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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

March 31, 2009

Employer Issues

1. IRS Continues to Target Worker Misclassification

The Treasury Inspector General for Tax Administration recently released a report detailing its evaluation of the effectiveness of IRS actions addressing the misclassification of employees as independent contractors. In response to the report, the IRS has committed to formulating a plan to respond to employment tax issues, including worker misclassification. The IRS' most recent estimate of the tax gap is approximately $345 billion, with an estimated $1.6 billion attributable to worker misclassification. However, preliminary studies based on more recent data indicate that amounts attributable to worker misclassification are likely to be markedly higher than $1.6 billion. The report of the Treasury Inspector General for Tax Administration can be viewed online at http://www.treas.gov/tigta/auditreports/2009reports/200930035fr.html. *See also* "Has the IRS been making good on promises to step up enforcement on worker misclassification issues?," Insurance Company Information Reporting and Withholding Update, May 23, 2008 (p. 2-3); "IRS Continues to Focus on Worker Misclassification in Effort to Narrow Tax Gap," Insurance Company Information Reporting and Withholding Update, November 30, 2007 (p. 5).

2. IRS Responds to Questions regarding Forfeited Transportation Reimbursement Account Values upon Termination of Employment

In two recently released letters, the IRS responded to constituents of Senator Richard Durbin (D-IL) and Senator Barack Obama (D-IL) asking why employees who terminate employment cannot receive any of the balance remaining on their transit reimbursement accounts as taxable compensation. Generally, qualified transportation fringes are excluded from gross income under section 132(a)(5). The letters explained, however, that if the employee could choose to receive the benefit at any time in the form of cash rather than qualified transportation fringe benefits, then the employee would be treated as constructively receiving the benefits as compensation and would be taxed on the full value. However, this was not the issue raised by the letter, which asked about payment of the benefit in cash upon termination, not "at anytime." *See* INFO 2009-0008 (Dec. 15, 2008); INFO 2009-0012 (Dec. 15, 2008).

3. Final Regulations Confirm Interest-Free Adjustment under Section 6205 Should Not Be Denied Solely Because of Application of Section 6662 Accuracy-Related Penalty

In a recent article published in the Journal of Taxation, the authors remind taxpayers that where an accuracy-related penalty has been assessed, the taxpayer should ensure that an interest-free adjustment has not been denied automatically and should request that the taxpayer's specific facts be considered in determining any such penalty. *See* Stephen J. Anderson, *Denial of Interest-Free Adjustment Not Automatic When Penalty Assessed*, J. Tax'n, Feb. 2009. The reason that an interest-free adjustment should not be denied automatically is because the standards for assessment of the accuracy-related penalty and the interest-free adjustment are different. In the article, the authors cite recently published final regulations under section 6502 (T.D. 9405) and CCA 200846022 (Oct. 6, 2008). In CCA 200846022, the IRS concluded that an interest-free adjustment under section 6205 should not be denied solely because the accuracy-related penalty under section 6662(b)(1) is imposed. However, the IRS determined that the facts and circumstances warranting application of the accuracy-related penalty may indicate that the underpayment was not the result of an error or that the taxpayer knowingly underreported its liability, therefore precluding availability of an interest-free adjustment under section 6205. According to the authors, the final regulations "confirm the application of interest-free adjustments in the examination context and specify that no correction of an underpayment is eligible for interest-free adjustment treatment, if the failure to report relates to an issue that was raised in an examination of a prior return period or if the employer knowingly underreported its employment tax liability."

Section 6205 and the regulations thereunder permit an employer who has made an undercollection or underpayment of Federal Insurance Contributions Act ("FICA") tax, Railroad Retirement Tax Act ("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. (Section 6205 does not apply to the Federal Unemployment Tax Act ("FUTA") tax.) An error is "ascertained" when the employer has sufficient knowledge of the error, to be able to correct it. The determination of the CCA is based on the IRS's determination that there is no statutory or regulatory provision linking the meaning of an "error" for purposes of section 6205 with the standard for imposing the accuracy-related penalty under section 6662(b)(1).

