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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

November 30, 2009

Legislation

1. House Version of Health Care Reform Would Include New Reporting Requirements

The House recently passed its version of health care reform (styled the “Affordable Health Care for America Act of 2009”) which would impose an additional tax on individuals who do not obtain acceptable health care coverage for themselves and their dependents. The Bill (H.R. 3962) would impose additional information and reporting requirements for providers of health insurance coverage. Specifically, for each policy issued, coverage providers would be required to report the name, address and taxpayer identification number of the primary insured, the names of other individuals covered under the policy, and the period each individual was covered. The coverage provider would also be required to provide this same information, along with the name, address and telephone number of the provider, to the primary insured by January 31 of the year following the calendar year for which the return is required. Failure to file the required information returns or to include complete and correct information on the returns would be subject to penalties under section 6721.

2. Joint Committee on Taxation Releases Technical Explanation of the Foreign Account Tax Compliance Bill

The Joint Committee on Taxation recently released its technical explanation of the Foreign Account Tax Compliance bill (H.R. 3933, S. 1934) introduced by Representative Rangel (D-N.Y.) in the House and Senator Baucus (D-Mont.) in the Senate. The bill would increase information reporting on foreign assets and would impose additional measures for withholding taxes on foreign accounts owned by U.S. taxpayers. A more detailed account of the additional information and withholding requirements contained in the bill is included in the October issue of this newsletter.

Employer Issues

1. Single Member LLC Not Disregarded for Common Paymaster Rules

In PLR 200944016 (July 21, 2009), the IRS concluded that employees of a single member limited liability company (LLC) were employees of the LLC and not employees of the member for purposes of the common paymaster rules. Under the facts presented, physicians were concurrently employed by a practice plan that operated as a nonprofit corporation and a public university. The practice plan was the single member (i.e., owner) of a limited liability company that had not elected to be taxed as a corporation. The limited liability company had its own employees that were not employed by the practice plan. Generally, a single member LLC is treated as a disregarded entity if the LLC does not elect to be taxed as a corporation. However, according to the IRS, under regulations effective January 1, 2009, a single member LLC is not a disregarded entity for employment tax purposes even though the LLC made no election to be recognized. Treas. Reg. 301.7701-2(c)(2)(iv)(A). As a result, the IRS concluded that an LLC must withhold, report and remit employment taxes with respect to its employees using its own name and employer identification number and not those of its single member.

2. Termination Payments Held to Be Ordinary Income Subject to Self Employment Tax

In *Lenard v. Commissioner*, T.C. Summ. Op. 2009-165, the Tax Court held that payments made to an insurance agent following termination of his agency relationship with an insurance company were ordinary income. Under an agency agreement between the agent and the insurance company, the agent received a specified amount (the “contract value”) when he terminated his relationship with the insurance company. The contract value was based on the amount of service commissions paid to the agent on active policies, the number of active policies at the time of termination and the number of years of continuous service. The agent also received a bonus equal to a percentage of the contract value at the time of termination. Upon receipt of these termination payments, the agent assigned his interests in the agency to the insurance company. The agent argued that the termination payments should be treated as capital gain because the termination payments were received in consideration for the sale of the agency. However, the court held that the agency was not a capital asset that could be sold by the agent, and therefore, the termination payments must be taxed as ordinary income. The court also held the payments were subject to self employment tax under the standard of section 1402(k) of the Code and sustained an accuracy-related penalty under section 6662(a) against the agent.

3. Independent Contractor Audit Resolved Favorably for FedEx

The IRS has concluded its audit of FedEx Corporation for tax years 2004 through 2006 and has decided that no federal employment tax or penalties will be assessed for FedEx’s classification of delivery drivers as independent contractors. 2009 TNT 217-5. Similar audits are pending for 2007 and 2008. FedEx continues to defend its position in several lawsuits brought by employees and by the attorneys general in the states of New York, New Jersey, and Montana, who allege that the classification is in error.

Reporting Guidelines and Forms

1. Changes in Differential Pay Reporting for Military Personnel

Differential pay provided to employees who go on active military duty for more than 30 days is subject to income tax withholding, but is not subject to Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) taxes. See Rev. Rul. 2009-11, 2009-18 I.R.B. 896. Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G, Forms W-2 and W-3, and Form 1099-MISC have been revised, instructing that such payments should be reported on Form W-2 rather than Form 1099-MISC.

