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INSURANCE COMPANY INFORMATION REPORTING AND WITHHOLDING UPDATE

May 29, 2009

Legislation

Obama Administration Releases 2010 Year Revenue Proposals

The Treasury Department recently released the *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (the "Green Book"). The administration has proposed to reduce the tax gap through expanded information reporting provisions, including reporting proposals in connection with certain life insurance contracts and payments to corporations, and TIN certification requirements for contractors.

Reports for Life Insurance Contracts

The administration's proposal would require life insurance companies to make a report to the IRS for each contract with cash value that is partially or wholly invested in a private separate account for any portion of the taxable year. The report would show the policyholder's taxpayer identification number, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that was invested in one or more private separate accounts. For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owned policies the cash values of which, in the aggregate, represented at least 10 percent of the value of the separate account. The proposal would be effective for taxable years beginning after December 31, 2010. The purpose of the provision is to allow the IRS to ensure that income is properly reported, and enable the IRS to identify more easily which variable insurance contracts qualify as insurance contracts under current law and which contracts should be disregarded under the investor control doctrine.

Reporting Payments to Corporations

In order to increase general tax compliance, the administration proposes to repeal the current reporting exception under section 6041 for payments to corporations. Under the proposal, a business payor would be required to file an information return for payments aggregating to $600 or more in a calendar year to a payee, whether or not the payee is a corporation (except a tax-exempt corporation).

The proposal would be effective for payments made to corporations after December 31, 2009.

Payments to Contractors – Form W-9, TIN Verification Required; Withholding at Payee's Option

Under the proposal, a contractor receiving payments of $600 or more in a calendar year from a business payor would be required to certify its TIN to the payor on Form W-9. Further, the payor would be required to verify the contractor's TIN with the IRS. If a contractor failed to furnish an accurate certified TIN, withholding would be required. In addition, a contractor receiving payments of $600 or more in a calendar year from a payor could elect withholding on its gross payments at a flat-rate percentage of 15, 25, 30, or 35 (contractor's choice). The proposal would be effective for payments made to contractors after December 31, 2009.

Third-Party Reporting concerning Establishment of Foreign Financial Accounts and Transfers of More than $10,000 to or from Such Account

The proposal generally would require any U.S. financial intermediary and any qualified intermediary that establishes a foreign bank, brokerage, or other financial account on behalf of a U.S. person to file an information return regarding the account. In addition, such an intermediary also would be required to file an information return regarding any transfer it makes to, or receives from, such an account of money or property worth more than $10,000. Exceptions to the reporting requirement would be provided for (1) accounts opened, and amounts transferred to, from, or on behalf of, publicly traded companies and their subsidiaries; (2) accounts opened at, and transfers made to, qualified intermediaries on behalf of a U.S. person; or (3) transfers received by, or on behalf of, a U.S. person from accounts held by a U.S. person as a qualified intermediary. The proposal would be effective for amounts transferred and accounts opened beginning after December 31 of the year of enactment.

Withholding on FDAP Income Payments through Nonqualified Intermediaries

Under the Administration's proposal, any payment of U.S.-source FDAP (fixed or determinable annual or periodic) income to a nonqualified intermediary would be treated as made to an unknown foreign person. As a result, any withholding agent making such a payment would be required to withhold tax at a rate of 30 percent).

The Green Book is online at http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf. For other proposed legislation relating to off-shore tax, *see* the *Stop Tax Haven Abuse Act* (S. 506, H.R. 1265), which was reintroduced for the 111th Congress in March 2009 by Sen. Carl Levin (D-Mich.) and House Ways and Means Committee Member Lloyd Doggett (D-Tex.).

Employer Issues

1. IRS Publishes Q&A's for Employers regarding Recovery Act Subsidy for Continuation of Health Coverage under COBRA

The IRS has published questions and answers for employers regarding administration of the new subsidy under the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5, "Recovery

Act") of the cost of COBRA health benefits for former employees. The questions and answers can be found online at http://www.irs.gov/newsroom/article/0,,id=204708,00.html. The Recovery Act provides a subsidy of 65 percent of the health insurance premiums for certain terminated employees and their family members who are eligible under COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) 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 941only after it has received the 35 percent premium payment from the individual.