Reporting Guidelines and Forms

1. IRS Revises Form 941, *Employer's QUARTERLY Federal Tax Return,* to Reflect Recent COBRA Changes

The IRS has published a revised Form 941, *Employer's QUARTERLY Federal Tax Return*, which reflects new COBRA continuation coverage provided by the American Recovery and Reinvestment Act of 2009, Pub. Law No. 111-5. Under the new law, employers who make COBRA premium assistance payments for eligible individuals for assistance are allowed a credit for the payments on Form 941. The instructions provide that on line 12a, employers should report the COBRA premium assistance payments made but should only report the premium assistance payments made for the eligible individuals who have paid their reduced premiums. This amount should be 65% of the total COBRA premiums for assistance to eligible individuals without regard to the reduction. Amounts paid to employers by the COBRA

eligible individuals are not included. For COBRA coverage provided under a self-funded plan, COBRA premium assistance payments are treated as having been made for each eligible individual who pays 35% of the COBRA premium. Employers should enter the total number of individuals provided COBRA premium assistance payments on line 12a, and include the COBRA credit with total deposits in line 13. The revised Form 941 is available online at http://www.irs.gov/pub/irs-pdf/f941.pdf. The IRS has also revised Form 941, Schedule B, *Report of Tax Liability for Semiweekly Schedule Depositors*, (http://www.irs.gov/pub/irs-pdf/f941sb.pdf) and Form 941-SS, *Employer's Quarterly Federal Tax Return - American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands* (http://www.irs.gov/pub/irs-pdf/f941ss.pdf).

2. Treasury and IRS Invite Comments on Guidance under Section 6050W, concerning Reporting on Payment Card and Third Party Payment Transactions

In Notice 2009-19, 2009-10 I.R.B. 660, Treasury and the IRS invited public comments on future guidance under section 6050W, relating to information reporting obligations on payment card and third-party payment transactions. Section 6050W was enacted as part of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, and signed into law on July 30, 2008. Under section 6050W, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions will be required to report to the IRS the business's gross credit card transactions for each calendar year. The bank also will be required to provide a copy of the information report to the business. Similar provisions will 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. This requirement to make information returns applies to returns for calendar years beginning after December 31, 2010.

Comments were requested on issues that should be addressed in guidance implementing the new requirements, and on a detailed list of specific issues provided in Notice 2009-19. Comments should be submitted by Wednesday, March 18, 2009.

Separately, on March 3, 2009, Steven Musher, IRS Associate Chief Counsel (International), spoke. He stated that the IRS will continue to focus on qualified intermediary and withholding issues because of concerns about U.S. taxpayers unlawfully hiding assets, and on the significance of the qualified intermediary system in investments into the United States.

3. Treasury and IRS Request Comments on Basis Reporting Guidance

In Notice 2009-17, 2009-8 I.R.B. 575, Treasury and the IRS requested comments relating to guidance in connection with new basis reporting requirements enacted as part of the *Emergency Economic Stabilization Act of 2008* (Pub. L. No. 110-343, 10/3/2008). Comments are requested regarding guidance to be provided to brokers, transferors, issuers, customers, and other affected persons concerning new requirements in sections 6045(g) and (h), section 6045A, and section 6045B. The new requirements generally take effect on January 1, 2011 (January 1, 2012, for mutual fund shares). Notice 2009-17 provides a detailed list of specific issues on which comments are requested. Any comments were to be provided by March 2, 2009.

Background

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sales transactions. Under section 6045(g), every broker that is required to file a return under section 6045(a) from the sale of a covered security must include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to that security is long-term or short-term. A "covered security" generally includes stock, debt, commodities, derivatives, mutual funds and other items as specified by the Treasury Secretary, which are acquired in the account or transferred to the account managed by the broker. In addition, section 6045(h) provides that gross proceeds and basis reporting is required when there is a lapse of, or a closing transaction with respect to, an option on a specified security or an exercise of a cash-settled option on a specified security.

Section 6045A provides that a broker and any other person specified in Treasury regulations that transfers to a broker, a covered security when held by that broker or other person must furnish to the transferee broker a written statement that allows the transferee broker to satisfy the basis and holding period reporting requirements of section 6045(g). In addition, under section 6045B, an issuer of specified securities must file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary. Section 6045B(e) provides that the Secretary may waive the return filing and information statement requirements if certain information is made publicly available. New rules for determining the basis of certain securities subject to the new reporting requirements under section 1012 were also provided.

Separately, Treasury released a letter from Steven M. Rosenthal of Ropes & Gray LLP, dated February 12, 2009, identifying projects that must be completed to develop a broker basis reporting software system that satisfied the aforementioned requirements. *See* 2009 TNT 45-12. In addition, an article written by Stevie D. Conlon was recently published in the Journal of Taxation of Financial Products that provides an examination of the basis reporting provisions in great detail. *See New Cost Basis Reporting Law Creates Challenges for Brokers*, 7 Journal of Taxation of Financial Products, Issue 4 at 21 (2009). A number of other comment letters have been released to the public, including by the Securities Transfer Association (2009 TNT 49-40), Computer Research, Inc. (2009 TNT 49-37), and the American Bankers Association (2009 TNT 44-58).

