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IRS Issues Final Regulations on Section 403(b) Annuities

The IRS has issued comprehensive final regulations on §403(b) retirement plans of public schools and tax exempt organizations [72 F.R. 41128, 7-26-07; <http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-3649.pdf>]. Existing regulations under IRC §403(b) date from 1964. Updates reflect the numerous changes made to §403(b) by legislation enacted since that date as well as interpretive guidance issued since that date. *Note:* Proposed regulations were issued in 2004 (see *PAYROLL CURRENTLY*, Issue No. 25, Vol. 12).

Written plan requirement

The final regulations retain the requirement from the 2004 proposed regulations that a §403(b) contract be issued pursuant to a *written* plan.

The final regulations clarify that a plan is permitted to allocate to the employer or another person the responsibility for performing functions to administer the plan, including functions to comply with §403(b). Any such allocation must identify who is responsible for compliance.

The final regulations also clarify the requirement that a plan include all material provisions by permitting the incorporation by reference of other documents, including the insurance policy or custodial account, which then become part of the plan.

Finally, the IRS recognizes that there may be a cost associated with satisfying the written plan requirement for employers that do not have existing plan documents, such as public schools, and advises that it expects to publish model plan provisions.

Plan-to-plan transfers

The final regulations permit plan-to-plan transfers if the participant whose assets are being transferred is an employee or former employee of the employer (or business of the employer) that maintains the receiving plan and certain additional requirements are met.

Distributions

The final regulations make a number of changes from the proposed rules relating to distributions, including:

- Clarifying that after-tax employee contributions are not subject to any in-service distribution restrictions.
- Clarifying that, if an insurance contract includes provisions under which contributions will be continued in the event a participant becomes disabled, then that benefit is treated as an incidental benefit that must satisfy the incidental benefit requirement applicable to qualified plans.
- Making changes with regard to elective deferrals that are designated Roth contributions.

The universal availability rule generally requires that a plan offer all

employees the chance to defer at least \$200 in compensation annually if one employee is given the opportunity (see *The Payroll Source*®, p. 4-81).

The final regulations clarify that an employee's right to make elective deferrals also includes the right to designate §403(b) elective deferrals as designated Roth contributions if any employee of the eligible employer may elect to have the organization make §403(b) elective deferrals as designated Roth contributions.

Exclusions for certain classes of employees for purposes of the universal availability rule, permitted under 1989 guidance, will no longer be permitted under the final regulations:

- employees covered by a collective bargaining agreement;
- employees making a one-time election to participate in a governmental plan instead of a §403(b) plan;
- professors providing services on a temporary basis to another public school for up to one year and for whom §403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the §403(b) plan of the original public school; and
- employees affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement.

In the preamble to the final regulations, the IRS notes that other rules may apply with respect to some of these individuals. For instance, individuals who work for an institution that is controlled by a church organization and whose compensation from the employer is not treated as wages for purposes of income tax

Inside this issue...

Update on Income Tax Treaties.....	3
School Tuition May Be a Medical Expense.....	4
On Second Thought, Court Says Taxation of Damages for Nonphysical Personal Injuries Is Constitutional After All.....	5
IRS Issues Proposed Regulations on Payment Card Transactions and TIN Matching.....	6
IRS Issues Electronic/Magnetic Media Filing Requirements for Forms 1098, 1099, 5498, and W-2G.....	7
State and Local News New Hampshire - paycards Pennsylvania - Local Services Tax.....	8

withholding may be excluded from the §403(b) plan because they are not treated as employees of the entity maintaining the plan.

Also, if an individual is performing services for a university as a visiting professor, but continues to receive compensation from his or her home university and elective deferrals are made on his or her behalf under the home university's §403(b) plan, that plan may treat the visiting professor as an eligible employee.

Effective date

The regulations are generally applicable for taxable years beginning after December 31, 2008. In addition, there are transition rules and special applicability dates.

Under one transition rule, for a §403(b) plan maintained pursuant to one or more collective bargaining agreements ratified and in effect on July 26, 2007, the regulations do not apply until the earlier of: (1) the date the last such agreement terminates (determined without regard to any extension of the agreement after July 26, 2007), or (2) July 26, 2010.

Under another transition rule, for a §403(b) plan maintained by a church-related organization for which the authority to amend the plan is held by a church convention, the regulations do not apply before the beginning of the first plan year following December 31, 2009.

