IRS plans to share Form 8919 data electronically with the Social Security Administration.

5. Form 940, Employer's Annual Federal Unemployment Tax Return

The due date for filing Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, for 2007 is January 31, 2008. However, if you deposited all your FUTA tax when it was due, you may file Form 940 by February 11, 2008. The 2007 Form 940 can be found on the IRS website at <http://www.irs.gov/pub/irs-pdf/f940.pdf>. The 2007 Form 940 Instructions can be found at <http://www.irs.gov/pub/irs-pdf/i940.pdf>

6. Form 941, Employer's Quarterly Federal Tax Return

The 2007 Form 941, *Employer's Quarterly Federal Tax Return*, Instructions were revised in October of 2007. Generally, employers must report wages paid during the first quarter, i.e., January through March, by April 30th. In the revised instructions, the IRS reminded taxpayers that when reporting a negative amount as a tax adjustment on line 7, use a "minus" sign instead of parentheses. The IRS explained that the use of a minus sign enhances the accuracy of their scanning software. However, the IRS notes that if the taxpayer's software only allows for parentheses in reporting negative amounts, the taxpayer may use parentheses. The revised 2007 Form 941 Instructions can be found on the IRS website at <http://www.irs.gov/pub/irs-pdf/i941.pdf>. The 2007 Form 941 can be found at <http://www.irs.gov/pub/irs-pdf/f941.pdf>.

7. Ninth Circuit Rules Insurance Agent Termination Payments Are Ordinary Income

In *Trantina v. United States*, 101 A.F.T.R.2d 2008-XXXX (2008), the U.S. Court of Appeals for the Ninth Circuit affirmed the district court's ruling and held that termination payments received by Trantina, a State Farm insurance agent, under an agreement (the Agreement) with State Farm were properly characterized as ordinary income because the agent did not have any property rights that he could sell under the terms of the agreement. Under the Agreement, Trantina became entitled to the termination payments after he complied with two additional conditions of the Agreement: he was required to return all of State Farm's property, and he was required to comply with a twelve-month non-compete agreement.

Citing the Supreme Court in *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960), the Ninth Circuit stated that “the term ‘capital asset’ should be construed narrowly.” The court explained that case law demonstrates that “when the property right asserted concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed.” The court rejected each of Trantina’s arguments that he had enforceable rights beyond a contractual right to perform services and receive compensation. The Ninth Circuit ultimately adopted the reasoning espoused in a similar case, *Baker v. Commissioner*, 338 F.3d 789, 791 (7th Cir. 2003). In doing so, the Ninth Circuit reasoned that a precondition to realizing a long-term capital gain is the ownership of a capital asset. Because Trantina had no property that could be sold or exchanged, the Ninth Circuit concluded that the Agreement was not a capital asset for purposes of section 1221(a). See *Trantina*, Opinion available at <http://altlaw.org/v1/cases/685495>. The court refused to consider whether the substance of the Agreement was essentially a franchise, which is recognized as a capital asset, because the taxpayer did not raise such an argument in the district court.

8. Treasury and IRS Issue Proposed Regulations And Field Guidance Relating To Interest-Free Adjustments

The IRS’s Small Business/Self-Employed Division issued a *Memorandum For Employment Tax Territory Managers, Group Managers And Specialists*, effective January 9, 2008 through January 9, 2009, that provides guidance regarding the date to enter on closing documents to compute properly the interest-free adjustment (explained below) on employment tax cases (SBSE-04-0108-004). The memorandum states that examiners are required to provide the due date of the return for the quarter in which the error was ascertained, or, in an examination situation, the date on which Form 2504, *Agreement and Collection of Additional Tax and Acceptance of Overassessment (Excise or Employment Tax)*, or Form 2504-WC, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment in Worker Classification Cases (Employment Tax)*, was signed. The correct date and Transaction Code 308 must be entered on Form 5344, *Examination Closing Record*, (Item 11). The guidance explains that this entry is necessary even if the deficiency is already paid to ensure that the taxpayer is not charged interest from the original due date of the return. The guidance also states that on Form 3198, on page 2 “Special Interest Features,” examiners must enter “interest-free adjustment” so that the case closing unit will have the data necessary to instruct IRS systems properly as to the adjustments and the interest-free period at closing.

