

SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. JONES
SAMUEL A. MITCHELL
JANEL C. FRANK *

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

* NOT ADMITTED TO D.C. BAR

INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

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Legislation

IRS Commissioner Asks Congress to Repeal Tax on Employer-Provided Cell Phones

In a statement published on the IRS website on June 16, 2009, IRS Commissioner Douglas Shulman asked that “Congress act to make clear that there will be no tax consequence to employers or employees for personal use of work-related devices such as cell phones provided by employers.” The statement comes on the wake of publication of Notice 2009-46, 2009-23 I.R.B. 1068, which requested comments on ways to simplify compliance with rules related to employer-provided cellular telephones. Commissioner Shulman states that the “current law, which has been on the books for many years, is burdensome, poorly understood by taxpayers, and difficult for the IRS to administer consistently.” Commissioner Shulman’s statement can be found online at <http://www.irs.gov/newsroom/article/0,,id=209795,00.html>.

Background

Section 132 provides that an employee may exclude from gross income as a working condition fringe benefit, the business use of an employer-provided cell phone. However, any personal use of an employer-provided cell phone is a taxable fringe benefit. Currently, strict substantiation requirements under section 274(d)(4) must be satisfied for business cell phone usage to qualify exclusion under the section 132 because cell phones are listed property under section 280F.

In Notice 2009-46, Treasury and the IRS proposed several approaches for modifying and simplifying the substantiation requirements applicable to employee usage of employer-provided cell phones, and requested public comments on such proposals and suggestions for other approaches. The IRS proposed four optional approaches. The first two approaches, alternative *Minimal Personal Use Methods*, allow an employer to deem all an employee’s usage as business usage, either (i) to the extent that an employee can establish that he or she has a personal cell phone for personal use, or (ii) by disregarding some minimum amount in determining the amount of personal use of an employer-provided cell phone.

In the third approach, the *Safe Harbor Substantiation Method*, the employer would treat a specified safe harbor percentage of the use as business usage and the remaining percent as personal. In the last approach, the *Statistical Sampling Method*, the employer would use statistical sampling to measure an employee's personal use.

There has been at least one legislative proposal aimed at excluding cellular telephones or similar telecommunications equipment from the heightened substantiation requirements that apply to listed property. *See, e.g.*, the Taxpayer Assistance and Simplification Bill (2008), H.R. 5719, with no major Congressional action since April of 2008. About that same time, in an April 2008 letter to Rep. Dennis Moore, the IRS stated that it was considering regulatory changes that will ease record-keeping requirements in connection with the exclusion of business cell phone usage from an employee's gross income under section 132. *See* INFO 2008-0012 (Apr. 24, 2008).

Employer Issues

1. IRS Publishes Revised Form 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*, to Accommodate COBRA Payroll Tax Credit

The IRS has issued revised Form 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*, to include new lines for claiming a payroll tax credit for the COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) continuation premium subsidy. Form 941-X, revised June 2009, is available online at <http://www.irs.gov/pub/irs-pdf/f941x.pdf>. Instructions for Form 941-X, revised June 2009, are available online at <http://www.irs.gov/pub/irs-pdf/i941x.pdf>.

Background

The American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5) provides a subsidy of 65 percent of the health insurance premiums for certain terminated employees and their family members who are eligible under COBRA for continued health coverage, or for similar coverage under state law. Under the new law, if an eligible employee pays 35 percent of the premium, the group health plan must treat the employee as having paid the full premium required. The employer may recover the 65 percent of the premium provided to assistance-eligible individuals by taking that amount as a credit on its quarterly employment taxes on Form 941. However, the employer may take the credit on Form 941 only after it has received the 35 percent premium payment from the individual. The revised Form 941-X can be used to correct errors on a previously filed Form 941.

2. IRS Suggests Consideration of Certain Factors in Worker Classification Analysis

In an informal e-mail advice, the Office of Chief Counsel stated that three categories of factors – behavioral control, financial control, and relationship of the parties – as discussed in IRS training materials, should be considered in the common law analysis of worker classification. *See* CCA 200922042 (Apr. 14, 2009).