2. Withholding on Settlement Payments Arising out of Employment Dispute

A recent article recaps the authorities for determining whether settlement payments arising out of an employment dispute constitute wages subject to withholding or non-wage damages. See R. Wood, "To Withhold or Not to Withhold on Settlements?," 125 *Tax Notes* 925 (Tax Analysts Nov. 23, 2009). Payments made in settlement of an employment dispute are generally not paid on "account of physical injury or sickness," and are therefore not excluded from gross income under section 104(a)(2). However, when the settlement payments include compensation for back pay or front pay, it is not clear whether those payments should be treated as wages subject to withholding, or as non-wage income. Most courts treat back pay as wages subject to withholding because the pay is for work already performed. However, the courts are divided as to whether front pay should be treated as wages because front pay relates to work that may never be performed. The article also addresses the recent trend by some courts to require that the damages should be grossed-up for taxes.

The IRS recently released a publication addressing proper reporting of employment-related judgments and settlements. See Program Manager's Technical Advice (PMTA) 2009-035. In the tables attached to this PMTA, the IRS indicates that back pay and, in most cases, front pay should both be considered wages subject to withholding. However, if the case involves back pay in the 8th Circuit, or front pay in the 5th Circuit, the IRS advises that further guidance should be sought.

3. IRS Solicits Comments on Final Regulations for Settlement Funds

As part of continuing efforts to reduce paperwork, the IRS is soliciting comments regarding final regulations under section 468B (T.D. 8459) governing the tax treatment of transfers to accounts or trusts that are used to make payments in settlement of certain controversies. Under the regulation, qualified settlement funds that make distributions or payments for settlement purposes are subject to information reporting requirements. Specifically, the fund is required to make a return and/or withhold tax on a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax, had that transferor made the payment or distribution directly to the claimant. A qualified settlement fund is a fund established pursuant to a court order or federal or state governmental approval, to resolve one or more contested claims. Written comments on the regulations must be received on or before December 28, 2009.

4. IRS Issues Final Regulations on Information Reporting for Statutory Stock Options and Employee Stock Purchase Plans

The IRS recently issued final regulations (T.D. 9470) under section 6039 regarding information and reporting requirements for statutory stock options described in section 422(b) (Form 3921) and employee stock purchase plans described in section 423(c) (Form 3922). The Tax Relief and Health Care Act of 2006 (Pub. L. No. 109-432), expanded section 6039 to require corporations to file a return and provide an information statement following the transfer of stock by the corporation pursuant to the exercise of a stock option. Proposed regulations under section 6039 were issued on July 17, 2008 (REG-103146-08). Under the proposed and final regulations (§ 1.6039-1(a)), corporations are required to file Form 3921, Exercise of an Incentive Stock Option under Section 422(b), whenever the corporation transfers a share of stock to a person following the exercise of an incentive stock option. The return is required to be filed in accordance with the instructions to Form 3921, which is expected to be released by the IRS, along with the Form, in the near future. A copy of Form 3921 must also be provided to the person who exercised the stock option, generally no later than January 31 of the year following the year for which the statement is required. Substitute returns are acceptable if they provide all required information. Information provided for statutory stock options must include –

- The name, address and employer identification number of the person receiving the stock after exercise of the option;
- If the stock transferred is not the stock of the corporation, than the name, address and employer identification number of the corporation whose stock is being transferred;
- The name, address and identifying number of the person who received the stock;
- The date the option was granted;
- The exercise price per share;
- The date the option was exercised;
- The fair market value of the stock on the date the option was exercised; and
- The number of shares transferred upon exercise of the option.

Some of the information and reporting requirements under the final regulations for employee stock purchase plans differ from those contained in the proposed regulations. The final regulations were modified to reflect the fact that some employers deposit shares acquired by an employee under an employee stock purchase plan directly into a brokerage account. Frequently, legal title is held by the custodian in “street name” while the employee has only a beneficial interest in the shares. The final regulations make it clear that such a transfer is considered “a transfer of legal title” under section 6039(a)(2). The corporation will be required to file a return and provide information to the employee for tax reporting purposes so long as the exercise price of the option is less than 100 percent of the value of the stock or is not fixed and determinable on the date of grant.

