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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

June 30, 2008

Legislation

Proposed Section 6050W Would Require Information Reporting on Payment Card and Third Party Payment Transactions - Critics Say Reporting Will Hurt Small Business

The House Ways and Means Committee, on June 20, 2008, released a committee report describing proposed section 6050W. *See* H. Rept. 110-728 to accompany H.R. 6275, the Alternative Minimum Tax Relief Act of 2008. Under the provision, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions would be required to report to the IRS the business's gross credit card transactions for each calendar year. The bank also would be required to provide a copy of the information report to the business. Similar provisions would apply to an organization that provides a network enabling buyers who have established accounts with the organization to transfer funds to sellers who have a contractual obligation to accept payment through the network.

The transactions subject to information reporting generally would be subject to backup withholding requirements. In addition, present law penalties relating to the failure to file correct information returns would apply to the new information reporting requirements required under the provision. The provision generally would be effective for information returns for reportable payment transactions for calendar years beginning after December 31, 2010.

At recent hearings held by the House Small Business Committee, the National Small Business Association argued that the proposals to require reporting of such electronic payments as a device to increase tax compliance would have a negative economic impact and be overly burdensome for small businesses. The National Small Business Association argued that the proposals would not shrink the tax gap or effectively increase compliance; instead small businesses would pass the additional cost of compliance to their customers.

Forms 1099, Backup and Foreign Payee Withholding, and Penalties

1. Payroll Group Seeks to Clarify Forms for Nonresident Alien Withholding

On June 11, 2008, the National Association of Tax Reporting and Payroll Management (NATRPM) submitted a letter to the IRS that requested clarification on some elements of Form 1042-S, which is used to report certain income and tax withholding information to nonresident alien payees and

other foreign beneficial owners. NATRPM suggested that the form's instructions be revised to clarify the following:

- That Income Code 16 continues to apply even though reliance is placed on the business profits article;
- Which income code is correct for service entities relying on the business profits article to exempt fees from withholding;
- That Income Code 09 should only be used where the capital gain payments could be considered subject to 30 percent withholding unless an express exemption applies; and
- That Income Code 36 only applies to declared capital gains from regulated investment companies and real estate investment trusts.

2. IRS Provides Guidance on Withholding Calculations for Supplemental Wages Paid to Employees

The IRS provided guidance, in Rev. Rul. 2008-29, 2008-24 I.R.B. 1149, on the amount of income tax withholding that is required under section 3402 (concerning income tax collected at source), in nine situations involving the payment of supplemental wages. The Service examined the following nine scenarios: (1) commissions paid at fixed intervals with no regular wages paid to the employee; (2) commissions paid at fixed intervals in addition to regular wages paid at different intervals; (3) draws paid in connection with commissions; (4) commissions paid to the employee only when the accumulated commission credit of the employee reaches a specific numeral threshold; (5) signing bonuses paid prior to the commencement of employment; (6) severance paid after the termination of employment; (7) lump sum payments of accumulated annual leave; (8) annual payments of vacation and sick leave; and (9) sick pay paid at different rates than the regular pay.

In each of the scenarios, the Service assumes that there is no constructive receipt or constructive payment of wages before the actual payment of wages, that no amounts are required to be included in income under section 409A before the actual payment of wages, and that all payments were made on or after January 1, 2007.

Reporting Guidelines and Forms

1. Retired Employees Not Entitled to FICA Refund on Compensation Never Paid Because the Plan Was Terminated

In CCA 200823001 (May 6, 2008), the IRS concluded that certain retired employees were not entitled to a refund of FICA taxes paid on the reasonably ascertainable value of nonqualified deferred compensation plan benefits, even though a portion of the valued benefits ultimately would never be distributed to the retired employees because the nonqualified deferred compensation plan was terminated. (Deferred compensation with a reasonably ascertainable value is subject to FICA taxation

when it vests, rather than when it is actually paid.) The IRS based its conclusion on the fact that there is no Internal Revenue Code provision allowing for a refund of properly paid FICA taxes in cases where the benefits are not ultimately paid, and that the failure to refund such amounts is consistent with Congressional intent.