3. IRS Revises Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, to Accommodate Newly-Expanded WOTC

The IRS has revised Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to accommodate the recently expanded Work Opportunity Tax Credit (WOTC). Generally, the WOTC offers tax savings to businesses that hire workers belonging to certain targeted groups. The American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5) expanded these targeted groups to include unemployed veterans returning to civilian life and “disconnected youth.” For unemployed veterans and disconnected youth who begin work anytime during 2009 or 2010, certification by the state workforce agency is required. (The certification requirement applies to all eligible groups of workers except employees who were Hurricane Katrina victims.) Normally, a business must file Form 8850 with the state workforce agency within 28 days after the eligible worker begins work. However, businesses have until Aug. 17, 2009 to file Form 8850 for unemployed veterans and disconnected youth who begin work on or after Jan. 1, 2009 and before July 17, 2009. See IR-2009-55 (May 28, 2009). For additional information, see Notice 2009-28, 2009-24 I.R.B. 1082, and *Instructions for Form 8850* (revised May 2009) which can be found online at <http://www.irs.gov/pub/irs-pdf/i8850.pdf>. Revised Form 8850 can be found online at <http://www.irs.gov/pub/irs-pdf/f8850.pdf>.

4. Chief Counsel Advises that Reimbursed Payments Made to Disabled Employee Are Not Deductible

In CCA 200923025 (Jan. 16, 2009), the Office of Chief Counsel advised that salary continuation payments made by an employer to a disabled employee were not deductible under section 162 when the employer received disability insurance payments as a result of the employee’s disability. According to the CCA, the payments were not deductible as ordinary or necessary business expenses under section 162 because the employer was “reimbursed” for the payments it made to the employee. This “right of reimbursement” would prevent a deduction under section 162, even if the right to receive the reimbursement was uncertain or contingent.

Further, the CCA advised that a deduction for the continuation payments was prohibited by section 265. Section 265(a)(1) disallows a deduction when the deduction is “allocable” to tax exempt income. According to the CCA, the disability insurance payments received by the employer were exempt from income tax under section 104(a)(3). Based upon the rule established in *Manocchio v. Commissioner*, 78 T.C. 989, 995 (1982) and other cases, an expense is allocable to tax exempt income, and therefore not deductible under section 265, when the expense has a nexus with tax exempt income. CCA 200923025 advised that salary continuation payments made to an employee during a period of disability had a nexus, and were therefore allocable, to exempt disability insurance payments received by the employer as a result of that disability.

5. IRS Publishes Guidance Regarding Treatment, Recordkeeping and Return Requirements for Employer-Owned Life Insurance Contracts

In Notice 2009-48, 2009-24 I.R.B. 1085 (May 22, 2009), the IRS published questions and answers concerning the treatment and reporting requirements for employer-owned life insurance contracts under sections 101(j) and 60391 of the Code. Notice 2009-48 provides guidance regarding: (i) the types of contracts that qualify as “employer-owned life insurance” under section 101(j)(3); (ii) when an exception to 101(j) applies; (iii) satisfaction of the notice and consent requirements under section 101(j)(4); (iv) when a contract issued as part of a like kind exchange under section 1035 is governed by section 101(j); and (v) the reporting requirements under section 60391 and Form 8925.

Background

Section 101(j)(1) limits the amount of insurance proceeds that may be excluded from gross income under an employer-owned life insurance policy to the amount of premiums or expenses paid by the employer for the policy. The application of section 101(j) depends upon whether the policy satisfies the definition of an “employer-owned life insurance policy.” In general, an “employer-owned life insurance policy” is a policy that is owned by a person engaged in a trade or business. However, certain exceptions apply. Insurance proceeds continue to be excluded from gross income under section 101(a) if the proceeds were received as a result of the death of an insured who was an employee at any time during the 12 month period before the insured’s death, or who was a director, a highly compensated employee, or a highly compensated individual, as defined by statute, at the time the contract is issued. In addition, any insurance proceeds used to purchase an interest in the policyholder from the deceased employee’s estate or beneficiary of the estate continue to be excluded from gross income under section 101(a). Notice and consent requirements provided in section 101(j)(4) must be satisfied before an exception will apply.