Under the final regulations (§ 1.6039-1(b)), corporations are required to file Form 3922, Transfer of Stock Acquired through an Employee Stock Purchase Plan under Section 423(c) following the transfer of stock to a person or a brokerage account where the person retains a beneficial interest following the exercise of an option under an employee stock purchase plan. A copy of Form 3922 must also be provided to the employee, generally no later than January 31 of the year following the year for which the statement is required. Substitute returns are acceptable. Information provided for employee stock purchase plans must include –

- The name, address and identifying number of the transferor;
- The name, address and employer identification number of the corporation whose stock is being transferred;
- The date the option was granted to the transferor;
- The fair market value of the stock on the date the option was granted;
- The actual exercise price paid per share;
- The exercise price per share determined as if the option were exercised on the date the option was granted to the transferor (to be provided only if the exercise price per share is not fixed or determinable on the date the option was granted);
- The date the option was exercised by the transferor;
- The fair market value of the stock on the date the option was exercised by the transferor;
- The date the legal title of the shares was transferred by the transferor; and
- The number of shares to which legal title was transferred by the transferor.

Under the final regulations, returns are not required for nonresident aliens when the corporation is not otherwise required to provide a Form W-2. Although section 6039 applies to stock transfers occurring on or after January 1, 2007, the IRS has waived the obligation to file an information return for 2007, 2008 and 2009.

In a related matter, the IRS advised that a wage event occurs, and employment taxes must be withheld, when nonstatutory stock options are exercised or the stock options are bought back. CCA 200944044 (Jan. 21, 2009).

5. IRS Revises Wage Withholding for Nonresident Alien Employees

Notice 2009-91, 2009-48 I.R.B. 717, released on November 13, 2009, modifies withholding computations for wages paid to nonresident alien employees for services performed within the United States. The changes were necessary to account for adjustments to the withholding tables that resulted from the Making Work Pay tax credit. Nonresident aliens are not entitled to the tax benefits from the Making Work Pay Tax Credit or the standard deduction. Previously, employers were required to make adjustments to account for the standard deduction by adding the amount of the standard deduction back into wages before applying the income tax withholding tables. See Notice 2005-76, 2005-2 C.B. 947. Effective with wages paid on or after January 1, 2010, a second adjustment will now be necessary. According to the Notice, employers will be required to determine an additional amount of withholding from a separate table applicable only to nonresident alien employees in order to offset the effect of the Making Work Pay tax credit currently built into the withholding tables. Specific instructions and tables are included in Notice 1036 available on the IRS website at <http://www.irs.gov/pub/irs-pdf/n1036.pdf?portlet=7> and will be incorporated into Publication 15.

6. IRS Publishes Early Release Withholding Tables for 2010

The IRS recently published an early release of the 2010 percentage method income tax withholding tables in Notice 1036, available on the IRS website at <http://www.irs.gov/pub/irs-pdf/n1036.pdf?portlet=7>. The Notice also includes the 2010 advance earned income credit tables and information, and tables to calculate withholding from wages paid to nonresident aliens in accordance with Notice 2009-91. Employers are required to implement the revised federal

withholding and percentage method tables for wages paid on or after January 1, 2010. The Notice also provides an optional procedure for calculating additional income tax withholding from pension payments to account for the withholding reduction that resulted from the Making Work Pay tax credit.

7. IRS Pilot Program Permits Truncation of Taxpayer Identification Numbers

Notice 2009-93, 2009-51 I.R.B. __, establishes a pilot program that permits a filer of information returns to truncate a payee's taxpayer identification number on payee information statements. Under current regulations, an information return filer is required to include the full taxpayer identification number for the payee on information statements provided to the payee. If truncation is appropriate, the first five digits of the nine-digit identification number on the payee statement may be replaced with asterisks or Xs. The purpose of the program is to minimize the risk that the taxpayer's identification number will be misappropriated from paper payee information statements. The pilot program is effective immediately for paper payee statements in the Form 1098, Form 1099 and Form 5498 series and does not apply to any information returns required to be filed with the IRS. The program is voluntary. The IRS asks the public to submit comments by May 1, 2010. Specifically, the IRS seeks comments regarding –

- Whether truncation on paper payee statements should be mandatory for all paper payee statements;
- Whether truncation should be permitted or required for payee statements furnished electronically;
- Whether a filer should be required to include the full taxpayer identification number on the payee statement if requested by the payee; and
- Whether truncation creates difficulties for filers or payees.