2. IRS Guidance Expected on Correction of Errors by Filing Form 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*

On May 12, 2009, during an IRS Tax Talk Today webcast, Mary Gorman, Assistant Division Counsel (Prefiling), announced that the IRS will soon issue guidance relating to the new processes for correcting errors on employment tax returns using Form 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*. To correct employment tax errors discovered on or after January 1, 2009, taxpayers may now use the new corresponding "X" forms as soon as the errors are discovered. For example, use the new Form 941-X to correct errors on a previously filed Form 941. The Form 941-X is available online at http://www.irs.gov/pub/irs-pdf/f941x.pdf.

3. IRS to Issue Guidance Clarifying Employer Substantiation Requirement under Section 274(d), Treatment of Judgments and Settlements

On May 8, 2009, at the Employment Taxes session of the American Bar Association Section of Taxation meeting, Lynn Camillo, Chief, Employment Tax Branch 2, IRS Office of Chief Counsel (Tax-Exempt and Governmental Entities), reported that the IRS intends to issue guidance relating to the substantiation requirement for employers under section 274(d), including how to differentiate between personal and business benefits. In addition, the IRS intends to issue guidance providing a roadmap for determining the appropriate tax treatment of payments made under judgments and settlements. The guidance is expected to be issued in the form of a program manager technical assistance memorandum.

Section 274(d) imposes strict substantiation requirements for certain deductible expenses. Under I.R.C. § 274(d), business expense deductions are disallowed for travel, entertainment, gifts and "listed property," as defined by section 280F(d)(4), unless the taxpayer substantiates by "adequate records or by sufficient evidence" the: (1) amount of the expense, (2) time and place of the expense, (3) the business purpose of the expense, and (4) the business relationship to the taxpayer of the person involved in the expense.

4. Recent Case Upholds Tax Gross-Up for Back Pay Award under ADA – Start of New Trend?

In a recent article, Robert W. Wood discusses the impact of the Third Circuit's decision, *Eshelman v. Agere Systems, Inc.*, No. 05-4895, 2009 WL 223858 (3d Cir. Jan. 30, 2009), where the Court of Appeals upheld a jury verdict for disability bias under the Americans with Disabilities Act (ADA), and, in a case of first impression, ruled that the additional tax gross-up in connection with the award of back-pay was necessary and appropriate. (For a brief description of the case, see "Third Circuit Allows Tax Gross-Up for Back Pay Award Under ADA," Insurance Company Information Reporting and Withholding Update, February 27, 2009.) Wood concludes that "the more modern trend of the case law suggests that tax gross-up claims are more favored today than in the past." *See* Wood, "Getting Damages for Adverse Tax Consequences," 2009 TNT 79-11.

5. IRS Tells U.S. Senators that Insurance Agent Termination Payments Are Ordinary Income

Responding to inquiries by two U.S. Senators and a taxpayer, the IRS explained why termination payments made to retired State Farm insurance agents are ordinary income. *See* INFO 2009-0040 (January 23, 2009), INFO 2009-0042 (December 30, 2008), and INFO 2009-0062 (November 7, 2008). In this regard, agents have contended that termination payments received from State Farm after retirement should be taxed as proceeds from the sale of capital assets because State Farm made these payments to purchase intangible capital assets. However, as noted in one of the IRS letters, the issue whether such payments constitute ordinary income or proceeds from the sale of capital assets has been litigated repeatedly by taxpayers, without success. The IRS also cited several cases, including *Trantina v. United States*, 512 F.3d 567 (9th Cir. 2008), and stated that no court has held that termination payments were made to purchase intangible capital assets from the agent.

Background

In *Trantina*, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court's ruling that termination payments received by Mr. Trantina, a State Farm insurance agent, under his Agreement with State Farm were properly characterized as ordinary income because the taxpayer did not have any property rights that he could sell under the terms of the Agreement. The taxpayer became entitled to the termination payments under the Agreement after he complied with two additional conditions: he was required to return all of State Farm's property, and he was required to comply with a twelve-month non-compete agreement.