Section 101(j) ordinarily applies to life insurance contracts issued after August 17, 2006. However, contracts issued after August 17, 2006 that are exchanged, under section 1035, for a contract issued before that date are not subject to section 101(j) unless there is a material change. A material change may include an increase in the death benefit, or other change that is significant enough to result in the contract being considered a “new contract” under section 863(d).

Policyholders owning one or more employer-owned life insurance contracts issued after August 17, 2006, must report, on Form 8925: (i) the number of employees at the end of the year; (ii) the number of employees insured under employer-owned life insurance contracts; (iii) the total amount of insurance in force at the end of the year under the contracts; (iv) the policyholder’s name, address, identifying number and type of business; and (v) whether the policyholder has obtained a valid consent for each insured employee.

Reporting Guidelines and Forms

1. IRS Designates Foreign Withholding as Tier One Issue

The IRS has designated “Foreign Withholding” as a “Tier I” issue. The IRS defines Tier I issues as those of “high strategic importance.” (See <http://www.irs.gov/businesses/corporations/article/0,,id=205415,00.html>). The IRS describes the issue as including payments that are generally subject to reporting on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and Form 1042-S, *Foreign Person’s U.S. Source Income Subject to Withholding*. As reported earlier this year, IRS Commissioner Douglas Shulman has stated that withholding taxes generally had been added to the list of Tier I issues. (See “IRS Commissioner Says Withholding Is Now a Tier One Issue,” Insurance Company Information Reporting and Withholding Update, February 27, 2009.) At that time, Shulman also noted that “withholding taxes is one of the key corporate tax areas on which IRS is focusing its international efforts.”

2. IRPAC Requests B-Notice Guidance

In a May 15, 2009 letter, John Lakritz, member of the Information Reporting Program Advisory Committee (IRPAC), requested that the IRS include in its 2009-2010 Guidance Priority List updated guidance on B-Notices. (2009 TNT 99-27.) Generally, the letter explains that a “B-Notice” is a notification from the IRS to a payor that the name/TIN combination submitted on an information return does not match the records of the Social Security Administration (SSA) or the IRS. When a payor receives two B-Notices within a three year period with respect to the same payee, the payor is required to: (i) send the 2nd B-Notice to the payee within 15 business days after receiving notification from IRS; (ii) inform the payee to have his or her social security number validated on Form SSA-7028; and (iii) begin backup withholding within 30 business days after the date of the 2nd B-Notice if the payer does not receive Form SSA-7028 from the SSA. The payor may not discontinue backup withholding without receipt of SSA-7028.

Currently, the SSA is evaluating creation of a usable version of Form SSA-7028 or a viable substitute, and Form SSA-7028 has been discontinued. In the interim, IRPAC has recommended the following:

- The SSA should restore issuance of Form SSA-7028 as soon as possible and should continue to issue Form SSA-7028 until a viable alternative is developed.
- The IRS should identify other official SSA documents that could be used in lieu of the SSA-7028 and permit payors to stop backup withholding upon receipt of one of these alternatives.
- The SSA should train their staff on the IRS B-Notice requirements so that taxpayers are appropriately assisted by the agency to resolve their backup withholding problems. In the past, payees have encountered SSA branch personnel who were unaware of the use of Form SSA-7028 and thus refused to assist taxpayers in resolving their withholding concerns.