A special rule applies if a plan has eligibility conditions for elective deferrals relating to:

- employees making a one-time election to participate in a governmental plan instead of a §403(b) plan,
- professors providing services on

a temporary basis to another school for up to one year and for whom §403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the §403(b) plan of the original school, or

- employees affiliated with a religious order who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement.

If a plan excludes any of these three classes of employees from eligibility to make elective deferrals on July 26, 2007, the exclusion can continue until taxable years beginning on or after January 1, 2010.

If a plan excludes employees covered by a collective bargaining agreement from eligibility to make elective deferrals on July 26, 2007, the exclusion can continue until the later of (1) the first day of the first taxable year that begins after December 31, 2008, or (2) the earlier of (a) the date that such agreement terminates (determined without regard to any extension of the agreement after July 26, 2007), or (b) July 26, 2010.

In the case of a governmental plan where the authority to amend the plan is held by a legislative body, the exclusion can continue until the earlier of (1) the close of the first regular legislative session that begins on or after January 1, 2009, or (2) January 1, 2011.

Public schools and the IRS 403(b)

Universal Availability project

The IRS is expanding an outreach effort to ensure that public schools are complying with the universal availability requirement for retirement annuities they may offer.

To assess the level of compliance,

the IRS's Employee Plans Compliance Unit has started sending questionnaires to public school districts in all 50 states under the auspices of the 403(b) Universal Availability project. This expands a pilot project that began in June 2006 with questionnaires sent to public school districts in Missouri, New Jersey, and Washington. The IRS has begun contacting school districts in Alaska, Florida, Hawaii, Illinois, Nevada, Pennsylvania, Tennessee, and Virginia. School districts in the remaining states will be contacted through 2008.

The IRS advises schools that receive the questionnaire to answer it completely and accurately. If a potential problem is identified, the IRS will correspond with the school district to help it analyze its 403(b) plan to determine whether it is noncompliant. If school officials find a problem, they should use one of the correction methods outlined in the IRS's follow-up letter. If a school makes the necessary corrections timely, the IRS will not impose a sanction.

"Our pilot project ... showed fairly widespread noncompliance ... with the universal availability requirement for 403(b) plans," reports Joseph Grant, Director of the IRS Employee Plans division. "We believe most of it was due to a lack of understanding about what the law requires" (i.e., that all employees normally expected to work 20 hours per week must be offered the opportunity to participate in a 403(b) plan if the district sponsors one). Typical noncompliance involves excluding participation by certain classes of employees, such as substitute teachers, janitors, cafeteria workers, and nurses. **PC**

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Payroll Solutions

Q. This year, for the first time, our health flexible spending arrangement (FSA) will end its plan year with a surplus. Our company never amended its health FSA to allow employees to take advantage of the 2½-month grace period that the IRS began allowing in 2005. Is there anything we can do with the surplus that would benefit employees who have contributed too much?

A. Yes. The general rule is that any amount in a health FSA that remains unused at the end of the plan year is forfeited by the employee (i.e., “use it or lose it”). However, under a special exemption, if all the premiums paid into an employer’s health FSA during a plan year exceed the FSA’s reimbursements of claims and administrative costs, the excess may be used to reduce employees’ required premiums for the next plan year or returned to the employees as a dividend or premium refund. The excess (i.e., experience gain) must be allocated on a uniform basis, which can be the coverage levels selected by employees. The excess may not be allocated based on the participants’ individual claims experience, since that would violate the use-it-or-lose-it requirements. The following example shows how the experience gain could be allocated:

EXAMPLE: An employer maintains a cafeteria plan under which its 1,200 employees may elect one of several different annual coverage levels under a health FSA in \$100 increments from \$500 to \$2,000. In a plan year, 1,000 employees elect levels of coverage under the health FSA. For that year, the FSA has an experience gain of \$5,000. The employer may allocate the \$5,000 to all premium payers for the year, as a premium refund, on a per capita basis weighted to reflect the participants’ elected levels of coverage. Alternatively, the \$5,000 may be used to reduce the required premiums under the health FSA for all eligible employees for the next plan year (e.g., a \$500 health FSA for the next year might be priced at \$480) or to reimburse claims incurred above the elective limit in such year as long as such reimbursements are made in a nondiscriminatory manner.

For more information about health FSAs, see *The Payroll Source*®, pp. 4-56 to 4-61.