Citing *Commissioner v. Gillette Motor Transp.*, 364 U.S. 130, 134 (1960), the Ninth Circuit stated "the term 'capital asset' should be construed narrowly." The court explained that case law demonstrated that "when the property right asserted concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed." The court rejected each of the taxpayer's arguments that he had enforceable rights beyond a contractual right to perform services and receive compensation. The Ninth Circuit ultimately adopted the reasoning of a similar case, *Baker v. Commissioner*, 338 F.3d 789, 791 (7th Cir. 2003). In doing so, the Ninth Circuit reasoned that a precondition to realizing a long-term capital gain is ownership of a capital asset. Because the taxpayer had no property that could be sold or exchanged, the Ninth Circuit concluded that the Agreement was not a capital asset for purposes of section 1221(a). The court refused to consider whether the substance of the Agreement was essentially a franchise, which is recognized as a capital asset, because the taxpayer did not raise such an argument in the district court.

Reporting Guidelines and Forms

1. IRPAC Comments on Insurance Issues under Section 6050W — Reporting on Payment Card and Third Party Network Transactions

The IRS has received numerous recommendations concerning payment card and third party payment transactions under section 6050W, in response to a request for comments in Notice 2009-19, 2009-10 I.R.B. 660. A recent IRS Information Reporting Program Advisory Committee ("IRPAC") comment letter addressed several potential insurance issues. (2009 TNT 57-23.)

First, IRPAC noted that the third party payment network requirements were directed at PayPal and other companies where widely disparate merchants are paid for goods and services through a credit card-like service. IRPAC recommended that the IRS define "third party network" to exclude certain health care payments already reportable under section 6041. IRPAC noted that the health care industry is concerned with the broad definition of "third party network." It is very common for health carriers to have contracts with a network of providers who provide services to the members under both insured and administrative service contract health plan arrangements. This hub networking facility collects premiums and other payments, as well as makes payments for many different insurance companies. The insurance company networks generally report these transactions already under section 6041.

Second, IRPAC noted that the IRS needs to clarify how section 6050W and section 6041(f) interact. There is concern in the health insurance industry about whether section 6050W conflicts with the intent behind section 6041(f) which was added in 2003 to override IRS Rev. Rul. 2003-43, 2003 C.B. 935. Section 6041(f) provides that no reporting is required under section 6041 for payments for certain qualified medical services made through debit, credit and stored value cards. However, the same exclusion is not set forth in section 6050W.

Background

Under section 6050W, a bank that enrolls a business (e.g., a merchant) 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 businesses 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.

2. AICPA Comments on New Rules on Basis Reporting in Securities Transactions

The American Institute of Certified Public Accountants ("AICPA") submitted comments on the new basis reporting rules in a letter dated May 5, 2009 (2009 TNT 86-18). The AICPA recommendations included:

- The IRS should create a form to be used when necessary to address reconciliation of a customer's Form 1040, Schedule D, *Capital Gains and Losses*, and a broker issued Form 1099-B.

- No Schedule D reporting by the taxpayer should be required if a taxpayer agrees that the gain and loss calculations provided by a broker are correct.

- The IRS should permit the attachment (and thereby, the reporting) of securities transactions detail in a PDF or electronic format, and the IRS should explicitly state that Schedule D reporting is not required or that the agency will accept e-filed returns that contain summary transaction information on Schedule D.

Treasury and the IRS requested comments on the new basis reporting requirements enacted as part of the Emergency Economic Stabilization Act of 2008 (Pub. L. No. 110-343, 10/3/2008) in Notice 2009-17, 2009-8 I.R.B. 575. The Notice sought comments 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).

3. Withholding Issues Surface under Recovery Act's New "Making Work Pay Credit"

Background

The Making Work Pay Credit was included as part of the $787.2 billion Recovery Act (American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5), signed into law by the President on February 17, 2009. The credit is as much as $400 for individual workers and $800 for couples. The benefit phases out for individuals making over $75,000 a year and for couples earning over $150,000. The IRS previously posted new withholding tables at http://www.irs.gov/pub/irs-pdf/n1036.pdf. Employers were asked to start using the new tables as soon as possible but not later than April 1, 2009. *See* IR-2009-13 (Feb. 21, 2009).

IRS Publishes Alternative Withholding Tables for Pensions to Offset Reductions for Making Work Pay Tax Credit

The IRS has published alternative withholding tables for pensions that reflect the fact that pensions are not eligible for the Making Work Pay Credit, which applies only to earned income. The IRS had previously issued new wage withholding tables in new Publication 15-T, *New Wage Withholding and Advanced Earned Income Credit Payment Tables*, to be put into effect no later than April 1, 2009. Under Notice 1036-P, *Additional Withholding for Pensions for 2009*, an optional procedure is provided for those making pension payments subject to withholding under section 3405. The procedure is an approximate offset for the withholding reduction included in the withholding tables found in Publication 15-T. Pension payors are not required to use this procedure but may instead continue to use only the Publication 15-T withholding tables to determine the amount of withholding. However, the IRS requests that if pension payors decide to use this optional procedure, they begin using it as soon as possible.

