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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

April 30, 2008

LEGISLATION

Taxpayer Responsibility, Accountability, and Consistency Act of 2008 - Introduced in House of Representatives

The Taxpayer Responsibility, Accountability, and Consistency Act of 2008 (H.R. 5804), which has been introduced but not passed in the House, includes several information reporting and withholding provisions. If enacted, the provisions would amend section 6041 to require reporting of general income payments to corporations; would add a new section 3511 which would clarify which workers can be classified as independent contractors and impose fines for misclassification; and would increase information return penalties under sections 6721, 6722 and 6723, relating to failure to file correct information returns or payee statements, or comply with other information reporting requirements.

FORMS 1099, BACKUP AND FOREIGN PAYEE WITHHOLDING, AND PENALTIES

Foreign Withholding-Like Arrangement Not Withholding Required by Foreign Law, for Purposes of Section 3401 Wage Withholding Exception, Despite Foreign Law Prohibition of U.S. Tax Withholding

In CCA 200814010 (December 12, 2007), the IRS determined that compensation paid by a Unites States ("U.S.") company to U.S. citizens working in a foreign country did not qualify for the exception to wage withholding under Treas. Reg. § 31.3401(a)(8)(A)-1(b)(2) because the company was not required by applicable foreign law to withhold income tax on the compensation. Section 3401(a) defines the term "wages" for purposes of federal income tax withholding as all remuneration for services performed by an employee for his employer, with certain specific exceptions. Section 3401(a)(8)(A), in part, provides an exception for services for an employer (other than the U.S. or any agency thereof) performed in a foreign country (including in a possession of the U.S.) by such a citizen if, at the time of the payment of such remuneration, the employer is required by the law of any foreign country to withhold income tax upon such remuneration. Treas. Reg. § 31.3401(a)(8)(A)-1(b)(2) provides that remuneration is not exempt from withholding under this paragraph if the employer is not required by the law of a foreign country to withhold income tax upon such remuneration.

The IRS advice leaves the employer in a quandary; it requires U.S. tax withholding that in certain circumstances is prohibited by applicable foreign law. Under the foreign law at issue, wages generally are not subject to tax withholding by the employer; instead the employee must make provisional tax payments. The foreign law generally prohibits the employer from withholding any amounts from an employee's wages, except as specifically permitted, but the prohibition does not apply to discretionary bonuses. To resolve the conflict between this prohibition and U.S. tax law, the employer had proposed an approach in which the employer would provide for the employee's foreign tax obligations through a withholding-like mechanism. The IRS advice concluded that the arrangement would not be withholding required by foreign law, and thus, the prerequisite of section 3401(a)(8)(A)(ii) for exemption from U.S. withholding would not be satisfied. The IRS advice noted that the foreign law prohibition against withholding does not apply to annual discretionary bonuses to employees, and that a significant portion of the total remuneration of the employees consists of annual discretionary bonuses. Nevertheless, it appears that the employer was still left with at least some wages subject to U.S. tax withholding that was prohibited by applicable foreign law.

The IRS advice also considered whether nonresident alien employees of the company may qualify for the exceptions from wage withholding under section 3401(a)(8)(A). In this regard, the IRS concluded that such exceptions apply only to U.S. citizens and not to U.S. resident aliens working in a foreign country.

REPORTING GUIDELINES AND FORMS

1. IRS Guidance Identifies Party Subject to 50 Percent Deduction Limitation of Section 274(n) for Meals and Incidental Expenses of Leased Employees