4. IRS Rules Attorney Fee Payments to Class Action Counsel Not Reportable to Class Members or Representatives under Section 6041

In PLR 200906010 (Oct. 24, 2008), the IRS concluded that attorney's fees paid by a defendant in a class action case to plaintiffs' counsel pursuant to a settlement agreement are not income to plaintiff class members or class representatives under section 61. Thus, the payments are not reportable to plaintiffs under section 6041. The IRS also ruled that the attorney fees are not remuneration to plaintiffs and therefore are not wages for purposes of federal employment taxes. Generally, a payment made to a taxpayer to satisfy the taxpayer's obligation to a third party is includable in the taxpayer's income. (See prior item.) However, the IRS concluded this rule does not apply to an opt-out class action lawsuit in which class members have no express contractual liability for paying litigating counsel a fee. For support, the IRS cited Rev. Rul. 80-364, 1980-2 C.B. 294, Situation 3, which provided that the amount of a settlement paid by a union for attorney's fees was a reimbursement for expenses incurred by the union

to enforce the collective bargaining agreement not includible in the gross income of the individual employees. *See also* PLR 200906012 (Oct. 24, 2008). It is interesting that neither ruling mentions the issue of reportability of the attorney's fees to the attorney under section 6050.

5. Ninth Circuit Rules Attorney Fees Awarded Plaintiff's Counsel under California Fair Employment and Housing Act Included in Plaintiff's Gross Income

In *Green v. Commissioner*, 103 AFTR 2d 2009-1007, (Feb. 24, 2009) the Ninth Circuit affirmed the decision of the Tax Court that statutory attorneys' fees awarded to plaintiff's counsel under the California Fair Employment and Housing Act ("FEHA") were included in plaintiff's income. The court found that plaintiff either (1) had a de facto contingency fee arrangement with the attorney to pay him forty percent of her recovery (as the tax court found), or (2) in the absence of an agreement, was deemed under California law "to have promised to pay the attorney the reasonable value of the services performed in his behalf and with his consent and knowledge." Based on the reasoning of *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), the court determined that payment to the attorney satisfied a contractual obligation and thus was income as a discharge of indebtedness. Although the fees were paid under FEHA, which treats the fees as belonging to the attorney, the court concluded that the discharge of indebtedness rationale operates independently of the underlying statute. However, the Ninth Circuit reversed the Tax Court's imposition on accuracy-related substantial understatement penalty against taxpayer under section 6662 and remanded to consider whether taxpayer's reliance on the advice of a tax professional was reasonable and in good faith.

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

In *Colquitt v. Commissioner*, T.C. Summ. Op. 2009-27, the Tax Court held that amounts paid in settlement of a suit for an employee's firing 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 court concluded that the taxpayer had tort-based claims against his employer both for negligence and wrongful termination. However, the record suggested that the settlement proceeds were intended as "additional pay and benefits" only for petitioner's wrongful termination claim. Even if some portion of the taxpayer's recovery was attributable to the negligence claim and was compensation for physical injury or sickness, the court found that the taxpayer did not demonstrate how much of the recovery should be apportioned to that claim. Thus, based on the decision in *Whitehead v. Commissioner*, T.C. Memo. 1980-508, the court was not allowed to make that allocation, and no amount was excludable under section 104(a)(2).

Similarly, in *Carranza v. Commissioner*, T.C. Summ. Op. 2009-28, the Tax Court ruled that amounts paid in settlement of a suit for wrongful termination 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 court looked to the express language of the agreement which attributed the settlement to emotional distress and mental suffering, and to the fact that the taxpayer did allege in his complaint he had been caused physical injury. Accordingly, the Tax Court ruled that no part of the settlement was excludable from gross income under section 104(a). Further, citing *Commissioner v. Banks*, 543 U.S. 426 (2005), the court ruled that the portion of the settlement paid to attorneys was income to the taxpayer under the anticipatory assignment of income doctrine. Nevertheless, the court held that the taxpayer's understatement of income was not subject to penalties under section 6662(a) because the taxpayer acted with reasonable cause and good faith.

Background

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).

These three cases and two rulings indicate some of the subtleties that are important in distinguishing settlement payments that are income and reportable to the claimant, and payments that are not.

Ask the expert

Is the Obama administration continuing to focus on information reporting issues in the midst of the financial crisis?

Yes. Recently, Treasury Secretary Timothy Geithner told the Senate Finance Committee that there is no solution to the tax gap "that doesn't rely on better reporting and better enforcement capacity of the IRS more carefully deployed." Illustrating the importance of information reporting to closing the tax gap, a report by the Government Accountability Office found that 53 percent of rental real estate owners misreported their rental income in 2001 by a net $12.4 billion. Obama's Year 2010 Budget Proposal estimates that requiring information reporting for rental payments could raise over $4 billion over 10 years.

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