

2010 INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE PUBLIC REPORT TABLE OF CONTENTS

2010 IRPAC Public Report Letter from the Chair.....	5
Executive Summary of Issues	9
Tax Gap Subgroup Report.....	17
A. Updating Estimates of Estate Tax Filing Noncompliance	19
B. Updating the Estate Tax Underreporting Gap for TY 2004	20
C. Strategy for Updating the Tax Gap Estimates	20
Employee Benefits & Payroll Subgroup Report	21
A. Health Care Valuation on Form W-2.....	23
B. Tip Reporting Compliance and Enforcement Efforts	27
C. EINs for Qualified Plans/Trusts.....	31
D. TIN Masking on Payee 1099s.....	33
E. Transparency for Abusive Use of Multiple EINs – to Establish Multiple Tax- Favored Benefit Plans	34
F. 2009 Form 5500/5330 Automatic Extension for Calendar Year Plans	35
G. Basis Allocation for Direct Rollovers.....	37
Ad Hoc Subgroup Report.....	41
A. Electronic Furnishing of Forms 1098, 1099, 5498 and W-2	43
B. Form 5498 and Fair Market Value Reporting for Deceased Beneficiaries and Successor Beneficiaries	44
C. Information Regarding Non-Resident Alien Taxation and Tax Reporting	46
D. Reporting Guidelines for the Return of Mistaken HSA Contributions to an Employer.....	47
E. Form 1099-R Reporting under EPCRS Guidelines for SEP, SARSEP and SIMPLE Excesses Returned to Employer	49
F. Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information Due Date Change	50
Burden Reduction Subgroup Report	53
A. Announcement 2010-41: New Backup Withholding Procedures.....	55
B. Form 1099-INT, Box 10 and Associated Instructions	56
C. IRC §1441 and §1442 Documentation and Withholding Issues on Freight, Shipping and Other Transportation Expenses.....	61
D. Comments on Proposed Cost Basis Regulations	68
E. K-1 Matching Program	74
F. Information Reporting for Tax Credit Bonds and Stripped Tax Credits	76

2010 INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE PUBLIC REPORT TABLE OF CONTENTS

G. Electronic Power of Attorney (POA) Validation for Business Returns	78
H. Central Withholding Agreements: Addressing Needs of Venues and Foreign Performing Artists through a Mini-CWA Program and Problems Encountered by Foreign Artists When Applying for U.S. Social Security Numbers (SSNs)	79
I. IRS Business Master File (BMF).....	81
J. Staggered “B” Notices	81
K. Form 8886, Reportable Transaction Disclosure Statement	82
Emerging Compliance Issues Subgroup Report	85
A. Foreign Account Tax Compliance (FATCA) Provisions	87
B. Section 6050W, Information Reporting of Payments Made in Settlement of Payment Card and Third Party Network Transactions	90
C. Expansion of Information Reporting Under IRC Section 6041.....	93
D. Withholding Tax Issues	96
E. Identity Theft and Information Reporting.....	98
F. Clarification of the Information to be Reported to U.S. Investors on the Form 1099-DIV, Box 6, Foreign Tax Paid.....	100
Appendix.....	103

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE

General Report

**LISA CHAVEZ, CHAIRPERSON
ELIZABETH DOLD, VICE-CHAIR
MARSHA BLUMENTHAL
DOUGLAS BORISKY
CHARLES CHRISTIAN
JAMES DRIVER
CANDACE B. EWELL
LISA GERMANO
JOAN M. HAGEN
C. LEONARD JACOBS
PHILIP KIRCHNER
JERRI LANGER
ANNE C. LENNAN
STEPHEN LEROUX
EMILY LINDSAY
CONSTANCE D. LOGAN
ANDREW B. LYON
BARBARA L. MCARTHUR
LILLIAN F. MILLS
DONALD C. MORRIS
MARJORIE A. PENROD
GEORGE A. PLESKO
KATHY PLOCH
PAULA D. PORPILIA
SUSAN P. SEGAR
ERIC J. TODER
KATHRYN S. TRACY
ARTHUR B. WOLK**

2010 IRPAC Public Report Letter from the Chair

The purpose of IRPAC is to provide recommendations to the IRS for the continued improvement of the tax information reporting program. IRPAC provides a public forum for the IRS to meet on a regular basis with tax professionals engaged in both the production and use of tax information returns to discuss issues and to work in partnership to develop solutions. The importance of IRPAC's role continues to grow as laws requiring more complex and voluminous information returns stretch the resources of both IRS and the information reporting community.

Congress recognized the critical function of tax information reporting in the federal tax system when it recommended that the IRS consider "the creation of an advisory group of representatives from the payer community and practitioners interested in the information reporting program to discuss improvements to the system."¹ The Information Reporting Program Advisory Committee (IRPAC) was formed in 1991 as a result of this recommendation, which is contained in the final conference report for the Omnibus Budget Reconciliation Act of 1989. Congress believed that such an advisory group would be helpful for the purpose of discussing "problems and the feasibility of complying with, or the economic impact of, rules and regulations affecting the reporting industry."²

IRPAC serves as an advisory body to the Commissioner of Internal Revenue. As reflected in its Charter,³ IRPAC's duties are to identify, research, analyze and provide recommendations regarding specific information reporting issues, current or proposed IRS information reporting policies, programs and procedures, and when necessary, suggest improvements to information reporting operations and/or administration of the Information Reporting Program. IRPAC is not permitted to engage in lobbying activities, but may comment on the benefits and burdens of legislation that includes tax information reporting provisions.

Over the past 20 years IRPAC has worked in partnership with the IRS to improve the information reporting program in a manner that facilitates the gathering of information useful to the IRS while balancing the burden placed on the parties required to provide it. Key initiatives in recent years aimed at raising revenue and increasing voluntary compliance will result in an exponential increase in the volume and complexity of information returns required to be filed in the very near future. Four such initiatives are particularly worthy of note, and are discussed in greater detail in the report that follows.

¹ H.R. CONF. REP. 101-386, at 662 (1989).

² *Id.*

³ See links to Charter at <http://www.irs.gov/taxpros/article/0,,id=98158,00.html>

- 1) **Expansion of Form 1099-MISC Reporting:** A provision in the Patient Protection and Affordable Care Act of 2010 added a new information reporting requirement under Internal Revenue Code (IRC) Section 6041 that will require all businesses to issue Forms 1099 for goods purchased after 2011 and will expand the scope of Section 6041 to require reporting with respect to payments made to corporations. Under prior law, reporting was required for the purchase of services but was not required for the purchase of goods, and payments to corporate vendors were exempt from reporting. IRPAC met with the IRS to discuss the challenges presented by these changes in law and issued two comment letters providing extensive analysis of the implications of these changes on the IRS and offering recommendations for the reduction of burdens on the IRS and the information reporting community.
- 2) **Cost Basis Reporting:** In late 2008, legislation was passed mandating the reporting by financial institutions of customer cost basis in securities transactions. IRPAC was engaged early in cost basis discussions⁴ and continued to meet with IRS executives and Chief Counsel in 2010 to discuss the challenges of implementing the cost basis reporting rules. IRPAC published four comment letters this year offering comprehensive comments and recommendations.
- 3) **Section 6050W Reporting:** Also in 2008, section 6050W was added to the IRC, requiring reporting of payments made in settlement of payment card and third party network transactions. IRPAC was also engaged early in these discussions⁵ and continued to meet with the IRS in 2010. IRPAC issued a comment letter in early January 2010 relating to the proposed section 6050W regulations, and our report summarizes those recommendations and comments on the final regulations published in August.
- 4) **Foreign Account Tax Compliance Act (FATCA):** Expansive new withholding and tax information reporting rules impacting payments of U.S. source income to foreign financial institutions and non-financial foreign entities became law in March 2010. IRPAC began reviewing earlier versions of this legislation in 2009, and continued discussions with the IRS and Treasury in 2010. A summary of those discussions is contained in this report and IRPAC intends to issue a formal written comment letter relating to FATCA guidance released in Notice 2010-60.

⁴ See IRPAC 2009 Public Report, Cost Basis Subgroup Report, at page 25 therein.

⁵ See IRPAC 2009 Public Report, Emerging Compliance Issues Subgroup Report, at page 37 therein.

IRPAC is generally supportive of the federal government's efforts to combat tax avoidance and close the tax gap, and agrees that tax information reporting plays an important role in these efforts. We also recognize that laws requiring more information reporting must be implemented in a manner that carefully balances the benefits to be gained with the burdens on both the IRS and the information reporting community; and this is particularly important when multiple new requirements, such as those highlighted above, impact the same institutions and have overlapping implementation time frames.

During 2010, IRPAC also recognized the increasing importance and complexity of payroll and employee benefits information reporting by forming a new subgroup focused on these issues. It is expected that this group will continue to work with the IRS on the challenges of reporting required under the recently enacted Patient Protection and Affordable Care Act, as well as other employee benefit and payroll related reporting issues. The breadth and depth of issues addressed by IRPAC in 2010 are impressive and there are success stories to tell. I encourage readers to review the Executive Summary and each of the detailed subgroup reports that follow.

The 2010 IRPAC team consists of 29 members,⁶ 22 of whom focus on matters related to information reporting.⁷ The members focused on information reporting worked together within the structure of four subgroups: Emerging Compliance Issues, Burden Reduction, Employee Benefits and Payroll and Ad Hoc. The Tax Gap subgroup conducted its tasks independently. Detailed reports from each of these groups are contained herein, and cover a variety of issues as summarized in the Executive Summary. The Appendix also contains comment letters issued by IRPAC for this year to date.

Throughout my three-year term on IRPAC, I have been impressed with the breadth and depth of knowledge of its members with whom it has been my pleasure to serve. As IRPAC's 2010 Chair, I have witnessed their dedication, hard work and professionalism and wish to thank them for the many hours they have devoted as volunteers to improve the tax information reporting program. In particular, I would like to thank the four subgroup chairs with whom I worked closely throughout the year: Douglas Borisky, Barbara McArthur, Elizabeth Dold and Stephen LeRoux.

IRPAC operates under the direction and with the assistance of the Office of National Public Liaison (NPL), under the leadership of Candice Cromling, Director of NPL, and could not function without their support. Our success is due in large part to the organizational skills of IRPAC Program Manager, Caryl Grant, and the persistence of our NPL liaisons: Anjali Garg, Velancia Matthews, Jane Agule and Michael Singleton, in setting up meetings with our IRS partners. On

⁶ See IRPAC 2010 Member Biographies: <http://www.irs.gov/taxpros/article/0,,id=177432,00.html>

⁷ The other seven members address matters related to the Tax Gap, and their report is included herein.

behalf of all IRPAC members, I would like to thank the members of NPL who continue to provide outstanding support and share in our successes.

This is an exciting time to be a tax information reporting professional. Our skills are in high demand within the industries that employ us, and our insights and experience are critical to the continued improvement of the tax information reporting program. As IRPAC looks forward to continuing its partnership with the IRS in the challenging years to come, I wish both partners continued success in balancing the needs of tax compliance with the burdens on the information reporting community.

Respectfully submitted,

A handwritten signature in cursive script that reads "Lisa M. Chavez".

Lisa M. Chavez
2010 IRPAC Chair

Executive Summary of Issues

Tax Gap Subgroup

The subgroup made recommendations concerning updating estimates of estate tax filing non-compliance and a strategy for updating the tax gap estimates. Members of the subgroup emphasized the need to explain carefully the determinants of the tax gap estimates and the degree of confidence associated with various components. There was concern that changes that reflect improvements in methodology or random errors could be misinterpreted as reflecting real changes in compliance rates. The group discussed how best to communicate the results to avoid any misinterpretation.

Employee Benefits and Payroll Subgroup

A. Health Care Valuation on Form W-2

Based on the lack of guidance and time necessary to implement system-wide W-2 changes, IRPAC recommends that the IRS make health care reporting optional for 2011 or waive penalties for failure to comply.

B. Tip Reporting Compliance and Enforcement Efforts

To facilitate tip reporting and increase compliance, IRPAC recommends a number of changes to simplify the process and help identify and conform non-filers.

C. EINs for Qualified Plans/Trusts

Based on the lack of clear guidance on the need and the proper procedure for obtaining EINs for qualified plans/trusts, IRPAC strongly recommends changes to Forms 5500 and SS-4 (and related instructions) to clarify these rules and encourage plan sponsors to obtain a trust EIN for qualified plans.

D. TIN Masking on Payee 1099s

Supported by initial comments on the temporary pilot program, IRPAC recommends that the TIN Masking pilot (which provides for optional masking) be made permanent beginning for tax year 2011, and expand the program to additional 1099 series forms, paper or electronic, and cover SSNs or EINs.

E. Transparency for Abusive Use of Multiple EINs – to Establish Multiple Tax-Favored Benefit Plans

IRPAC recommends additional certification/disclosures be made on the entity's annual tax return for employers that improperly establish multiple tax-favored plans for its workforce through the use of multiple entities.

F. 2009 Form 5500/5330 Automatic Extension for Calendar Year Plans

IRPAC first recommended an automatic extension of the filing deadline for 2009 Form 5500s (without the need to file Form 5558) for calendar year plans to October 15, 2010 to be able to comply with EFAST2. As that extension was not granted, IRPAC further recommend that the 2009 Form 5500/5330 deadline for all calendar plans be extended to December 31, 2010 (or otherwise waive penalties for late filers through such date).

G. Basis Allocation for Direct Rollovers

IRPAC recommends that the IRS retain the long-standing interpretation of Code section 402(c)(2) and treat a partial or split direct rollover as a single distribution for basis allocation purposes.

Ad Hoc Subgroup

A. Electronic Furnishing of Forms 1098, 1099, 5498 and W-2

IRPAC recommends the IRS publish guidance to clarify procedures by which furnishers of these information statements might standardize the process for obtaining electronic affirmative consent, such as through a global consent to conduct business electronically, and bring it in line with other electronic business practices. IRPAC advanced this cause by gaining approval for a global electronic delivery consent FAQ for Form 1098-T, Tuition Statement.

B. Form 5498 and Fair Market Value Reporting for Deceased and Successor Beneficiaries

Effective for 2011 Form 5498 reporting, the IRS will provide instructions for IRA custodian/trustee/issuers to prepare such forms for deceased beneficiaries and their successor beneficiaries. The IRS will bring standardization to this reporting where no guidance previously existed.

C. Information Regarding Non-Resident Alien Taxation and Tax Reporting

IRPAC initiated and has supported an ongoing effort by the IRS to publish taxpayer friendly web-based content on IRS.gov for non-resident alien taxation, withholding and reporting. The content will be found in a section titled "Taxation of Aliens by Visa Type and Immigration Status." The IRS will populate IRS.gov in stages with content by visa type as it is approved by Counsel.

D. Reporting Guidelines for the Return of Mistaken HSA Contributions to an Employer

IRPAC requested 2011 reporting guidance in the Instructions for Forms 1099-SA and 5498-SA related to excess employer contributions to an HSA that are returned to an employer. A 2008 IRS Notice created this possibility but the reporting of the transactions had not been addressed. The request will result in an update to these instructions.

E. Form 1099-R Reporting under EPCRS Guidelines for SEP, SARSEP, and SIMPLE Excesses Returned to Employer

IRPAC requested 2011 reporting guidance in the Instructions for Form 1099-R with respect to SEP, SARSEP and SIMPLE excess employer contributions returned to the employer under an EPCRS streamlined VCP correction. The request will result in an update to these instructions.

F. Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information Due Date Change

A proposal was made to change the due date of Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information to participants from May 31 to January 31 to aid practitioners and taxpayers. Currently, there is insufficient support to make this change.

Burden Reduction Subgroup

A. Announcement 2010-41: New Backup Withholding Procedures: Social Security Number Validation following Receipt of Second “B” Notice

IRPAC commends the IRS on their release of interim procedures for payees requiring validation of their social security number to prevent or stop backup withholding. IRPAC will continue working with IRS as additional guidance, including revision of Rev. Proc. 93-37 and Publication 1281, is prepared.

B. Form 1099-INT, Box 10

As published for 2010, Form 1099-INT includes a new box 10 which is intended to convey the CUSIP number of each tax exempt bond from which the taxpayer derived tax exempt income. The addition of this information to the form comes from IRS’s need to identify taxpayers that are the beneficial owners of tax exempt private activity issues which are in danger of or have lost their tax exempt status. IRPAC’s recommendations are oriented toward consideration of alternate

approaches to communication with bondholders and, if the alternatives are untenable, addressing the structural and logistical shortcomings of the addition of box 10 to the Form 1099-INT. Since the introduction of the revised form 1099-INT there has been insufficient time for IRS to consider the issues identified by IRPAC or for payers to implement any systematic changes. It is recommended, therefore, that the obligation to report the CUSIP numbers of tax exempt bonds be deferred for at least one year.

C. IRC §1441 and §1442 Documentation and Withholding Issues on Freight, Shipping and Other Transportation Expenses

IRPAC began discussion with IRS Chief Counsel about Chapter 3, IRC §1441 and §1442 documentation and withholding issues on freight, shipping and other transportation expenses. Discussion topics have included: the absence of a clear withholding process for payments for transportation services made to foreign persons; the application of IRC §1441 and §1442 withholding to transportation payments that vary depending upon whether the services are classified as ship and air transportation subject to the 4% excise tax on U.S. source gross transportation income (GTI) or classified as trucking or rail transportation; the need for a simpler sourcing method for Chapter 3 withholding such as the one now used for GTI sourcing of transportation income; and the need for regulations that exempt "freight" from withholding under IRC §1441 and §1442 rules as part of the purchase price of the goods.

D. Comments on Proposed Cost Basis Regulations and the Draft 2011 Form 1099-B

IRPAC published three comment letters in 2010 and participated in many meetings and conference calls on cost basis reporting with IRS Chief Counsel. IRPAC notes that with the late release of cost basis regulations, the necessary guidance will not have been made available in time to guide required system development and provide time for testing of system changes. There are many implementation details that remain ambiguous or that are impossible to implement in the remaining time frame. IRPAC continues to recommend that serious consideration be given to delaying the implementation of these provisions to 2012, particularly as they apply to transfer statements, and to deferring enforcement of the gift and inheritance provisions to 2013.

E. K-1 Matching Program

IRPAC met with IRS SB/SE to discuss the IRS K-1 matching procedures, specifically to determine what is causing erroneous mismatch notices and what the IRS and practitioners can do to alleviate the false mismatches. Further, IRPAC asked IRS to investigate frivolous return notice procedures based on a case where fuel tax credit from a passthrough entity resulted in a frivolous return

notice even though the taxpayer's return was not disproportionately excessive to any business income.

F. Information Reporting for Tax Credit Bonds and Stripped Tax Credits

IRPAC made many recommendations in response to provisions outlined in IRS Notice 2010-28, Stripping Transactions for Qualified Tax Credit Bonds. IRPAC's recommendations are intended to harmonize the statutory requirements with how the securities industry functions while ensuring the availability of the information needed for a robust system of information reporting. All stakeholders will benefit from the recommendations because they provide the minimum disruption to existing processes. This translates into smoother and timelier implementation once all the details of the requirements are finalized by IRS.

G. Electronic Power of Attorney (POA) Validation for Business Returns

Rather than requiring personal information related to shareholders, partners or trustees to validate an electronically filed POA for a business entity, IRS e-Services should develop alternative criteria related specifically to the entity, such as the date of incorporation, date business started or was created, and the entity's taxable income or ordinary business income.

H. Central Withholding Agreements: Addressing Needs of Venues and Foreign Performing Artists through a Mini-CWA Program and Problems Encountered by Foreign Artists When Applying for U.S. Social Security Numbers (SSNs)

IRPAC began discussions with IRS LMSB regarding Central Withholding Agreements (CWA). Issues include addressing the needs of venues and foreign performing artists through the creation of a mini-CWA program and problems encountered by foreign artists when applying for U.S. social security numbers.

I. Business Master File (BMF)

IRPAC met with IRS W&I and Chief Counsel to discuss the Business Master File. The technology employed by IRS only allows for one address per business. IRPAC raised concerns about the current procedure of automatic change of business address with every tax filing. IRPAC recommended the Business Master File issue for inclusion on the 2010-2011 Guidance Priority List.

J. Staggered "B" Notices

IRS responded to IRPAC's concerns regarding randomly staggered "B" Notices with 2010 changes to the processing of CP2100, Notice of Missing or Incorrect Name/TIN Match for large volume filers. However, this change does not address the issues with randomly staggered CP2100A Notices which are

extremely burdensome for related groups of information return filers. IRPAC recommends that IRS's Martinsburg center use the same notice date on all CP2100A notices regardless of when they are mailed. Alternatively, IRS should distribute CP2100A notices for related entities during the same mailing period so that they include the same notice date.

K. Form 8886, Reportable Transaction Disclosure Statement

IRPAC reiterates its 2009 recommendation that IRS should clarify that the reporting requirements under IRC Section 6011 will terminate for the corporate participants in the Lease-in/Lease-out and Sale-in/Sale-out (LILO/SILO) Settlement Initiative after the year of actual or deemed termination of the tax shelter related transactions. IRS Office of Chief Counsel acknowledged, in an unofficial correspondence, that these taxpayers do not have a continuing obligation to file Forms 8886. IRS indicated that they would send letters to the settlement participants explaining this position. IRPAC, however, has not received verification of whether this has occurred.

Emerging Compliance Issues Subgroup

A. Foreign Account Tax Compliance Act (FATCA)

On March 18, 2010, the Hiring Incentives to Restore Employment Act (the HIRE Act) was enacted. The Foreign Account Tax Compliance provisions of Subtitle A of Title V of the HIRE Act (commonly referred to as FATCA) enact an expansive new withholding tax and reporting regime. IRPAC has been working closely with the IRS and Treasury regarding the implementation of FATCA. The ECI Subgroup report summarizes a number of issues on which IRPAC has provided recommendations.