Rev. Rul. 2008-23, 2008-18 I.R.B. XX, involves a client that leased drivers from a leasing company, where the leasing company reimbursed its driver employees for meal and incidental expenses (M&IE) the drivers incurred in the course of performing services, and the leasing company then passed the cost of wages and M&IE reimbursements back to the client. The IRS considered three fact patterns, in each of which the driver accounted for the reimbursement under a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3), and neither the leasing company nor the client deducted the M&IE amounts as compensation or treated them as wages. The IRS concluded that the deduction limits of section 274(n) did not apply to the drivers (*see* section 274(e)(3)(A)), but that the leasing company generally would bear the expense and be subject to the section 274(n) limits unless accounting information was provided to the client. Thus, if the leasing company was reimbursed under a reimbursement or other expense allowance arrangement with the client, and the client was provided an accounting of the driver's expenses, then the leasing company would satisfy section 274(e)(3)(B). Treas. Reg. § 1.274-2(f)(2)(iv)(c)(1). In that case, the client bears the expenses, and section 274(n) limits the section 162(a)(2) deduction of the client for those expenses.

In the first situation described in the ruling, the leasing company sent the client only a lump sum billing invoice for services and expenses and did not itemize the amount of any M&IE reimbursement. The leasing company did not provide the client with an accounting of the M&IE and did not have a reimbursement or other expense allowance arrangement with the client. Therefore, the IRS concluded that the leasing company did not meet the requirements of section 274(e)(3)(B), bore the expense of the M&IE, and was subject to the section 274(n) limitation.

In the second situation, the leasing company initially sent the client a lump sum bill, but immediately after paying the driver, the leasing company followed up with a statement to the client of the amount of reimbursed M&IE and an accounting with a copy of the driver's substantiation to the leasing company. In the third fact pattern in the ruling, the driver provided the accounting of his M&IE directly to the client, which in turn provided a copy to the leasing company. The IRS concluded in both of these situations that the leasing company met the requirements of section 274(e)(3)(B) where: (i) under the employee leasing contract and as indicated by their course of dealing, the leasing company could prove that it has established a reimbursement or other expense allowance arrangement with the client within the meaning of section 274(e)(3), and (ii) the leasing company accounted to the client by delivering a copy of the substantiation that the driver had provided to the leasing company (Situation 2) or by referring to the substantiation that the driver originally submitted to the client (Situation 3). In both situations, the client, not the leasing company, was subject to section 274(n).

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

In *Pettit v. Commissioner*, T.C. Memo 2008-87, the Tax Court ruled that amounts paid under an agreement in settlement of a complaint for damages for employment age discrimination 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. The taxpayer filed a lawsuit alleging physical injuries, emotional distress, and family problems arising out of the termination of his employment by the employer. The settlement agreement explicitly stated that the taxpayer "presented evidence of serious emotional distress during the trial," but it did not contain language indicating that the taxpayer presented any evidence of physical injuries or physical sickness. In addition, the agreement did not apportion any of the settlement proceeds to a physical injury or physical sickness. Accordingly, the Tax Court sustained the IRS's assessment and ruled that no part of the settlement was excludable from gross income under section 104(a). In addition, the court held that the taxpayer's understatement was not subject to penalties under section 6662(a) because the taxpayer acted with reasonable cause and good faith.

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 was 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).

3. Retired Insurance Agent's Renewal Commissions Treated as Nonqualified Deferred Compensation Subject to a Substantial Risk of Forfeiture for FICA Purposes

In CCA 200813042 (December 17, 2007), the IRS concluded that a retired insurance agent's right to renewal commissions under the insurer's compensation plan was a nonqualified deferred compensation plan and was subject to a substantial risk of forfeiture for purposes of section 3121(v)(2).

Generally, wages are subject to FICA tax when they are actually or constructively paid. Treas. Reg. § 31.3121(a)-2(a). However, section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA purposes as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amount.

The IRS concluded that the insurance agent's right to renewal commissions constituted a nonqualified deferred compensation plan for purposes of section 3121(v)(2). Under Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i), a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the term of the plan, is payable in a later year. The IRS stated that an employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right to the compensation have been performed. For this purpose, the IRS explained, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of section 83).