Background

Section 6205 and the regulations thereunder permit an employer who has made an undercollection or underpayment of FICA tax, RRTA tax (both the employer and employee shares), or federal income tax withholding, and who ascertains the error after filing the return reporting such tax, to make an adjustment without owing interest on the underpayment. An error is “ascertained” when the employer has sufficient knowledge of the error to be able to correct it. The interest-free adjustment is made by reporting the additional amount due as an adjustment on a current return (e.g., Form 941) filed for the return period in which the error is ascertained, or by reporting the amount on a supplemental return for the return period in which the wages or compensation was paid. In both cases, the return with

the adjustment or the supplemental return must be filed by the due date of the return for the return period in which the error was ascertained. (Section 6205 does not apply to FUTA.) The executed Form 2504 and Form 2504-WC are supplemental returns for purposes of making an interest-free adjustment of an error ascertained in the course of the examination. *See* Rev. Rul. 75-464, 1975-2 C.B. 474. To be entirely interest-free, full payment of the underpayment adjustment must be made on or before the due date of the return for the return period in which the error was ascertained, e.g., the return period in which the Form 2504 or Form 2504-WC is signed. Accordingly, outside of the examination context, interest-free adjustments of employment tax are made on a current return. *See* Treas. Reg. 601.601(d)(2)(ii)(b). If the tax adjustment is not paid when due, interest will begin accruing on the day following the due date of the return for that period. For adjustments related to Form 944 and Form 945, the due date for the return is January 31 of the following year.

Proposed Regulations

The Treasury and IRS have issued proposed regulations (REG-111583-07) under section 6011 relating to the requirement to file a return, under sections 6205(a) and 6413(a) relating to the process for making adjustments of underpayments and overpayments, respectively, of employment taxes, under section 6302 relating to deposit obligations, and under sections 6402 and 6414 relating to the process of filing a claim for refund for an overpayment of employment taxes.

Adjusted return replaces current return process

The proposed amendments change the process by which employers can make interest-free adjustments to correct underpayments or overpayments of employment tax. The proposed amendments to the regulations eliminate the existing process that uses the current return to make adjustments and provide a new process which will use a separately filed adjusted return to make adjustments. Unlike Form 941c, the new adjusted return will not be filed as an attachment to a current return and will not affect the liability reported on the current return. Accordingly, the proposed amendments to the regulations eliminate any reference to the use of supplemental returns to make adjustments, and provide that Forms 2504 and 2504-WC will be treated as adjusted returns under the same rationale and criteria that they have been treated as supplemental returns under Rev. Rul. 75-464. Thus, corrections reported on these forms following an examination will continue to be eligible for interest-free adjustment treatment.

Time for filing adjusted return

Under the proposed regulations, an employer may file an adjusted return correcting an underpayment or an overpayment as soon as the employer ascertains the underpayment or overpayment error, rather than waiting to report the adjustment with the regularly filed employment tax return. The adjusted return for an underpayment may only be filed within the applicable period of limitations for assessing the underpayment, and the adjusted return for an overpayment may only be filed before the 90th day prior to the expiration of the applicable period of limitations on credit or refund.

Treatment as interest-free adjustment where original return never filed

Under the proposed rules, an interest-free adjustment is generally available if an employer failed to file a return for a return period solely because the employer failed to treat any individuals as employees.

Repayment or reimbursement of employees required for interest-free adjustments of overpayments

The proposed regulations provide that when an overpayment error is ascertained, the proposed amendments to the regulations retain the rule that the employer must repay or reimburse the employee's share of FICA or RRTA tax before making the overpayment adjustment to both the employees' and employer's taxes. The employer must do so by the due date of the return for the return period following the return period in which the error is ascertained and within the applicable period of limitations on credit or refund. However, the requirement to repay or reimburse does not apply to the extent that taxes were not withheld from the employee or if, after reasonable efforts, the employer cannot locate the employee; in such case, the employer may make an adjustment for only the employer share of FICA or RRTA tax.

Deposits, payments, and credits

For interest-free adjustments of underpayments, the proposed rules provide that the amount must be paid when the adjusted return is filed. If the amount is not paid when the adjusted return is filed, interest will begin to accrue as of the date the adjusted return is filed. The adjusted overpayment amount will be applied as a credit toward payment of the employer's liability for the calendar quarter (or calendar year for annual returns being adjusted) in which the adjusted return is filed, unless the IRS notifies the employer that the credit will be applied to a different return period or that the employer is not entitled to the adjustment under applicable laws or procedures.

Proposed effective date

The proposed amendments are to be effective on the date they are published as final regulations in the Federal Register and, with respect to sections 6205, 6302, 6402, 6413, and 6414, are to be applicable to any error ascertained on or after January 1, 2009.