Update on Income Tax Treaties

The U.S. has income tax treaties with nearly 60 countries. Income tax treaties exempt or reduce the amount of withholding from wages earned by nonresident aliens in the U.S. if certain conditions are met (see *The Payroll Source*®, pp. 14-17 and 14-18 for additional discussion of income tax treaties). Since PAYROLL CURRENTLY last reported on the subject (see *Issue No. 18, Vol. 14*), a protocol amending an existing income tax treaty with France has entered into force, a new income tax treaty with Belgium has been signed, the U.S. has signed its first income tax treaty with Bulgaria, and a new treaty with Iceland has been negotiated. In addition, significant changes have been made to the U.S. Model Income Tax Convention.

U.S.-France treaty protocol enters into force

A protocol amending the 1994 income tax treaty between the U.S. and France was ratified by the U.S. Senate on March 31, 2006. Among other things, the protocol revises the provisions governing the tax treatment of retirement benefits. Payments under social security or similar legislation of one country to a resident of the other country, and pension distributions and other similar remuneration arising in one country in exchange for past employment paid to a resident of the

other country, will be taxable only in the source country. Pension distributions and other similar remuneration are “sourced” in a country only if paid by a pension or other retirement arrangement established in that country.

On December 21, 2006, the Treasury Department announced that the U.S.-France treaty protocol had entered into force. It is generally effective with respect to taxes withheld at source for amounts paid or credited on or after February 1, 2007. With respect to other taxes, it is effective for taxable periods beginning on or after January 1, 2007.

Treaty signed with Bulgaria

On February 23, 2007, the U.S. and Bulgaria signed their first income tax treaty and protocol, the result of negotiations begun in 2005. In general, the agreements require Bulgaria to exempt the income of a resident of Bulgaria from its income tax if the income may be taxed in the U.S., while the U.S. is required to provide a credit against its income tax to a U.S. resident for income tax paid or accrued to Bulgaria. The treaty and protocol have not yet been transmitted to the Senate.

The agreements reduce, but do not eliminate, the rates of taxation on cross-border dividends, interest, and royalty payments, and generally eliminate withholding when cross-border dividends

are paid to pension funds, and when cross-border interest is paid to the government of the other country or to a financial institution resident in the other country. Like the agreement negotiated by the U.S. with Belgium (see below), this agreement has provisions designed to prevent treaty shopping, which is the inappropriate use of a tax treaty by third-country residents, as well as provisions to improve the exchange of information.

Treaties/protocols signed, awaiting ratification

On July 17, 2007, the Senate Committee on Foreign Relations held a ratification hearing on a proposed tax treaty with Belgium and proposed tax protocols with Denmark, Finland, and Germany.

U.S.-Belgium. The U.S. and Belgium signed a new income tax treaty on November 27, 2006, to replace an existing treaty. The new agreement significantly reduces tax-related barriers to trade and investment between the U.S. and Belgium, and takes into account changes in the laws and policies of both countries since the current treaty was signed.

For example, it eliminates source-country withholding tax on dividends arising from certain direct investments and on dividends paid to pension funds. Provisions have been added governing

contributions to, and benefit accruals of, pension plans to remove barriers to the flow of personal services between the two countries. Students, teachers, business trainees, and researchers from one country visiting the other country would generally be exempt from the other country's taxation on certain types of payments. The agreement is the second signed by the U.S. to provide for mandatory arbitration of certain disputes that cannot be resolved by the competent authorities of the two countries within a specified period of time. It also includes stronger provisions to prevent treaty shopping and provisions to improve the exchange of information between the two countries.

U.S.-Denmark. The U.S. and Denmark signed a treaty protocol on May 2, 2006, amending an existing treaty. It allows the U.S. to tax a former citizen

or former long-term resident under IRC §877 (i.e., for 10 years following the loss of such status) regardless of whether a principal purpose of the termination of citizenship or residency was to avoid tax. It provides for elimination of source-country withholding tax on dividends arising from certain direct investments and on dividends paid to pension funds. There are also new anti-treaty-shopping provisions.

U.S.-Finland. The U.S. and Finland signed a treaty protocol on May 31, 2006, to amend an existing treaty. Like the Denmark protocol, it allows the U.S. to tax a former citizen or former long-term resident under IRC §877 regardless of whether a principal purpose of the termination of citizenship or residency was to avoid tax. It provides for elimination of source-country withholding tax on dividends arising from certain direct investments and on dividends paid to pension funds. It also provides for the elimination of cross-border royalty payments and includes new anti-treaty-shopping provisions.