B. IRC Section 6050W, Information Reporting of Payments Made in Settlement of Payment Card and Third Party Network Transactions

IRC Section 6050W was added to the Internal Revenue Code on July 30, 2008, by section 3091 of the Housing Assistance Tax Act of 2008. On November 24, 2009, the IRS released proposed regulations and a draft of new Form 1099-K. On January 19, 2010, IRPAC submitted a comment letter addressing several issues. A copy of IRPAC's January 19, 2010 comment letter relating to the proposed regulations is included in Appendix K. IRPAC's ECI subgroup also met with IRS Office of Chief Counsel at its January and April meetings, and provided both written and oral information regarding several issues, including ACH transactions, the payment process, and convenience checks. On August 16, 2010, the final regulations were published. In the final regulations, the IRS made a number of clarifications, but did not adopt IRPAC's principal recommendation regarding the definition of gross amount. Unfortunately, this will create a number

of processing problems and will substantially complicate reporting parties' ability to comply with IRC Section 6050W.

C. Expansion of Information Reporting Under IRC Section 6041

The Patient Protection and Affordable Care Act of 2010⁸ expanded information reporting under IRC Section 6041 by repealing two exemptions that have been in the regulations for over a half-century. Effective 2012, payers will be required to report payments for property and payments to corporations. These changes have been discussed for years but never before enacted due to numerous challenges to utilizing the information reported. IRPAC met twice with IRS Office of Chief Counsel to discuss these challenges. IRPAC also sent the IRS two letters, the first dealing with a legal analysis of the scope of the changes, and the second dealing with practical implications of the changes. Copies of the letters are included in Appendix L and M.

D. Withholding Tax Issues

IRPAC has identified several issues concerning withholding tax imposed under Chapter 3 (section 1441 et seq.) of the Code. These issues also will be important under the new Chapter 4 regime enacted by the HIRE Act. IRPAC met with the IRS to discuss these issues and offer recommendations. The ECI Subgroup Report summarizes the issues and recommendations.

E. Identity Theft and Information Reporting

The problem of identity theft has become a serious issue within the payer community. While the circumstances in which identity theft can affect an account are quite varied, IRPAC's focus has been on the question of whether a payer must report payments of income or proceeds on Forms 1099 when the named payee is known to be a victim of identity theft. IRPAC met twice this year with the IRS to address possible solutions that would best protect the identity theft victim while minimizing the reporting burden of payers. IRPAC also recently raised with the IRS the issue of whether Forms 1099 should be issued when the address of the payee is known to be a "stale" (or undeliverable) address. IRPAC expects to have further discussions with the IRS on this issue next year.

F. Clarification of the Information to be Reported to U.S. Investors on the Form 1099-DIV, Box 6, Foreign Tax Paid.

U.S. payers are required to report to U.S. investors on Form 1099-DIV dividend payments made in respect of foreign securities. In addition to reporting the dividend payments, payers are also required to report any foreign tax paid on such dividends. Prior to 2008, the Instructions for Form 1099-DIV directed payers to report in Box 6 any foreign tax withheld and paid on dividends and

⁸ P.L. No. 111-148, 124 Stat. 119.

other distributions on stock. However, in 2008 the language in the instructions was changed to direct payers to enter *creditable* foreign tax withheld and paid (within the meaning of IRC Section 901) on dividends and other distributions on stock. IRPAC requested that the IRS reconsider this change because payers do not possess the type of information required to make a determination as to whether the foreign tax withheld may be taken as a credit by the payee. IRPAC met with members of the IRS's Forms and Publications Division to discuss this issue. All agreed that reinstating the language provided on the 2007 Form 1099-DIV would be appropriate. The IRS has published a correction to the 2010 Instructions for Form 1099-DIV in the "What's Hot" section of IRS.gov because the form instructions had already been published for this year. The IRS also agreed to make the language change for the 2011 Instructions for Form 1099-DIV.

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE

Tax Gap Subgroup Report

**MARSHA BLUMENTHAL
CHARLES CHRISTIAN
ANDREW B. LYON
LILLIAN F. MILLS
GEORGE A. PLESKO
GEORGE K. YIN
ERIC J. TODER, SUBGROUP CHAIR**

Tax Gap Subgroup

Discussion

The IRS periodically releases estimates of the tax gap – the difference between taxes owed and taxes paid in a timely manner. The latest IRS estimates show a tax gap of about \$350 billion for tax year 2001. The tax gap consists of three components – non-filing (taxes not paid by those with a filing requirement who fail to file), underreporting (taxes underpaid by those who file but underreport what they owe), and underpayment (taxes not paid by those who fail to remit reported amounts owed when due). IRS reports the tax gap for separate tax sources, including individual income taxes, corporate income taxes, employment taxes, and estate taxes.

The purpose of the Tax Gap Subgroup is to help the IRS improve its estimates of the tax gap. In prior years, the subgroup reviewed and supplied comments on the IRS research methodology for estimating underreporting of corporate income taxes, individual income taxes, income reported by flow-through enterprises (partnerships and subchapter S corporations), and estate and gift taxes. During 2010, the subgroup reviewed revised drafts of two white papers prepared by the IRS Office of Research that described improvements in the methodology used for estimating two components of the estate tax gap – the non-filing gap and the underreporting gap – and provided updated estimates. The group met with IRS research staff on June 8, 2010 in a meeting chaired by the Director of the Office of Research, Analysis and Statistics and provided additional feedback on these papers. Generally, the subgroup was supportive of the IRS analyses, but did offer some additional technical suggestions. At the meeting, the group also discussed the broader strategy for updating estimates of the total tax gap and all its components to a more recent year, based on new estimates of some components of the tax gap and revised projections of older estimates.

Recommendations

A. Updating Estimates of Estate Tax Filing Noncompliance

The subgroup continued a discussion initiated in 2009 of a revised methodology used by IRS to generate estimates of the estate tax non-filing gap, providing feedback on a revised draft paper. In response to earlier feedback, IRS staff had made several improvements in the estimating methodology. The latest IRS paper estimates a non-filing gap for estate taxes in tax year 2004 (at the midpoint of a confidence interval) of \$2.5 billion, or about 9.2 percent of tax liability. The estimate is similar in magnitude to estimates for earlier years using a different methodology. The subgroup raised some additional technical issues about the estimates, including taking into account the division of assets within households, the interaction between the estate tax and the gift tax, and the effects of tax planning behavior.

Tax Gap Subgroup

B. Updating the Estate Tax Underreporting Gap for TY 2004

The subgroup also reviewed a white paper on the estate tax underreporting gap. The paper introduced a new methodology based on the use of IRS operational audit data, with statistical adjustments to remove sample selection bias.

The IRS research paper estimated a voluntary reporting rate of 92 percent (underreporting of 8 percent of tax liability), with a 95 percent confidence interval ranging from 87 to 96 percent. In dollar terms, this represents an underreporting gap of \$1.9 billion in 2004, with a confidence interval ranging from \$0.7 billion to \$3.0 billion). Based on the statistical confidence intervals, IRS staff concluded that the results were not significantly different from the estimates previously released for tax year 2001. The subgroup provided IRS staff with some additional suggestions on presentation of the results.

C. Strategy for Updating the Tax Gap Estimates

IRS is committed to providing updated estimates of the tax gap by the end of 2011. IRS staff and the subgroup discussed how frequently the tax gap estimates should be updated in the future, taking account of public demands for updated information, the uncertainty surrounding the estimates, and issues of how the estimates might be misinterpreted.

Members of the subgroup emphasized the need to explain carefully the determinants of the tax gap estimates and the degree of confidence associated with various components. There was concern that changes that reflect improvements in methodology or random errors could be misinterpreted as reflecting real changes in compliance rates. The group discussed how best to communicate the results to avoid any misinterpretation.

Concluding Remarks

The subgroup has received positive feedback from IRS research staff on the value of their input to the development of improved ways of estimating the tax gap and presenting the estimates. IRS research has offered to continue to consult with the subgroup on an ad-hoc basis as their estimates continue to evolve and new technical issues arise.

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE

Employee Benefits & Payroll Subgroup Report

**LISA GERMANO
C. LEONARD JACOBS
PHILIP KIRCHNER
ANNE C. LENNAN
EMILY LINDSAY
ELIZABETH DOLD, SUBGROUP CHAIR**

Employee Benefits and Payroll Subgroup

A. Health Care Valuation on Form W-2

Recommendations

IRPAC makes the following recommendations to assist IRS in developing resolutions to issues related to the new Form W-2, Wage and Tax Statement, health valuation reporting and in communicating information to taxpayers:

1. IRS should delay the reporting requirement or waive penalties (or at a minimum impose a good faith compliance standard) for employers who are not able to comply with the W-2 health valuation reporting requirements that are effective January 1, 2011.
2. IRS should resolve as soon as possible the various issues regarding new Form W-2 reporting required by the Patient Protection and Affordable Care Act (PPACA). IRS should work with stakeholders to ensure that solutions are workable and can be implemented by taxpayers in a compliant manner. IRS must also communicate instructions timely to stakeholders. IRPAC is very concerned that all issues related to new Form W-2 health valuation reporting have not yet been resolved and communicated to the reporting community. The reporting changes are very significant and the ability for W-2 issuers to comply is seriously jeopardized by the lack of issue resolution and communication.
3. IRS should continue to communicate to taxpayers that the new Form W-2 health valuation reporting will not result in the taxation of this value.
4. IRS should engage the self-funded employee benefit plan community in a discussion about the COBRA "applicable premium" with respect to valuing health coverage for self-funded plans before issuing any guidance in this area. These stakeholders, in particular, require IRS guidance as soon as possible.
5. IRS should issue guidance as soon as possible on what types of health coverage must be included in the W-2 health reporting (e.g., what coverage is required to be aggregated beyond major medical, dental and vision and whether administrative costs are included in the reported amount).
6. IRS should provide employers and service providers the option of employing a special accounting rule (similar to that allowed for the reporting of certain taxable fringe benefit amounts) so that the W-2 health valuation amounts could be computed in an orderly manner for Form W-2 reporting.

Employee Benefits and Payroll Subgroup

7. IRS should provide employers and service providers the option to exclude the reporting of health valuation amounts from any W-2 that is issued prior to the January 31 annual deadline. In this case, the employer could distribute the final W-2 that reports the health valuation amount with the Forms W-2 issued by January 31.
8. IRS must issue guidance on how plans/employers should prepare Forms W-2 issued to retirees who are covered by health plans but no longer receive Forms W-2, and the impact on W-2 sick pay reporting procedures.

In addition, with respect to provisions that are not immediately effective, IRPAC recommends that the following reporting issues be considered in the near term to provide for a cohesive reporting program for PPACA changes.

1. IRS should implement a separate form for calendar year 2014 (other than the Form W-2) to report all the information required for large employers and certain employers offering minimum essential coverage. IRS should also provide for electronic reporting of this information to employees since many employees currently access Form W-2 electronically.
2. IRS must issue guidance to large employers who incur a coverage penalty (noted as an excise tax) with respect to the payment and reporting mechanism for this penalty.
3. IRS must issue guidance regarding the Excise Tax on High-Cost Coverage for employers who must report this information to the IRS. IRS guidance should address the specific reporting format to be used by the employer, electronic filing requirements, and the reporting due date.
4. IRS must issue guidance on Form W-2 requirements to report the amount of the health FSA benefit (PPACA imposes a \$2500 limit in 2013) including if the amount will be in a new box on the Form W-2. Further guidance will be required regarding the employer reporting of Medicare tax on high earners.
5. The IRS must issue guidance concerning the notice of coverage to new employees. This guidance should consider the need to commence this reporting at the beginning of a calendar year. The IRS guidance should address the fact that the notice may be deemed to be delivered to the employee when it is delivered to the employee electronically or made available electronically.

Discussion

IRPAC's Employee Benefits and Payroll Subgroup (EB&P) met with IRS representatives in June on issues regarding new Form W-2 reporting required by

Employee Benefits and Payroll Subgroup

the PPACA. It is essential that IRS work with stakeholders to ensure that solutions are workable and can be implemented by taxpayers in a compliant manner. IRS must also communicate instructions timely to stakeholders. After the June meeting with IRS, IRPAC provided IRS with input on the various open issues consistent with these recommendations, which IRPAC understands the IRS is considering.

IRPAC is very concerned that all issues related to new Form W-2 health valuation reporting have not yet been resolved and communicated to the reporting community. The reporting changes are significant and the ability for W-2 issuers to comply is jeopardized by the lack of issue resolution and communication. As a general rule, a minor change for Form W-2 issuers requires at least six months to design, develop and implement changes to systems, processes and methods. The Form W-2 changes related to health care are especially complex as the data to be reported is typically not stored in an employer's payroll system or controlled by the same group that controls payroll data for Form W-2 reporting. Therefore, the health care data will need to be obtained from a third party and merged with the payroll Form W-2 data. This will require a much greater lead time for compliant Form W-2 reporting, which is effective January 1, 2011 (which impacts W-2 issued as soon as February 1, 2011).

The lack of timely resolution and adequate communication of all issues related to this important topic causes serious concern for compliance for 2011, particularly where without guidance employers and health care providers are hesitant to develop software prior to issuance of guidance (as additional cost and redesign risks/delays are inherent with system changes prior to final guidance) or even to build out new systems based on proposed (rather than final) guidance.

Accordingly, IRPAC strongly recommends that the IRS delay this reporting requirement (e.g., make it optional for a transition period as with Code V and Code Y reporting in box 12 of the Form W-2) or otherwise waive any penalty for noncompliance (or, at a minimum, impose a good faith compliance standard).

As a first step, IRPAC commends IRS on the messages sent related to the nontaxability of health care valuation reporting. However, IRS must continue to communicate to taxpayers that the new Form W-2 health valuation reporting will not result in the taxation of this value, and the W-2 instructions should also make this point very clear. While IRS has posted information on www.irs.gov that this will not result in the taxation of this value, there continues to be confusion about this point that could be mitigated by enhanced communication by IRS.

IRS should issue guidance as soon as possible on the COBRA "applicable premium" with respect to valuing health coverage. IRS must begin a discussion with the self-funded employee benefit plan community concerning the methodologies for valuing health coverage. The statutory language of PPACA

Employee Benefits and Payroll Subgroup

references the COBRA applicable premium under section 4980B(f)(4). The COBRA law gives vague guidance on determining the "applicable premium." There are two methods: (1) "reasonable estimate" of the cost of providing coverage for similarly situated beneficiaries, taking into account such factors as the Secretary may prescribe; and (2) determination on past costs. Past cost may not be used when there is a significant change in coverage. Employers should be provided flexibility in selection of valuation methods and in determining how the selected method is to be calculated.

IRS should also issue guidance on what types of health coverage must be included in the Form W-2 health reporting, whether administrative costs are included in the reported amount, and the impact of coverage of spouses, alternate payee, dependents and domestic partners. Employers and service providers require clear and detailed specifications and substantial lead time to implement payroll reporting and Form W-2 changes. Compliance will be difficult, if not impossible, since clear and detailed specifications have not been provided. The Form W-2 changes related to health care are especially complex as the data to be reported is typically not stored in an employer's payroll system or controlled by the same group that controls payroll data for Form W-2 reporting.

The group controlling the payroll data will frequently have to coordinate with multiple third parties, as coverage often changes mid-year (e.g., the employer moves from a fully-insured plan to a self-funded plan, or the administrator of the self-funded plan changes). In addition, if an individual switches from single coverage to family coverage mid-year, or the employer has an open enrollment mid-year (i.e., the plan runs on a fiscal year that is not a calendar year) and employees change coverage options, the payroll group may need to apportion and then aggregate a value to create one number, or provide multiple values based on the different benefit coverages, which would add to the complexities. Therefore, the health care data will need to be obtained from a third party and merged with the payroll Form W-2 data. This will require an even greater lead time for reporting due to these complexities regarding the computation, compilation and coordination of health care amounts.

IRS should provide employers and service providers the option of employing a special accounting rule (similar to that allowed for the reporting of certain taxable fringe benefit amounts) so that the Form W-2 health valuation amounts could be computed in an orderly manner for Form W-2 reporting. For nearly all employers, the payroll department or payroll services provider is responsible for Form W-2 reporting and distribution; and the health insurance plan administrator is the record keeper for the plan and the party that will provide the health valuation amounts for Form W-2 reporting. Time will be required for the health insurance plan administrator to compute the Form W-2 health valuation amounts and to transfer the amounts to the employer's payroll department or payroll services provider for Form W-2 reporting and distribution.

Employee Benefits and Payroll Subgroup

by January 31 of the year following the calendar year. Use of a special accounting rule may alleviate some of the timing problems that will result.

For mid-year Forms W-2, IRS should provide employers the option of excluding the reporting of health valuation amounts from any Form W-2 that is issued prior to the January 31 deadline. In this case, the employer could distribute the final Form W-2 that reports the health valuation amount with the Forms W-2 issued by January 31. If requested, employers must furnish the Form W-2 within 30 days of the request or, if later, within 30 days of the last payment of wages. Typically, the payroll area is separate from the health plan administrator. In most cases, it may be difficult (if not impossible) for accurate health valuation amounts to be sent to payroll in advance of the issuance of Forms W-2 by January 31.

Lastly, IRS should issue guidance as soon as possible on a variety of related topics, addressing issues such as (1) reporting to retirees who are covered by health plans but no longer receive Forms W-2; (2) the impact on sick pay reporting process; (3) method to report for calendar year 2014 (other than the Form W-2) all the information required for large employers and certain employers offering minimum essential coverage; (4) method for large employers to report and pay any coverage penalty incurred; (5) method to report any excise tax on High-Cost Coverage; (6) the interplay between reporting under Code section 6055, 6056, and W-2; (7) Form W-2 reporting of the health FSA benefit (PPACA imposes a \$2500 limit in 2013), and (8) how the withholding change on additional taxes on high income individuals is implemented and reported. And with all this guidance, clarification of the applicable reporting penalties that may be imposed (and on who) and the correction process if a reporting error results is critical to the process.

IRPAC looks forward to assisting IRS in implementing these important PPACA reporting changes.

B. Tip Reporting Compliance and Enforcement Efforts

Recommendations

IRS should continue its efforts to improve tip income reporting compliance within the Food & Beverage (F&B) Industry. IRS should also continue its efforts to understand better the operations and practices of non-F&B service industries with employees who customarily receive tip income with the aim of improving tip income compliance in these industries. IRPAC makes the following recommendations to assist IRS in its efforts to improve compliance:

1. IRS should continue its efforts aimed at increasing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, compliance

Employee Benefits and Payroll Subgroup

by non-filers. IRS should also continue its tip reporting compliance initiatives with respect to small business and with respect to service sector businesses beyond the F&B industry.

2. IRS and Treasury should amend the regulations⁹ to provide employers the option of combining data for all tipping establishments located at a business location in order to simplify the computational requirements related to Form 8027 and allocated tip reporting on Form W-2.
3. IRS should simplify the instructions to Form 8027 and Form 4137, Social Security and Medicare Tax on Unreported Tip Income, and put these materials in "plain English" so that they are more understandable to employers and to employees who receive tip income. IRS should also clarify certain definitions and terms used in tip income reporting compliance in order to improve understandability and, IRPAC hopes, overall levels of compliance. IRPAC looks forward to partnering with IRS on these efforts.
4. IRS and Treasury should amend the regulations to provide employers the option (without regard to the number of employees) of using either the Hours Worked Method or the Gross Receipts Method to compute allocated tips at an individual tipping establishment level. Allowing additional flexibility should improve overall employer compliance and reduce employer burden.
5. IRS should seek legislative changes needed to allow employers, at their option, to post credit card tips directly to employee payroll records as reported tips subject to tax withholding.

Discussion

IRPAC's EB&P subgroup met on April 20 and August 17, 2010 with a number of IRS representatives working on a nationwide effort to improve tip income reporting compliance. The IRS' current efforts are aimed at better understanding compliance in the F&B industry as well as in other service industries where employees customarily receive tip income.

With respect to the F&B industry, IRS is seeking to improve the level of tip reporting compliance for those who file Form 8027, and to improve filing and payment compliance with respect to non-filers. IRS is also working with a variety of stakeholders to understand the level of tip income in non-F&B industries so that appropriate and workable compliance programs can be undertaken.

⁹ Any reference in this section B of the report to amend the "regulations" should be viewed as also making corresponding changes to the IRS forms and instructions, and related procedures. Moreover, to the extent a regulatory change is not required by law, these changes should be implemented through such IRS forms, instructions, and procedures.

Employee Benefits and Payroll Subgroup

IRPAC commends IRS for its efforts to improve compliance in this area and its work with stakeholder groups to understand the issues involved in compliance. IRS is expanding its Form 8027 compliance efforts beyond those who are currently filers. Of the current filers, there are many large employers and chains that may also be on a Tip Reporting Alternative Commitment Agreement (TRAC), Tip Rate Determination Agreement (TRDA), or other similar type arrangement. IRS is focusing also on non-filers who have, in many cases, not been subject to IRS scrutiny with respect to tip income reporting compliance. IRS has been working effectively with state agencies and other organizations to identify non-filers. IRS worked with the State of California Employment Development Department (CA EDD) to identify 4,200 active restaurants. These were matched against Form 941, Employer's Quarterly Federal Tax Return filings in order to identify employers who are Form 8027 non-filers who should, potentially, be filing this form. Note that not all identified are required to file Form 8027. The California pilot resulted in IRS's "soft notice campaign" to targeted non-filers requesting that these employers voluntarily file Form 8027 or provide information why the form is not required. The positive response has been very encouraging and is providing valuable information to IRS that will be useful in future compliance efforts. The IRS has also used these pilots as opportunities for stakeholders outreach on tip income reporting compliance topics. IRS is also using Dun & Bradstreet data to expand its non-filer campaign nationwide in order to improve Form 8027 and Form 941 compliance. These non-filer initiatives appear to be positive steps in improving compliance. IRPAC recommends that IRS expands and/or continues these programs since improved compliance regarding Form 8027 filing will result in increased compliance by employees with respect to reporting of tip income.