Unfortunately, if a pension payee submitted a Form W-4P, *Withholding Certificate for Pension or Annuity Payments*, to request additional withholding on line 3 after issuance of the revised withholding tables contained in Publication 15-T, it may not be clear whether the payee was relying on the old withholding tables or the new. Pension payors using this optional procedure should consider contacting the payee to determine if the additional withholding requested on line 3 is still desired or whether the payee wants to submit a new Form W-4P.

Anomalies under Updated Publication 15-T, New Wage Withholding and Advanced Earned Income Credit Payment Tables

Sources have reported that the tables in Publication 15-T can produce anomalous results. Under the tables, some employees will receive an increase in take home pay that does not correspond to their eligible credit. As a result, those employees will need to file a new Form W-4 to prevent under withholding. Similarly, under the tables, some employees will receive little change in their take home pay, even though they are eligible to receive the credit and a correspondingly higher take home pay amount. As a result, those employees will need to file a new Form W-4 to adjust the take home pay to reflect the proper credit.

The updated Publication 15-T can be found online at http://www.irs.gov/pub/irs-pdf/p15t.pdf. Publication 15, *(Circular E) Employer's Tax Guide*, has also been updated, and can be found online at http://www.irs.gov/pub/irs-pdf/p15.pdf. The IRS has also published *Making Work Pay Questions and Answers* to address questions relating to the credit. The questions and answers are available online at http://www.irs.gov/newsroom/article/0,,id=204447,00.html.

4. Revised Section 1441 Withholding Rules on Qualified Intermediaries to Be Finalized by IRS Soon

On May 5, 2009, at a conference sponsored by the Tax Reporting Group, Carl Cooper, senior counsel with the IRS Office of Associate Chief Counsel (International), indicated that guidance is imminent on changes in the Qualified Intermediary (QI) program proposed in Announcement 2008-98, 2008-44 I.R.B. 2082 (Nov. 3, 2008). Mr. Cooper also noted that the IRS also hopes to soon finalize proposed regulations under section 302 (REG-140206-06), which require withholding agents to escrow withholding on certain redemption payments to nonresident alien shareholders by publicly traded corporations.

Background

In Announcement 2008-98, the IRS proposed changes to the section 1441 withholding rules applicable to QIs and solicited public comments. Specifically, the proposed amendments were to the

Qualified Intermediary Agreement, Appendix, Rev. Proc. 2000-12, 2000-1 C.B. 387 (QI Agreement), and to the Guidance for External Auditors of Qualified Intermediaries, Appendix, Rev. Proc. 2002-55, 2002-2 C.B. 435. *See* IR-2008-116. These amendments were intended to ensure that QIs are taking the steps necessary to comply fully with their obligations under the QI Agreement, and were proposed to be effective for calendar years beginning after December 31, 2009.

The IRS established the QI program in 2001 to encourage better compliance by foreign financial intermediaries with U.S. withholding requirements under sections 1441 and 1442, without discouraging foreign investors that may not want U.S. tax authorities to know their identities. Under the program, foreign banks that agree to follow certain procedures may assume the responsibilities of a U.S. withholding agent without disclosing to U.S. authorities the identities of their non-U.S. account holders. A QI is any foreign intermediary (or foreign branch of a U.S. intermediary) that has entered into a QI withholding agreement with the IRS pursuant to Rev. Proc. 2000-12, 2002-1 C.B. 374, and Treas. Reg. §1.1441-1(e)(5). Rev. Proc. 2002-55, 2002-2 C.B. 435, contains audit guidance for an external auditor engaged by a QI to verify the QI's compliance with the withholding agreement entered into with the IRS. Under its QI Agreement, the QI generally must report annually certain aggregate information concerning the beneficial owners of U.S. source payments and make any necessary tax payments to the IRS. In lieu of an IRS audit, the QI may engage an external auditor to conduct an audit to determine whether it is complying with the withholding and reporting obligations covered by the QI Agreement.

