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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

March 31, 2008

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

1. IRS Offers Generous Presumption in Determining Settlement Payments Excludable from Gross Income under Section 104(a)(2)

In CCA 200809001 (Nov. 27, 2007), the IRS determined that payments made to settle tort claims were excludable from gross income under section 104(a)(2) and not reportable under section 6041, based on an IRS presumption that such amounts compensated for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries. 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. The IRS explained that it was reasonable to presume that the settlement compensated the claimant for personal physical injuries and that all damages for emotional distress were attributable to the physical injuries because the claimant may have difficulty establishing the extent of his physical injuries in light of the passage of time and the claimant's status as a minor when the tort allegedly occurred. However, the IRS noted that any portion of the payments that were allocable to punitive damages or interest, includible in the gross income of the claimant under section 61, and may be reportable under section 6041.

2. IRS Officials Address Tax Treaties on *Tax Talk Today* Webcast: *Understanding Tax Treaties*

IRS officials addressed international tax treaties on the *Tax Talk Today* webcast during its March 11, 2008 program. IRS officials noted that the big issue practitioners face is whether the 30 percent withholding applies to payments to a foreign person. Under sections 1441 and 1442, a person that makes a payment of U.S. source interest, dividends, royalties, and certain other types of income (i.e., fixed or determinable annual or periodic payments) to a foreign person must generally deduct and withhold 30 percent from the payment. However, under certain circumstances, a lower treaty rate of withholding may apply. Generally, a payor of these types of income must also report the payments on Form 1042-S. *See* section 1.1461-1(c).

IRS officials reminded taxpayers that failure to withhold properly can be costly. The payor is generally personally liable for any tax required to be withheld. This liability is independent of the tax liability of the foreign person to whom the payment is made. If the payor fails to withhold and the foreign payee fails to satisfy its U.S. tax liability, then both the payor and the foreign person are generally

liable for tax, as well as interest and any applicable penalties. The applicable tax will be collected by the IRS only once. However, if the foreign person satisfies its U.S. tax liability, the payor may still be held liable for interest and penalties for failure to withhold. *See* Publication 515 (Rev. April 2007), Withholding Agent, at 3.

3. IRS Announces Corrections to 2008 Form W-2, Form W-3, and Instructions for Forms W-2 and W-3

On March 11, 2008, the IRS website announced that 2008 Form W-2, Form W-3 or the Instructions for Forms W-2 and W-3, downloaded before March 11, 2008, contain due date errors, and noted the following corrections:

- On Form W-2, page 10, under Due dates, the first two sentences should read, "Furnish Copies B, C, and 2 to the employee generally by February 2, 2009. File Copy A with the SSA by March 2, 2009."
- On Form W-3, under When to File, the first sentence should read, "Mail any paper Forms W-2 under cover of this Form W-3 Transmittal by March 2, 2009."
- In the Instructions for Forms W-2 and W-3 –
    - On page 3, under Furnishing Copies B, C, and 2 to employees, the first sentence should read, "Furnish Copies B, C, and 2 of Form W-2 to your employees, generally, by February 2, 2009."
    - On page 8, under Failure to file correct information returns by the due date, the third, fourth, and fifth sentences should read, "$15 per Form W-2 if you correctly file within 30 days (by March 31 if the due date is March 2); maximum penalty $75,000 per year ($25,000 for small businesses, defined later)"; "$30 per Form W-2 if you correctly file more than 30 days after the due date but by August 3; maximum penalty $150,000 per year ($50,000 for small businesses);" "$50 per Form W-2 if you file after August 3 or you do not file required Forms W-2; maximum penalty $250,000 per year ($100,000 for small businesses)."
    - On page 8, under Exceptions to the penalty, the last bullet should read, "Filed corrections of these forms by August 3."
    - On page 8, under Failure to furnish correct payee statements, the second sentence should read, "The penalty applies if you fail to provide the statement by February 2, if you fail to include all information required to be shown on the statement, or if you include incorrect information on the statement." The last sentence of the second paragraph should read, "The penalty is not reduced for furnishing a correct statement by August 3."

The corrected version of the 2008 Form W-2, the 2008 Form W-3 and the 2008 Instructions for Forms W-2 and W-3 are available for download on the irs website at http://www.irs.gov/pub/irs-pdf/fw2.pdf, http://www.irs.gov/pub/irs-pdf/fw3.pdf, and http://www.irs.gov/pub/irs-pdf/iw2w3.pdf, respectively.