The current administrative requirements for Form 8027 and Form 4137, Social Security and Medicare Tax on Unreported Tip Income, are complicated and the instructions for completing these forms are difficult to understand. IRPAC believes that simplification of requirements and the language on forms and instructions will lead to reduced employer burden and improved compliance.

Related to this, IRPAC recommends that the IRS and Treasury revise the regulations to provide employers the option of combining data for all tipping establishments located at a business location in order to simplify the computational requirements related to Form 8027 and allocated tip reporting on Form W-2. In many cases, businesses that operate multiple F&B outlets at a given business location (e.g., a hotel with several tipping establishments on the hotel property) incur significant administrative burden keeping all the data required for Form 8027 and Form W-2 reporting separate by individual tipping establishment. Record-keeping is complicated by the fact that employees at these business locations typically work at multiple tipping outlets within the business location during a given payroll week and even during the same work day. Permitting businesses the option of aggregating data to a property location

Employee Benefits and Payroll Subgroup

level would significantly reduce burden, complexity, and errors related to reported tips, allocated tips, and related sales. A simpler process would be easier to explain to tipped employees. Employees will be more compliant with a requirement that is clear and understandable.

IRS and Treasury should amend the regulations to provide employers the option (without regard to the number of employees) of using either the Hours Worked Method or the Gross Receipts Method to compute allocated tips at an individual tipping establishment level. Allowing additional flexibility should improve employer compliance and reduce employer burden. Tracking of employee reporting of sales data required by the Gross Receipts Method is very burdensome and prone to error. The Hours Worked Method relies on data already maintained by most payroll systems and is easier to explain to tipped employees.

A less burdensome, streamlined, and simpler method would likely prove to yield a higher level of compliance. IRPAC also proposes the following to improve the current method: (a) clarify distinctions between directly and indirectly tipped employees; (b) clarify the \$20/month minimum threshold for reporting; and (c) or clarify the distinction between direct tips and indirect tips.

IRS should seek legislative changes needed to allow employers, at their option, to post credit card tips directly to employee payroll records as reported tips subject to tax withholding. Allowing employers to implement a direct interface from a point-of-sales system to the payroll system would increase compliance and reduce employer burden as it would avoid having to require that the employee report tips to the employer which the employer already has record of via the customer's credit card receipt data. IRPAC recognizes that such a change would likely require modification of an employer process related to "tip outs" and to the reporting of tips by indirectly tipped employees. IRS has noted that currently reporting of tips by indirectly tipped employees seems to be low. IRPAC believes that this change to the posting of credit card tips as reported tips to the employer's payroll system will reduce employer burden and increase the overall total level of tip income reporting compliance.

IRPAC has offered to assist IRS on its efforts to reduce complexity and burden related to these forms and looks forward to contributing in this area. IRPAC looks forward to working with the IRS on ways it can improve the overall tip income reporting compliance and reduce employer burden related to Form 8027.

Lastly, IRPAC recommends that IRS continue its tip income reporting compliance efforts and expand efforts to service industries other than F&B in which there could be substantial underreporting of tip income.

Employee Benefits and Payroll Subgroup

C. EINs for Qualified Plans/Trusts

Recommendations

Based on the lack of clear guidance on the need and the proper procedure for obtaining employer identification numbers (EINs) for qualified plans/trusts, IRPAC strongly recommends changes to Forms 5500, Annual Return/Report of Employee Benefit Plan, and SS-4, Application for Employer Identification Number, (and related instructions) to clarify these rules and encourage plan sponsors to obtain a trust EIN for qualified plans/trusts. More specifically, to address the instructions for obtaining an EIN for qualified plans/trusts, which are outdated, confusing, and difficult to find, IRPAC recommends that these instructions be updated (as described below), and cross-referenced on the Employee Plans (EP) website, and further develop specific instructions and guidance on the EP website on the need for, and process to obtain an EIN, and recommend that the plan/trust EIN be added as an optional box on Form 5500.

Discussion

EIN Application Process for Employee Benefit Plans

The SS-4 online application process is very robust with many helpful tools and aids, but the application process for qualified plans is less than clear. Therefore, IRPAC recommends an alert on the landing page of the SS-4 online application to briefly describe the process for a qualified plan, with a link to the EP website for more details. Moreover, IRPAC recommends that the EIN application and maintenance process for employee benefit plans be referenced (to the extent possible) on the employee plans part of the IRS website. With all the different options available for business entities, it is not easy to discern what may be relevant for employee benefit plans. Unless otherwise specified, the references below are to Publication 1635, Understanding Your EIN.

1. Under the question Do you need an EIN the only reference is to a Keogh plan; whereas this should be referencing an employee benefit plan, including pension and profit sharing plans.
2. Under the question Do you need a New EIN, there is no reference for spin-off plans, mergers or other events that plans may survive through – leaving questions as to when, if ever, a new EIN should be obtained and how to ensure that its use will be properly reported on all reporting and disclosure form.
3. IRPAC recommends that an electronic application process be also available for when a Third Party Designee is the individual obtaining the EIN. To be required to mail or fax an application solely because there is a Third Party Designee is not efficient and causes delays.

Employee Benefits and Payroll Subgroup

4. After the section on Misplaced EINs, there should be a section on de/reactivation of the EIN that was issued in the past.
5. How EINs are assigned. It used to be that a suffix was assigned – usually a P or numeric sequence at the end of the EIN to identify it as an employee benefit program. IRPAC believes that it would be most efficient to continue in some way with that practice, as it would readily identify the number as relates to an employee benefit plan which helps plan sponsors and third party administrators/trustees identify the appropriate tax obligations.¹⁰
6. Canceling an EIN. The information provided in this help booklet says that IRS can not cancel an EIN but IRPAC knows this has happened via deactivation. This may be a good place to explain this issue and how it has been resolved. Ideally, there would be a section on Deactivation, but if that is not possible, then a paragraph in this section would be beneficial. Along those lines, anywhere the deactivation is discussed, there should be an explanation about how to reactivate, including how a Third Party Designee may do so on behalf of the Plan Sponsor or Plan Administrator.
7. Updating Incorrect Business Entity Information. This information is not well-known and should be emphasized on the SS-4 application itself if IRS wants to mandate it, but understand that the SS-4 is viewed as a one-time use form that is not suitable for ongoing taxpayer review and update.
8. Publication 1635 – general comments. This publication is a great resource but much of it does not apply to employee benefit plans. IRPAC recommends that the requirements for obtaining an EIN for employee benefit plans be positioned in the EP part of the IRS website. Some of the information in the publication is outdated – such as the reference to an alpha or numeric following the assigned EIN as stated in the paragraph What is an EIN on page 2. Also the reference to Form 5500-C/R on page 9 and Form 941 on page 24 – the instructions for Line 14 should be modified.

EIN Application Process Placed on EP Website

In order to encourage plan administrators and plan sponsors to obtain an EIN for the plan, it is ideal to have guidance and instructions on the EP website. The EP website has become quite the place for instruction and education and not having guidance about this process leads one to believe that there is no need for a plan to obtain an EIN. Many plan sponsors do not believe they need to obtain

¹⁰ This is a difficult request to fulfill due to systemic constraints.

Employee Benefits and Payroll Subgroup

an EIN for the plan – especially because there is no place to report the number once it is obtained, unless there has been a distribution from the plan, requiring the information returns that may (or may not – as it is not required) use that number.

In particular, the information that is published should include specifics regarding what to do in the event of a plan merger, acquisition, etc. The website should include specific instructions and guidance.

Deactivation of Employer Identification Numbers

IRPAC members have experienced situations where the EIN for the plan or for the Plan Administrator has been deactivated after a period of nonuse. This has been especially noted when filing Form 8802, Application for U.S. Residency Certification. Because the EIN was deactivated, IRS would not process Form 8802. In order to request Form 6166, Foreign Certification Program status, Form 8802 must be processed and many Form 6166 requests have been denied. IRS personnel communicated to IRPAC that as of December 2009 this process to deactivate was ceased and IRS provided communication that announced the deactivation was no longer in use. However, plan administrators will continue to encounter this issue until the deactivation process is more broadly communicated so plan administrators can rectify the situation by reactivating the EIN before any form needs to be filed.

To avoid situations where a form can not be processed because plan administrators did not know about the EIN deactivation process, IRPAC members believe that information about the past deactivation process should be contained in the SS-4 instructions as well as on the EP Website with helpful tips for plan administrators to properly complete form SS-4 and reactivate any EINs that have been deactivated. All of the main concerns with transparency, deactivation, proper completion and how to reissue or reapply for the EIN in anticipation of or as a result of certain events are also appropriate for the EP website. Moreover, IRPAC recommends that a process that permits plan administrators to check on whether or not an EIN is active be considered.

Lastly, IRPAC recommends that any Frequently Asked Questions (FAQ) on the website provide a place or person to send problems to should any be encountered in the EIN process.

D. TIN Masking on Payee 1099s

Recommendation

IRS should continue the Tax Information Number (TIN) Masking pilot and resolve any issues to make the program permanent for tax year 2011.

Employee Benefits and Payroll Subgroup

Discussion

IRPAC commends IRS for their efforts over the past year regarding TIN Masking. In December of 2009, IRS created a pilot program for the truncation of Taxpayer Identification Numbers on certain Forms 1099 and on paper payee statements in the Form 1098 series and the Form 5498 series. That program has been widely praised by the industry and is a very positive step in protecting the identity of the American taxpayer.

Following the initiation of the TIN Masking pilot, IRPAC provided comments to IRS. The primary proposals were:

1. IRS should allow for the truncation of EINs in addition to SSNs as many institutions do not have the ability to distinguish between the two Taxpayer identification numbers.
2. IRS should allow the truncation to apply to electronic delivery as well as paper delivery. Some providers are attempting to assist IRS in the conversion to an electronic format, but as the pilot program is limited to paper filers, those firms are not permitted to participate in the program.
3. IRS should consider extending the pilot an additional year. Due to the late announcement of the pilot, some firms were not able to participate in the pilot. That timing issue will limit IRS pilot data to one complete tax season.

IRPAC's correspondence regarding the pilot is in Appendix A.

IRPAC met with staff from the Privacy office and the office of Chief Counsel at its August meeting. IRPAC learned that IRS was still in the process of receiving input into the pilot process. IRPAC also understands that the overall response to the pilot has been favorable.

In light of the success of the TIN Masking pilot program with minimal issues, IRPAC believes that IRS should continue the program with the intent of transitioning to a permanent production program. IRS should also consider the expansion to other form types.

E. Transparency for Abusive Use of Multiple EINs – to Establish Multiple Tax-Favored Benefit Plans

Recommendations

To help identify abusive use of EINs where an employer establishes multiple plans (without complying with the Code's coverage and non-discrimination provisions), IRPAC recommends that a change be made to the

Employee Benefits and Payroll Subgroup

annual entity's tax return (e.g., Form 1120 series, U.S. Corporation Income Tax Return), 1065 (U.S. Return of Partnership Income, 990, Return of Organization Exempt from Income Tax, 1040, Schedule C, Individual Income Tax Return and this same provision can also be added to the Form 5500 series (annual return). A question should be added to the above returns that would provide the information requested by the IRS. For example, the following question could be added:

Do you or any related entity (in accordance with Code section 414 and including the use of a leasing agency) maintain a qualified plan (Code section 401(a), 403(b), 457(b)), a SEP or SIMPLE IRA: yes no. If yes (and there is 5 or fewer related entities), list the following: (1) name of the plan sponsor, (2) name of the plan/trust, (3) plan number (if any), and (4) EIN of the plan/trust (or plan sponsor, if none).

To the extent that there are similar concerns outside the qualified plan context in identifying multiple ownership arrangements, IRPAC similarly recommends adding a question to the entity's annual tax return (and not Form SS-4).

Discussion

The IRS requested IRPAC to consider ways to increase ownership transparency by improving the EIN Application Process and updating Form SS-4.

IRS initially proposed that IRPAC consider if the Form SS-4 was a proper form to gather ownership and qualified plan information. IRPAC strongly believes that the use of the Form SS-4 for this purpose is not appropriate, as the entity may not have yet adopted any retirement plans nor organized any related companies at the time the SS-4 is filed with the IRS. Moreover, this form is viewed as a one-time form to obtain an EIN and not a form that gathers ongoing information. Rather, an ongoing annually filed return, which is filed under penalties of perjury, is more appropriate.

Because the concern appears to be limited to small entities, limiting the transparency related inquiry to those entities noted above (5 or fewer entities in the controlled group) should be sufficient to assist in the effort to identify potentially abusive entities, while not including large national entities.

F. 2009 Form 5500/5330 Automatic Extension for Calendar Year Plans

Recommendations

IRPAC first recommended an automatic extension of the filing deadline for 2009 Forms 5500/5330, Application for Determination for Employee Benefit Plan, (without the need to file Form 5558, Application for Extension of Time to File

Employee Benefits and Payroll Subgroup

Certain Employee Plan Returns) for calendar year plans to October 15, 2010 to be able to comply with EFAST2.¹¹ As that extension was not granted (but the need remains), IRPAC further recommends that the 2009 Forms 5500/5330 deadline for all calendar plans be extended to December 31, 2010 (or otherwise waive penalties for late filers through such date), without regard to whether or not an extension request was filed.

Discussion

IRPAC initially requested that an automatic extension be given for the 2009 Form 5500 for the reasons provided below. As that request was denied, but the need for additional time to process these forms remain, IRPAC recommends that an automatic extension be provided from the October 15, 2010 extended due date for the 2009 calendar year filers until December 31, 2010. IRPAC believes this extension will greatly enhance the accurate reporting and accurate transmittal under the new process and procedures. The extension of time will also increase plan sponsor recognition and comfort in its new role and responsibility for electronic filing of the 2009 Form 5500.

IRPAC asks that in its deliberations, the IRS consider in particular the small business plan sponsor. Many small business plan sponsors have not previously filed electronically, do not use the Internet, and do not have the resources to use an independent service provider. In these situations, the Form 5500 is completed with little or no external assistance. With the new form and procedures, even tax professionals are grappling with issues related to the delayed issuance of the software, new processing requirements, and glitches in the software – all in combination with questions that need time to research regarding all of these new features.

IRPAC anticipates that the IRS received more extensions of Form 5500 than in prior years due to the new form and filing process. Moreover, there will likely be more delinquent 2009 filers as a result of not understanding the new procedures. More importantly, IRPAC anticipates that the accuracy of the returns may also be affected by the lack of understanding of the new form provisions and the new filing process. The new schedules, the new process, the new regulations relating to certain information disclosures were issued during the busiest time of year, with the Economic Growth and Tax Relief Reconciliation Act of 2001 plan document adoption deadline of April 30, 2010 within the same timeframe.

Many plan sponsors have concerns about not only the new filing process but that obtaining signing credentials involves more internal security than previously necessary because of the PIN procedures. Plan sponsors need more time to be acclimated to this new process and the decision to have their

¹¹ See Appendix B.

Employee Benefits and Payroll Subgroup

signature on the Internet if they allow their service provider to transmit the filing as many service providers have done in the past.

Form 5330 is requested as part of this automatic extension. If the Form 5500 requires extension because it has not been processed and accepted, often there is no way to determine whether a return needs to be made for the transactions reported on Form 5330. In these situations, Form 5558 is used to request this extension.

To summarize, IRPAC requests a narrow extension of time for 2009 calendar year plans to file the 2009 Form 5500 and Form 5330 for the following reasons:

- The late issuance of the 5500 Form
- The delay in vendor software
- The time needed to assess which vendor software a service provider may consider using
- The new process for a plan sponsor to determine whether to obtain signing credentials or provide signature to the Form 5500
- The time to educate plan sponsors and their tax advisors
- The time to assist plan sponsors to obtain signing credentials
- The time for service providers to learn the new form, new software and create procedures to prepare plan sponsors for understanding and executing their responsibility.

G. Basis Allocation for Direct Rollovers

Recommendations

IRPAC strongly recommends that the IRS permit plan sponsors to follow the long-standing interpretation of IRC Section 402(c)(2) and treat a partial or split direct rollover as a single distribution for basis allocation purposes, which would continue to allow after-tax contributions to be distributed to the participant in cash and the remainder of the account rolled to an IRA or qualified plan. This approach is consistent with legislative history, and provides for consistent treatment between direct and indirect rollovers.

However, in the event that a partial or split rollover is to be viewed as two separate distributions, IRPAC strongly recommends that this position be taken prospectively only, with generous transition relief to allow for system changes (which will be time consuming and costly). Otherwise, this view will result in unintended adverse tax consequences for plan sponsors and participants, including reporting and withholding and plan qualification concerns.

Employee Benefits and Payroll Subgroup

Discussion

EGTRRA expanded the rollover provisions to permit the rollover of after-tax amounts (directly and indirectly), and expressly provided in the flush language of IRC Section 402(c)(2) that the amount transferred shall be treated as consisting first of "the portion of such distribution that is includible in gross income." The legislative history similarly stated that "if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts." Accordingly, plan sponsors and third party administrators have historically permitted a participant to directly or indirectly roll over the entire pre-tax amount first. For example, if the participant took a full distribution of \$10,000 of his account, which had \$2,000 of after-tax contributions and the remainder as pre-tax amounts, the participant could elect to rollover the entire \$8,000 pre-tax amount to a traditional IRA and the remaining \$2,000 to be paid in cash (or beginning in 2008, rolled to a Roth IRA) to the participant tax-free.

An updated model 402(f) (rollover notice) was issued in late 2009 (Notice 2009-68, Safe Harbor Explanation — Eligible Rollover Distributions) that challenged this approach. The Notice states that if the distributee elects to rollover only a portion of the distribution in a direct rollover, an allocable portion of any after-tax contributions are considered rolled over.

IRPAC understands that each rollover/cashout is being treated as a separate distribution (which is prior, under the IRS's analysis, to the annuity starting date) and therefore subject to IRC Section 72(e)(8), which requires this pro rata allocation approach.

This approach appears to mirror the approach taken for Roth contributions under Treas. Reg. § 1.402A-1, Q&A-5, where (1) the regulations expressly limit the special ordering rule to indirect rollovers -- the part that is rolled over is deemed to consist first of the portion of the distribution that is attributable to income under section 72(e)(8), and (2) following the Preamble to TD 9324, treat the portion of the distribution that is rolled over as a separate distribution for purposes of applying Code section 402(c)(2). However, Roth accounts are different from after-tax amounts because Roth accounts are generally treated as a "separate account" for section 72 purposes, which would prohibit commingling earnings on Roth contributions with other taxable amounts.

Moreover, the clear language of IRC Section 402(c)(2), which expressly applies to direct rollovers, appears to trump the pro rata allocation rules, and the fact that a separate Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. may need to be filed for the rollover and the cashout (or for split distributions between IRAs), due to the box 7 coding provisions, should not alter this result. The legislative history, as noted above, also does not make this pro rata allocation point clear. And, there is no policy reason for providing for a different result depending solely

Employee Benefits and Payroll Subgroup

on whether the amount is directly or indirectly rolled over, or whether the distribution is split between multiple IRAs.

Importantly, if the pro rata allocation method is required, Form 1099-R reporting and withholding violations and related penalties (and interest) may result in numerous cases. Moreover, this may result in improper rollover of after-tax amounts to qualified plans (either because the law prohibited roll over of after-tax amounts (pre-PPA, only certain defined contribution plans were permitted to accept them) or because the plan terms prohibited acceptance of such amount), which will require corrective distributions from the impacted plans to preserve the tax-qualified status of the plans.

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE

Ad Hoc Subgroup Report

**JAMES DRIVER
JOAN HAGEN
KATHY PLOCH
STEPHEN LEROUX, SUBGROUP CHAIR**

Ad Hoc Subgroup

A. Electronic Furnishing of Forms 1098, 1099, 5498 and W-2

Recommendations

IRPAC recommends that Form 1098 Series, 1099 Series, 5498, Individual Retirement Account (IRA) Contribution Information and W-2, Wage and Tax Statement would be most effectively and securely delivered electronically subject to recipient's negative consent. Absent a change in regulations to the affirmative consent requirements, and as a positive first step, IRPAC recommends the IRS publish guidance to clarify procedures by which furnishers of these information statements might standardize the process for obtaining affirmative consent and bring it in line with other electronic business practices. IRPAC supports integrating affirmative consent to electronic delivery of information reporting returns with more global consents to do business electronically with the furnisher. Such an agreement would cover primary business functions that are conducted electronically or that include electronic information delivery components.

Discussion

In general, a global consent to conduct business electronically would include a systematic process for recording and storing an affirmation of e-consent from statement recipients and would be built on the requirement that the only person permitted to provide the affirmation of consent is the recipient him/herself. An integrated global consent process allows furnishers to leverage extensive work already committed to other electronic business transaction communications and to present a more seamless and user-friendly process to the recipient. The consent would incorporate required consent text and all other requirements for disclosure, format, notice, posting, access periods, and withdrawal of consent can be accommodated within this agreement. IRPAC believes these procedures will enhance elements related to both the delivery and the receipt of information statements. The global consent process, and the related enhancements to the process of electronic delivery of tax information statements, would be more in line with the expectations of recipients and would facilitate the process for both furnishers and recipients.