U.S.-Germany. The U.S. and Germany signed a treaty protocol on June 1, 2006, to amend an existing income tax treaty. It updates the existing treaty to incorporate changes in the laws and policies of the two countries since that time, including changes involving relief from double taxation. This is the first protocol to incorporate a provision directing the mandatory arbitration of certain disputes that cannot be resolved within a certain time by the treaty's competent authorities.

The protocol also allows the U.S. to tax a former citizen or former long-term resident under IRC §877 regardless of whether a principal purpose of the termination of citizenship or residency was to avoid tax. It would treat the income derived from independent personal services (such as income from the performance of professional services) as "business profits" and eliminate the article in the present treaty governing independent personal services. It would eliminate source-country withholding tax on dividends arising from certain direct investments and on dividends paid to pension funds. It would also provide that pensions and other similar remuneration paid in consideration of past employment

as well as benefits paid under the social security legislation of one country are taxable only in the country of which the recipient is a resident, based on the social security legislation. The provision governing visiting professors and teachers, and students and trainees, would increase the exemption from host country tax for students and trainees receiving certain types of payments, and provides that professors or teachers from one country visiting the other country for more than two years do not retroactively lose their exemption from the host country's income tax. There are also updated anti-treaty-shopping provisions.

U.S. and Iceland negotiate new treaty

On September 28, 2006, the U.S. announced that negotiations had been concluded with Iceland to replace the 1975 tax treaty between the two countries. The agreement must be signed by the two countries and ratified before it can enter into force.

The proposed treaty takes into account changes in the law and policies of both countries since the current treaty was signed. For example, the proposed treaty provides for a positive rate of withholding on certain cross-border royalty payments, in conformity with Iceland's current tax treaty policy. To conform to the current tax treaty policy of the U.S., the proposed treaty has a comprehensive limitation on benefits provision so that only residents satisfying the conditions of that paragraph enjoy the benefits of the treaty.

New Model Income Tax Convention released

In negotiating bilateral tax treaties with other countries, the U.S. uses a Model Income Tax Convention as a starting point. On November 15, 2006, the Treasury Department issued a new version of the Model Income Tax Convention that reflects changes in U.S. domestic law and tax treaty policy since the model was last updated in 1996. Here are some of the changes made by the 2006 Model Convention:

- Article 1 (General Scope) has been modified to allow the U.S. to tax a former citizen or former long-term resident under IRC §877. The requirement that the loss of status must have been made with the intent to avoid tax has been removed.
- In Article 2 (Taxes Covered), the

News Notes...

School Tuition May Be a Medical Expense

According to a recent IRS letter ruling, the cost of tuition for a medically handicapped child may be deductible as a medical expense under IRC §213 [LTR 200729019, 4-10-07]. Of interest to payroll professionals is the fact that deductible medical expenses for individual income tax purposes under §213 are reimbursable under medical flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs) or from health savings accounts (HSAs).

IRS regulations (26 C.F.R. §1.213-1(e)(1)(v)(a)) provide that the cost of medical care includes the cost of attending a "special school" whose primary purpose is enabling students to compensate for or overcome handicaps. In the scenario under consideration, the taxpayer's child had been diagnosed with several developmental disorders, including learning disabilities of a medical nature. As a result of this diagnosis, the child was referred to a school with a program designed "to enable [the child] to compensate for and overcome her diagnosed medical conditions." The Service concluded that the tuition paid to the school was a deductible medical expense.

scope of taxes covered has been expanded to include taxes on income imposed on behalf of a Contracting State (the U.S. or the other signatory country), irrespective of the manner in which they are levied. This replaces a listing in the 1996 Model Convention of specific taxes covered for both of the Contracting States. Taxes on income would include all taxes imposed on total income, or on elements of income.

- Article 3 (General Definitions), defines an “enterprise” and a “business” for the first time, and specifies that a “business” includes the performance of professional services and other activities of an independent character. In addition, the 2006 Model Convention no longer defines “qualified governmental entity.” As a consequence, activities (other than those of pension funds) of the U.S. or its political subdivisions (e.g., states) could be subject to tax on dividends in the other treaty country. (Activities of a foreign country in the U.S. remain covered by IRC §892.)

The 2006 Model Convention eliminates the concept of a qualified governmental entity and grants treaty benefits instead to a treaty country government and to a political subdivision or local authority of that government. This grant of treaty benefits to governments and political subdivisions may be narrower than the 1996 rule because the definition of qualified governmental entity in the 1996 Model Convention included certain quasi-governmental entities.

