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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

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LEGISLATION

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

Proposed Regulations Requiring Tax Withholding under Section 1441 on Redemption Distributions to Foreign Shareholders Criticized as Unadministrable

Speakers at a public hearing on February 6, 2008 strongly criticized proposed withholding regulations under section 1441 relating to distributions to foreign shareholders, as unadministrable. The proposed regulations, released on October 17, 2007, 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) (REG-140206-06). Speakers criticized the proposed certification process as overly onerous and complex, and expressed concern relating to the cost of the proposed escrow procedures. In response to questions from an IRS representative, speakers also suggested that creating a presumption of exchange treatment would be preferable to having the IRS make narrow changes to the regulations based on comments.

Under the proposed regulations, once amounts are set aside in the 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 whether the distribution is a distribution in exchange for stock or 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.

REPORTING GUIDELINES AND FORMS

1. IRS Issues Guidance Setting 2008 Auto and Truck FMVs for Cents-per-mile Valuation

The IRS has issued Rev. Proc. 2008-13, 2008-6 I.R.B. 407, setting the maximum fair market values for employer-provided autos, truck and vans, for purposes of valuing an employee's personal use of an employer-provided vehicle under the cents-per-mile method. Under section 280F(d)(7), the mileage allowance rate can only be used if an auto's fair market value does not exceed \$12,800, before adjustment for inflation measured by the Consumer Price Index. As adjusted for 2008, the maximum fair market for employer-provided vehicles first made available to employees for personal use in 2008 for which the vehicle-cents-per-mile valuation rule may be applicable is \$15,400 for a passenger automobile and \$16,700 for a truck or van. The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2008 for which the fleet-average valuation rule provided under section 1.61-21(d) of the regulations may be applicable is \$19,900 for a passenger automobile and \$20,800 for a truck or van.

2. IRS Finalizes Form 8925, *Report of Employer-Owned Life Insurance Contracts*

The IRS has finalized Form 8925, *Report of Employer-Owned Life Insurance Contracts*, in connection with information reporting requirements for employer-owned life insurance contracts under section 6039I. Employers holding life insurance contracts should use Form 8925 to report the number of employees covered by employer-owned life insurance contracts issued after August 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders must also indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received for purposes of Form 8925. An insurance contract is an employer-owned life insurance contract if it (i) is owned by a person who is engaged in a trade or business that employs the insured and is the direct or indirect beneficiary of the contract, and (ii) covers the life of the owner's employee(s) on the date the life insurance contract is issued. Special rules apply in the context of master contracts. Form 8925 should be attached to the policyholder's income tax return for each tax year ending after November 13, 2007, during which the policyholder has employer-owned life insurance contract(s) in force.

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. 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. In the notice proposing 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.

Form 8925 is available online at <http://www.irs.gov/pub/irs-pdf/f8925.pdf>.

3. IRS Again Updates Publication 1187, Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically or Magnetically

The IRS has announced an update to Publication 1187, *Specifications For Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically or Magnetically*, which was previously revised in September of 2006. Announcement 2008-6 supersedes recently published Announcement 2007-110 and incorporates additional changes to Publication 1187. The changes below are effective for Form 1042-S for tax year 2007, filed in calendar year 2008.

- An explanatory note was added to the Recipient 'Q' Record which reads:

If you are a nominee that is the withholding agent under Code Section 1446, enter the Publicly Traded Partnership's (PTP) name and other information in the NQI/FLW-THR fields; positions 401-666.

- In the Recipient 'Q' Record, a new field, NQI/FLW-THR State Code, was added to positions 643-644.
- Additional instructions were added to the Recipient 'Q' Record, NQI/FLW-THR Country Code, positions 647-648. The instructions read:

Enter the two-character Country Code abbreviation, where the NQI/FLW-THR is located. Enter blanks if the NQI/FLW-THR has a U.S. address.

- The Field Title was changed and additional instructions were added to the Recipient 'Q' Record, NQI/FLW-THR Postal Code or ZIP Code, positions 649-657. The instructions read:

Enter the alpha/numeric foreign postal code or U.S. ZIP Code for all U.S. addresses including territories, possessions and APO/FPO. Enter the code in the left most position and blank fill the remaining positions. DO NOT use hyphens or blanks between numbers or letters (e.g. if the postal code is written as A6B3C5 input as A6B3C5).

The changes included in Announcement 2008-6 that were not included in Announcement 2007-110 relate to Canadian Province codes. The announcement, including the new Canadian Province codes, can be found online at http://www.irs.gov/irb/2008-05_IRB/ar12.html.

4. IRS Issues Rev. Rul. 2008-13: New Rule for Application of Exception for Performance-based Compensation Plans under Section 162(m) is Prospective

In Rev. Rul. 2008-13, 2008-10 I.R.B. 1, the IRS concluded that compensation payable by a publicly held corporation to a covered employee (within the meaning of section 162(m)(3)) is not considered “remuneration payable solely on account of attainment of one or more performance goals” under section 162(m)(4)(C) even though the plan or agreement under which the covered employee is paid provides that the compensation will be paid upon attainment of a performance goal under certain circumstances. The ruling excepts circumstances in which compensation will be paid without regard to whether the performance goal is attained in either of the following situations: (i) the covered employee’s employment is involuntarily terminated by the corporation without cause or the covered employee terminates his or her employment for good reason; or (ii) the covered employee retires.