Guidance for the furnishing of electronic recipient statements is found in Regulations section 1.6050S-2 (Forms 1098-T, Tuition Statement and 1098-E, Student Loan Interest Statement), Regulations section 31.6051-1 (Form W-2), Notice 2004-10 I.R.B. 433 (Forms 1099, 5498 and W-2G, Certain Gambling Winnings), and the General Instructions for Certain Information Returns (Forms 1098, 1099, 5498, and W-2G). These sources provide that recipient statements may be furnished in electronic format in lieu of a paper format if the furnisher meets certain requirements. Furnishers of Forms W-2, 1098-T and 1098-E who meet requirements related to consent, disclosures, format, notice and access period; and furnishers of Forms 1099, 5498 and W-2G who meet requirements related to consent, format, posting and notification, are treated as furnishing the

Ad Hoc Subgroup

required statement. The consent requirement for these returns requires that the recipient must consent in the affirmative.

The affirmative consent model addressed concerns relating to access to electronic business communications that were valid before electronic business became a standard means of doing business. Since the publication of affirmative consent guidance in 2004, the environment and scope for conducting business electronically has changed substantially. Financial institutions, educational institutions and other furnishers of information statements have developed well-established platforms upon which business with employees and other constituents, including information statement recipients, is conducted electronically. For example, educational institutions conduct most, if not all, administrative functions and correspondence with students electronically. Access to university systems providing these functions and services are commonly made available to students via secure institutional portals or websites. Financial institutions have similar systems in place for conducting business electronically with customers.

Statement recipients tend to expect that the conduct of business electronically with statement providers extends to all business with that provider, and typically would not have need to distinguish the delivery of tax statements with delivery of other business statements and communications. Such a distinction would seem arbitrary and unnecessary, and separate communications and methods for consent to do business electronically are burdensome, confusing and ineffective.

IRPAC drafted Q&A guidance for Chief Counsel's review, covering integrated global affirmative consent agreements between furnishers and recipients, and recommended the guidance be posted on www.irs.gov. Chief Counsel's Office has approved an FAQ related to the global electronic delivery consent method for Forms 1098-T, Tuition Statement. The FAQ can be found in the Appendix C. Tax Forms and Publications has agreed to publish related content in the 2011 Form 1098-T instructions. IRPAC will continue to pursue Chief Counsel's approval of similar guidance for all Forms 1098, 1099, 5498 and W-2.

B. Form 5498 and Fair Market Value Reporting for Deceased Beneficiaries and Successor Beneficiaries

Recommendations

1. In response to a rejection of IRPAC's 2009 Public Report recommendation on the same topic, we recommend the 2011 Instructions for Form 5498 apply the same reporting guidelines currently specified for deceased IRA owners/plan participants and their beneficiaries to reporting for deceased IRA beneficiaries and their successor beneficiaries. The result of these

Ad Hoc Subgroup

new instructions will require a final Form 5498 for the deceased IRA beneficiary and if a year end IRA balance remains, a Form 5498 for the successor beneficiary. The Form 5498 for the deceased beneficiary should state "Deceased beneficiary name as beneficiary of the individual it was inherited from." The Form 5498 for the successor beneficiary should state "successor beneficiary name as beneficiary of deceased beneficiary name." Working with the IRS in it's drafting, in addition to a note in *What's New*, we recommend language similar to the following be added to the 2011 Instructions for Form 5498 at the end of the section titled "Inherited IRAs":

In the case of successor beneficiaries, apply the preceding rules by treating the prior beneficiary as the decedent and the current beneficiary as the beneficiary. Include on Form 5498 and the annual statement the name of the deceased owner and of each beneficiary of the IRA, abbreviating as necessary to fit the space available. Using the example above (Brian Willow as beneficiary of Joan Maple), when that account passes to Brian's successor beneficiary, Maurice Poplar, Form 5498 and the annual statement for Maurice should state "Maurice Poplar as beneficiary of Brian Willow." The final Form 5498 and annual statement for Brian Willow will state "Brian Willow as beneficiary of Joan Maple" and will show the FMV as of the date of Brian's death or year-end valuation, depending on the method chosen.

2. IRPAC also recommended a grandfather provision be added for reporting existing successor beneficiary accounts in existence prior to 2011 which have been reported under a different account title (for example, successor beneficiary name as beneficiary of the original deceased account owner), since no reporting rules existed prior to the expected 2011 guidance. According to IRS officials, a grandfather rule addressing this concern will not be forthcoming.

Discussion

We began the year by asking for the status of the guidance for Form 5498, Reporting for Successor Beneficiaries. We reiterated that there are no clear guidance/instructions that address Form 5498 reporting for participant name box and fair market values (FMV) in the case of a deceased beneficiary and successor beneficiaries to whom they have left IRA assets. Current guidance only addresses the initial beneficiary and deceased account owner. The 2009 instructions for Form 5498 is a regurgitation of Revenue Procedure 89-52 that addresses Inherited IRAs. IRPAC was advised by IRS TE/GE per the Public Report at the 10/28/09 IRPAC Public Meeting, that the issue would be added to its current priority guidance list.

Ad Hoc Subgroup

IRPAC had recommended guidance/instructions providing that Form 5498 reporting for the year of an IRA beneficiary's death and subsequent years indicate only the successor beneficiary and the original IRA owner or plan participant as well as such successor's share of any December 31st FMV. To the extent multiple successor beneficiaries exist and have assets remaining, separate Forms 5498 were recommended for each one with their share (amount) of the December 31st FMV. IRPAC also recommended for the year of a beneficiary's death that no final Form 5498 be required in the deceased beneficiary name. However, IRPAC recommended that guidance/instructions should state that upon request, the beneficiary's date of death value must be provided to the executor or administrator of the deceased beneficiary's estate.

IRPAC provided proposed language to be inserted in the instructions for Form 5498 and 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Following receipt and review the IRS reconsidered its original acceptance of the proposal. The IRS wanted a reporting methodology it felt more closely resembled the guidance in Rev. Proc. 89-52. The IRS and IRPAC then mutually agreed to the language presented in the recommendation above. The concern with the reporting language as agreed to is that it presents potential compliance difficulties for IRA custodian/trustees that had guessed at reporting on existing successor beneficiary accounts and is currently reporting FMVs with the original IRA owner/plan participant name. Beginning with 2011 reporting, IRA custodian/trustees will have to determine the deceased beneficiary name from which the successor beneficiary inherited, if any. To address this data verification and reporting concern, IRPAC proposed a grandfather provision to allow continued successor beneficiary reporting using methodology initiated by the custodian/trustee for deaths occurring December 31, 2010 or prior. Without this grandfather provision custodian/trustees that did not guess right regarding the agreed to methodology for 2011 reporting will have to contact every existing beneficiary IRA owner to determine if they have the correct decedent for future reporting. At this point we have been told that no grandfather provision will be forthcoming.

C. Information Regarding Non-Resident Alien Taxation and Tax Reporting

Recommendations

IRPAC recommends that the IRS publish information to assist taxpayers in the following areas of nonresident alien taxation and reporting:

- Tax residency rules
- Income tax rules
- Withholding tax rules (including employment tax)
- Tax treaty rules
- Special tax information for alien categories

Ad Hoc Subgroup

The information should be published as web based content on irs.gov in a new section titled "Taxation of Aliens by Visa Type and Immigration Status."

Discussion

Based on meetings with the Ad Hoc Subgroup, the IRS LMSB/LBI Operating Division is developing extensive web-based content to provide detailed guidance and background on non-resident alien taxation and reporting issues.

The content will be organized by visa type and immigration status. The treatment of tax residency rules will include detailed discussion of each visa type's substantial presence tests, followed by the federal income tax, social security and Medicare tax, federal unemployment, and retirement plan distribution tax withholding rules based on resident status. Tax treaty benefits will be explained, as they relate to both payers and payees.

This information will enhance tax reporting of nonresident alien payments, and also improve compliance with withholding rules related to payments to nonresident aliens.

This recommendation for web-based content was initiated in 2008 and has been documented in IRPAC's last two Annual Reports. IRPAC will continue to work next year with Large Business and International (LB&I) on the development of this content.

D. Reporting Guidelines for the Return of Mistaken HSA Contributions to an Employer

Recommendations

1. IRPAC recommends the IRS add guidance to the 2011 Instructions for Form 1099-SA, Distributions From an HSA, Archer MSA, or Medicare Advantage MSA, and Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, stating that if an excess employer contribution (and earnings on them) is returned to an employer using guidance from Notice 2008-59 Q/A 24, the health savings account (HSA) custodian /trustee does not report the excess contribution nor does it report the distribution to the employer. Working with the IRS in it's drafting, in addition to a note in *What's New*, we recommend language similar to the following be added to the instructions:

In Form 1099-SA instructions, Box 1: *Do not report the withdrawal of excess employer contributions (and the earnings on them) returned to an employer as a distribution from an employee's HSA.* In Form 5498-SA instructions, Box 2: *Any excess employer contributions (and earnings on*

Ad Hoc Subgroup

them) withdrawn by the employer pursuant to Notice 2008-59 Q/A 24, available at www.irs.gov/irb/2008-29_IRB/ar11.html, should not be reported as a contribution.

2. We also recommended the IRS add guidance to the instructions for the return of HSA contributions to an employer following the determination that an employee was never an eligible individual pursuant to Notice 2008-59 Q/A 23. The IRS declined based on the reasoning that if an individual was not an eligible individual, he never established an HSA and since there is no HSA there is no associated HSA reporting.

Discussion

This recommendation and discussion is generated based on Q/As 23 and 24 of IRS Notice 2008-59, Health Savings Accounts. This issue is two-fold, one is when you have an individual that was never eligible for an HSA and the other when an employer contribution (not elective contributions) exceeds the maximum annual contribution allowed. According to the IRS Tax Exempt and Government Entities Division (TE/GE), if an individual was not an eligible individual, the HSA never existed. Form 1099-SA distribution reporting for assets returned to the employer in the year of original contribution or at any future date is not applicable. A financial organization would treat it like a regular bank account or investment account owned by the individual. Thus, if a financial organization learns of ineligibility in the year of individual contributions or subsequent years it may be negligent for other 1099 reporting (interest, dividends, basis tracking, etc.) and may have issued Forms 1099-SA and 5498-SA in error as well. IRPAC suggests that the IRS considers adding such language to IRS model Forms 5305-C, Health Savings Custodial Account, etc., HSA agreement. IRS TE/GE stated it is on a 3-year cycle and they will look into it, although unlikely.

Second, with respect to an employer exceeding the eligible individual's annual maximum contribution limit and then such amount is returned to the employer in the same year, as described in Q/A 24 of Notice 2008-59, there is no guidance for reporting. IRS TE/GE stated that in this instance the HSA custodian/trustee will not report the excess amount contributed by the employer on Form 5498-SA and the distribution of excess as adjusted back to the employer in the year of contribution is not reported on Form 1099-SA. IRPAC noted that not reporting the contribution or distribution is more difficult than reporting it.

IRPAC requested that the reporting instructions for Forms 1099-SA and 5498-SA reflect this lack of reporting and Tax Forms and Publications agreed to draft language and agreed to have it reviewed by IRPAC. Additionally, if an employer does not have this excess as adjusted returned to it, the contribution remains reportable and the individual must deal with the contribution as HSA

Ad Hoc Subgroup

excess contribution. According to IRS TE/GE, in the near term do not expect anything published on HSAs due to Health Care Tax Legislation.

IRPAC requested that the 2011 reporting instructions for Forms 1099-SA and 5498-SA reflect both the lack of reporting regarding excess employer contributions to an eligible individual employee's HSA and the earnings on them, and also for employers that contribute to an ineligible employee. The IRS stated it will not address an ineligible individual's contribution or distribution in its reporting instructions, since the account was never an HSA. However, with respect to the return of excess contributions to an employer in the year of contribution due to an employer contribution in excess of the annual limit, the IRS, in conjunction with IRPAC input, will add language to the instructions as described in the recommendation.

IRPAC also requested the IRS to include information in Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans, that if an individual was never an eligible individual, an HSA was never established and if an employer made the contribution and it was not returned timely it would be considered wages for the employee reported on Form W-2. IRS TE/GE was hesitant to make such statements in the Publication because of confusion it may generate.

E. Form 1099-R Reporting under EPCRS Guidelines for SEP, SARSEP and SIMPLE Excesses Returned to Employer

Recommendations

IRPAC recommends the IRS add guidance to the 2011 Instructions for Form 1099-R for reporting the return of excess Simplified Employee Pensions (SEP), Salary Reduction Simplified Employee Pensions (SARSEP), and Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) employer contributions from an Individual's IRA to an employer/plan sponsor as prescribed under Employee Plans Compliance Resolution System (EPCRS). The correction and reporting stated for these returns in Revenue Procedure 2008-50, Section 6.10(5) and Appendix F - Streamlined Voluntary Compliance Program (VCP), Schedules 3 and 4 are not reflected in Form 1099-R instructions. Working with the IRS in its drafting, in addition to a note in *What's New*, we recommend language similar to the following be added to the 2011 Instructions for Form 1099-R under the section titled Distributions under Employee Plans Compliance Resolution System (EPCRS):

If excess employer contributions (other than elective deferrals), and the earnings on them, under SEP, SARSEP, or SIMPLE IRA plans are returned to an employer, enter the gross distribution (excess and earnings) in box 1 and 0 in box 2a. Enter Code E in box 7.

Ad Hoc Subgroup

Discussion

The purpose of reviewing this issue is that IRA custodian/trustee/issuers do not have clear reporting instructions. The current EPCRS Rev. Proc. 2008-50, Appendix F, Schedules 3 and 4, for streamlined VCP program corrections and distribution reporting for SEP/SIMPLE, and Section 6.10 (5) only address the amount of excess employer contributions (plus earnings on them) returned to the employer as a taxable amount of zero. The instructions for Form 1099-R are silent as to this issue and the issue of an applicable code to use in Box 7. The instructions for Form 1099-R say to use Code E for EPCRS distributions of elective deferrals and employee contributions. According to IRS TE/GE, as long as the taxable amount is zero, there will be no difference with the code no matter what year the distribution occurred.

A suggestion was made to add a sentence stating for a return of employer excess contributions use Code E if nothing else is appropriate.

IRPAC, IRS TE/GE, and Tax Forms & Publications collaborated in drafting language to be included in the instructions for Forms 1099-R and 5498 under the section titled Distributions under Employee Plans Compliance Resolution System. In addition, the IRS will look to expand the description of Code E in the chart of codes in the instructions on page 13 of the Form 1099-R instructions, distribution code definition. According to IRS TE/GE, the updated Revenue Procedure to Rev. Proc. 2008-50, which will include 403(b) plans, should not affect this correction methodology.

The IRS encourages employers/plan sponsors to use EPCRS, not just the general instructions, for purposes of this SEP/SARSEP/SIMPLE IRA correction.

F. Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information Due Date Change

Recommendation

IRPAC proposes that the due date to the participants for Form 5498-SA HSA, Archer MSA, or Medicare Advantage MSA information be changed from May 31 to January 31. The May 31 date can remain the same for submitting to the IRS.

Discussion

There are three reporting statements associated with health savings accounts not filed by an HSA owner: Form W-2, specifically Box 12a, Code W; Form 1099-SA Distributions from an HSA, Archer MSA, or Medicare Advantage MSA; and Form 5498-SA. When a person prepares their individual income tax return, they may need all three statements to accurately complete Form 8889,

Ad Hoc Subgroup

Health Savings Accounts. Taxpayers and tax practitioners rely on various IRS reporting statements. The timeliness of receiving a Form 5498-SA on May 31 when the other reports are due to the taxpayer on January 31 creates a gap. IRC Sections 223(d)(4)(B) and 219(f)(3) state that contributions to an HSA for a tax year must be made by the tax return filing due date (not including extensions). Generally, contributions for tax year 2009 can be made from 1/1/09 until 4/15/10. Therefore if one hasn't contributed up to the limit by the end of the year, then they have until 4/15/10 to make a contribution for the difference. It is burdensome for taxpayers to extend their returns for the sole purpose of waiting for the Form 5498-SA to verify their contribution amount. From the practitioner's point of view, having contribution information by January 31 allows practitioners to advise the taxpayer how much they can contribute if they are short. If practitioners know the amount contributed and the additional amount the taxpayer will contribute, there is no need to receive the Form 5498-SA on May 31 for this purpose. In addition, if practitioners have prepared a return before May 31, the taxpayers generally will not forward the Form 5498-SA for verification purposes. The results of not having timely information for taxpayer return filing include excess contributions, under contributing, taking incorrect deductions and filing of amended returns.

Another issue regarding contributions is that family members or any other person may also make contributions on behalf of an eligible individual. If the practitioner does not have the Form 5498-SA by January 31 reporting all contributions through the prior December 31, then the practitioner might not have the correct contribution amount to show on the tax return.

IRS Response

The IRS commented that anything relating to the Health Savings Accounts have been put on hold due to the more immediate concern regarding the Affordable Care Act. Additionally, the IRS responded that to make any change to a deadline for Form 5498-SA they would likely need to make an earlier participant reporting deadline for the entire Form 5498 series and they were currently not interested in making this change.

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE

Burden Reduction Subgroup Report

**JERRI LANGER
CONSTANCE LOGAN
KATHRYN S. TRACY
ARTHUR B. WOLK
BARBARA L. McARTHUR, SUBGROUP CHAIR**

Burden Reduction Subgroup

A. **Announcement 2010-41: New Backup Withholding Procedures: Social Security Number Validation following Receipt of Second “B” Notice**

Recommendation

IRPAC commends the IRS on their release of interim procedures for payees requiring validation of their social security number to prevent or stop backup withholding. IRPAC will continue working with IRS as additional guidance, including revision of Rev. Proc. 93-37 and Publication 1281, is prepared.

Discussion

Prior to the release of Announcement 2010-41 the IRS required that an individual receiving a second “B” Notice¹² go to the local Social Security Administration (SSA) office to have his or her Social Security Number (SSN) validated on Form SSA-7028, Notice to Third Party of Social Security Number Assignment, in order to stop or prevent backup withholding. Over the last few years payees have found it increasingly difficult to obtain Form SSA-7028 with a growing number of Social Security offices refusing to provide the form.

This issue was originally brought to IRS by IRPAC in 2008.¹³ In 2009 IRPAC continued its efforts to draw awareness and suggest solutions to the problems encountered by individual taxpayers who received a second “B” Notice but had no remedy available to them to stop backup withholding.¹⁴

In 2010 the problem became more pronounced when the Social Security Administration posted an FAQ on their website stating that as of January 1, 2010, Form SSA-7028 was no longer available. The Office of Chief Counsel and IRS Small Business and Self Employed (SBSE) Operating Division continued discussions with SSA toward a workable interim solution which culminated with the release of Announcement 2010-41 on June 2, 2010. Interim procedures provide that to obtain validation of the payee’s SSN from the SSA for purposes of responding to a second “B” Notice, each individual should now contact the local SSA office and request a Social Security Number Printout.

A copy of Announcement 2010-41 is provided in Appendix D. Taxpayers may obtain the SSN printout by visiting a local Social Security office. Taxpayers

¹² See Backup Withholding webpage: <http://www.irs.gov/govt/fslg/article/0,,id=110339,00.html>

¹³ 2008 IRPAC Annual Report, Emerging Compliance Issues Subgroup, “Procedures for complying with Second “B” Notices appear outdated and should be coordinated with the Social Security Administration’s current policies.

¹⁴ IRPAC Response Letter to the 2009-2010 Guidance Priority List (May 2009): http://www.irs.gov/pub/irs-utl/irpac_priority_guidance.pdf ; 2009 IRPAC Annual Report, Burden Reduction Subgroup, “Form SSA-7028, Notice to Third Party of Social Security Number Assignment.

Burden Reduction Subgroup

will be asked to provide their SSN and identifying information such as date of birth, city of birth and mother's maiden name.

IRPAC appreciates the opportunities it had to share its concerns about second "B" Notice procedures and provide input regarding the interim guidance to the IRS Office of Chief Counsel and IRS SBSE.

B. Form 1099-INT, Box 10 and Associated Instructions

As published for 2010, Form 1099-INT, Interest Income, includes a new box 10 which is intended to convey the CUSIP (Committee on Uniform Security Identification Procedures), number of each tax exempt bond from which the taxpayer derived tax exempt income.¹⁵ This new reporting requirement introduces fundamental changes to a payer's data processing routines and the consolidated statement design that most payers use to provide payees with 1099 reports. These requirements cannot be easily addressed in time for reporting due in early 2011 for the 2010 tax year.

As was explained to IRPAC, the addition of this information to the form comes from IRS's need to identify taxpayers that are the beneficial owners of tax exempt private activity issues which are in danger of or have lost their tax exempt status. This application of information reporting differs from the traditional matching of aggregate income from Form 1099 to Form 1040, U.S. Individual Income Tax Return. Rather, it is a warehousing of data intended to allow IRS to consistently meet its obligation to communicate with these taxpayers when the bond issuer's tax exempt status is being examined.

Considering the size of the tax exempt bond market, this approach casts a hugely disproportionate net in hopes of identifying a very small number of bondholders. Additionally, not all bondholders receive Forms 1099-INT nor do all tax exempt issues have industry-recognized CUSIP numbers, leaving holes in the potential coverage envisioned.

Based on its discussions with IRS Tax Exempt and Government Entities (TEGE) Operating Division, the IRS Office of Chief Counsel and the IRS Wage and Investment (W&I) Operating Division, IRPAC's recommendations are oriented toward consideration of alternate approaches to communication with bondholders and, if the alternatives are untenable, addressing the structural and logistical shortcomings of the addition of box 10 to the Form 1099-INT.

¹⁵ The instructions for Form 1099-INT read: "For tax-exempt bonds, enter the CUSIP number of the tax-exempt bond for which tax-exempt interest is reported in box 8. If a CUSIP number was not issued for the tax-exempt bond, leave box 10 blank."