- Article 4 (Resident) is modified to address additional situations in which a company may be a resident of both Contracting States.

- Article 10 (Dividends) eliminates special rules for dividends beneficially owned by a “qualified governmental entity.”

- Article 14 in the 1996 Model Convention (Independent Personal Services) has been removed and is replaced with a new Article 14 (Income from Employment), which is substantially similar to Article 15 (Dependent Personal Services) of the 1996 Model Convention. The subject matter of Article 14 from the 1996 Model Convention is covered by the new definition of “business,” described above, and by Article 7 (Business Profits).

- Article 18 (Pensions) has been completely rewritten. It incorporates, with modifications, provisions from the 1996 Model Convention governing situations in which an individual participating in a pension plan established and legally recognized in a treaty country performs services in the other treaty country (the “host country”).

Under new rules governing pension fund contributions and benefits with respect to U.S. citizens who are residents of the treaty country in which the pension fund is resident, contributions attributable to the employment paid by or on behalf of the individual during the employment period to the pension fund are deductible or excludable in computing the individual’s income tax.

- Article 20 (Students and Trainees) has been modified so that the income tax exemption for students and business trainees who are residents of one Contracting State visiting another Contracting State to pursue full time education or training no longer applies to apprentices. A new additional exemption for remuneration from personal services has been created, is initially set at \$9,000, and will be adjusted every five years to take into account changes in the U.S. income tax personal exemption and standard deduction. The 2006 Model Convention defines a “business trainee,”

a term that had been left undefined in the 1996 Model Convention.

- Article 22 (Limitations on Benefits) has been changed significantly in the 2006 Model Convention to make it more difficult for third-country residents to engage in treaty shopping.

- Article 23 (Relief from Double Taxation) is unchanged except that a new “resourcing” rule has been added, under which gross income derived by a resident of the U.S. that under the treaty may be taxed in the other Contracting State is deemed to be income from sources in the other Contracting State so as to enable a U.S. resident to obtain an appropriate U.S. foreign tax credit.

Information about tax treaties

- Detailed summaries of the individual tax treaties currently in force between the U.S. and other countries can be found in the APA’s *Guide to Global Payroll Management* (see www.americanpayroll.org).

- IRS Publication 515 (*Withholding of Tax on Nonresident Aliens and Foreign Entities*) contains general tax treaty information, as well as a table of tax treaties providing information about tax exemptions for nonresident aliens. Publications 901 (*U.S. Tax Treaties*) and 597 (*Information on the U.S.-Canada Income Tax Treaty*) contain more detailed explanations. Form 6166 is a letter of U.S. residency certification for purposes of claiming benefits under an income tax treaty.

All of these materials, plus tax treaties and proposed treaty documents themselves, and the 2006 Model Convention (together with a technical explanation) can be found on a new IRS Web page: www.irs.gov/businesses/international/article/0,,id=96739,00.html. **PC**

On Second Thought, Court Says Taxation of Damages for Nonphysical Personal Injuries Is Constitutional After All

The U.S. Court of Appeals for the District of Columbia has affirmed the constitutionality of IRC §104(a)(2) after previously ruling that the section was unconstitutional [*Murphy v. IRS*, No. 05-5139 (D.C. Cir., 7-3-07)]. Note: IRC §104(a)(2) excludes an award of damages (other than punitive damages) from gross income if it is received “on account of

personal physical injuries or physical sickness.” For purposes of this exclusion, a provision added in 1996 explains that “emotional distress shall not be treated as a physical injury or physical sickness.”

Background

In its earlier ruling (see *PAYROLL CURRENTLY*, Issue No. 19, Vol. 14), the court had ordered a refund of taxes

paid by Marrita Murphy on an award of \$70,000 for emotional distress and injury to her reputation because of the misconduct of her former employer, the New York Air National Guard. The NYANG had “blacklisted” her and provided unfavorable references to potential employers after she complained to state authorities about environmental hazards

on a NYANG airbase.

A psychologist testified that Murphy had suffered “physical manifestations of stress,” including teeth grinding, anxiety attacks, shortness of breath, and dizziness; Murphy testified that she could not concentrate, stopped talking to friends, and no longer enjoyed “anything in life.”