5. Practitioners Request Repeal of Government Contractor Withholding under Section 3402(t) at IRS Hearing on Proposed Regulations

At an April 16, 2009 public hearing on proposed regulations (REG-158747-06) relating to withholding tax on government contractors under section 3402(t), practitioners called for a repeal of the provision entirely. Practitioners explained that the provision should be repealed because implementation would cost millions more than the $200 million in annual revenue generated by the provision after it is fully in effect. Some also suggested that the $10,000 minimum threshold for withholding should be raised.

Section 3402(t), added by the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109–222), requires all government entities, with certain exceptions, to withhold 3 percent of all payments for property or services, originally effective for payments made after December 31, 2010. Treasury and the IRS published the proposed regulations on December 5, 2008 under section 3402(t). Subsequently, the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, section 1511, amended section 3402(t) by delaying its effective date for one year, applicable to payments made *after December 31, 2011*.

6. IRS Rules Factoring Payments by Structured Settlement Company to Claimant Are Exempt from Reporting

In PLR 200918001 (May 1, 2008), the IRS considered a transaction to factor a payment due under a structured settlement agreement previously made to resolve a personal injury suit. The IRS held that factoring payments made in a factoring transaction by the structured settlement company to the personal injury claimant are not reportable under section 6041 as long as certain conditions are satisfied. The factoring transaction was approved by the court in an order which qualified under section 5891(b)(2).

The IRS held that the amounts paid were not reportable because they qualify as excludable from income under section 104(a)(2), provided the following conditions are satisfied: (a) the claimant uses the cash method of accounting; (b) each of the payments under the original settlement agreement were excludable under section 104(a)(2); (c) the original assignment of the defendant's obligations to the structured settlement company was a qualified assignment under section 130; (d) the settlement agreement was not readily saleable when the claimant and settlement company entered into the factoring transaction; (e) the aggregate amount of payments under the factoring transaction does not exceed the payment under the original settlement that is to be factored; (f) the factoring payments are all due and paid before the due date of the payment under the original settlement; and (g) the factoring transaction is a structured settlement transaction described in section 5891(b)(1) and is valid under applicable laws.

Interestingly, the letter ruling does not discuss how it is determined whether the settlement agreement was "readily saleable" at the time of the factoring transaction. Also, it is not clear that the factoring transaction was wholly unrelated to the original assignment.

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

In *Hansen v. Commissioner*, T.C. Memo. 2009-87 (Apr. 28, 2009), the Tax Court held that amounts paid in settlement of three complaints, alleging employment discrimination and violation of a collective bargaining agreement, 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. Generally, to qualify for this exclusion, the taxpayer must demonstrate: (1) the underlying cause of action giving rise to the recovery is 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). In this case, the court relied on *United States v. Burke*, 504 U.S. 229, 237 (1992), which held that where damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under section 104(a)(2). The Tax Court noted that the settlement agreement expressly provided that the agreement was to resolve three specific complaints alleging employment discrimination and violation of a collective bargaining agreement. The settlement agreement provided that of the total settlement payment, $20,000 was attributable to taxpayer's "claims for back wages" and subject to standard withholdings for taxes and reporting on Form W-2; and $100,000 was attributable to his "claims of emotional distress and his attorney's fees" and reportable on Form 1099, but not subject to withholding. The court rejected the taxpayer's argument that the $100,000 payment was not intended to be included in income, relying in part on the language of the settlement agreement that it would be reported on Form 1099. Although petitioner had sustained some physical injuries such as bruises, and although the settlement agreement referred to the taxpayer's "emotional distress," the court noted that settlement agreement did not specify that any portion of the $100,000 was on account of personal physical injuries or physical sickness. The court concluded that none of the claims that petitioner asserted in the three complaints were for damages on account of those bruises or any other alleged personal physical injuries or physical sickness.

Ask the expert

How should section 403(b) distributions be reported where the distributions relate to plan terminations?

Recently, Robert Architect, senior tax law specialist at the IRS, addressed the issue of proper reporting treatment for distributions from terminating section 403(b) plans. Mr. Architect acknowledged that guidance has not been issued in this regard. However, he suggested that organizations making such a distribution could indicate on Form 1099-R "taxable amount undetermined," after properly notifying the participants and the vendor that would make the distributions.

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