Burden Reduction Subgroup

Recommendations

1. Since the introduction of the revised form 1099-INT there has been insufficient time for IRS to consider the issues identified by IRPAC (on both the form and instructions) or for payers to implement any systematic changes. It is recommended, therefore, that the obligation to report the CUSIP numbers of tax exempt bonds be deferred for at least one year.
2. IRPAC recommends that IRS look to models currently in place for reporting, Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and Undistributed Capital Gains as well as the proxy notification process in place in the securities industry as possible reporting approaches that are more likely to capture all the beneficial bond owners and will avoid a massive effort of data collection, storage and mining to identify the small number of cases that are of interest. The currently proposed approach of data warehousing is an unnecessary departure from the traditional annual matching processes employed by the information reporting program.
3. By including the CUSIP number as a new reporting element on Form 1099-INT, there is an implication that IRS no longer intends it to be a form on which payers report income at an aggregated level (at least for tax exempt interest). If this approach is retained in lieu of alternate proposals, IRPAC recommends that IRS:
 - Instead of creating an ambiguous Form 1099-INT structure with some elements in aggregate and others in detail at the CUSIP level, consider a form such as the 1099-OID, Original Issue Discount (already a CUSIP level report) as a more appropriate vehicle. Similarly, a new form, 1099-TEB, Tax Exempt Bond, could be created, as this would separate the tax exempt bond interest (on which CUSIP numbers are desired) from the exempt interest dividends (on which CUSIP numbers would be of no value). In addition, moving exempt interest dividends, dividend distributions that are reported on an aggregate basis, to new boxes on the Form 1099-DIV would better organize the overall information reporting program.
 - Give consideration to different reporting requirements with regard to the level of detail for exempt interest. Aggregate totals by income type from a single payer are what a taxpayer needs to complete his or her tax return. The CUSIP level detail appears to be only a requirement for the IRS which could be satisfied on the payer's information return filing with the IRS, but not included on the payee statement. The notion of reporting at different levels of granularity to the beneficial owner of an asset and the IRS is already a part of

Burden Reduction Subgroup

the reporting regime for Widely Held Fixed Investment Trusts (WHIFIT).

- Reflect on what the requirement would be for distinguishing reporting of multiple bond issues, within an account, that do not have CUSIP numbers. Are they aggregated? Assigned some type of user-defined number to distinguish them as distinct issues?
- Provide explicit clarification that taxable interest should still be reported as an aggregate amount

Discussion

Due to limitation of the information reporting requirements, there is significant reason to believe that the new requirement introduced on the 2010 Form 1099-INT will not accomplish its desired goal of facilitating uniform communication to the intended audience. Simply stated, not all bond holders receive Forms 1099-INT. With a process that contemplates capturing huge volumes of data in pursuit of a small subset, any consideration of expanding the information reporting requirements to include previously exempt entities in an effort to close this identification gap would mainly exacerbate the inherent shortcoming of this approach. IRPAC's dialog with IRS has focused on the potential of a notification process that leverages the proxy process that currently exists as part of the structural framework of the securities industry and potentially incorporates features of the existing reporting practices for FIRPTA and Undistributed Capital Gains. Both parties have agreed to explore the viability of this approach in future discussions.

Should the proxy model prove to be impractical, IRS should consider that the new Form 1099-INT presents considerable challenge to the information reporting community due to its uneven approach to reporting. If this approach is retained, it is important for IRS to contemplate the data processing issues identified in this report.

As it existed prior to 2010, Form 1099-INT conveyed the aggregate interest income (taxable, tax-exempt and private activity portion) for a taxpayer, earned at a reporting institution, for a given year. Beyond deposit interest, the reportable amounts represent income earned throughout the year from a variety of financial instruments. Systems that are designed and built for the purpose of reporting annually must capture these disparate amounts, but do not necessarily maintain the details in a way that allows for reporting in the manner and timeframe required by the new version of Form 1099-INT. Reporting at a detailed level is a fundamental change that would require extensive modifications to the data base structure, the overhaul or rewrite of entire systems, the creation

Burden Reduction Subgroup

of greatly enhanced data storage capacities, changes to printed statement designs and the modification of electronic filing routines.

Among the Forms 1099, the 1099-B, Proceeds From Broker and Barter Exchange Transactions and 1099-OID are unique in that they report (to the taxpayer and IRS) with greater granularity than the other forms such as 1099-DIV, Dividends and Distributions and 1099-INT. In short, the 1099-DIV and 1099-INT are summary level forms and the 1099-OID and 1099-B are detail level forms. The existing designs of composite substitute statements must tread very carefully to present data in a consistent way (summaries together, details in dedicated sections) while staying within the framework for composite forms provided in Publication 1179. This makes clear to the taxpayer which information is being provided to the IRS. The newly introduced requirements for Form 1099-INT for 2010 stretch the limits, taking this balancing act to the breaking point by creating a single form that is sometimes granular (tax exempt interest at the CUSIP level) and sometimes summary (taxable interest and exempt interest dividends).

Why is this so challenging? Currently, a filer of Form 1099-INT, in a single section bearing the appropriate Office of Management and Budget (OMB) number and box headings, may report all the appropriate totals. In the new approach this is not possible; boxes 8 and 9 no longer represent totals and, if for clarity and consistency the filer wants to display summary totals of boxes 8 and 9, they are not permitted to appear in the section that is identified as 1099-INT, bears the OMB number and notifies the recipient that the information is being reported to the IRS. Further, a different section of the composite substitute statement (addressing the individually reportable items for boxes 8, 9 and 10) must now become a Form 1099-INT, with the heading (and associated information) indicating that the amounts are being separately reported to the IRS. Pair this with the fact that the filer may provide, as a customer service, similarly detailed information for taxable interest income (which should not be identified as a Form 1099-INT), the stage has been set for considerable investor confusion.¹⁶

Information that is reportable on Forms 1099 often originates in disparate systems due to the varying types of activity and different business units in which the transactions take place. With Publication 1220, Specifications for Filing Form 1098, 1099, 5498, and W2-G Electronically, only recently published for 2010, and greater guidance needed from Publication 1179, General Rules and Specifications For Substitute Forms 1096, 1098, 1099, 5498, W-2G and 1042-S to effect the needed programming changes, there is no time left to reprogram the

¹⁶ In reality this situation is even further complicated by the fact that many firms who provide detailed information in support of the current form 1099-INT income totals do so at the payment level, a step beyond the new CUSIP level requirement. Again, this implies a potential mixture of granularity that would logically be displayed together (payment detail followed total for the CUSIP) but require a degree of separation mandated by the composite substitute statement requirements of Publication 1179 that would be difficult to navigate.

Burden Reduction Subgroup

reporting process to capture the new data, making the challenge of implementing a change like this tantamount to impossible.

Moving *from reporting interest totals by type* (taxable, tax exempt, private activity, Treasury) *to totals for each security* implies a large increase in the volume of records captured, processed, stored and transmitted. For these requirements to be met, firms must have enough time to build a process to evaluate the impact of these changes and to analyze historical data. IRPAC notes such retroactive data gathering is a time consuming process in the best of circumstances much less one done without the proper timeframe allotted. For new data to be safely captured to support the reporting change, the process needs to be set up, tested and running effective on the first day of the year to which the change relates. Until the reporting rules are finalized and released, payers are unable to determine the additional resources that will be required to comply.

The number of firms with securities operations that would report tax-exempt interest is probably far exceeded by the significant number of banks, thrifts and credit unions that use Form 1099-INT solely to report deposit interest. These payers and, more importantly, their customers/taxpayers are accustomed to the 1099-INT reflecting deposit interest in a simple, easy to understand fashion. Maintaining the simplicity of this form is important to assuring proper income recognition on Forms 1040. Adding more tax-exempt interest elements to this form brings additional complexity that may be the source of some confusion to their customers/taxpayers. Additionally, every payer who is required to use this form, including not just banks, thrifts, credit unions and brokers, but also corporate treasury and accounts payable operations, will be required to modify systems (at least for electronic filing) for changes that are not applicable to their businesses.

Issues that do not have standard industry CUSIP numbers will still, for the purpose of processing, have unique identifiers on the books of each processing firm. With the form's instructions saying to leave box 10 blank when no CUSIP number exists, it is unclear whether an aggregation of income for all such issues is expected or separate Forms 1099-INT should be filed for each distinct bond issue, each with box 10 blank. Instructions assume that only one bond is held with interest reported in Box 8, and are unclear regarding how to report if there are several bonds.

Boxes 8 and 9 of the 1099-INT are devoted to tax exempt interest and original issue discount (OID) and the portions thereof that are attributable to private activity bonds. In addition, these boxes capture exempt interest dividends from mutual funds.¹⁷ The box 10 requirement, however, applies only to the tax

¹⁷ Although there is no requirement for 1099-INT payee statements for WHFITs, as a practical matter firms also report tax exempt distributions on these instruments on this form as part of their processes to meet the requirement for an additional written statement.

Burden Reduction Subgroup

exempt bonds. While the tax exempt mutual funds will have CUSIP numbers, those numbers will provide no direct correlation to bond issues held in the fund's portfolio.¹⁸ This presents another tangled approach to reporting; there appears to be no need for detail level information for the mutual funds, but they are grouped into the same boxes as the tax exempt bonds. There ought to be a consistent approach and requirement to boxes 8, 9 and 10 which is devoted strictly to tax exempt bonds. Detailed reporting of exempt interest dividends will be superfluous, adding tremendous volumes to processing and data storage, while conveying no useful data with regard to private activity bonds.¹⁹ Consideration needs to be given to clarifying how these dividends are to be reported, whether CUSIPs are required, whether the amounts may be aggregated and whether such dividends even belong on a Form 1099-INT that is designed to report interest.

The proposed change to Form 1099-INT introduces inconsistencies to the information reporting process that are difficult to reconcile with existing data structures, processes, procedures, transmission and storage provisions. Also of great concern is the incompatibility of the requirements with logical and consistent design of composite substitute statement that will provide clarity to the taxpayer and is manageable for the payer. Finally, the proposed change to reporting is not likely to consistently fulfill its objective. IRPAC's recommendations are intended to fulfill IRS's requirements while minimizing the burden and disruption to all stakeholders by providing alternative approaches that are targeted to the situations of interest and do not introduce to the payer or taxpayer any superfluous reporting.

C. IRC §1441 and §1442 Documentation and Withholding Issues on Freight, Shipping and Other Transportation Expenses

Recommendations

1. **Instructions to Form W-8BEN, Beneficial Owner's Certificate of Foreign Status for U.S. Tax Withholding**, should be updated to clarify that the no effectively connected income (ECI) certification on the form is broad enough to cover terms of ECI for transportation income defined under IRC §887(b)(4) as well as the more general definitions of ECI under IRC §882 and §864. Absent ECI as defined under IRC §887(b)(4), income subject to gross transportation income (GTI) excise tax would be exempt from Chapter 3 withholding under IRC §1441 and §1442 (Form 1042 withholding). To date, no documentation has been specified for use

¹⁸ Since box 10 is intended for the CUSIP numbers of tax exempt bonds, a circumstance similar to the lack of CUSIP number arises. Would all exempt interest dividends be aggregated or reported individually for each mutual fund with box 10 left blank?

¹⁹ With a notification process (as previously discussed) the mutual fund will be aware of the change of character of its earnings and will be able to characterize its distributions at the conclusion of the calendar year to reclassify portions to taxable using existing industry practices and procedures. This is often done with these types of mutual funds to reflect bond premium on the portfolio.

Burden Reduction Subgroup

in claiming exemption from this withholding on U.S. source shipping or air transportation income otherwise subject to the GTI 4% excise tax where the income is not ECI.

2. **Instructions to Form W-8ECI, Foreign Person's Claim of Income Effectively Connected with the Conduct of a Trade or Business in U.S.**, should be updated as to the application of the form to transportation income. It is important that the instructions clearly explain that ECI is defined broadly enough to cover terms of ECI for shipping and air transportation defined under IRC §887(b)(4) as well as ECI for other forms of transportation such as trucking and railway defined under the general rules found in IRC §882 and §864.
3. **Instructions for identifying income falling under the GTI exception**, and related methods of documenting these items, need to be developed for payers to better understand their responsibilities when making these payments and that can be relied upon for withholding purposes.
4. **Adopt the special sourcing rules used for GTI** under IRC §863(c) for purposes of withholding under Chapter 3, IRC § 1441 and 1442, and extend the application beyond air and vessel services to include rail and trucking services. Accounts payable (AP) professionals have extreme difficulty in sourcing transportation services due to the impossible tasks of examining road, container logs, shipping schedules, dates of ports of service, etc. Even if logs are found, there is no clear method in the regulations or elsewhere to assist in allocating these services to the proper sources when they are partially within and without the U.S. IRPAC believes that the IRS has broad statutory discretion to develop sourcing rules for other types of income where sourcing is not clearly established and can adopt the IRC §863(c) rules for other transportation income.
5. **Exempt "freight" from IRC §1441 and §1442 withholding when billed as part of goods purchased** as with the present exception from reporting freight on Form 1099-MISC, Miscellaneous Income. The cost and burdens of withholding on freight far outweigh the revenue collected. An exception should be considered for freight charges particularly if associated with purchase of goods that is already exempt from withholding under IRC §871 or §881.
6. **Users and providers of transportation services need written guidance and education on the related compliance process.** Examples of transportation income with an explanation of requirements for related compliance need to be added either to Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, instructions, IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities or a publication dedicated to transportation. Instructions need to

Burden Reduction Subgroup

consider the use of Forms W-8ECI and W-8BEN where required, treaty applications, income codes on Form 1042-S and withholding requirements in general. Foreign suppliers of transportation services with places of business in the U.S. fail to understand the need to supply Form W-8ECI to claim exemption from IRC §1441 and §1442 withholding. Others fail to understand the need for providing Form W-8BEN.

Discussion

IRPAC has met with IRS Office of Chief Counsel to discuss the absence of a clear withholding process for payments for transportation services made to foreign persons. All parties recognized early on the significance of the issues surrounding this topic and recognized that resolutions could impact most every AP function with a global interface across many diverse industries. IRPAC's recommendations have been refined through those conversations and IRPAC intends to continue to work with the IRS in making the changes needed to ease the confusion that now exists in making these payments.

Unlike Form 1099-MISC reporting, there is no blanket exemption from withholding and reporting on freight expenses under Chapter 3, IRC §1441 and 1442. There is, however, a similar exemption in Reg. §1.1441-2(b)(2)(i) that exempts gains derived from the sale of property from Chapter 3 withholding. Where freight is actually part of the cost of acquiring the property, some have treated the freight charges as part of the purchase price of the property and exempted the payment from IRC §1441 and §1442 withholding. There appears to be no direct authority to support this position, but IRPAC notes that it is a street practice. For the most part, payments for freight, shipping and other transportation expenses are generally fixed and determinable, annual or periodic gains, profits or income (FDAP) subject to withholding under IRC §1441 and 1442.²⁰

The application of IRC §1441 and §1442 withholding on transportation payments will vary depending upon whether the services are classified as ship and air transportation subject to the 4% excise tax on U.S. source GTI or classified as trucking or rail transportation.

1. Ship and air transportation: There is a 4% excise tax on U.S. source gross transportation income (GTI) when earned by a nonresident or foreign corporation. U.S. payers do not withhold this tax. It is paid by the shipper. When the GTI excise tax applies, there is a statutory exception from IRC §1441 and §1442 withholding.²¹

The GTI excise tax applies to income derived from or in connection with the use, hiring or leasing of a vessel or aircraft and includes services directly

²⁰ See IRC §871, §1441, and §1442; Reg. §1.871-7(a) and Reg. §1.1441-2.

²¹ IRC §887(a); §887(b)(2), §887(c).

Burden Reduction Subgroup

related to the use of the vessel or aircraft as well as the use of containers with the vessel or aircraft. It is noted that to be "directly related", the services must be incidental to the operation of the vessel or aircraft.²²

Where the GTI excise tax does not apply, IRC §1441 and §1442 withholding will apply. The GTI tax has several complex exceptions; if the income is exempt from the excise tax and U.S. sourced IRC §1441 and §1442 withholding will apply. The most significant exception where the GTI tax does not apply is for transportation income taxable as effectively connected income (ECI) with the taxpayer's trade or business in the United States pursuant to section IRC §887(b)(4).

For the most part, it is the determination of the ECI exception from GTI that is critical to the IRC §1441 and §1442 withholding compliance process as it will always involve some U.S. source income where the ship docks or plane lands in a U.S. port and may require 30% withholding if a W-8ECI has not been provided.

ECI has a different meaning in the context of GTI than in the normal course of IRC §1441 and §1442 withholding rules and will attach if the vendor merely has a fixed place of business in the U.S. and substantially all its shipping income is attributable to that fixed place. Unlike the general rules for ECI under IRC §882 and §864, for water and air transportation ECI will attach even if the income is not in any way related to that fixed place of business.²³ Facts necessary to make this determination are mostly unknown to the payer. Payers are also unable to identify payments to which these rules attach.

Payers have no way of evaluating whether the payment they make is subject to the GTI ECI exception and thus, whether they need to withhold 30%, unless they receive either a Form W-8ECI from the shipper that specifies the income or a W-8BEN that certifies no ECI.

It is important that the instructions to the W-8ECI clearly explain that ECI is defined broadly enough to cover terms of ECI for shipping and air transportation defined under IRC §887(b)(4) as well as ECI for other forms of transportation such as trucking and railway defined under the general rules found in IRC §882 and §864.

Instructions to W-8BEN need to clarify the application of GTI and exemption from IRC §1441 and §1442 withholding. Where there is no ECI, and GTI attaches to the income being paid, the IRS Form W-8BEN (Part I and the signatory) should be approved for use to determine foreign status of the vendor when the vendor is willing to provide it. Today, many payers do try to obtain this form from shippers, but with significant push back. This form is mostly used for

²² See IRC §863(c)(3), and Rev. Proc. 91-12, 1991-1 CB 473.

²³ Rev. Proc. 91-12; IRC §887(b)(4).

Burden Reduction Subgroup

air and water transportation, and docking or landing occurs at a U.S. port, unless the AP professional is aware that the operator has a U.S. business site and they attempt then to acquire a Form W-8ECI. No U.S. TIN should be required on the W-8BEN for an exemption claim, but it does need to be renewed if received without the TIN. Currently, there are no Form 1042-S instructions as to proper coding where the GTI exemption may apply and many believe that such income is not reportable on Form 1042-S unless there is withholding or a Form W-8ECI is received.

W-8BEN does provide for a general certification that the related income is not effectively connected with the conduct of a trade or business in the United States (read to mean ECI as defined under IRC §882 and §864). However, the concern is that because ECI is defined differently for GTI purposes under IRC §887(b), the general certification of no ECI on Form W-8BEN may not cover all transportation income needs. On the urging of several accounting firms, many AP departments are attempting to supplement the W-8BEN certification with a separate express declaration of no shipping ECI, for example:

"Under penalties of perjury, I declare that to the best of my knowledge and belief the following is true, correct, and complete: _____ does not have income effectively connected with a U.S. trade or business within the meaning of IRC §887(b), and does not have a fixed place of business, office, branch or agent in the U.S. through which transportation income is earned."

As a solution, it would be an easy fix to amend the instructions to the W-8BEN to clarify that the no ECI certification includes both ECI under IRC §882 and §864 as well as when involving ship or air transportation ECI under §887(b).

Many foreign airlines and vessel operators are declining to provide a W-8ECI that includes their U.S. TIN in the context of ECI, citing application of GTI or that they pay U.S. taxes. Others decline to provide the W-8BEN clarifying that they do not have ECI. As a solution, clear language on the application of IRC §1441 and §1442 withholding and reporting to these services needs to be added to the instructions to Form 1042, to Publication 515, or to some other formal written notice made widely available. In addition, an IRS publication or notice needs to be developed that can be shared with service suppliers so they understand the need to provide the right documentation.

A revenue procedure under IRC §1441 establishing a method for identifying relevant reportable transactions should also be explored. Revenue Procedure 91-12 spells out what qualifies as income derived from the use or hiring of a vessel for GTI purposes, but this procedure is directed to shippers and relies heavily on the shipper's actual knowledge of its own treatment of the item to which the expense relates. These matters are unknown to payers. From a payer's standpoint, extrapolation can be difficult even from detailed invoices and

Burden Reduction Subgroup

when they ask the shippers, shippers are making very broad declarations of income types they believe fall under the exemption.

2. Trucking and railing: The GTI excise tax does not apply to trucking or rail transportation. Other taxes such as the federal road use tax will apply, and NAFTA has a provision for Canadian and Mexican transportation that exempts or allocates even these road use taxes. NAFTA also grants special treatment to Canadian and Mexican employees regarding U.S. wage withholding involved in the covered transportation. However, unlike GTI, there is no express statutory exemption from the general IRC §1441 and §1442 withholding if the road use taxes apply. So, AP is required to handle the transportation income under the general withholding rules.

Many foreign companies that operate trucks or that provide railroad shipping services in the U.S. have ECI, have U.S. EINs usually beginning with "98" and file U.S. income tax returns, so they can provide a W-8ECI if asked. Others with limited U.S. intrusion might be able to claim treaty benefits, e.g., under Article VIII (Business Profits Article) of the Canadian tax treaty. AP professionals frequently receive Forms W-8BEN claiming treaty benefits where the rail or trucking firms have U.S. offices and where there are permanent U.S. employees operating the service. These are very difficult forms to manage without a better understanding on the part of AP of the treaty applications to these services. In addition, it is not unusual for the foreign provider of these services to give a W-9 certifying U.S. status even though not incorporated or formed in one of the 50 United States or under U.S. federal laws.