8. IRS Issues Proposed Regulations on Information Reporting for Payment Card and Third Party Network Transactions

The IRS recently issued proposed regulations (REG-139255-08) for payment card and third party network transactions. The regulations provide rules for new information reporting requirements under section 6050W, which was added to the Code as part of the Housing and Economic Recovery Act of 2008 (Pub. L. No. 110-289). Under the regulations, debit and credit card payment processors will be required to track and report the gross amount of each merchant's credit and debit card receipts, broken down for each month in the reporting period. The information is to be reported on Form 1099-K, Merchant Card and Third-Party Payments, and will be required for calendar years beginning after December 31, 2010. Information statements must also be furnished to each merchant on or before January 31 of the year following the year for which the return is required. The amounts reportable under section 6050W may also be subject to backup withholding if the merchant fails to furnish a correct taxpayer identification number. Backup withholding applies to amounts paid by a debit or credit card payment processor after December 31, 2011. Under the regulations, gift cards that are usable only at a single store or chain are exempt from reporting. In addition, healthcare networks or managed care networks are outside the scope of section 6050W. Finally, transactions that are reportable under both sections 6050W and 6041 must be reported only under section 6050W. The IRS asks that written comments regarding the proposed regulations be submitted before January 25, 2010.

9. IRS Targets Foreign Withholding Compliance

On November 9, Lori Nichols, IRS Large and Midsize Business Division director, speaking at the High Technology Tax Institute, stated that the IRS intends to improve foreign withholding in four phases. See Amy S. Elliott, *Highlights and Documents* at 7344 (Nov. 12, 2009). U.S. taxpayers who pay fixed or determinable annual or periodic income to a foreign person must withhold tax under section 1441. The foreign recipient of these payments is generally required to file Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons. In the first phase of its foreign withholding compliance project, the IRS compiled and compared data from a variety of tax and information returns to determine whether Form 1042 was being filed appropriately. The IRS discovered that a large percentage of payors were not reporting U.S.-source income payments as required. In the second phase, the IRS is currently determining which payors are obligated to withhold. In the third phase, the IRS is exploring the extent that foreign withholding is being avoided through the use of total return swaps and notional principal contracts. In the fourth and final phase of the project, the IRS is educating taxpayers about their reporting and withholding responsibilities.

10. Social Security Administration Announces Wage Base Unchanged for 2010

The Federal Insurance Contributions Act (FICA) imposes two taxes on employers, employees and self-employed individuals – a tax of 6.2% (Old Age, Survivors and Disability Insurance (OASDI)), and a tax of 1.45% (Medicare). Self-employed individuals are required to pay both the employer and employee tax, for a combined FICA tax rate of 12.4% for OASDI and 2.9% for Medicare. For the OASDI portion of FICA taxes, the statute imposes a maximum wage base subject to tax, and since 1975 the statute has provided an automatic cost-of-living adjustment of the wage base. The Social Security Administration has announced that for 2010 the wage base remains unchanged at \$106,800. This is the first year that there is no adjustment under the automatic adjustment provision since it went into effect in 1975. The Medicare portion of the FICA tax is not subject to the limitation of the wage base.