IRC §104(a)(2) and IRC §61

The court said that Murphy was compensated only for mental pain and anguish and for injury to her professional reputation. At best, her physical injuries may have been considered as evidence of the severity of her emotional distress, but “her physical injuries themselves were not the reason for the award.” Therefore, said the court, §104(a)(2) does not permit Murphy to exclude her award from gross income.

IRC §61(a) defines gross income as “all income from whatever source derived,” but because damages for

emotional distress are not listed among the examples of income under that section, it is unclear whether they are included in the definition. However, reading §61 with §104(a)(2) clarifies the matter, said the court.

The §104(a)(2) exclusion from gross income was narrowed by Congress in 1996 explicitly to provide that “emotional distress shall not be treated as physical injury or physical sickness.” In other words, an award on account of emotional distress is *not excluded* from gross income. “For the 1996 amendment of §104(a) to make sense,” said the court, “gross income in §61 must include an award for nonphysical damages such as Murphy received.”

Congress's power to tax

To be permitted under the Constitution, a direct tax – laid on the general ownership of property – must be apportioned by population. For example, taxes on real or personal property are

direct taxes. An indirect tax – generally referred to as an excise tax – must be uniform throughout the U.S. Examples of excise taxes include taxes on activities, uses, and privileges incidental to the ownership of property such as sales, gifts, and particular business transactions.

Here, Murphy's award was not a tax on the ownership of property. She surrendered some part of her mental health and reputation in return for monetary damages, and was taxed only after she received a compensatory award. In other words, the tax was assessed on a transaction.

Murphy was vindicating her rights using the legal system; and legal rights are a privilege taxable by excise, said the court. Finally, the court noted that the tax on an award of damages for a nonphysical personal injury operates with “the same force and effect” throughout the U.S. and therefore satisfies the requirement of uniformity. **PC**

IRS Issues Proposed Regulations on Payment Card Transactions and TIN Matching

The IRS has issued proposed regulations on information reporting and backup withholding in connection with payment card transactions and the Taxpayer Identification Number (TIN) Matching Program [72 F.R. 38534, 7-13-07].

Background

Businesses must report payments to individuals and others who are not employees if they consist of interest or dividends, payments of wages due a deceased employee made to the employee's beneficiary or estate, compensation (\$600 or more for the year) for services rendered by independent contractors, royalties, broker transaction payments, payments to attorneys, or direct sales of \$5,000 or more. Payers of reportable payments must withhold 28% in 2007 for federal income tax from such payments if:

- the payee fails to provide the payer with a TIN – either a Social Security Number (SSN), IRS Individual Taxpayer Identification Number (ITIN), or Employer Identification Number (EIN) – or provides one that is obviously incorrect (e.g., wrong number of digits);
- the payer is notified by the IRS

that the TIN provided by the payee is incorrect;

- the payer is notified by the IRS that a payee has underreported interest or dividend payments; or
- the payer does not receive from a payee receiving interest or dividend payments a certification that the payee is not subject to withholding (see *The Payroll Source*[®], p. 6-39).

2004 regulations

Final regulations issued in 2004 (69 F.R. 41938, 7-13-04; see **PAYROLL CURRENTLY, Issue No. 15, Vol. 12**) permit a payment card organization to obtain an IRS determination that it is a Qualified Payment Card Agent (QPCA) and provide limited exceptions to the backup withholding requirements for payment card transactions:

- **Qualified payees.** Backup withholding does not apply to a payment card transaction if the reportable payment is made through a QPCA and the payee is a qualified payee. A payee is qualified if, at the time of the payment, the QPCA has validated the payee's TIN through the IRS TIN Matching Program or if the payment is made during the six-month period

following the date on which the QPCA first makes a payment to the payee. A QPCA must notify a cardholder/payer of any merchant/payees that are not qualified payees.

- **Nonqualified payees.** Backup withholding also does not apply to a reportable payment made through a QPCA if the purchase to which the payment relates is made no later than two months after the date by which the QPCA is required to provide notification to the payer that the payee is not a qualified payee. A cardholder/payer may establish, based on good faith reliance on a QPCA, that a failure subject to penalty is due to reasonable cause.

Proposed regulations

In response to comments, the IRS is proposing certain modifications to the 2004 guidance:

Merchant/payee opts out of QPCA program

- If a merchant/payee opts out of the QPCA program, payments to the merchant/payee made after the six-month grace period are treated as payments to a nonqualified payee.
- Cardholders generally would not be permitted to rely on a QPCA to

solicit, validate, and furnish a payee's TIN after the cardholder is notified that the merchant is not a participating payee.