There is considerable confusion on the part of transportation services and payers under the withholding rules. In addition, dispatchers are frequently used and they also collect the payments, sometimes in an agent capacity. As a solution, clear language on the application of IRC §1441 and §1442 withholding and reporting to these services needs to be added to the instructions to Form 1042 or to Publication 515 or in some other formal written notice made widely available. In addition, an IRS publication or notice needs to be developed that can be shared with service suppliers so they understand the need to provide the right documentation and when they will experience withholding.

3. Sourcing transportation for withholding purposes: AP professionals have extreme difficulty in sourcing transportation services due to the lack of any instructions as to the proper methods for so doing. They face impossible tasks of examining road, container logs, shipping schedules, dates of ports of service, etc., and even if logs are found, there is no clear method in the regulations or elsewhere to assist in allocating these services to the proper sources when they are partially within and without the U.S.

IRPAC strongly suggests that the IRS adopt the process outlined in IRC §863(c) for sourcing GTI for use in sourcing other transportation income. IRC

Burden Reduction Subgroup

§863(c)(1) currently sources transportation income that does not involve an individual's personal services when beginning *and* ending in the United States as derived from sources within the United States. IRC §863(c)(2) sources 50 percent of all transportation income attributable to transportation which begins OR ends in the United States as from sources in the United States. These are fairly easy rules to follow and should be widely applied to all transportation income. Currently, IRC §863(c) only applies to income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft, or the performance of services directly related to the use of a vessel or aircraft, and includes any container used in connection with a vessel or aircraft.

IRPAC believes that the IRS has broad statutory discretion to develop sourcing rules for other types of income where sourcing is not clearly established and can adopt the IRC §863(c) rules for other transportation income. The sourcing regulations are limited and if a category of income is not listed, case law tells us to proceed by analogy. Certainly, the IRS can also develop sourcing rules by analogy. Regulations should be able to address this matter without statutory constraint. See *Hunt v. Commissioner*, 90 T.C.1289, 1301 (1988).

4. Freight as an exemption from Form 1042 process: AP professionals have long screened out transportation expenses from IRC §1441 and §1442 withholding and reporting because AP systems are designed around Form 1099 reporting processes where "freight" is exempt from reporting. The IRS has consistently defined very broadly the term "freight" in numerous private letter rulings under IRC §6041 as the cost of transporting goods. This interpretation results in a general exception from reporting of payments on Form 1099-MISC for truck, rail, ship, and air freight services no matter their context, allowing the exemption even if the truckers are paid directly. The exception to information reporting for payments of "freight" under Reg. §1.6041-3 includes not only a taxpayer's payment of incidental freight costs during the taxable year, but also payments of freight that are an integral part of a taxpayer's business. This exception for freight has not been eliminated by the new legislation on reporting of goods and merchandise and may survive the regulation process as an exception.

Many times "freight" has not been separately invoiced and where freight becomes part of the purchase price of goods from a foreign provider, it is very difficult to identify the specific charge and even more difficult to coax the correct documentation from the foreign vendor, usually a third party to the actual shipper, resulting in a 30% withholding on a \$100 shipping charge, the collection costing far more than the revenue it derives. As in the context of domestic goods, a regulation should be considered that exempts "freight" from withholding under Form 1042 rules as part of the purchase price of the goods. It is not necessary that the ruling be as far reaching as the 1099 exemption for freight, but to avoid the unduly burdensome difficulties involved in isolating these expenses when involved in purchases of goods, such an exemption may be warranted.

Burden Reduction Subgroup

Finally, foreign providers of transportation services have a significant presence in the U.S., and IRS increased audit activity in this area has lifted up concerns where little information is available. AP organizations urgently need transportation items addressed so they can learn to handle the payments correctly and make sure the appropriate processes are in place to support the compliance needs.

D. Comments on Proposed Cost Basis Regulations and the Draft 2011 Form 1099-B

Recommendations

IRPAC notes that with the late release of cost basis regulations, the necessary guidance will not have been made available in time to guide required system development and provide time for testing of system changes. In addition, there will not be sufficient time to educate financial institution staff and their customers. There are many implementation details that remain ambiguous or that are impossible to implement in the remaining time frame. IRPAC continues to recommend that serious consideration be given to delaying the implementation of these provisions to 2012, particularly as they apply to transfer statements, and to deferring enforcement of the gift and inheritance provisions to 2013.

IRPAC published four comment letters in 2010 and participated in many meetings and conference calls on cost basis reporting with IRS Office of Chief Counsel. See copies of the comment letters in Appendix E, F and G for detailed discussion.

Highlights of IRPAC's comments and recommendations:

1. **Need for final rules quickly:** There is an urgent need to issue final rules quickly, and consideration should still be given to extending the effective date for equities to 2012.
2. **Need for penalty relief in the first years of new regulations:** The Service should grant penalty relief during the initial stages of implementation of the final regulations for the following reasons:
 - Complex systems development will take several years, and in some cases will require changes to the underlying trade processing systems.
 - The recent economic downturn has affected the financial services industry particularly hard so that funds needed for systems development and training are limited or not available.
 - Developmental issues are fairly complex, even on matters as simple as determining who owns needed data, and it will take time to work through the interrelated processes.

Burden Reduction Subgroup

- Financial service providers are traditionally not tax return preparers.
- 3. Revision of Form 1099-B:**
 - Eliminate reporting of number and class of shares in an acquisition of control or substantial change in capital structure.
 - Address differences in adjusting for commissions and transfer taxes.
 - Address option premium reporting concerns as to both cost basis and gross proceeds.
 - Clarify whether reporting for disallowed wash sale losses is independent of the gain/loss reportable in Box 7. Form 1099-B reporting treatment and transfer statement sharing of the carryover of the holding period in a wash sale also needs to be clarified.
 - 4. Eliminate Qualified Intermediaries (QIs) from cost basis reporting requirements:** In light of the Congressional decision to eliminate from FATCA provisions that would treat all qualified intermediaries (QIs) as U.S. payers required to file Forms 1099-B, the IRS should strongly consider exempting QIs that are not U.S. payers from the cost basis reporting requirements except to the extent otherwise currently applicable.
 - 5. Continue to allow the corporate "eyeball" test:** Consideration should be given to allowing the existing Treas. Reg. §1.6049-4(c)(1)(ii)(A)(1) "eyeball" test to continue to be applied as is, granting exemption unless the payer has actual knowledge of S corporation status since the population of these entities with investment accounts is so small. This approach should be considered at least for existing accounts with a coupling of a new rule for prospective new accounts opened after 2011 to be screened for S corporation status. At a minimum, use of the "eyeball" test should be allowed to continue for entities that could never qualify as S corporations, such as foreign "per se" corporations under Treas. Reg. §301.7701-2(b)(8)(i) and large public entities. This will cut back on the wave of inappropriate backup withholding that could occur should the proposed regulations be finalized as written.
 - 6. Expand TIN Matching to cover identification of S Corporations:** IRPAC reiterates the recommendation made in its report dated October 28, 2009,²⁴ that the IRS consider expanding its TIN Matching program to allow payers to use the program for identifying S corporation status.
 - 7. S corporation reporting:** The IRS should reconsider its initial denial of commenter's requests that S corporation reporting apply only to accounts opened after December 31, 2011, when S corporations can be

²⁴ 2009 IRPAC Annual Report, Cost Basis Reporting.

Burden Reduction Subgroup

appropriately identified going forward and after a new Form W-9 has been developed that helps to identify S corporations.

8. **Existing inconsistent treatment of certain substantive transactions and available taxpayer elections has negative impact on cost basis tracking. IRPAC recommends:**
 - Greater simplicity and uniformity with respect to the application of available cost basis adjustments and taxpayer election options.
 - Limitations on a taxpayer's ability to elect or change basis calculation methods for reporting purposes.
 - Standardization of long-term holding period for uniform system application.
 - Clarification of tax reporting requirements for distributions in the context of tax-free reorganizations and IRC §302 transactions, including stock tender offers, particularly where distributions can be either a dividend, partial liquidation or a return of capital.
 - Clarification regarding a long list of other transactions described in IRPAC's letter dated March 3, 2010, Part IV, B that require standardized rules that will need to be adopted to permit the effective implementation of the new tax reporting requirements.
9. **The application of any inheritance and gift provisions once finalized should have a deferred effective date until 2013, and refinement of these regulations should come after details are worked out for transfer statements in general.** The proposed regulations addressing inheritance and gifts are complex and will impact a broad range of persons not likely to be accustomed to providing cost basis information. As a result, before the transfer statement rules related to inheritance and gift provisions are finalized, all parties including estate planning specialists and fiduciaries in the business of handling estates impacted by the provisions should have ample opportunity to comment. IRPAC believes that many planners and fiduciaries are unlikely to have devoted much attention to the proposed cost basis regulations, under the general belief that they apply only to custody banks and brokers. In addition, any regulations addressing inheritance and gifts will take more time to fully understand, and related applications will take more time to develop and deploy. Their effective date needs to take this into consideration.
10. **Need to standardize what is a "tax lot," considering limit and market order processing.**
11. **Need to standardize foreign currency treatment.** Proposed regulations extend the present foreign currency applications for handling reportable gross proceeds to basis reporting. For cost basis purposes, currency rules need to consider the possible impact that currency value fluctuations

Burden Reduction Subgroup

12. **Option and debt obligation rules are needed quickly.** In previous letters to the IRS issued in 2009, IRPAC provided the IRS with a suggested structure for handling option reporting.
13. **Transfer Statements - Applicable Persons:** Clarify the meaning of a "person that acts solely as a clearing house" for the transfer and address gaps in transfer statement information. Brokers should be able to rely on third party information without risk of penalty. It will be imperative that the "applicable person" accountable for providing the transfer statement be that party best equipped to deliver the appropriate cost basis information even if not the actual party that transfers the security. It is far better to use the actual business classifications in defining any responsibilities rather than a blanket statement that exempts "any person that acts solely as a clearing house for the transfer" as the present version of the proposed regulations now reads.
14. **Transfer statements – DVP and multiple broker rule:** IRPAC worked with the IRS to understand the application of "delivery versus payment" (DVP) exemption rules and the multiple broker rules in existing regulations under IRC §6045 and helped to consider their ramifications under the new transfer statement requirements. IRPAC recommended that the multiple broker rule be adopted for both IRC §6045(g) and §6045A purposes, designating the party who has accountability for posting the transactions to the holder's account to be responsible for providing transfer statements to a new broker when required. Further details can be found in IRPAC's June 8, 2010 letter on DVP and multiple broker examples.
15. **Transfer statements - wash sales, short sales and other unique basis adjustment considerations:**
 - Resolve how to coordinate transfer statement processing with issuer corporate action reporting, as well as with other basis adjustments already required to avoid duplicate broker adjustments when accounts are transferred.
 - Under Prop. Reg. §1.6045-1(d)(2) and §1.6045A-1(b)(2), a transferred security will be presumed to be a covered security unless the transfer

Burden Reduction Subgroup

statement expressly states that the security is a noncovered security. Where securities are transferred before the effective date of the regulations for the type of security involved, they should be presumed noncovered.

- A corrected transfer statement should not always require a corrected Form 1099-B.

- 16. Technical support of wash sales:** Certain wash sale reporting exceptions are needed and, as outlined in the IRPAC March 3, 2010 letter, other considerations need to be addressed. Therefore, an extension of the effective date for application of the new reporting requirements to wash sales is needed at least to 2012.
- 17. Managing the complexities of short sale basis reporting:** New reporting rules that will disallow 2010 reporting on Form 1099-B of short sales opened in 2010 that remain open after 2010 need to be eliminated. Further, additional time is needed beyond 2011 to handle the unique basis adjustments that short sales require. Reporting for adjustments in basis from short sales needs to apply when a transaction is entered rather than when it is closed.
- 18. Communications between brokers and customers/ taxpayers:** Clarity is needed in how and when to communicate a broker's default cost basis method to customers.
- 19. Components of dividend reinvestment plan reporting:** Clear guidance is necessary to facilitate a smooth transition for reporting cost basis on equities where reporting in general begins in 2011, but if the equity is subject to a dividend reinvestment plan reporting does not start until 2012. IRPAC supports use of the broader rule in defining dividends that does not restrict the definition of dividends by IRC §316 and that would include any payment or distribution from stock, including ordinary dividends, capital gains dividends or distributions, non-taxable returns of capital, and cash dividends in lieu of fractional shares.
- 20. Examples are needed to clarify when communicating specific identification is in a "timely manner."**
- 21. Handling high frequency traders:** Further study is required to determine the best way to handle high frequency traders. Some institutions have designed mechanisms to handle cost basis tracking in high volumes, but many have not and may not be able to handle tax lots and basis adjustments for large volume traders.
- 22. Issuer action statements not sufficient:** A clearing facility is needed to ensure uniform classification of the same security by multiple brokers.

Burden Reduction Subgroup

23. Rules for tracking and reporting cost basis for equity-based compensation:

- IRS should carefully consider the long-standing basis and reporting positions of equity-based compensation before requiring any separate reporting of exercises of compensation-based options and before requiring any basis disclosures on Form 1099-B pursuant to IRC section 6045(g) or subjecting such compensation to the transfer statement requirement of IRC section 6045A. Any such reporting should be reviewed in light of the existing reporting under Forms W-2, Wage and Tax Statement, 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., 1099-MISC, Miscellaneous Income, 3921, Exercise of a Qualified or Restricted Stock Option and 3922, Transfer of Stock Acquired by Certain Options in order to avoid duplication and misleading data. Also, any change should be coordinated and reflected in the various IRS guidance available for participants to calculate income resulting from equity-based compensation, including Publications 15-B, Employers Tax Guide to Fringe Benefits, 525, Taxable and Nontaxable Income, and 575, Pension and Annuity Income (Including Simplified General Rule).
- The current exception for Form 1099-B reporting for certain noncash exercises pursuant to Revenue Procedure 2002-50 should be retained and interpreted to exempt such compensation from any new cost basis reporting or transfer statements under Code sections 6045(g) and 6045A.
- Any guidance should be made effective prospectively, with a delayed effective date with good faith transition relief. Brokers, plan sponsors and third-party administrators will need ample time to update plan documents (including award letters, prospectuses, and participant statements) and coordinate systems, which historically have not been integrated or designed to support additional data.

24. The effect of a customer's passive acceptance of a broker's

default method: IRPAC believes that a customer's passive acceptance of the average basis method as the broker's default method should be considered an effective election as long as the default method has been communicated to the customer in some manner.

25. Single Account Election: The effect of a single-account election during the period in which a customer can revoke its average basis method calculation should be clarified in the regulations, as well as the application of the single-account election in general as to joint account holders.

Burden Reduction Subgroup

E. K-1 Matching Program

Recommendations

1. Modify the automated Schedule K-1, screening program to compare net ordinary income, including IRC section 179 deductions, reflected on the K-1 to the net amount reported on Form 1040 Schedule E in addition to the current line by line screening.
2. Develop a mandatory worksheet to be used when the manual K-1 screening procedures identify a mismatch, to compare the amounts from the K-1, including amounts on attachments, to the amounts reported on the return, including supporting schedules, and require a manager review prior to sending a letter or deficiency notice.
3. Develop a method to evaluate the effectiveness of the automated and manual screening processes by tracking the number of erroneous K-1 mismatches identified.
4. Modify the policies and procedures used to determine that a return is frivolous based on a claimed fuel tax credit to consider pass-through income and credits reported on K-1s and to require a second level of review prior to the issuance of frivolous return letters.

Discussion

The K-1 matching procedures are part of the Automated Underreporter Program (AUR),²⁵ and are designed to identify underreported income from S Corporations, Partnerships and Trusts passing to individual taxpayers and required to be reported on their 1040 returns. When a discrepancy is found, the IRS contacts the taxpayer for additional information and/or to propose a deficiency. Taxpayers often receive K-1 mismatch deficiency notices, even though the K-1 information is correctly reported, which creates unnecessary burdens on the resources of taxpayers and the IRS to resolve the asserted discrepancy.

IRPAC met with IRS SBSE to discuss the IRS K-1 Matching procedures, specifically to determine what was causing the erroneous mismatch notices and what the IRS and practitioners can do to alleviate the false mismatches. Prior to the meeting, several examples of erroneous K-1 mismatch notices were submitted to the SBSE. Although the K-1s in each example were correctly reported, the taxpayers received notices that their K-1 income was substantially underreported, and additional tax and penalty deficiencies were proposed.

²⁵ Automated Under Reporter Inventory Strategy Database (AUR-ISD): <http://www.irs.gov/privacy/article/0,,id=174470,00.html>

Burden Reduction Subgroup

These examples demonstrated that deductions reported on statements attached to the K-1 were not included in the IRS calculation. In each case the taxpayers had attached a summary schedule to their returns reconciling the income and deductions on the K-1 to the amounts reported on the Form 1040, Schedule E. An example of a frivolous return letter related to a credit from a partnership K-1 was also submitted for IRS comment. The taxpayer in this case correctly reported the pass-through fuel credit on Form 4136, Credit for Federal Tax Paid on Fuels, and attached the supporting documentation that was attached to the K-1.

SBSE described the K-1 matching procedures. Potential K-1 mismatches are first identified by an automated computer screening program that is run twice each year and compares dollar amounts on the K-1 to the amounts reported on Form 1040, Schedule E. This inventory of potential mismatches is then manually reviewed. SBSE explained that Internal Revenue Manual (IRM) 4.19.3.7.11, Conduit Income, provides the case analysis procedures for the manual processing of K-1 mismatches. This procedure specifically requires examiners to thoroughly review the entire return, schedules and attachments before pursuing discrepant K-1 amounts. The examiner is cautioned to be aware that the taxpayer may have netted several items of income and deductions and to consider if the income has been included on a different line or in the total net amount. The examiner is instructed to ensure that any amounts reported on attachments to the K-1 are properly included on Schedule E. These procedures were clearly not followed in the K-1 mismatch examples provided by practitioners for discussion with SBSE. SBSE has agreed to issue a reminder to Tax Examiners to follow all IRM procedures for analysis of K-1 mismatches. SBSE advised that a revision of IRM 4.19.3.7.11, Conduit Income, instructions and procedures for tax examiners is in process.

The procedures for the processing of frivolous returns are at IRM 4.19.3.4.7 and 4.10.12., which define a frivolous return as “noncompliance with filing and/or paying tax based on unfounded legal or constitutional arguments.” In 2008, IRS identified a claim for excessive fuel credits under IRC section 6421 as a frivolous tax return position, and examiners are instructed to forward returns with excessive fuel credits for frivolous return processing. The credit is considered excessive if the taxpayer claims an amount of credit that is so disproportionately excessive to any business income reported as to be patently unallowable. This clearly was not the position taken on the example case, in which the taxpayer claimed an alternative fuel credit under IRC section 6236(d), not section 6421, and the fuel credit was less than 1% of the income from the K-1 generating the credit. SBSE has agreed to follow-up on this case to determine where the procedures failed.

SBSE has noted improvements in compliance from the inception of the program in 2001 measured by the decline in their potential mismatch inventory. They do not have data to compare the ratio of erroneous mismatch notices to the

Burden Reduction Subgroup

total number of deficiency notices sent. The biggest issue encountered by the IRS is the netting of the K-1 information on Form 1040, Schedule E. Taxpayers and practitioners are encouraged to provide reconciliation schedules with returns. Another frequent issue noted by SBSE is the mischaracterization of capital gains and losses.

SBSE pointed out that Form 1040, Schedule E instructions provides guidance for taxpayers and practitioners in an effort to improve the K-1 mismatch results. For example, Schedule E instructions provide that each separately stated item on the K-1 should be reported on a separate line on Schedule E. If these items are netted, the electronic screening program will capture this as a mismatch. SBSE recognizes that many software tax programs present the correct K-1 amounts but net them on one line, in contradiction to the instructions. This is a problem that SBSE will communicate to the programmers for the computer screening process in an effort to recognize other presentation formats and reduce the inventory of potential mismatches and the need for manual screening.

F. Information Reporting for Tax Credit Bonds and Stripped Tax Credits

Recommendations

In response to provisions outlined in IRS Notice 2010-28, Stripping Transactions for Qualified Tax Credit Bonds, IRPAC made the following recommendations:

1. For the purpose of computing and reporting accruals of Original Issue Discount (OID) on stripped tax credits IRS should establish an additional table for Publication 1212, Guide to Original Issue Discount (OID) Instruments, devoted to stripped tax credits. This would provide the means for middlemen to compute reportable OID when an acquisition transaction does not include the purchase price which would otherwise be used to calculate the yield specific to that investment.
2. IRS should discard the notion of aggregating tax credit strips with a common origin into a single synthetic instrument for the purposes of OID accruals as this is an unmanageable task that puts excessive burden on the bond owner, the transfer agent and the custodial broker. Brokers and other middlemen should be required to report on each individual strip as this would provide sufficient information for determining income and the associated tax liability.
3. IRS should clarify whether it expects the “maturity” of a stripped tax credit to be reported on a 1099-B or solely on the new form 1097-BTC.