4. Seventh Circuit Concludes that Worker Classification is a Matter of Public Policy in Retaliatory Firing Case

In *Bender v. Bellows & Bellows*, No. 06-1487 & 06-2716 (Feb. 12, 2008), the U.S. Court of Appeals for the Seventh Circuit reversed a district court grant of summary judgement for the employer where the employee plaintiff alleged a claim of retaliatory discharge, in part, under Illinois common law in connection with the employee's threat to notify the IRS that the firm had improperly classified the employee as an independent contractor. Under Illinois law, as an exception to the at-will employment rule, a retaliatory discharge claim may succeed if an employee shows: (1) that she was discharged; (2) in retaliation for her activities; and (3) in contravention of a clearly mandated public policy. *McGrath v. CCC Info. Servs., Inc.*, 314 Ill. App. 3d 431, 246 Ill. Dec. 856, 731 N.E. 2d 384, 388 (Ill. App. Ct. 2000). Further, Illinois courts have held that the "clear mandate of public policy" standard is met in the context of workers' compensation claims and whistleblowing. *Brandon v. Anesthesia & Pain Mgmt. Assocs., Ltd.*, 277 F.3d 936, 941 (7th Cir. 2002). The U.S. Court of Appeals concluded that the federal laws governing the classification of workers as employees or independent contractors for tax purposes concern more than workers' economic interests because they affect the tax revenues collected by the federal government, the compliance with which is a matter of public concern. The Court identified a number of specific issues of material fact and remanded to the district court for further proceedings.

5. IRS Announces Benefit Valuation Rates for Flights on Employer Provided Aircraft

The IRS has issued Rev. Rul. 2008-14 (2008-11 I.R.B. 578), announcing the Standard Industry Fare Level ("SIFL") cents-per-mile rates and the terminal charges in effect for the first half of 2008 under Treas. Reg. § 1.61-21(g). Treas. Reg. § 1.61-21(g) provides a rule for valuing noncommercial flights on employer-provided aircraft for purposes of the taxation of fringe benefits under section 61. Treas. Reg. § 1.61-21(g)(5) provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the SIFL formula by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in Treas. Reg. § 1.61-21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are reviewed semi-annually.

For flights taken in the first half of 2008, the terminal charge rose to $39.86 (from $37.91 for the second half of 2007). The SIFL rates are $.2180 per mile up to 500 miles (up from $.2074 per mile for the second half of 2007); $.1662 per mile from 501-1500 miles (up from $.1581 per mile for the second half of 2007); and $.1598 per mile over 1500 miles (up from $.1520 per mile for the second half of 2007).

REPORTING GUIDELINES AND FORMS

1. IRS Allows Employers' to Deduct Certain Additional Payroll Tax Liabilities Under New Safe Harbor Method; Automatic Consent Provided

In Rev. Proc. 2008-25, 2008-13 I.R.B. XX, the IRS provided a safe harbor method of accounting for taxpayers using an accrual method of accounting that incur Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax ("payroll tax") liabilities for compensation,

including bonuses and vacation pay, and also provided procedures for taxpayers to obtain the automatic consent to change to the safe harbor method of accounting.

Treas. Reg. § 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which: (1) all the events have occurred that establish the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy (1 and 2 together are the "all events test"); and (3) economic performance has occurred with respect to the liability. *See also* Treas. Reg. § 1.446-1(c)(1)(ii)(A). Generally, if a taxpayer is liable to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed it. However, Treas. Reg. § 1.461-5(b)(1) provides a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature; and (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. Further, under Treas. Reg. § 1.461-5(b)(5)(ii), in the case of a liability for taxes, the matching requirement of the recurring item exception is deemed satisfied.

Under the safe harbor method, a taxpayer will be treated as satisfying the requirement in Treas. Reg. § 1.461-5(b)(1)(i) for its payroll tax liability in the same taxable year in which all events have occurred that establish the fact of the related compensation liability and the amount of the related compensation liability can be determined with reasonable accuracy. The IRS states that for reasons of administrative convenience and to reduce further controversy, it will not challenge a taxpayer's use of the safe harbor method for payroll taxes on compensation, even though such amounts would not be deductible under the standards of *Eastman Kodak Co. v. United States*, 534 F.2d 252 (Ct. Cl. 1976), acq., 1996-2 C.B. 1. The Court of Claims in *Eastman* ruled that an accrual method employer may deduct its share of payroll tax liabilities for year-end wages paid in Year 2 because the fact of the liability was established for purposes of the *all events test*. *See also* Rev. Rul. 96-51, 1996-2 C.B. 36; Rev. Rul. 2007-12, 2007-11 I.R.B. 685. However, the court concluded that such amounts relating to bonuses or vacation pay were not deductible until the taxable year in which those wages are actually or constructively paid. The court's holding was based on the fact that the liability for payroll taxes on bonuses and vacation pay was not established in Year 1 because of the uncertainty as of the end of Year 1 that the employee may have reached the payroll tax ceiling at the time of payment in Year 2.