3. IRS Makes Last-Minute Changes Affecting Filers of Form TD F 90.22-1, *Report of Foreign Bank and Financial Accounts*, due June 30, 2009

In Announcement 2009-51, 2009-25 I.R.B. XX, the IRS temporarily suspended changes in the definition of “United States person” required to report certain foreign accounts on Form TD F 90.22-1, *Report of Foreign Bank and Financial Accounts* (“FBAR Form”). The changes in the definition of United States person had been included in the instructions for the new version of the FBAR Form released October 2008, and particularly affected those persons who are not citizens, residents, or domestic entities, but who do business in the United States. Announcement 2009-51 provides that, only for FBAR Forms due on June 30, 2009, taxpayers and others can rely on the definition of United States person included in the prior instruction (the July 2000 version): “The term ‘United States person’ means (1) a citizen or resident of the United States, (2) a domestic partnership, (3) a domestic corporation, or (4) a domestic estate or trust.”

As recently as June 24, 2009, the IRS posted on its website a revised version of frequently asked questions and answers concerning voluntary disclosure of offshore accounts. *See* <http://www.irs.gov/newsroom/article/0,,id=210027,00.html>. Revised Q&A 26 reflects the impact of Announcement 2009-51 on who is required to file the FBAR Form. The revision also includes new Q&As 31 through 51 covering additional areas. In particular, Q&A 43 provides a very limited exception to late filing penalties (i.e., an extension of sorts). Answer 43 provides that if the taxpayer reported and paid tax on all its 2008 taxable income but only recently learned of its FBAR filing obligation and has insufficient time to gather the necessary information to complete the FBAR by the June 30, 2009 due date, the taxpayer should file the delinquent FBAR report according to the instructions and attach a statement explaining why the report is filed late. The taxpayer should send a copy of the delinquent FBAR, together with a copy of the 2008 tax return, by September 23, 2009, to the Philadelphia Offshore Identification Unit at the address in Q&A 9.

Otherwise, all other requirements of the current version of the FBAR form and instructions (revised in October 2008) are still in effect. Thus, the current version of the form must be used when filing an FBAR. *See also* IR-2009-58 (June 5, 2009). The IRS will be following up with additional guidance on the requirement to file for future years. The IRS took these actions to reduce burden after concerns and questions were raised regarding the new instructions issued last year in Form TD F 90.22-1 (revised October 2008) on who must file. The Service also invited comments regarding the revised FBAR Form and instructions (revision October 2008). Comments must be submitted by August 31, 2009.

4. Eighth Circuit Affirms Tax Court That Crop Insurance Proceeds Could Not Be Deferred Under Section 451(d)

In *Nelson v. Commissioner*, 103 A.F.T.R. 2d 2009-1029 (June 10, 2009), the Court of Appeals for the Eighth Circuit, affirming the Tax Court, ruled that the taxpayers did not qualify for the exception under section 451(d) to defer the income from crop insurance payments until the following year. The taxpayers did not show that they customarily deferred all or a substantial portion of their crop income to the tax year following production, as required to qualify for the exception. The Eighth Circuit found that the legislative history did not support the taxpayers' contention that the exception applies if "any" income is deferred. Further, the court explained that Rev. Rul. 74-145, 1974-1 C.B. 113, established what is known as the "substantial portion" test, and clearly provided that the deferment is only available to farmers who customarily defer more than 50 percent of their crop income. In this case, the taxpayers customarily deferred only 35 percent to the following year, and reported 65 percent of the income in the year of the harvest. Thus, the taxpayers failed to defer all of their income, and failed to satisfy the substantial portion test under section 451(d) to defer crop insurance proceeds.

Background

Generally, under Treas. Reg. § 1.61-4(c), crop insurance proceeds and disaster payments received by a cash method farmer as the result of crop damage must be included in income on Schedule F in the year received. However, the farmer is allowed to deduct the cost of the insurance premiums as a business expense. In certain circumstances, a cash method farmer may elect to defer the income under section 451(d), which states:

In the case of insurance proceeds received as a result of destruction or damage to crops, a taxpayer reporting on the cash receipts and disbursements method of accounting may elect to include such proceeds in income for the taxable year following the taxable year of destruction or damage, if he establishes that, under his practice, income from such crops would have been reported in a following taxable year An election under this subsection for any taxable year shall be made at such time and in such manner as the Secretary prescribes.

