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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

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Legislation

H.R. 3408 Would Narrow Section 530 Safe Harbor regarding Worker Classification

H.R. 3408 (styled “Taxpayer Responsibility, Accountability, and Consistency Act of 2009”), introduced on July 30, 2009 by Representatives McDermott (D-WA), Tierney (D-MA) and Neal (D-MA), would codify and narrow the Section 530 safe harbor regarding worker classification. Section 530 of the Revenue Act of 1978 (never included as part of the Internal Revenue Code), provides relief from potential employment taxes for employers who have consistently treated workers as independent contractors and fully reported the compensation as income on Forms 1099, even where the workers would otherwise be classified as employees under the common law. H.R. 3408 would narrow the scope of the Section 530 safe harbor, would raise the employer’s burden to a “preponderance of the evidence,” and would provide a means for workers to petition for a determination of the individual’s status for employment tax purposes. H.R. 3408 would also amend section 6721(a)(1) to increase penalties for failure to file correct information returns and section 6722(a) to increase penalties for failure to furnish correct payee statements. H.R. 3408 is in the process of being scored, therefore revenue estimates are not yet available.

North Carolina Enactment Requires Withholding for Payments to Contractors

Under recently enacted legislation in North Carolina, individuals and businesses will be required to withhold from compensation paid to contractors in excess of \$1,500 per year. S.B. 1006. The legislation, effective January 1, 2010, requires withholding equal to 4% of the compensation paid and is applicable only to contractors who have individual tax identification numbers. The legislation also requires payers to provide information returns to payees listing the total amount of compensation and withholding no later than January 31 following the end of the calendar year.

Employer Issues

1. IRS Provides Guidance on Worker Classification

IRS recently released “Summertime Tax Tip 2009-20,” available on its website at <http://www.irs.gov/newsroom/article/0,,id=173423,00.html>. The article provides ten (10) tax tips to assist businesses in properly classifying workers for employment tax purposes. In the article, the IRS groups the 20 worker classification factors from Rev. Rul. 87-41, 1987-1 C.B. 296, into three primary groups: (i) behavioral control (the right to direct or control how the work is done); (ii) financial control (the ability to control the financial and business aspects of the worker’s job); and (iii) type of relationship (as perceived by the workers and the business owner). The article also encourages workers to know their proper status and discusses the Form SS-8 Determination Process, which enables both employers and workers to ask the IRS to make a determination regarding proper worker classification.

2. IRS Advice on Severance Pay

In CCA 200935034 (Aug. 28, 2009), the IRS clarified that payments made by an employer to an employee on account of dismissal or involuntary separation from employment is considered severance pay, regardless of the employer’s contractual obligation to make the payments. The IRS concluded that such severance pay is included in the payee’s gross income and is considered wages subject to FICA and income tax withholding requirements.

3. IRS Includes Employment Taxes in National Research Program

The IRS recently expanded its National Research Program to include employment taxes and their contribution to the tax gap, according to a recent article. See Gardner, “Employment Tax Research Program Expected to Spur Autumn Audits by IRS,” *Daily Tax Report* G-1 (BNA Sept. 3, 2009). The IRS National Research Program (Program) is designed to measure payment, filing and reporting compliance and to collect data to support the development of IRS strategic plans. The employment tax element of the Program is expected to analyze trends in worker classification, fringe benefits, non-filers, and officer compensation. The IRS is expected soon to initiate random audits of businesses under the program. Practitioners quoted in the article acknowledged that it would be difficult to prepare for an employment tax audit, but recommended that businesses, at minimum, have in place accountable plans for business reimbursement and sufficient documentation regarding worker classification. A related article noted that employment tax audits are expected to include 6,000 U.S. companies over a three year period starting in February, 2010. See Gardner, “NRP Employment Tax Audit Program to Examine 6,000 U.S. Companies,” *Daily Tax Report* G-1 (BNA Sept. 23, 2009).

4. Letters Seek IRS Moratorium on Audits of Employee Cell Phone Use, Pending Action on Legislation

Several groups recently have submitted letters asking the IRS to suspend audits related to employer-provided cell phones until legislation addressing the matter makes its way through Congress. See 2009 TNT 174-14 (Letter from CTIA-The Wireless Association); 2009 TNT 174-15 (Letter from USTelecom); and 2009 TNT 163-27 (Memorandum from Tax Executives Institute). As reported in the June 30, 2009 issue of the newsletter, IRS Commissioner Douglas Shulman asked, in a statement

published on the IRS website on June 16, 2009, 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 MOBILE Cell Phone Act of 2009 (H.R. 690, S. 144), currently pending in the House and Senate, would remove cell phones from listed property under section 280F effective retroactively to January 1, 2009.