2. Court of Appeals Reverses Court of Federal Claims: Supplemental Unemployment Compensation Benefit Payments Subject to Employment Taxes

In *CSX Corp. v. United States*, 101 A.F.T.R. 2d 2008-1120 (March 6, 2008), the U.S. Court of Appeals for the Federal Circuit held that all the payments at issue to employees who were separated from employment or who experienced reduced hours because of the reduction in the company's workforce, regardless of whether such payments were supplemental unemployment compensation benefit (SUB) payments for purposes of section 3402(o), were "wages" for purposes of Federal Insurance Contributions

Act, sections 3121–3128, and "compensation" for purposes of the Railroad Retirement Tax Act (RRTA), sections 3201–3202 and 3231–3233.

Section 3402(o) provides that any SUB paid to an individual is treated as wages for income tax withholding purposes. Supplemental unemployment compensation benefits are amounts paid to an employee under an employer's plan because of the employee's "involuntary separation" from employment (whether or not the separation is temporary) which directly results from a reduction in force, the discontinuance of a plan or operation or other similar conditions. *Id*. The appeals court addressed whether the statement in section 3402(o) that a SUB payment "shall be treated as if it were a payment of wages" for income tax withholding purposes necessarily implies that SUB payments are not wages for either income tax or FICA purposes.

In an earlier opinion, *CSX Corp. v. United States*, 89 AFTR 2d 2002-1935 (Fed. Cl. 2002), the trial court concluded that SUB payments as defined in section 3402(o) do not constitute payments subject to federal employment taxes under the RRTA or FICA. The trial court also held that certain payments made by plaintiffs to their employees pursuant to a reduction-in-force program qualified as such benefits, where lump-sum amounts were given in exchange for an employee's agreement to terminate his or her employment relationship with the company and to relinquish all rights and benefits associated with that relationship. The trial court determined that such payments, when elected by an employee then in a layoff status, qualified as SUB payments, whereas such payments when elected by an employee then in active status did not. The court reasoned that employees who elected separation payments in lieu of layoff benefits had not "voluntarily separated" from employment.

In *CSX Corp. v. United States*, 97 AFTR 2d 2006-3134 (Fed. Cl. 2006), the trial court considered whether separation payments not previously considered constitute SUB payments under section 3402(o). The Court of Federal Claims held that certain separation payments made to laid-off employees pursuant to a provision allowing an employee to separate, to transfer, or to remain laid off do not constitute supplemental unemployment compensation benefits under section 3402(o) and are therefore subject to federal employment taxes. Based on the facts considered, certain laid-off employees were given the option to separate from the company with a separation allowance, to transfer to a position in another location, or to remain on furlough but lose the furlough benefits they would normally be entitled to. The court determined that payments made to a furloughed employee, who had declined the opportunity to resume employment, including employment offered at another location, could not be said to have been "involuntarily separated." Accordingly, any payments made upon the employee's separation did not qualify as supplemental unemployment compensation benefits, and were subject to federal employment taxes. *See also CSX Corp. v. United States*, 92 AFTR 2d 2003-6903 (Fed. Cl. 2003).

ASK THE EXPERT

Is the IRS Expected to Implement Deferral Reporting Requirements on Employers and Payers under Section 409A for the Calendar Year 2008?

The timing of IRS imposition of deferral reporting requirements under section 409A is still unclear. Recently, however, IRS officials addressed future "Code Y" reporting under section 409A at the meeting of the Federal Bar Association Section on Taxation on March 7, 2008. William Schmidt of the

IRS Office of Chief Counsel stated that the question of how and when the IRS will implement Code Y reporting under section 409A is "up in the air."

As background, Notice 2007-89, 2007-46 I.R.B. 998, permanently waived for calendar year 2007 requirements for deferral reporting imposed under section 409A on employers and payers under section 6041 and section 6051. Thus, an employer was 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 was 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. Similar transitional relief with respect to the 2005 and 2006 reporting requirements was provided in Notice 2005-94, 2005-52 I.R.B. 1208, and Notice 2006-100, 2006-51 I.R.B. 1109.

Notably, an employer is currently 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. *See also* Notice 2007-100 for IRS transitional relief and other guidance relating to section 409A operational failures.

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