- Notification requirements would be added relating to payments to nonparticipating merchant/payees. A QPCA would be required to inform a cardholder using the QPCA's card to make reportable payments to a nonparticipating payee that the payee is not a participant in the QPCA program and is not a qualified payee. In addition, the QPCA would have to advise the cardholder/payer of the cardholder/payee's obligation to solicit the TIN of a nonparticipating merchant/payee to which it makes a reportable payment.

Furnishing payee status information electronically

In order to reflect the current electronic business operations of the payment card industry (and consistent with the regulations permitting Forms W-2 to be furnished electronically), the proposed regulations would permit a QPCA to furnish notifications of payee status and participation electronically, including by posting on a secure Web site, if the payment card organization:

- obtains certain consents from cardholder/payers and merchant/payees, and
- provides certain disclosures to cardholders/payers and merchant/payees.

Notice 2007-59

To implement the proposed regulations, the IRS has issued a notice with a proposed revenue procedure modifying the requirements a payment card organization would have to satisfy to obtain and retain QPCA status [Notice 2007-59, 2007-30 IRB 135]. Four

significant changes are highlighted:

- The written notices that the payment card organization must provide to cardholder/payers and merchant/payees may be mailed *or furnished electronically*. If a notice is furnished electronically, a notification that important tax and privacy information is being provided must be included on the subject line of the electronic communication through which the notice is furnished.

- The written notices provided to merchant/payees will no longer be required to inform merchant/payees that they will be treated as participants in the QPCA program if they continue to accept the organization's payment card. Instead, the notice must inform merchant/payees that they may opt out of the QPCA program by completing and returning a written statement to the payment card organization and that they may continue to accept the organization's payment card even if they opt out of the QPCA program.

- The reporting requirements are modified to reflect the fact that a QPCA's payment card may be accepted by merchant/payees that have opted out of the QPCA program. Although QPCAs do not act on behalf of such nonparticipating payees in furnishing payee data to cardholders, the QPCA is required to furnish certain information to cardholders that use the QPCA's card to make reportable payments to nonparticipating payees. Specifically, the QPCA is required to inform the cardholder that the payee is not a participant in the QPCA program and is not a qualified payee. In addition, the QPCA must advise the cardholder/payer of the cardholder/payer's

obligation to solicit the name and TIN of a nonparticipating merchant/payee to which it makes a reportable payment.

- The reporting requirements are also modified to provide specific authority for furnishing the merchant/payee data report electronically, including by posting on a secure Web site. Electronic reporting is permitted only if both the cardholder/payer and merchant/payee consent by returning the consent form included with the written notice provided by the QPCA.

Proposed effective date

The amendment on electronic furnishing of notifications is proposed to be effective on the date it is published as a final regulation. The other amendments are proposed to be applicable to payments made and information returns/statements filed after December 31, 2007.

Comments

Comments on the proposed regulations must be received by October 9, 2007. Send written comments to: CC:PA:LPD:PR (REG-163195-05), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Or submit comments electronically at: www.regulations.gov (IRS-REG-163195-05).

Comments on the proposed revenue procedure must be received by September 24, 2007. Send written comments to: CC:PA:LPD:PR (NOT-2007-59), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Or submit electronically to: Notice.Comments@irs.counsel.treas.gov (include "Notice 2007-59" in the subject line). **PC**

IRS Issues Electronic/Magnetic Media Filing Requirements for Forms 1098, 1099, 5498, and W-2G

The IRS has published the requirements for filing Forms 1098, 1099, 5498, and W-2G electronically or magnetically for current and prior year information returns filed beginning January 1, 2008, and postmarked by December 1, 2008 [Rev. Proc. 2007-51, 2007-30 IRB 143; www.irs.gov/pub/irs-irbs/irb07-30.pdf]. Changes for tax year 2007 are as follows:

Important notices

- IRS/ECC-MTB (Internal Revenue Service, Enterprise Computing Center – Martinsburg) offers an Internet connection at <http://fire.irs.gov> for electronic filing. The FIRE (Filing Information Returns Electronically) system will be down from 2 p.m. ET, December 20, 2007, through January 2, 2008, for upgrading. It will not

be operational during this time for submissions. *Note:* The FIRE system does not provide fill-in forms for information returns.