Reporting Guidelines and Forms

1. IRS Issues Proposed Regulations Clarifying Section 104(a)(2) Exclusion

On September 14, 2009, the IRS issued proposed regulations (REG-127270-06) that clarify when amounts received on account of physical injury or physical sickness are excluded from gross income under section 104(a)(2). The regulations incorporate amendments to section 104(a)(2) that were enacted as part of the Small Business Job Protection Act of 1996 (“the Job Act”), Pub. L. No. 104-188. Although the Job Act excluded only those amounts that are received on account of “physical” injury or “physical” sickness, emotional distress damages may also be excluded if the emotional distress is *attributable* to physical injury or physical sickness. In addition, emotional distress damages may be excluded generally in an amount not to exceed the cost of medical care incurred to treat the emotional distress. Finally, under the proposed regulations, the IRS clarifies that damages do not need to be based upon a tort or tort type action to be excluded under section 104(a)(2), so long as the damages were received on account of physical injury or physical sickness. The regulations are proposed to apply to damages paid pursuant to a court decree or other binding agreement entered into or issued after September 13, 1995 for damages received after final regulations are published in the Federal Register. However, taxpayers may apply for a refund within the limitations period specified in section 6511 for damages received after August 20, 1996, if application of the proposed regulations results in an overpayment of tax.

In a related development, in a chief counsel advisory issued before the proposed regulations were published, the IRS advised that payments received in settlement of a claim are exempt from gross income under section 104(a)(2) only if the claim was based on a tort or tort-type right. See CCA 200935032 (Jul. 8, 2009).

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

In *Save v. Commissioner*, T.C. Memo. 2009-209, the Tax Court held that proceeds received by the taxpayer in settlement of whistle blower claims alleging retaliation, intentional and negligent infliction of emotional distress, and defamation were not excludable from gross income under section 104(a). In its decision, filed the same day that proposed regulations (REG-127270-06) were published in the Federal Register, the court discussed the fact that the settlement agreement failed to allocate damages between tort claims and non-tort claims. However, the court’s decision appears to be based primarily on the failure to prove that any of the damages resulted from personal physical injury or physical sickness, which is required for exclusion under section 104(a)(2).

3. IRS Publishes Final Regulations for Reporting Cancellation of Indebtedness

On September 16, 2009, the IRS published final regulations (T.D. 9461) describing the reporting requirements for cancellation of indebtedness under section 6050P. The final regulations adopt the proposed regulations published in November, 2008 (REG-118327-08) without change, and eliminate the corresponding temporary regulations (T.D. 9430). Under section 6050P, “applicable financial entities” that discharge an indebtedness of more than \$600.00 in any year must file an information return on Form 1099-C. The regulations list certain “identifiable events” that are considered to be a discharge of indebtedness. The regulations also create a rebuttable presumption that nonpayment on indebtedness for a period in excess of 36 months is an identifiable event. Under the final regulations, the rebuttable presumption only applies to financial institutions, credit unions and government agencies, but does not apply to other applicable financial entities such as any other “organization a significant trade or business of which is the lending of money,” as described in section 6050P(c)(2)(D).

4. IRS Publishes Revised Instructions for Form 1042-S

In Rev. Proc. 2009-35, 2009-35 I.R.B. 265, published August 31, 2009, the IRS updated instructions for e-filing Form 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding. Withholding agents are required to prepare the information returns for amounts paid to foreign persons (including persons presumed to be foreign) that are subject to withholding, even if the amounts are exempt from withholding. Amounts paid to bona fide residents of U.S. possessions and territories are not subject to reporting on Form 1042-S if the beneficial owner of the income is a U.S. citizen, national, or resident alien. Rev. Proc. 2009-35 supersedes Rev. Proc. 2008-44, 2008-30 I.R.B. 187 and must be used to prepare information returns for 2009 and prior years, filed with the IRS Filing Information Returns Electronically (FIRE) system beginning January 1, 2010. Withholding agents who file 250 or more of the information returns are required to file the returns electronically.

5. Increased IRS Focus on Form 5471

Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, must be filed by U.S. persons to report certain acquisitions and dispositions of foreign corporate stock under section 6046, and to provide information in connection with foreign corporations under section 6038. Form 5471 is due at the same time as the filing of the taxpayer’s U.S. income tax return, with extensions. According to a recent article, as of January 1, 2009, the IRS may automatically assert penalties when the Form 5471 is filed late. See Schlaman and DerOhanesian, “IRS Increases Focus on Form 5471 Reporting Requirements,” *Daily Tax Report* J-1 (BNA Sept. 15, 2009). Penalties may be assessed under either section 6038, section 6679 or both. Section 6038 and section 6679 each impose a \$10,000 monetary penalty for failure to provide required information or to file Form 5471. Additional penalties equal to \$10,000 for each 30 day period of noncompliance (not to exceed a total of \$50,000) may be imposed if the taxpayer fails to comply for more than 90 days following notice from the IRS. The IRS may also impose additional penalties under section 6038 in the form of a reduction in foreign tax credits otherwise available to the taxpayer. Penalties assessed under sections 6038 and 6679 may be mitigated if the taxpayer can show reasonable cause for failure to comply. Generally, reasonable cause exists if the taxpayer can demonstrate an inability to comply, even though the taxpayer exercised ordinary business care and prudence. Penalties may also be mitigated if the taxpayer can demonstrate that it substantially complied with reporting requirements.