The revenue ruling appears to have been issued in response to concerns raised by practitioners subsequent to the publication of PLR 200804004 (Sept. 21, 2007). PLR 200804004, released at the end of January, was viewed as a marked departure from prior rulings by the IRS on what is covered by the exception for performance-based compensation under section 162(m)(4)(C). Although the revenue ruling’s holdings are consistent with PLR 200804004, pursuant to section 7805(b)(8) the IRS limits the retroactive effect of the ruling. Rev. Rul. 2008-13 provides that it will not be applied to disallow a deduction for any compensation that otherwise satisfies the requirements for qualified performance-based compensation under section 162(m)(4)(C) and Treas. Reg. § 1.162-27(e)(2), and that has payment terms similar to those described in the ruling if either (1) the performance period for such compensation begins on or before January 1, 2009, or (2) the compensation is paid pursuant to the terms of an employment contract as in effect (without renewals) on February 1, 2008.

Other Matters

Employment Tax Enforcement Issues Addressed at ABA Midyear Meeting

The IRS addressed numerous employment tax enforcement issues at the January 18, 2008 American Bar Association Section of Taxation midyear meeting in Lake Las Vegas, Nevada (the ABA meeting). IRS representatives announced that its employment tax unit plans to focus on worker classification, tip reporting and officer compensation in the 2008 year.

At the ABA meeting, Anita Bartels, IRS senior program analyst (employment tax), identified an IRS concern that employers are improperly using tool plans to recharacterize amounts properly treated as employee wages. In recent guidance, amounts paid by taxpayer to its employee service technicians as purported reimbursements for the use of the technicians’ tools under the taxpayer’s “tool plan” were not excluded from wages for employment tax purposes as amounts paid under an accountable plan. *See* CCA 200745018. As a result, the IRS concluded that amounts paid under the plan must be included in the technician’s gross income, reported as wages or other compensation on the technician’s Form W-2, and subject to withholding and payment of employment taxes. The IRS based its conclusion on the fact that taxpayer’s plan failed each of the three requirements of an accountable plan (both in design and operation): business connection, substantiation, and return of excess.

IRS representatives also noted that recently proposed regulations on employment tax adjustments (REG-111583-07) should soon be finalized. The proposed regulations change the process by which employers can make interest-free adjustments to correct underpayments or overpayments of employment tax. If finalized, the proposed regulations would eliminate the existing process that uses the current return to make adjustments and provide a new process which would use a separately filed adjusted return to make adjustments. The IRS is anticipating that the new procedures would be implemented by March of 2009.

Ask The Expert

Is the Recent Arkansas Supreme Court Holding, That “Back Pay” and “Front Pay” Do Not Constitute Wages Subject to Federal Income Tax Withholding, Based on Settled Law?

I assume that the Arkansas Supreme Court case you are referring to is *Arkansas Department of Health and Human Services v. Storey*, Ark., No. 07-525 (Dec. 13, 2007). If so, the answer is no; appellate courts have been split on this general issue, and it has yet to be resolved by the Supreme Court. Moreover, recently, the Supreme Court declined to review the Sixth Circuit’s decision in *Appoloni v. United States*, 450 F.3d 185 (6th Cir. 2006), discussed more fully below, (127 S.Ct. 1123 (2007)), in the context of early retirement incentive payments.

In a lower court proceeding in *Storey*, an employer was ordered to pay damages to a former employee for “lost wages, benefits, and other remuneration” and “front pay in lieu of reinstatement” under the Arkansas WhistleBlower Act. The employer withheld federal and state income tax and employee FICA tax and paid the net amount of the award. The issue for the Supreme Court of Arkansas was whether the employer should be released from the judgment. The Arkansas court held that the damages were not “wages” subject to federal income tax withholding under section 3402(a), FICA taxes under section 3102(a), or state withholding under Arkansas state law, and ordered that the employer pay the former employee the amount of withheld taxes, plus interest. The court reasoned that if an employer-employee relationship does not exist during the time period for which the judgment is awarded, then the award does not constitute “wages,” and the income tax withholding requirement is not applicable. The Arkansas court cited, e.g., *SangHoon Kim v. Monmouth College*, 320 N.J. Super. 157, 160, 726 A.2d 1017, 1019 (1998) (explaining that when no employer-employee relationship existed, because the plaintiff had been terminated and had never been reinstated, a “lost income” award did not constitute “wages” subject to federal income tax withholding) and *Churchill v. Star Enters.*, 3 F. Supp. 2d 622, 624 (E.D. Pa. 1998) (explaining that when a plaintiff is terminated and obtains an award of damages for a period of time when she was an ex-employee, “the jury’s award does not and cannot represent wages for services performed since she performed none during the relevant time frame”). The court stated that in *Storey*, during the time period for which these awards were meant to compensate the recipient, she was not an employee. Thus, the compensation was not for services performed in the nature of an employment relationship. Accordingly, the court concluded that by their very nature, the awards cannot be “wages” because they did not arise out of an employer-employee relationship but rather the lack thereof.

The court distinguished cases which have held that the definition of wages should be construed very broadly, and that back and front pay awards come within the broad definition of wages for federal employment tax purposes. The court concluded that they were all inapposite as they all dealt with the

question of whether certain types of awards are taxable, and not the question of whether a former employer is obligated to withhold taxes from an award. These cases included *Social Security Board v. Nierotko*, 327 U.S. 358, 365-66 (1946) (“‘service’ . . . means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer”), *Appoloni v. United States*, 450 F.3d 185 (6th Cir. 2006) (holding that the government properly withheld FICA taxes from early retirement incentive payments because the payments were “wages” taxable under FICA), *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999) (holding that taxpayers were not entitled to a refund for federal income and FICA taxes paid on amounts they received in settlement of an Employees Retirement Income Security Act (ERISA) action against their former employer because the portion of the settlement received for back wages or future wages received as a result of the firing were taxable as income), and *Mayberry v. United States*, 151 F.3d 855 (8th Cir. 1998) (holding that taxpayers were not entitled to a refund of income and employment taxes paid on an ERISA settlement award because the settlement constituted wages for the purposes of FICA taxes).

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