In concluding that its determination was consistent with Congressional intent, the IRS cited legislative history relating to section 3121(v)(2), and contended that Congress was attempting to create parity between the FICA tax treatment of cash (subject to FICA), and nonqualified deferred arrangements. The IRS reasoned that an employee must pay FICA taxes on the full amount of cash actually received from his or her employer, even if the employee invests the cash and the value of the investments later declines as a result of poor investment choices. Similarly, because the intent of section 3121(v)(2) is to impose FICA taxation on amounts deferred under a nonqualified deferred compensation arrangement when the amounts become vested in the employee, the fact that the employee later receives less than the amount originally deferred (or ultimately receives nothing at all) does not give rise to a right to a refund of the FICA taxes paid on amounts deferred.

The IRS also considered the applicable statute of limitations period under section 6511 with respect to the employee's share of FICA taxes paid. In this regard, the IRS concluded that the applicable three-year period begins on April 15th of the year following the year in which the employee retired, and the employer filed the FICA tax return and remitted the appropriate FICA taxes to the IRS with respect to the reasonably ascertainable value of nonqualified deferred compensation plan benefits.

2. IRS Changes Reporting of Deductions for ESOP Section 404(k) Dividends

The IRS has changed the method of reporting of dividends on employer securities that are distributed from an employee stock ownership plan (ESOP) under section 404(k). According to Announcement 2008-56, 2008-26 I.R.B. XX, distributions from plans that are section 404(k) dividends made in 2009 or later, must be reported on a Form 1099-R that does not report any other distributions. Accordingly, if there are other distributions from the plan in such years that are not section 404(k) dividends, they must be reported on a separate Form 1099-R.

The new reporting instructions will likely require a special code in box 7 of the form to indicate the special tax treatment and rollover restrictions applicable to section 404(k) dividends. In addition, the IRS states that backup withholding, under section 3406, does not apply to such distributions because they are reportable under section 6047, not sections 6041 or 6042.

The IRS noted that payments of section 404(k) dividends made directly from the corporation to the plan participants or their beneficiaries are reported on Form 1099-DIV in accordance with the instructions to that form.

3. IRS Releases Extensive HSA Guidance - Notice 2008-59

The IRS has released extensive new guidance relating to Health Savings Accounts (HSAs), Notice 2008-69. The notice addresses HSA issues in the form of a 42 questions and answers, including the following general issues:

- The circumstances under which an individual is an eligible individual for purposes of section 223(c)(1);
- Application of the maximum annual HSA contribution limits in certain circumstances;
- Specific distribution issues, including distributions through debit cards that restrict payments and reimbursements to health care, and amounts treated as qualified medical expenses (including Medicare premiums);
- Transactions that are prohibited transactions, e.g., under section 4975;
- The determination of when an HSA is treated as established; and
- Proper reporting of HSA administration and maintenance fees.

Other Matters

California State Assembly Passes 7 Percent State Withholding to Piggyback on Federal Backup Withholding - Bill Moves to California Senate

On May 29, 2008, the California State Assembly passed legislation requiring a 7 percent withholding "piggyback" on current Federal income tax backup withholding amounts. The proposal (A.B. 1848) would require payors that are performing backup withholding for Federal income tax purposes to withhold an additional 7 percent for California state income tax purposes, and submit such amounts to the state of California. The bill now moves to the Senate for committee assignment and consideration.

Ask the Expert

What is the status of the 2007 Form W-2 "No-Match" Letters? Is the delay still in effect?

Yes. As we reported last month, the Social Security Administration (SSA) has delayed letters for the 2007 tax year to inform employers of unresolved name-SSN mismatches on Form W-2 submissions. The delay has been caused by legal challenges relating to a Department of Homeland Security (DHS) insert to be included in the letters. On October 10, 2007, the U.S. District Court for the Northern District of California issued a preliminary injunction in *AFL-CIO, et al., v. Chertoff, et al.,* (N.D. Cal. Case No. 07-CV-4472 CRB). The preliminary injunction enjoined and restrained the DHS and the SSA from

implementing the Final Rule entitled “Safe-Harbor Procedures for Employers Who Receive a No-Match Letter.”

On March 21, 2008, the DHS issued a supplemental proposed rule with employer guidance regarding no-match letters. The supplemental proposed rule addressed the three issues cited in the decision enjoining the August 2007 No-Match Rule. The DHS also requested public comment on the Supplemental Proposed Rule. Over 250 of such comments have been submitted, including comments from immigrant and labor groups which have requested that the government cease implementation. Reportedly, the DHS is reviewing the comments, and has not yet taken further action to finalize and implement the rule.

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