- IRS/ECC-MTB no longer accepts 3½-inch diskettes for filing information returns.

- Tax year 2007 is the last year IRS/ECC-MTB will accept tape cartridges for filing information returns.

Tape cartridges must be received by December 1, 2008, in order to be processed for the current year. After December 1, 2008, electronic filing through the FIRE system will be the *only* acceptable method for filing information returns for those payers with 250 or more returns of any one type to file.

Programming changes

General

- Test procedures have been eliminated from Part A, because tape cartridges will not be acceptable after December 1, 2008. Electronic filing specifications in Part B (Section 4) detail testing procedures for electronic files.

- Form 8809, *Application for Extension of Time to File Information Returns*, is available as a fill-in form on the FIRE system (see Part E, Section 1).

Use of this version of the form is highly encouraged instead of the paper Form 8809.

Transmitter "T" Record

- For all forms, Payment Year, Field Positions 2-5, must be incremented to update the four-digit report year (2006 to 2007), unless reporting prior year data.

Payer "A" Record

- For all forms, Payment Year, Field Positions 2-5, must be incremented to update the four-digit report year (2006 to 2007), unless reporting prior year data.

- Three fields have been deleted and are no longer required: Original File Indicator (position 48), Replacement File Indicator (position 49), and Correction File Indicator (position 50). Positions 48-50 are now blank.

Payee "B" Record

- For all forms, Payment Year, Field Positions 2-5, must be incremented to update the four-digit report year (2006 to 2007), unless reporting prior year data.

- For Form 1099-R, Date of Designated Roth Contribution (position 552-559), has been changed to First Year of Designated Roth Contribution (positions 552-555). Only the year of the first Roth contribution is now required, not the complete date.

- For Form 1099-R, Distribution Code "B" may now be used with codes "P" and "4."

- Utah, State Code 49, has been added to the Combined Federal/State Filing Program (see Part A, Section 12, for the Participating States and Their Codes table). **PC**



STATE AND LOCAL NEWS

For more state and local news, subscribe to APA's *PayState Update*, the biweekly newsletter devoted exclusively to state and local payroll compliance. Call 210-224-6406 or visit www.americanpayroll.org for more information.

New Hampshire Effective 9-11-07, employers may pay wages using a payroll card provided the employee has at least one free means to withdraw the full amount of the balance in the payroll card/payroll card account during each pay period at a financial institution or other location convenient to the place of employment. None of the employer's costs associated with a payroll card/payroll card account may be passed on to the employee. An employer that offers payroll cards must provide written disclosure of the terms and conditions of the payroll card account option, including a list of fees. An employee must voluntarily consent in writing to be paid via a paycard [H.B. 611, L. 2007].

Pennsylvania Effective 1-1-08, the Emergency and Municipal Services Tax (EMST) is renamed the Local Services Tax (LST). All employers with worksites in a taxing jurisdiction (municipalities, except for the city of Philadelphia, and school districts, except for the Philadelphia and Pittsburgh School Districts) are required to deduct the LST from employees' wages at the site of employment if the tax is listed in the *Local Tax Register*. The LST may be no more than \$52 per employee for each calendar year, regardless of the number of taxing jurisdictions within which a person may be employed.

If the LST is levied at a combined rate of \$10 or less, it may be withheld in a lump sum. If the LST is levied at a combined rate of more than \$10 in a calendar year, the LST must be assessed and collected on a prorated basis for each payroll period. Employers are required to remit the LST to the designated tax collector 30 days after the end of each calendar quarter. Taxing jurisdictions that levy an LST at a rate of more than \$10 must exempt from the LST those taxpayers whose earned income and net profits from all sources within the taxing jurisdiction is less than \$12,000 for the calendar year in which the LST is levied. Taxing jurisdictions that levy an LST at a rate of \$10 or less may provide for the low-income exemption. In order to receive an upfront exemption, employees must file an exemption certificate (to be developed by the Department of Community and Economic Development) with the taxing jurisdiction and employer. Employers are relieved of liability for the LST if they fail to withhold the tax due to incorrect information provided by the employee regarding the employee's principal employer or if the employer complies with the provisions establishing the collection of the tax on a payroll period basis. Except for monitoring when an employee who has filed an exemption certificate earns more than \$12,000, employers are not responsible for investigating exemptions, monitoring tax exemption eligibility, or exempting an employee from the LST [S.B. 218, L. 2007; Gov. Edward Rendell Press Release, 6-21-07].