The IRS also concluded that because renewal of the insurance policy and payment of the renewal premium on the policy were conditions related to the compensatory purpose of the transfer of the right to the renewal commission by the insurer, and because the agent forfeited the right to any renewal commission if the customer did not renew the policy or did not pay the renewal premium, the renewal commissions were subject to a substantial risk of forfeiture as of the date the agent retired. As a result, on that date the insurer could not take the nonqualified deferred compensation into account for purposes of section 3121(v)(2).

Deferral of FICA tax on renewal commissions is not necessarily advantageous to the retiring agent. Because of the limitation on the amount of wages paid during a year by an employer to an employee that is subject to the social security tax portion of FICA, if the renewal commissions were not subject to risk of forfeiture and were taken into account at retirement, they may exceed the annual FICA wage limit and escape FICA tax in whole or in part. On the other hand, if the commissions are paid, or risk of forfeiture lapses, in a later year when the wage limit is not exceeded, the renewal commissions may be subject fully to FICA tax.

4. IRS to U.S. Senators: Settlement Payments Paid Directly to Employees in Lieu of Retiree Health Coverage Subject to FICA

Responding to inquiries by two U.S. Senators, the IRS explained why settlement amounts that constituents received from former employers in lieu of health care coverage were subject to FICA withholding. *See* INFO 2008-0001 (January 28, 2008) and INFO 2008-0006 (February 29, 2008). Under the "origin of the claim doctrine" the proper tax treatment of a court award or settlement is based on the nature of the claim that led to the award or settlement. *United States v. Burke*, 504 U.S. 229 (1992). The IRS stated that the term "wages" for FICA purposes includes all remuneration for employment, subject to certain specified exceptions. Section 3121(a). The regulations thereunder provide that, unless specifically excepted, all remuneration for employment constitutes "wages" even though at the time paid

the recipient is no longer an employee. Treas. Reg. § 31.3121(a)-1(i). Further, the IRS explained that although for this purpose the law excludes from the definition of wages payments an employer makes under a plan or system that provides sickness or accident disability benefits to employees and their dependents, amounts paid directly to employees in lieu of health coverage are not subject to this exception. *See e.g.*, Treas. Reg. § 31.3121(a)(2)-1(a). The IRS cited Rev. Rul. 75-241, 1975-1 C.B. 316, which determined that similar cash amounts in lieu of health and welfare benefits were wages for FICA purposes, because the payments were attributable to services performed by the employee for the employer. A significant factor was that the employee had complete control over the disposition of the funds, and the employer did not verify that the employees used the cash to purchase health and welfare benefits.

5. "Code Y" Reporting under Section 409A Guidance May Be Forthcoming by the End of 2008

In last month's "ask the expert" question, we quoted William Schmidt of the IRS Office of Chief Counsel, who stated on March 7, 2008, that the issues how and when the IRS will implement Code Y reporting under section 409A were "up in the air." We are pleased to report that at an American Payroll Association conference recently in Washington, Helen Morrison, acting deputy benefits tax counsel at Treasury, said that reporting guidance is now expected by the end of the year. Guidance will include "Code Y" reporting under section 409A and, necessarily, rules for calculating the amounts of deferred compensation that must be reported. For additional information on "Code Y" reporting, see "Is the IRS Expected to Implement Deferral Reporting Requirements on Employers and Payers under Section 409A for the Calendar Year 2008?," Insurance Company Information Reporting and Withholding Update, March 31 2008 (p. 5).

6. IRS Finalizes Proposed Regulations, without Substantive Changes, Relating to Comparable HSA Account Contributions

The IRS has published final regulations (T.D. 9393) providing guidance on employer "comparable contributions" to Health Savings Accounts (HSAs) under section 4980G. The regulations cover instances where an employee has not established an HSA by December 31st and in instances where an employer accelerates contributions for the calendar year for employees who have incurred qualified medical expenses. The regulations adopt proposed regulations (REG-143797-06) published June 1, 2007, without substantive changes.