Burden Reduction Subgroup

4. Serious consideration should be given to the viability of the quarterly reporting requirement for tax credits passed through by Regulated Investment Companies (RICs) because there is no mechanism in place within the financial services industry to capture and disseminate this type of information with a quarterly frequency. Additionally, there would be no way to match the information with the filing by the underlying bond issuer.
5. In developing an information reporting regime for tax credits, IRS should consider all the desired data elements, the timing of their availability, and who has control of each. Proposals cited in Notice 2010-28 imply a confluence of information at the Service consisting of a taxpayer's Forms 1040 and 8912, Credit to Holders of Tax Credit Bonds an institution's Forms 1099-INT, 1099-OID, 1099-B and 1097-BTC and the bond issuer's Form 8038-TC. The design and requirements of all of these must be considered in concert to avoid superfluous requirements, wasteful movement of information and time consuming dependencies in the information reporting process.
6. Most types of financial instruments are eventually incorporated into more complex structured products. IRS should carefully consider what requirements, if any, will be imposed on the issuers of the structured products that incorporate tax credit bonds.
7. With no version of form 1097-BTC yet available to the public for evaluation and comment and no IRS response to the structural impediments to complying with the requirements identified by IRPAC, the Service should modify the effective date of the requirements outlined in Notice 2010-28 to a date substantially in the future that will allow for the appropriate systems and procedural modifications. Further consideration should be given to the question of whether reporting of the tax credits on a dedicated form annually is necessary when it is already reported as income.

Discussion

IRPAC's recommendations are intended to harmonize the statutory requirements with how the securities industry functions while ensuring the availability of the information needed for a robust system of information reporting. All stakeholders will benefit from the recommendations because they provide the minimum disruption to existing processes. This translates into smoother and timelier implementation once all the details of the requirements are finalized by IRS. IRPAC met with IRS Chief Counsel in April and June of 2010 to discuss these issues and also provided two written comment letters (see Appendix H and I).

IRPAC will continue discussions with IRS Chief Counsel regarding these recommendations. In addition, IRPAC will provide feedback on Form 1097-BTC, its associated instructions and any further guidance when published.

Burden Reduction Subgroup

G. Electronic Power of Attorney (POA) Validation for Business Returns

Recommendation

Rather than requiring personal information related to shareholders, partners or trustees to validate an electronically filed POA for a business entity, IRS e-Services should develop alternative criteria related specifically to the entity, such as the date of incorporation, date business started or was created, and the entity's taxable income or ordinary business income.

Discussion

A Power of Attorney (POA) for a business entity allows the IRS to discuss the entity's returns and other information with the tax preparer or other practitioner to assist with the timely resolution of tax issues. An electronic POA allows immediate access to taxpayer information and is usually a more expeditious method compared to mailing or faxing the POA and waiting several weeks for access. It is particularly helpful to resolve business e-file rejections based on EIN/name control mismatches. IRS assigns a specific four character name control code to each business entity based on a set of complex rules, and requires this exact code to e-file a corporate, partnership, or trust return. Without a POA, the IRS cannot provide the name control to the practitioner. If the practitioner cannot secure an electronic POA, the return must either be paper filed, or delayed pending processing of a valid POA. Conversely, with a valid POA, the name control code would be immediately accessible and the return promptly e-filed.

Currently, to validate an electronic POA for a corporation, partnership or trust, the IRS requires the date of birth and adjusted gross income (AGI) for the person authorized to sign the business return. This would generally be the shareholder of the corporation, the tax matters partner for the partnership or the trustee for a trust. This sensitive and personal information is not readily available to the practitioner and is a potential privacy violation with ethical implications.

IRPAC met with IRS W&I , who acknowledged the intersecting challenges of the need for a specific name control code in order to e-file business returns and the inability to timely access the information without the personal information of the business owner required to validate an electronic POA. In fact, due to the large number of e-file rejections, particularly for partnerships and trusts, IRS temporarily suspended the requirement for a name control match for e-filed business returns effective April 12, 2010. A more expeditious method of validating an electronic POA could resolve both issues. Alternative criteria for validating an electronic POA for a business entity were discussed, including date of entity creation, income and/or balance sheet information from a prior filed return, business activity code, name of the signer and other entity specific

Burden Reduction Subgroup

information. IRS agreed to consider the recommendations with the next revision of e-Services.

H. Central Withholding Agreements: Addressing Needs of Venues and Foreign Performing Artists through a Mini-CWA Program and Problems Encountered by Foreign Artists When Applying for U.S. Social Security Numbers (SSNs)

Recommendations

1. A smaller version of the Central Withholding Agreement (CWA) is needed to support single and limited venues. IRPAC recommends that IRS develop a mini-CWA program that would apply to performers with annual fees of \$50,000 or lower. The program should allow the performer to apply directly for a lower withholding rate or a waiver from withholding based on disclosed fees and known expenses.
2. Allow the CWA Program to issue Individual Taxpayer Identification Numbers (ITIN) to performers who have applied for relief in the CWA Program but have not acquired a U.S. social security number (SSN).

Discussion

The CWA process is not adaptable to performers who are part of cultural exchanges or to performers whose fees are fixed in smaller dollars (usually under \$5,000) and not specified as a percent of gross take. The majority of international performing artists that accept venues in the U.S. fit in this category. Many international performers' fees barely cover their travel expenses and certainly are at levels where the cost of applying for the CWA is prohibitive. With the annual day and dollar limitations that most treaties impose and the cumbersomeness of the Form 8233, Exemption from Withholding on Compensation for Independent (& Certain Dependent) Personal Service of a Nonresident Alien Individual, treaty applications rarely work to give relief at source to these performers. Moreover, many come from countries where there are no treaties and the Form 8233 process does not even apply to grant relief.

The imposition of the 30% withholding under IRC §1441 to the gross amount of small fees that they are paid can reduce the net take below the performer's legitimate travel expenses. Venues are not always able to pay the travel expenses through an accountable plan process. The only recourse performers have is to file a U.S. tax return and then wait, well into the year following their performance, for their refund. Many international artists do not have the wherewithal to fund their expenses and therefore choose not to accept U.S. performances. As a result, U.S. cultural exchange suffers. The 30% withholding is significantly higher than other countries' value added tax (VAT) or use taxes. Without relief, many throughout the country, who have benefited from

Burden Reduction Subgroup

the diverse artists exchange programs in the past, will see a marked decrease in cultural exchange programs.

A smaller version of the CWA is needed to support single or limited venues where the performer can apply for a lower withholding rate or waiver from withholding. IRPAC recommends the development of a mini-CWA program using a threshold of under \$50,000 of expected gross fees as a qualifying guideline. Applicants should be asked to include any pertinent facts to support the request, including the amount of expected gross fees for the year, schedule of venues, amount of expenses relevant to the services being performed, and any other information the IRS deems important to calculate a proposed reduced withholding amount. Further, IRS should be able to request all relevant documentation including, but not limited to, a statement from the venue as to contracted fees and related terms, and expense documentation such as receipts and contracts if need be. IRS written responses to the mini-CWA program applications should provide directions on actions that a withholding agent should take, and should be sent directly to the applicant (foreign performer) and to the venues (withholding agents).

Individual artists frequently encounter problems in applying for SSNs while they are in the U.S. Foreign performers receive an ITIN, which is issued for federal tax reporting purposes only. The problems performers face include:

- Artists apply for SSNs but never receive a number OR a rejection letter from SSA (it's as if their application went into a black hole);
- Personnel at SSA offices around the country sometimes will not allow individual artists to apply for numbers on the basis that the artist is not eligible. This may result from the fact that the artist is in the country for too few days to qualify, or for other – erroneous – reasons, such as lack of work authorization, even when the artist IS work authorized;
- Sometimes artists are booked so tightly during their US tour that it simply is not possible for them to get into a SSA office to apply for a SSN.

IRPAC understands that the CWA Program frequently runs into this concern and allows a CWA to proceed, even if the SSN is not always available, however, the final process is held up until an SSN is assigned. Ideally, if an SSN were easier to obtain, these problems could be alleviated. IRPAC recommends that IRS consider an expansion of SSN procedures that would allow the CWA and mini-CWA programs to assist with SSN applications and the processing and issuance of social security numbers for foreign performers.

Burden Reduction Subgroup

I. IRS Business Master File (BMF)

Recommendations

1. To avoid privacy breach situations, IRPAC recommends that IRS immediately cease processing an automatic change of business address with every tax filing. Taxpayers can be instructed to file Form 8822 to change their business address while alternative solutions are investigated.
2. IRPAC recommends that IRS develop alternative procedures for the update of Business Master File addresses, including the creation of a BMF indicator to lock an address, utilization of form address check boxes for business to indicate address change and/or allowing business to opt out of the current automatic address change process.
3. IRS should update Rev. Proc. 2010-16, Definition of Last Known Address, to provide procedures specific to business taxpayers.
4. IRS should accelerate the development of a system that allows for multiple addresses and contacts.

Discussion

The IRS Business Master File is the repository for Name and Address information for all of the registered business entities within the United States. The current technology employed by IRS only allows for one address per business. This limitation causes many problems, including misdirected correspondence and refunds, for the ever increasing number of multi-location businesses. The current IRS procedure changes the business address with every tax filing; e.g. income tax, payroll, information reporting. Therefore, it is extremely difficult for a business to know which address is currently on the IRS Business Master File. Further, automatic address change raises privacy concerns, e.g., a bank's customer, who mistakenly used the bank's EIN on a nominee Form 1099 filing, received the bank's IRS correspondence.

IRPAC recommended the Business Master File issue for inclusion on the 2010-2011 Guidance Priority List, see Appendix I for details. IRPAC looks forward to continued discussion of this issue with IRS.

J. Staggered "B" Notices

Recommendations

IRPAC initially raised concerns with IRS in 2009 regarding processing problems experienced by taxpayers receiving randomly staggered "B" Notices.

Burden Reduction Subgroup

IRS has responded to these concerns with 2010 changes to the processing of CP2100, Notice of Missing or Incorrect Name/TIN Match for large volume filers. However, this change does not address the issues with randomly staggered CP2100A Notices which are extremely burdensome for related groups of information return filers.

IRPAC recommends that IRS Martinsburg use the same notice date on all CP2100A Notices regardless of when they are mailed. Alternatively, IRS should distribute CP2100A Notices for related entities during the same mailing period so that they include the same notice date.

Discussion

In order to more efficiently distribute the workload at the Payor Call Site, by 2008 IRS had begun to send CP2100 and CP2100A Notices (“B” Notices), on a randomly staggered schedule. Previously, while the mailings were staggered, they were done by the Service Centers on a specific schedule so a filer could generally plan on when its notices would be mailed and also that most of its notices (for filers with multiple EINs) would be sent at the same time. Under this new random processing schedule, a filer does not know when its notices will arrive, and multiple notices may arrive at different times. This makes planning for and processing the “B” Notices very difficult. Related groups of information return filers share a common “B” Notice processing system. Receipt of staggered CP2100A notices with multiple notice dates creates excessive burden with multiple mailings and backup withholding start dates.

IRPAC initially discussed this issue with IRS Martinsburg in April 2009. IRS was not aware of the problem and agreed to investigate whether programming changes were feasible. IRPAC was informed that there was insufficient time for 2009 changes.

In January 2010, IRS Martinsburg reported to IRPAC that for 2010 forward, all CP2100 Notices, Notice of Missing or Incorrect Name/TIN Match for large volume filers (250 or more error documents) will be mailed out the end of October, at the same time with the same notice date. However, CP2100A Notices, Notice of Missing or Incorrect Name/TIN Match for all other filers, will continue to be staggered with separate notice dates beginning the first week of September to the end of October.

IRPAC appreciates IRS’s efforts in making programming changes to the CP2100 Notices. IRPAC looks forward to further discussion with IRS about CP2100A Notice alternatives.

K. Form 8886, Reportable Transaction Disclosure Statement

Recommendations

Burden Reduction Subgroup

IRPAC reiterates its 2009 recommendation that IRS should clarify that the reporting requirements under §6011 will terminate for the corporate participants in the Lease-in/Lease-out and Sale-in/Lease-out (LILO/SILO) Settlement Initiative after the year of actual or deemed termination of the tax shelter related transactions. Further, IRS should consider adding a provision to all closing agreements or settlements related to reportable transactions that specifies the reporting obligation, if any, for that transaction in subsequent years.

Discussion

IRC §6707A imposes a severe penalty on the failure to disclose the details of reportable transactions on a properly filed IRS Form 8886 as required by §6011. For tax shelters, designated by the IRS as “listed” transactions, this is a mandatory penalty without exceptions for reasonable cause or good faith, and is not required to be proportional to the tax benefits derived from the transaction.

A reporting issue identified in the 2009 IRPAC report involves the recent settlement initiative related to Lease-in/Lease-out and Sale-in/Lease-out (LILO/SILO) transactions. LILO/SILO transactions are listed tax-shelter transactions under Rev. Rul. 2002-69 and Notice 2005-13, respectively, and subject to the reporting penalties. In October 2008, IRS offered a settlement initiative to approximately 45 corporations and two-thirds agreed to participate. The terms of the settlement required the participants to terminate the LILO/SILO activity in 2008 and report 80% of the inception to date original issue discount income (OID) related to the LILO/SILO in 2008 and report 100% of the remaining OID in subsequent years. If the participants are required to continue reporting for each year that OID is accrued, failure to file Form 8886 in those subsequent years would result in a \$200,000 annual penalty. According to the settlement, the activity will be deemed terminated in 2008 notwithstanding the recognition of the OID in subsequent years. However, absent clarification to the contrary, participants will be compelled to file a complete Form 8886 each year thus burdening the participants and the IRS unnecessarily. This dilemma was discussed with SBSE representatives on June 16, 2009 and they acknowledged the need for further guidance.

In June 2010, IRS Office of Chief Counsel acknowledged to IRPAC, in an unofficial correspondence, that taxpayers who settled LILO/SILO transactions by closing agreement to the LILO/SILO settlement initiative do not have a continuing obligation under Reg. §1.6011-4 to file Forms 8886 to disclose the LILO/SILO OID transactions for the years after signing the closing agreement. IRS noted that taxpayers still have to file any forms as specifically required by the closing agreement. IRS further indicated that they would send letters to the settlement participants explaining this position; however, IRPAC has not received verification whether this has occurred. There was no indication whether the IRS would consider adding a provision to all closing agreements or settlements

Burden Reduction Subgroup

related to reportable transactions that specifies the reporting obligation, if any, for that transaction in subsequent years.

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE

Emerging Compliance Issues Subgroup Report

**CANDACE B. EWELL
DONALD C. MORRIS
MARJORIE A. PENROD
PAULA D. PORPILIA
SUSAN P. SEGAR
DOUGLAS BORISKY, SUBGROUP CHAIR**

Emerging Compliance Issues Subgroup

A. Foreign Account Tax Compliance (FATCA) Provisions

Recommendations

On March 18, 2010, the Hiring Incentives to Restore Employment Act (HIRE Act) was enacted. The Foreign Account Tax Compliance provisions of Subtitle A of Title V of the HIRE Act (commonly referred to as FATCA) adopted an expansive new withholding tax and reporting regime by enacting a new chapter 4 of the Code and a number of related provisions. These provisions had their origin in Treasury's "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," on which IRPAC commented extensively in 2009.²⁶

IRPAC has been working closely with the IRS and Treasury regarding the implementation of FATCA. The Discussion section below summarizes the principal issues that have been discussed.

IRPAC also notes that the IRS has recently released Notice 2010-60, Notice and Request for Comments Regarding Implementation of Information Reporting and Withholding Under Chapter 4 of the Code, which provides some preliminary guidance under FATCA, and addresses a number of the recommendations that IRPAC has made to the IRS. Because the Notice was released after IRPAC's last 2010 working meeting in August, IRPAC has not had an opportunity to discuss the Notice with IRS and Treasury. However, IRPAC intends to provide a formal written comment letter relating to Notice 2010-60, and may discuss some of those recommendations at the October public meeting.

Discussion

FATCA adopts a new withholding tax and reporting regime, requiring in general terms that U.S. source "withholdable payments" and certain gross proceeds paid to a foreign financial institution (FFI) be subject to withholding unless the FFI agrees to comply with certain reporting requirements with respect to "United States accounts" maintained by the FFI. FATCA also imposes a withholding tax on similar amounts payable to non-financial foreign entities unless they provide information regarding their direct and indirect U.S. owners. The statutory FATCA rules provide few details regarding the withholding and reporting requirements with which market participants will be required to comply. Thus, the IRS will need to issue extensive guidance on a broad range of issues to permit FATCA to be implemented effectively.

The principal issues that IRPAC discussed with the IRS and Treasury include the following:

²⁶ See the Legislative Subgroup Report in the 2009 IRPAC Public Report and IRPAC's June 25, 2009 letter to the IRS regarding the Administration's Proposals – Tax Information Reporting and Withholding.

Emerging Compliance Issues Subgroup

- **Guidance Process:** IRPAC worked with the IRS and Treasury to identify the most critical issues raised by the enactment of FATCA and those issues with respect to which the issuance of prompt guidance is most critical. IRPAC also has discussed with the IRS and Treasury the feasibility of adopting guidance in stages and phasing in the applicable rules over time.
- **Due Diligence Requirements:** IRPAC discussed with the IRS and Treasury the processes that withholding agents, including FFIs, will be required to use to determine the status and characteristics of their customers and other payees. The issues discussed include the following:
 - The processes that financial intermediaries (and other payers) currently use to collect and preserve information regarding their customers and payees.
 - The challenges that withholding agents will face if required to obtain additional information regarding existing customer/account relationships. With respect to existing account relationships, IRPAC recommended that withholding agents be permitted to rely on information currently collected and systems currently in place, to the greatest extent possible.
 - The circumstances under which regulations issued under FATCA should impose different due diligence and documentation standards for different classes of payees.
 - The processes that withholding agents and other market participants will be able to use to determine whether a payee is an FFI, whether it has entered into an agreement with the IRS and other characteristics relevant to the application of FATCA to the payee.
- **Definition of Foreign Financial Institution:** IRPAC discussed with the IRS and Treasury numerous issues regarding how the rules applicable to FFIs should apply in particular contexts and to particular types of institutions. For example, IRPAC discussed the differing characteristics of different categories of institutions that may be treated as FFIs and has made recommendations regarding how the application of the rules may need to be modified to account for differences in the nature of the business and operations of different categories of FFI. IRPAC also attempted to identify categories of entities that do not raise significant compliance issues and thus for which exemptions or reduced burdens may be appropriate.
- **FFI Agreements:** IRPAC discussed with the IRS and Treasury several issues regarding the scope and nature of the agreements that FFIs will enter into pursuant to FATCA, including issues relating to FFIs' due

Emerging Compliance Issues Subgroup

diligence obligations, their reporting obligations and the verification process.

- **Verification Process:** IRPAC discussed with the IRS and Treasury numerous aspects of the “verification” process that FATCA contemplates will be necessary to ensure that FFIs fulfill their obligations. IRPAC recommended that the scope of the verification requirements be sensitive to the scope and nature of the activities of particular types of FFIs and take into account existing processes currently in use. IRPAC also made recommendations regarding the need to adopt simplified and streamlined processes in many cases, to make the processes manageable given the very substantial number of FFIs that will be subject to the requirements.
- **Coordination with Chapter 3 Withholding and Reporting Requirements and Chapter 61 Reporting Requirements:** IRPAC discussed with the IRS and Treasury issues relating to the coordination of the FATCA documentation and reporting rules with other rules that apply under chapters 3 and 61 of the Code, including the desirability of integrating FATCA compliance with the existing qualified intermediary program where appropriate, and the need to avoid duplicative reporting obligations.
- **Documentation Implications:** IRPAC discussed with the IRS and Treasury the types of documentation that may need to be developed or revised to accommodate processes under FATCA, including potential revisions to the Form W-8 series and Forms 1042 and 1042-S, or the development of new forms to implement the new chapter 4 requirements. IRPAC recommended that the IRS consider attempting to incorporate the FATCA documentation requirements into the existing forms used under chapter 3, to simplify the reporting and withholding process and facilitate the coordination of chapter 3 and chapter 4 obligations.
- **Exceptions:** IRPAC discussed with the IRS and Treasury the potential exceptions to FATCA withholding and reporting suggested in the legislation, as well as other exceptions that may be adopted in order to enable FATCA to operate effectively. These conversations focused both on the scope of the substantive exceptions that may be adopted, as well as the procedural requirements for establishing that an exception applies in a particular case.
- **Refunds:** IRPAC previously commented on problems with the current process for obtaining refunds in respect of amounts overwithheld under

Emerging Compliance Issues Subgroup

chapter 3.²⁷ IRPAC believes that the complexity of FATCA makes it likely that significant overwithholding will occur, in particular in the initial years following FATCA's entry into force. Thus, an effective and efficient refund process will need to be implemented. In addition, to be fully effective, any such refund process will need to address the problems experienced with the existing process under chapter 3.

- **Affiliate Accounts:** IRPAC discussed with the IRS and Treasury issues relating to the provisions of FATCA that may in some circumstances require that affiliated entities share information and responsibility for obtaining and reporting customer information, including the application of data and consumer protection laws in other countries and systems limitations that may make it difficult for affiliated entities to share information even when otherwise permitted.
- **Non-Financial Institution Payers:** IRPAC discussed with the IRS and Treasury the particular challenges inherent in applying the FATCA rules outside the context of customary interest, dividend and similar payments made by and to financial institutions and intermediaries. Particular challenges are anticipated in applying the new rules to accounts payable operations, where payers frequently do not have well-developed systems for implementing complex withholding and documentation procedures, in particular in the cross-border context. IRPAC also discussed with the IRS and Treasury the possibility of adopting targeted exceptions to reduce these burdens in contexts in which a rigid application of the FATCA rules is not necessary to avoid a significant risk of tax avoidance.

B. Section 6050W, Information Reporting of Payments Made in Settlement of Payment Card and Third Party Network Transactions

Recommendations

In response to the issuance of proposed regulations, IRPAC made the following recommendations in a comment letter on January 20, 2010 (see Appendix K):

1. The existence in the statute of the Electronic Payment Facilitator (EPF) demonstrates that Congress was seeking to have payments, not transactions, reported. As a result, "gross amounts" should be defined as the amount of the payment provided to the merchant not adjusted for cashback or other items. New Form 1099-K, Merchant Card and Third-

²⁷ See Section C of the Emerging Compliance Issues Subgroup Report in the 2009 IRPAC Public Report and Section B.1 of IRPAC's June 25, 2009 letter to the IRS regarding the Administration's Proposals – Tax Information Reporting and Withholding.