To qualify for the exception, a farmer must be able to show that, under his or her normal business practice, the income from the crop for which the payment is received would have been reported in a year following the receipt of payment; that is, the crop destroyed or damaged would have been sold in the year following the receipt of the payment. Treas. Reg. § 1.451-6(a)(1).

The statute does not expressly provide that "all" or some particular percentage of a farmer's crop income must be deferred to a following year to qualify for a one-year deferral of insurance proceeds. However, the court found that the legislative purpose for the deferral of crop insurance proceeds under section 451(d) was to allow farmers, in and for the year they incur crop damage and receive insurance proceeds, to avoid having to pay federal income tax on two years' worth of income relating to their crops (i.e., the insurance proceeds plus the normal deferral from the previous year).

In Rev. Rul. 74-145, the IRS concluded that the deferral of recognition of crop insurance proceeds under section 451(d) was available to a farmer who, under his normal method of accounting for crop income, deferred to the following year not all but more than 50 percent of his crop income, a percentage which IRS referred to as a “substantial portion” of the farmer’s annual crop income.

Information Reporting

In Rev. Rul. 78-110, 1978-1 C.B. 390, the IRS held that an insurance company paying crop insurance proceeds of \$600 or more per year to a farmer generally must file an information return under section 6041. The ruling specifically considered whether the potential availability to the farmer of the election under section 451(d) to defer the income for one year affected the status of the insurance proceeds as “fixed or determinable income” subject to reporting. The ruling concluded that the insurance proceeds were fixed and determinable income when paid, and therefore reportable in that year, regardless of whether the recipient could defer the income to a later year. *See* Rev. Rul. 82-93, 1982-1 C.B. 196, amplifying Rev. Rul. 78-110, holding that the Federal Crop Insurance Corporation was required to report payments of crop insurance proceeds under similar circumstances. *See also* Rev. Rul. 80-22, 1980-1 C.B. 286, clarifying Rev. Rul. 78-110, holding that reporting was not required if the farmer was required to capitalize expenses pursuant to section 278 or 477 and had informed the payor that the expenses had been capitalized. (Section 278 requires the capitalization of certain expenses attributable to planting and maintaining fruit or nut groves, orchards or vineyards. Section 447 requires capitalization of certain expenses of a corporation, or partnership that includes a corporation, engaged in the business of farming.) Rev. Rul. 80-22 reasoned that because such capitalized expenses created a basis for the farmer in the crops, only crop insurance proceeds in excess of that basis would be “gains, profits, or income.” The ruling concluded that because the payor cannot require the farmer to disclose that basis, the amount of gains, profits, or income, if any, is not fixed or determinable by the payor.

5. Tax Court Allows Section 104(a)(2) Exclusion for Class Action Settlement Paid by Auto Insurer

In *Watts v. Commissioner*, T.C. Memo. 2009-103 (May 18, 2009), the Tax Court held that settlement proceeds received by an insured following litigation with her auto insurance provider were excludable from gross income under section 104(a)(2). Taxpayer was injured as a result of a motor vehicle accident with an uninsured motorist. As part of a class action lawsuit against the auto insurance provider, taxpayer litigated the validity of certain anti-stacking provisions in the insurance policy. The Service argued that the settlement proceeds received as a result of that lawsuit were not excludable from gross income under section 104 because the proceeds resulted from litigation related to breach of contract and not on account of personal physical injuries. In finding for the taxpayer, the Tax Court considered: i.) whether the policy was “accident or health insurance;” ii.) whether the payment was an amount received “through” accident or health insurance; and iii.) whether the payment was received “for” personal injuries or sickness. Relying in part on *Marsh v. Commissioner*, T.C. Memo. 2000-11 (Jan. 11, 2000), the Court found that the insurance policy was an accident or health insurance policy for purposes of section 104(a)(3). The court also found that the payment was received “through” an accident or health

insurance based on the regulations, which clarify that an amount is excludable if an individual purchased the policy and the amounts were received “thereunder.” Treas. Reg. § 1.104-1(d). Finally, the court held that the payment was received “for” personal injuries or sickness because the insured had “uncompensated personal injuries for which she had made a bona fide claim against her insurer for indemnification.” According to the Court, taxpayer’s litigation against the insurer to enforce the policy did not change the fact that the underlying settlement was received for personal injuries suffered by the taxpayer. The Court found that the settlement proceeds were excludable from gross income under section 104(a) to the extent that the proceeds did not exceed the limits of the policy.