An employer is not required to contribute to the HSAs of its employees. In general, however, if an employer makes contributions to any employee's HSA, the employer must make "comparable contributions" to the HSAs of all comparable participating employees. Under section 4980G, an excise tax is imposed on an employer that fails to make comparable contributions to the HSAs of its employees.

Where Employee Has Not Established HSA by December 31

The regulations provide a means for employers to comply with the comparability requirements with respect to employees who have not established an HSA by December 31, as well as with respect to employees who may have established an HSA but not notified the employer of that fact. In order to

comply with the comparability rules for a calendar year with respect to such employees, the employer must satisfy a notice requirement and a contribution requirement.

- *Notice requirement*. The employer must provide all such employees, by January 15 of the following calendar year, written notice that each eligible employee who, by the last day of February, both establishes an HSA and notifies the employer that he or she has established the HSA, will receive a comparable contribution to the HSA.

- *Contribution requirement*. For each such eligible employee who establishes an HSA and so notifies the employer by the end of February, the employer must contribute to the HSA by April 15 comparable amounts (taking into account each month that the employee was a comparable participating employee), plus reasonable interest. The notice may be delivered electronically, and sample language is provided in the regulations.

Where Employer Accelerates Contributions

The regulations also provide that, for any calendar year, an employer may accelerate part or all of its contributions for the entire year to the HSAs of employees who have incurred during the calendar year qualified medical expenses exceeding the employer's cumulative HSA contributions at that time.

- *Equal and uniform basis*. These contributions must be available on an equal and uniform basis to all eligible employees throughout the calendar year, and employers must establish reasonable uniform methods and requirements for acceleration of contributions and the determination of medical expenses.

- *Interest*. An employer is generally not required to contribute reasonable interest on either accelerated or non-accelerated HSA contributions. *But see* Q & A-6 and Q & A-12 in Treas. Reg. § 54.4980G-4 for circumstances when reasonable interest must be paid.

The regulations apply to employer contributions made for calendar years beginning on or after January 1, 2009, but may be relied upon beginning on or after the date of publication.

Other Matters

IRPAC to Hold Public Meeting Addressing Recommendations to OPR

On April 30, 2008, the Internal Revenue Service Information Reporting Program Advisory Committee plans to hold a public meeting which will address, among other items, the Office of Professional Responsibility.

Ask The Expert

Are there significant reporting/withholding provisions in the Taxpayer Assistance and Simplification Bill, as recently referred to the Senate Finance Committee?

Yes. The Taxpayer Assistance and Simplification Bill, H.R. 5719, has been passed by the House and referred to the Senate Finance Committee. This legislation, in part, proposes the following amendments:

- *Section 6694*. Under current provisions, a tax return preparer can be penalized for preparing a return on which there is an understatement of tax liability as a result of a position that a return preparer does not reasonably believe is "more likely than not" to be sustained on its merits, unless the position is disclosed on the return and there is a reasonable basis for the position. The proposed amendments change the standards for imposition of the tax return preparer penalty. The preparer standard for undisclosed positions is reduced to "substantial authority," and for disclosed positions is "reasonable basis." For tax shelters and reportable transactions to which section 6662A applies a tax return preparer is required to have a reasonable belief that such a transaction was "more likely than not" to be sustained on its merits.

- *Section 280F*. The proposed amendment removes cell phones from the definition of listed property. As a result, under the proposal, the heightened substantiation requirements that apply to listed property do not apply to cellular telephones or similar telecommunications equipment.

- *Section 223*. The proposal provides that in the case of a health savings account distribution, in order to be a qualified medical expense, the amount must be substantiated to the trustee in a manner similar to that required for health flexible spending arrangements. As under present law, distributions from a HSA would be allowed for any purpose. However, substantiated expenses would be excludable from income and unsubstantiated expenses would be includible in income and subject to the 10-percent additional tax. Under the proposal, the HSA trustee is required to report the amount distributed out of the HSA for the preceding year that was not substantiated, by January 15 of each calendar year.

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