Comments requested

The Treasury and the IRS specifically requested comments on the clarity of the proposed rules and how they can be made easier to understand. A public hearing has been scheduled for April 17, 2008, and persons who wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic by March 27, 2008.

Other Matters

1. New IRPAC Members Announced

The IRS has appointed 20 new members to the Information Reporting Program Advisory Committee (IRPAC) (IR-2008-07). IRPAC is composed of thirty-four members who represent various segments of the information reporting and tax professional community, from major national professional and trade associations to state tax agencies. Returning members of the IRPAC include Erica L. Dinner, Director, Tax Information Reporting at Hartford Life Insurance Company. Erica has been an IRPAC member since 2006, and her appointment is slated to expire this year.

2. GAO Study Addresses Information Reporting

On December 20, 2007, the Government Accountability Office (GAO) released a report addressing certain information reporting issues in light of the administration's fiscal year 2008 budget proposals to require information reporting on merchant payment card reimbursements and on certain payments to corporations, which would raise an estimated \$18.4 billion over 10 years (GAO-08-266). The report's objectives were to (i) identify, using case studies, the compliance costs of existing information reporting; (ii) determine the kinds of third-party compliance costs that may result from the two budget proposals and options for mitigating the costs; and (iii) determine the IRS's ability to process and use additional information returns.

The GAO report concluded that the compliance costs of existing information reporting were relatively low. In addition, the report concluded that the administration's two information reporting proposals (a conclusion that our readers may find controversial) would impose new compliance costs, some of which could be mitigated. For the two proposals, the IRS budgeted \$11.8 million in programming and start-up costs for fiscal year 2008, with another \$16.8 million expected in administrative implementation costs after 2008. Lastly, according to IRS officials, the IRS uses about 90 percent of potentially usable information returns in its matching efforts for individual taxpayers. However, millions of discrepancies are not pursued because of resource constraints.

3. California's Franchise Tax Board To Add Online Wage and Withholding Information

On January 2, 2008, California became the first state to offer its taxpayers online access to wage and withholding information. The information will be available on the Franchise Tax Board's online web site in addition to other new information including data on interest, refunds, credits, or offsets from state Forms 1099-INT and 1099-G.

Ask the Expert

In our last issue, we noted that the Tax Technical Corrections Act of 2007, H.R. 4839, had been passed by the House and the Senate and cleared for the White House. The Tax Technical Corrections Act of 2007 (the Act), Pub. L. No. 110-172, was signed into law by the President on December 29, 2007. The Act includes several notable technical corrections related to reporting and withholding, including:

Corrections to provisions of the Pension Protection Act of 2006

Section 408(d)(8) of the Code provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. The Act amends subparagraph (D) of section 408(d)(8) by striking “all amounts distributed from all individual retirement plans were treated as 1 contract under paragraph (2)(A) for purposes of determining the inclusion of such distribution under section 72” and inserting “all amounts in all individual retirement plans of the individual were distributed during such taxable year and all such plans were treated as 1 contract for purposes of determining under section 72 the aggregate amount which would have been so includible.” Thus, under the new provision, when determining the portion of a distribution that would otherwise be includible in income, the otherwise includible amount is determined as if all amounts were distributed from all of the individual’s IRAs. *See* section 3 of the Act, and the Pension Protection Act of 2006, Pub. L. No. 109-280, Sec. 1201.

Corrections to provisions of the Economic Growth Tax Relief Reconciliation Act of 2001

Section 402(g)(7) of the Code provides a special rule allowing certain employees to make additional elective deferrals to a tax-sheltered annuity, subject to (1) an annual limit of \$3,000, and (2) a cumulative limit of \$15,000 minus the amount of additional elective deferrals made in previous years under the special rule. Prior to amendment, a rule coordinated the cumulative limit with the ability to make designated Roth contributions, but inadvertently reduced the \$15,000 amount by all designated Roth contributions made in previous years. The Act amends subclause (II) of section 402(g)(7)(A)(ii) by striking “for prior taxable years” and inserting “permitted for prior taxable years by reason of this paragraph.” Thus, the new provision clarifies that the \$15,000 amount is reduced only by additional designated Roth contributions made under the special rule. The Act also amends subparagraph (A) of section 3121(v)(1) by inserting “or consisting of designated Roth contributions (as defined in section 402A(c))” before the comma at the end. Under section 3121(v)(1)(A), elective deferrals are included in wages for purposes of social security and Medicare taxes. The new provision clarifies that wage treatment also applies to elective deferrals that are designated as Roth contributions. *See* section 8 of the Act, and the Economic Growth Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, Sec. 617.

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