11. Additional Comments on FBAR Filing Requirements

The IRS has received more comments regarding FBAR filing requirements for Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR). Any United States person who has a financial interest in or signature authority over a foreign financial account with an aggregate value in excess of \$10,000 in a calendar year is required to file the FBAR. The Committee on the Investment of Employee Benefit Assets asked the IRS to exempt employee benefit plans from the FBAR filing requirements because the plans are tax exempt and are already subject to extensive regulation under the Code and the Employee Retirement Income Security Act (ERISA). 2009 TNT 208-21. The New York State Bar Association Tax Section also submitted a comment letter to the IRS with numerous recommendations. See Alison Bennett, *Daily Tax Report* at G-3 (Nov. 3, 2009). Some of the recommendations include –

- Requiring only one FBAR for any single foreign account;
- Permitting one qualified or designated filer to file the FBAR on behalf of the filer and others;
- Expanding the employee and consolidation exceptions to FBAR reporting;
- Studying whether to narrow the focus of the reporting regime to jurisdictions that do not adequately supervise banking and other financial activities;

- Raising the minimum aggregate dollar threshold amount for FBAR reporting and indexing the threshold for inflation; and
- Following traditional notice-and-comment rulemaking procedures when providing rules and guidance for FBAR filing.

12. ACLI Comments on Information Reporting for Foreign Subsidiaries of U.S. Life Insurers

In a November 18, 2009 letter to the IRS Office of Associate Chief Counsel, the American Council of Life Insurers (ACLI) expressed concern regarding information reporting requirements for U.S. life insurance companies that sell life insurance and annuity products through foreign subsidiaries. Currently, payments from life, annuity or endowment contracts made to U.S. persons are reportable to the IRS if the payments equal or exceed \$600 and the payments are made by a U.S. payor. A controlled foreign corporation (CFC) of a U.S. payor is treated as a U.S. payor. Consequently, the CFC is required to report payments to those customers who are known or presumed to be U.S. persons. Because customers are presumed to be U.S. persons when their status as a foreign person has not been documented, the CFC is required either to file Form 1099 for payments made to these customers or to obtain a written attestation from the customer certifying that the customer is not a U.S. person. According to the ACLI, both options are unduly burdensome. The ACLI recommends that the IRS exempt all payments from life insurance policies sold by CFCs outside of the U.S. from reporting requirements in light of the small amounts of reportable income that these policies generate. The ACLI also recommends that the IRS exempt payments from annuity or endowment contracts from reporting requirements unless the CFC knows or has reason to know that the customer is a U.S. person. A copy of the letter is available at 2009 TNT 222-21.

13. IRPAC Releases 2009 Report

The IRS Information Reporting Program Advisory Committee (IRPAC) recently released its 2009 report containing over 50 recommendations covering a wide variety of information and reporting issues. IR-2009-097. Key issues covered in the report include review, analysis and recommendations in the following areas:

- Reporting requirements for payments made in settlement of payment card and third party network transactions under section 6050W;
- Inclusion of logos on payee statements;
- New guidance on the IRS website related to employer tax compliance for payments made to non-resident aliens;
- Proposed regulations under section 3402(t) related to withholding on certain payments made by government entities;
- Form 5498 reporting for successor beneficiaries;
- The practice of masking taxpayer identification numbers on information statements to reduce the likelihood of identity theft;
- Section 530 relief for worker classification;
- The impact of the Social Security Administration's discontinuation of Form SSA-7028, as it relates to "B" Notices;
- Proposed enhancements to the IRS E-Services and E-Channel programs;

- Form 1098;
- Information reporting associated with Build America Bonds and Widely Held Fixed Investment Trusts;
- Backup withholding in the barter industry;
- Suggested improvements to Form 5500; and
- Reporting for an employee's personal use of a cell phone.

An executive summary of the report is available on the IRS website at <http://www.irs.gov/taxpros/article/0,,id=214437,00.html>. The full report is available at http://www.irs.gov/pub/irs-utl/irpac_2009_public_report.pdf.

14. Wage Event Occurs When Nonstatutory Stock Options Are Exercised

In CCA 200944044 (Jan. 21, 2009), released on October 30, 2009, the IRS advised that a wage event occurs and employment taxes must be withheld when nonstatutory stock options are exercised or stock options are bought back.

Other Matters

IRS Releases Priority Guidance Plan for 2009-10

On November 24, 2009, The Treasury Department and the Internal Revenue Service released its 2009-10 priority guidance plan. The plan includes 315 projects to be completed from July, 2009 through June, 2010. Under the plan, the IRS anticipates issuing guidance under section 1441 related to qualified intermediaries and other withholding issues. The complete priority guidance plan is available on the IRS website at <http://www.irs.gov/pub/irs-utl/2009 - 2010 priority guidance plan.pdf>.

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