6. Tax Court Denies Section 104(a)(2) Exclusion for Sexual Harassment Lawsuit

In *Shelton v. Commissioner*, T.C. Memo 2009-116 (May 26, 2009), the Tax Court found that settlement proceeds received by a taxpayer as a result of a sexual harassment lawsuit were not excluded from gross income under section 104(a)(2). Section 104(a)(2) excludes from gross income damages received by a taxpayer on account of physical injuries or physical sickness that are received pursuant to a tort or tort-type claim. The Court found that the settlement did not qualify for exclusion under section 104(a)(2) because the payment was for emotional pain and suffering as provided in the settlement agreement, not received “on account of physical injury or sickness.” The Court however, found that the taxpayer was not liable for accuracy-related penalties under section 6662(a) because the taxpayer demonstrated reasonable cause and acted in good faith, in part, because the taxpayer attempted to clarify the tax treatment of the settlement proceeds with the IRS before filing the tax return.

7. IRS Holds Differential Wage Payments to Active Duty Military Are Subject to Income Tax Withholding But Not FICA or FUTA Taxes

In Rev. Rul. 2009-11, 2009-18 I.R.B. 896 (Apr. 16, 2009), the IRS concluded that differential wage payments made by an employer to an employee who leaves the job for active military duty for more than 30 days is subject to income tax withholding, but is exempt from Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes. Previously, in Rev. Rul. 69-136, 1969-1 C.B. 252, the IRS found that differential wage payments to active duty military were exempt from income tax withholding, as well as FICA and FUTA. However, the Heroes Earnings Assistance and Relief Tax Act of 2008 (Pub. L. No. 110-245) added new section 3401(h) to the Code. Section 3401(h), which applies to differential wage payments made after December 31, 2008, provides that such payments are to be treated as “wages” for the purpose of income tax withholding. Because 3401(h) does not address whether differential wage payments are subject to FICA and FUTA, the IRS concluded that these payments remain exempt from FICA and FUTA under Rev. Rul. 69-136. Employers may use either the aggregate procedure or the flat rate withholding method to satisfy its federal income tax withholding requirements. Treas. Reg. § 31.3402(g)-1(a)(6). Employers are also required to furnish a Form W-2 showing the amount of wages paid, including differential wage payments, and amounts withheld for income tax purposes. Treas. Reg. § 31.6051-1(a).

Ask the expert

What is the Status of the 2007 Form W-2 “No-Match” Letters? Is the Delay Still in Effect?

Yes, for *employer* letters. As we reported last year, 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. (See Social Security Administration Fact Sheet, *Release of Tax Year 2007 DECOR Letters*. The Fact Sheet can be viewed online at <http://www.ssa.gov/legislation/Release%20of%20TY07%20DECOR%20040308%20FINAL.pdf>.) That delay is still in effect.

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 v. Chertoff*, (N.D. Cal. Case No. 07-cv-4472 CRB). The preliminary injunction enjoined and restrained DHS and SSA from implementing the Final Rule entitled “Safe-Harbor Procedures for Employers Who Receive a No-Match Letter.” However, the SSA began releasing the Tax Year 2007 *employee* “No-Match” letters on April 3, 2008. Employee no-match letters are not subject to the Department of Homeland Security’s rule entitled “Safe-Harbor Procedures for Employers Who Receive a No-Match Letter” or the *AFL-CIO v. Chertoff* case.

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