6. IRS Fields More FBAR Exemption Requests

Certain filers who are not exempt from filing Form TD F 90.22-1, Report of Foreign Bank and Financial Accounts (“FBAR”), were required to complete FBAR filing for the calendar year 2008 by the extended due date of September 23, 2009. As reported in the August 2009 issue of this newsletter, the IRS further extended the deadline until June 30, 2010, for some filers, including those persons with signature authority but no financial interest in the foreign account, and those having signature authority and/or a financial interest in assets that are held in a commingled fund. The IRS continues to receive comments and recommendations regarding the FBAR filing requirements, including –

- A State Investment Board’s recommendation that public pension funds be excluded from FBAR filing requirements on the basis that such reporting serves no useful purpose when governmental entities are exempt from tax (2009 TNT 167-15);
- An attorney’s request that pension plans owning private equity partnerships be excluded from FBAR reporting because the pension plans, as limited partners in these investments, have no discretionary control over money or property of the partnerships (2009 TNT 167-14);
- The recommendation of an attorney, on behalf of an advocacy group, that investments in private equity funds be excluded from FBAR reporting when the funds do not provide a right of redemption during the first two years or more (2009 TNT 167-13);
- The request of the American Chamber of Commerce in Canada that the IRS provide a bright line test for determining whether a person is “doing business” in the U.S. for purposes of FBAR filing requirements (2009 TNT 173-18);
- The recommendation of an attorney representing non-profit corporations that section 501(c)(3) nonprofit corporations be removed from the FBAR filing requirements (2009 TNT 174-16);
- A certified public accountant’s request that the IRS coordinate the FBAR filing due dates with the filing due dates for individual income tax returns with extensions (2009 TNT 164-19); and
- The request of a certified public accountant that the IRS exempt all employees who have signatory authority but no financial interest in a foreign account from FBAR filing (2009 TNT 164-18).

7. Comments on Administration’s Budget Proposal regarding Information Reporting for Private Separate Accounts

The Obama Administration’s 2010 budget proposal is detailed in the May 2009 General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals (“the Green Book”). The budget includes a proposal to impose information reporting requirements on life insurance companies when the cash value of a life insurance contract has been partially or wholly invested in a private separate account. The Green Book defines a private separate account as “any account with respect to which a related group of persons owned policies whose cash values, in the aggregate, represented at least

10 percent of the value of the separate account.” Recently, the Committee of Annuity Insurers submitted comments and recommendations to the Department of Treasury regarding the proposal. 2009 TNT 168-8. In general, the Committee recommends that, if implemented, the new reporting requirement –

- Clarify that the existence of private separate accounts is only one factor to consider when analyzing the investor control doctrine;
- Exclude arrangements that are registered under federal securities laws from additional information reporting;
- Increase the 10 percent threshold in the definition of “private separate account;”
- Limit reporting to those contracts within each private separate account that meet the percentage threshold limits;
- Conform information reporting to existing procedures established under section 817(h) and the regulations thereunder;
- Exclude pension plans contracts from the reporting requirements; and
- Consider eliminating the “related group of persons” aspect of the proposed reporting requirement.

8. AICPA Comments on Other New Information Reporting Proposed in Administration’s 2010 Budget

In a September 11, 2009 letter to the Department of Treasury, the American Institute of Certified Public Accountants (“AICPA”) commented on additional proposals for information reporting included in the Administration’s Green Book. See 2009 TNT 182-12. One Green Book proposal calls for general reporting of payments to corporations. Businesses would be required to prepare and file Form 1099-MISC for payments of income to a corporation aggregating \$600 or more in a calendar year. The AICPA expressed concerns that this reporting requirement would not provide any useful information because Form 1099-MISC is a cash method, calendar year report, while many corporations operate on a fiscal year using an accrual method of accounting. The AICPA also “urged caution” regarding the increase in penalties for failure to file informational returns because of the potential to create cash flow problems for small business during the current economic downturn.

Other Matters

Deadline for Applying for QI Status for 2009 Fast Approaching

The IRS recently published a notice on its website indicating that the deadline to apply for Qualified Intermediary (“QI”) status for 2009 is November 27, 2009. To apply for QI status, applicants

are required to complete the Application for New QI Agreement and an SS-4, Application for Employer Identification Number and submit both forms to the IRS New York office. Forms are located on the IRS website at http://www.irs.gov/pub/irs-utl/fillable_qi_status_application.pdf and <http://www.irs.gov/pub/irs-pdf/fss4.pdf>.

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