Emerging Compliance Issues Subgroup

Party Payments, calls for reporting payments; at the very least coordination between the regulations and the form will be necessary. In addition, reporting transactions would result in several backup withholding problems including how to withhold on the day of a transaction when no funds are available until 1-2 days later, how to deal with transactions in one period and backup withholding in another, and the effective rate increase due to backup withholding on gross transactions not adjusted for returns.

2. Clarification is needed regarding the rules to be applied to determine whether a merchant qualifies for the “foreign address” exception, both in the United States and abroad, particularly with regard to the use of Forms W-8, documentary evidence standards, and any presumptions.
3. IRPAC applauded the IRS for adopting the anti-duplication rules for the overlap between IRC Sections 6050W and 6041, and urged the IRS to extend them to the overlap between Sections 6050W and 3402(t).
4. Modify the existing electronic payee statement standards to reflect the differences between reporting in a paper-based consumer world of the past decade and the electronic based business world of today. Specifically, IRPAC asked the IRS to permit filers to notify merchants electronically of their right to opt out of electronic payee statements, and to permit paper-based merchants to opt in by registering on the filer’s web site.
5. IRPAC provided several examples of different types of cards and how they should be treated under the statute.
6. De minimis rules for third party networks should not be mandatory.

In addition to the recommendations made in our formal comment letter, IRPAC responded to several questions posed by Counsel. Recommendations as a result of those discussions included:

7. The payment settlement entity (PSE) is the acquiring bank. If not, and there are multiple parties meeting the definition of PSE, the one making payment should be the default PSE.
8. “Making payment” should be defined as the process of taking steps to provide the merchant with funds.

Discussion

IRPAC supports the IRS’s need for accurate taxpayer data to promote compliance and reduce the agency’s audit burden. IRPAC also believes that the

Emerging Compliance Issues Subgroup

compliance burdens placed on filers should be reasonable and provide useful information to the IRS and to taxpayers. Distorted or confusing data will only lead to tax return errors and unnecessary audits. The information provided and the recommendations made by IRPAC in our oral and written comments are all aimed at the goals of providing useful and understandable data to the IRS and the taxpayer, in a manner that places the lowest burden on the filing community and on the IRS processing and audit systems.

The final regulations published in August adopted a number of IRPAC recommendations clarifying who the PSE or EPF is, when withholding attaches, and the scope of the third party network rules. However, the final regulations keep the proposed definition of gross amounts, which IRPAC believes is contrary to the statute and legislative history of the provision. In doing so, the final regulations greatly complicate reporting for those that heretofore have had one party doing the processing and another party doing the paying. This complexity could easily have been avoided by requiring the reporting of payments rather than transactions. The retention of the proposed definition of gross amounts also will create backup withholding problems for all PSEs. For payment card transactions there is never any money at the time of transaction, the normal time to do withholding. The final regulations provide that the backup withholding may be done later when payment is made. This will involve complex recordkeeping to associate each payment with specific transactions. It will also require the payer to know the transaction amount, which will always be different than the payment amount, in order to calculate the appropriate amount of withholding. Because the reportable amount will not be adjusted for things like returns of merchandise, the effective rate will always be more than the statutory rate. The final regulations' retention of the proposed definition requires a jerry-rigged backup withholding approach that fails to provide guidance on what a timely deposit would be and fails to reconcile these delayed deposits with Form 945. They also created a competitive disadvantage for those PSEs (likely the smaller ones) that prefer to have one party process transactions and another handle the payments.

The final regulations clarified the standards to be applied to treat a merchant as exempt from reporting under the foreign address rule. While IRPAC believes that Congress intended the rule to be a simple foreign address rule without further documentation, IRPAC applauds the IRS for providing some relief in grandfathering current accounts from the new requirement to obtain Forms W-8 for merchants processed in the United States.

With regard to IRPAC's recommendation that the IRS revise existing, consumer-based, electronic payee statement rules for an electronic business environment, the final regulations provide that consent can be obtained electronically, but saddled that consent process with a lengthy list of disclosure requirements. The proposed regulations appear to provide relief through a rule whereby a merchant that has previously provided consent to receive tax documents electronically could be deemed to have consented to receive the

Emerging Compliance Issues Subgroup

Forms 1099-K electronically. However, this provision will not provide useful relief because no PSE/merchant relationship has previously entailed any tax reporting, so no such consent would ever have been provided.

Finally, the final regulations fail to provide penalty relief. Providing only 4½ months to implement these complex rules is totally inadequate. IRPAC renews its call for across-the-board penalty relief for all involved who make a good faith effort to comply by the effective date.

C. Expansion of Information Reporting Under IRC Section 6041

Recommendations

As a follow-up to the discussions held at the April and June meetings, IRPAC sent a letter on May 24, 2010 (see Appendix L) providing a legal analysis of the scope of the legislative changes. Recommendations included:

1. Corporations that qualify for exceptions based on factors unrelated to their status as corporations (such as being a foreign person) can still qualify for that other exemption from reporting; and
2. The changes made to section 6041 are limited to the rules of IRC Section 6041, and do not override the corporate exemption under other sections including IRC Sections 6042, 6044, 6045, 6049, and 6050N.

In response to the IRS's call for comments issued in Notice 2010-51, Information Reporting Under the Amendments to Section 6041 for Payments to Corporations and Payments of Gross Proceeds and With Respect to Property, IRPAC sent a second letter on August 19, 2010 (see Appendix N) that:

1. Provided an extensive analysis of the implications of these changes on the IRS including:
 - a. Exponential increase in returns filed, potentially ten-fold or more;
 - b. Concomitant increase in paper returns filed, along with increases in corrections, B Notices, penalty notices, and impacts on the Fed/State filing program;
 - c. Increase in the number of underreporter cases and non-filer cases that likely will not result in increased compliance, along with increase in appeals and litigation and the need for more highly trained employees to deal with the more technically complicated cases involving non-individual tax returns; and
 - d. Need to revise Forms 1099-MISC or create a new form, with commensurate changes to filing instructions.

Emerging Compliance Issues Subgroup

2. IRPAC noted the reasons why a document matching program, the mainstay of the automated compliance efforts with regard to individual taxpayers, may not be possible with respect to entity taxpayers including:
 - a. Cash reporting for accrual taxpayers;
 - b. Calendar-year reporting for fiscal-year taxpayers;
 - c. Gross proceeds reporting for merchandise with basis;
 - d. Lack of requirements for consumers to report their transactions;
 - e. Foreign income earned may mask domestic income;
 - f. Filing of consolidated returns by affiliated groups of taxpayers;
 - g. Allocation of income among members of a consolidated group;
 - h. Some income may be tax-exempt or tax deferred;
 - i. Some pension plans use their corporate sponsor EINs confusing the issue of whose income it is; and
 - j. More complicated tax returns with timing issues that may not be coordinated between payer and payee.
3. IRPAC recommended that several optional exceptions be created in the regulations to help limit the burden on the payer community by limiting required reporting to payee data that may actually be useful to, and processable by, the IRS. The suggested exceptions include:
 - a. Payments to publicly traded entities;
 - b. Payments to publicly regulated entities;
 - c. Payments to tax-exempt organizations;
 - d. Payments to governments;
 - e. Payments to international organizations;
 - f. Payments to financial institutions; and
 - g. Payments within affiliated groups.
4. The second letter also noted the challenges facing payers including:
 - a. The need for sufficient time to implement any regulatory changes;
 - b. The need to re-classify existing payees as reportable;
 - c. The need to obtain TINs for existing payees that heretofore were non-reportable;
 - d. The need to adjust new accounts procedures;
 - e. The need to re-write internal procedures and re-train personnel;
 - f. The need to re-program systems for reporting and withholding; and
 - g. The need to budget for such additional burdens in a time of economic uncertainty.
5. Other recommendations included:
 - a. Use of box 11 or 12 on Form 1099-MISC to report merchandise transactions;
 - b. Clarification of the existing rules for use of Form W-9;

Emerging Compliance Issues Subgroup

- c. Expansion of TIN matching databases to include “doing-business-as” names;
- d. “Soft” B Notices for the first two years to give payers time to improve their databases;
- e. Penalty relief for payers making a good faith effort to comply;
- f. No backup withholding on individual transactions under \$600;
- g. Use of any known payee address; and
- h. Elimination of duplication between and among sections 6041, 6050W, and 3402(t).

Discussion

IRPAC supports the IRS’s need for accurate taxpayer data to promote compliance and reduce the agency’s audit burden. IRPAC also believes that the compliance burdens placed on filers should be reasonable and provide useful information to the IRS and to taxpayers.

The changes enacted by the Patient Protection and Affordable Care Act of 2010²⁸ raise numerous issues about the utility of the data to be reported and the ability of the IRS to process it. The expected exponential increase in the number of returns filed, especially paper returns, and the hurdles the IRS must overcome in actually utilizing the return information in any matching program between information returns and tax returns, cry out for a series of exceptions where the utility of the data is small relative to the cost to produce and process it. It is important that these exceptions be optional as reporting all payees will be more efficient for some payers. To minimize the significant burdens these reporting changes will engender, payers should have maximum flexibility to determine when and whether to report payees that potentially qualify for an exemption, even refusing a claim of exemption of Form W-9, and to change that determination at any point.

IRPAC is very concerned about the burdens these changes place on the IRS, and, given the current economic situation, the lack of sufficient resources to accomplish the tasks at hand. The huge increase in the number of returns to be filed is just the beginning. Those increases will be followed by increases in corrected returns, B Notices, penalty notices, underreporter cases, appeals, and even litigation, among other things. The IRS needs to supplement its staff, training, and systems in all those areas, especially given the fact that many of payers filing under these new rules will be first-time filers and will need assistance in understanding their obligations and their rights.

IRPAC also believes that the IRS should clarify without delay that the changes to section 6041 are limited to section 6041 and do not alter the reporting rules under any other section, and that a payment exempt under another section does not become reportable under section 6041 as a result of that other

²⁸ P.L. No. 111-148, 124 Stat. 119.

Emerging Compliance Issues Subgroup

exemption. While we believe that this is clearly the intent of the statute, confusion in the payer community about the scope of the statutory change should be put to rest as soon as possible. Confusion also exists as to whether a corporation, which no longer qualifies as an exempt payee due to the repeal of the corporate exemption under section 6041 may still qualify as exempt from reporting by virtue of its status as another type of exempt recipient, such as a foreign person.

IRPAC appreciates the willingness of Counsel to openly explore the parameters of this statutory change. IRPAC is committed to providing continued assistance over the next few months as the IRS sorts out its regulatory scheme and the practical applications of these new rules.

D. Withholding Tax Issues

Recommendations

IRPAC met with the IRS to discuss Chapter 3 withholding tax issue and made the following recommendations.

1. **Capacity:** The determination of whether the capacity of a person who executes a Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, for an entity should be considered valid continues to be an issue for U.S. withholding agents. IRPAC recommends that the IRS issue guidance to the effect that a U.S. withholding agent may treat a person who has executed a Form W-8BEN for an entity as an authorized representative regardless of the person's title shown on the Form W-8BEN.
2. **Permanent Residence Address:** The instructions to the Form W-8BEN state that the Permanent Residence Address (Line 4) of the beneficial owner should not be the address of a financial institution, a post office box, or an address used solely for mailing purposes. The only address of many offshore investment funds is that of a registered agent or investment advisor. IRPAC recommends that the IRS issue guidance on the acceptability of such an address and the type of additional documentation, if any, that is required to validate the Form.
3. **Claims for Refund by Foreign Persons Investing Through a Qualified Intermediary:** IRPAC met with the IRS and discussed the need for a process for foreign persons who invest through a Qualified Intermediary (QI) to obtain refunds of withholding tax. IRPAC recommends that the IRS issue guidance that will allow such foreign persons to substantiate the amount of tax withheld by the QI by providing alternative documentation in lieu of a Form 1042-S issued in the name of the foreign person.

Emerging Compliance Issues Subgroup

4. Bilingual Forms W-8: IRPAC met with the IRS to discuss the use of bilingual substitute Forms W-8. There is little published guidance on the use and completion of Forms W-8 that are in a foreign language. For example, the scope of the requirement that the form include “the English version of the statements and information otherwise required to be included” is somewhat unclear. IRPAC recommends that the IRS issue more detailed guidance concerning the requirements for the completion of bilingual Forms W-8. In particular, it is recommended that the guidance clarify that identifying information regarding the beneficial owner may be completed in the language of the beneficial owner.

Discussion

The Form W-8BEN requires the person who signs the Part IV Certification for an entity to enter the capacity in which the person is acting. U.S. withholding agents continue to see many different titles entered for capacity. One major financial institution has compiled a list of over 100 different titles. It is not possible for a U.S. withholding agent to know whether a particular title provides the signer with the actual authority to sign the Form W-8BEN for a foreign entity. The Certification on the Form W-8BEN does, however, include the statement: "I am the beneficial owner (or am authorized to sign for the beneficial owner)...." Based on this language, a U.S. withholding agent should be permitted to treat the signer as authorized, unless the U.S. withholding agent has reason to know that the signer is not authorized.

IRPAC recognizes the need for the Form W-8BEN to contain a permanent residence address that is outside of the United States and that the address should not be a mailing address or an in-care-of address. However, some entities (such as investment funds) have no other address than a mailing or in-care-of address. In such cases the address represents the principal place of business of the entity and generally is the address shown on organizational documents. IRPAC recommends that the IRS issue guidance on the acceptability of such an address and whether any additional documentation (such as an organizational document) is required to validate the Form.

IRPAC has also raised concerns regarding certain documentation issues that have arisen in the context of the refund process.²⁹ Foreign persons who invest through a QI are unable to obtain refunds of overwithholding unless they receive a Form 1042-S from the QI. In many cases, QIs will not issue Form 1042-S to individual investors since reporting is done by the QI on a pooled basis. The only documentation that the service center will accept to substantiate the overwithholding is a Form 1042-S issued in the name of the foreign investor.

²⁹ These conversations were a continuation of conversations that IRPAC held with the IRS in 2008. See Section C of the Emerging Compliance Issues Subgroup Report in the 2009 IRPAC Public Report and Section B.1 of IRPAC's June 25, 2009 letter to the IRS regarding the Administration's Proposals – Tax Information Reporting and Withholding.

Emerging Compliance Issues Subgroup

IRPAC recommends that the IRS issue guidance that will allow foreign persons to substantiate the amount of tax withheld by the QI by providing alternative documentation.

There is little published guidance concerning the use of bilingual substitute Forms W-8. The only guidance is that the form must include “the English version of the statements and information otherwise required to be included”.³⁰ This instruction raises a number of questions, including whether the Form must be filled out in English. In particular, this is an issue with respect to the beneficial owner’s identifying information (e.g., name and address), which may not be readily translatable into English. The enactment of FATCA will increase the number of Forms that will need to be completed by foreign persons. The issuance of more detailed guidance regarding the use of bilingual forms, in particular guidance clearly permitting the Forms to be filled out in the language of the beneficial owner, would facilitate completion of the Forms by foreign persons.

E. Identity Theft and Information Reporting

Recommendations

IRPAC recommends that the IRS provide clear guidance on whether Forms 1099 should be filed with the IRS and recipient copies issued to the named payees of fraudulent accounts. IRPAC recommends that the IRS consider the potential burdens to the identity theft victims if such forms were or were not issued. IRPAC also recommends that, if Form 1099 reporting or some other notice to the identity theft victims is required, the IRS should consider the potential burdens to the payer community if reporting changes are required, particularly any changes that would require system modifications.

Discussion

Earlier this year, IRPAC became aware of situations where payments were being made to accounts that were fraudulently opened with the name and social security number of an identity theft victim. In cases where the payer has knowledge before the Form 1099 filing deadline that payments were made to a fraudulent account, the question raised was whether a Form 1099 should be issued for that account. The current rules and regulations do not provide clear guidance on what a payer should do in these identity theft situations. IRPAC met twice this year with IRS staff from Counsel and Privacy, Information Protection and Data Security (PIPDS) to discuss whether reporting should be required, and if so, ways to protect the theft victim while minimizing the burden to the payer community.

IRPAC noted that if Forms 1099 were issued in the name and SSN of the identity theft victim (i.e., the named payee), with no knowledge of the theft, the

³⁰ See the IRS’s Instructions for the Requester of Forms W-8BEN, W-8ECI, W-8EXP, and W-8IMY.

Emerging Compliance Issues Subgroup

IRS would expect the payments to be reported on the identity theft victim's Form 1040. The victim may not include the payment amounts on his or her return either because (s)he knows the income was not his/hers or the victim remains unaware of the theft (if, for example, the Form 1099 was not sent to the victim's correct address). This may result in the IRS sending an unreported income notice to the victim, beginning a process that could be burdensome (administratively, mentally, and possibly economically) for the victim.

IRPAC questioned whether it was necessary for payers to issue Forms 1099 to the IRS and/or the named payees and requested that the IRS consider specifically stating that such reporting is not required in a known identity theft situation. IRPAC noted that the current instructions to Form 1099-C, Cancellation of Debt, indicate that the form should not be issued in an identity theft situation and suggested expanding this treatment to other Forms 1099 indicating situations where reporting was not required. IRPAC indicated that, in cases where there was backup withholding on the fraudulent account, Forms 1099 could be issued to an "unknown payee," enabling the payer to reconcile its Forms 1099 and Form 945, while shielding the theft victim's name and SSN and hopefully not generating a B Notice or penalty notice.

IRPAC understands that PIPDS may be concerned that, if a theft victim is not issued a Form 1099 or some notice of the payments made to the account with the victim's name and SSN, the victim may become the subject of further identity theft, and may face more difficult burdens in the long run. In response to this concern, IRPAC and the IRS discussed ways in which the theft victims could be notified of the payments while minimizing the reporting burdens on the payer community. IRPAC and the IRS considered changes to the Forms 1099, or the provision of special instructions regarding how the Forms 1099 should be completed in these circumstances, as well as the idea of a new notice that could be issued to both the IRS and the theft victim. IRPAC noted that it would be very burdensome to the payer community if the reporting to the theft victim would require changes to payer systems, particularly given the relatively few cases in which the identity theft issue arises.

IRPAC also has discussed with the IRS the question of whether Forms 1099 should be issued when the address of the payee is known to be "stale" (or undeliverable). A payee has a "stale" address if mailings to that address have been returned because the address is incorrect and no new address has been provided. The general rule for most IRS-required mailings is to mail to the last known address for the payee, but there is some guidance for Forms 1099-INT and W-9 and B Notices providing that this general rule is changed for mailings where the last known address is known to be stale.³¹ However, this guidance does not directly apply to all Form 1099 filings. In addition, IRPAC understands that in some circumstances, the IRS has advised payers to send certain Forms

³¹ See Rev. Rul. 81-64; Internal Revenue Manual § 20.1.7.9.2.6, item 9; Publication 1281; Rev. Proc. 93-37.

Emerging Compliance Issues Subgroup

1099 to the last known address, even when it is a known bad address. In other contexts, the IRS has advised that certain mailings should not be done in such circumstances.

Given the rise in the incidence of identity theft, payers are concerned that, if Forms 1099 are sent to the “stale” address, personal data of the account holder may be made available for potential theft.

IRPAC intends to further its discussions next year with the IRS regarding this issue, with the goal of obtaining clear guidance on whether and, if so, which Forms 1099 should be mailed to “stale” addresses.

F. Clarification of the Information to be Reported to U.S. Investors on the Form 1099-DIV, Box 6, Foreign Tax Paid

Recommendations

IRPAC recommended that the IRS change the language in the Instructions for Form 1099-DIV, Dividends and Distributions, Box 6, Foreign Tax Paid to direct payers to report any foreign tax withheld and paid on dividends and other distributions on stock. The current instructions provide that payers should enter the “creditable foreign tax withheld and paid (within the meaning of section 901).” The IRS and IRPAC have discussed this issue and concur that payers would generally not know what portion, if any, of an amount of foreign tax withheld from a dividend payment was creditable for any particular taxpayer. Payers, however, would know the actual amount of foreign tax withheld. Accordingly, the IRS and IRPAC agree that the following language (provided in the instructions prior to 2008) be used in the Form 1099-DIV instructions going forward.

“Enter any foreign tax withheld and paid on dividends and other distributions on stock. A RIC must report only the amount it elects to pass through to the recipient. Report this amount in U.S. dollars.”

Discussion

U.S. payers are generally required to report to U.S. investors dividend payments made in respect of foreign securities on Form 1099-DIV. In addition to reporting the dividend payments, payers are also required to report any foreign tax paid or withheld on such dividends. Prior to 2008, the Instructions for Form 1099-DIV directed payers to report in Box 6 any foreign tax withheld and paid on dividends and other distributions on stock.

In 2008, however, the language in the instructions was changed to direct payers to enter *creditable* foreign tax withheld and paid (within the meaning of IRC Section 901) on dividends and other distributions on stock. Payers have

Emerging Compliance Issues Subgroup

raised concerns with this instruction because they do not possess the type of information required to make a determination as to whether the foreign tax withheld may be taken as a credit by the payee. In order for a payer to reliably determine whether a payee is eligible to claim a tax credit on an amount withheld, much more detailed information about the nature of the foreign tax and the payee's specific tax situation would be required. The Code generally permits credits to be taken only in respect of foreign taxes that qualify as "income taxes" under complex regulations issued under section 901. The Code also imposes numerous limitations and restrictions on the amount of foreign tax that may be claimed as a credit. The actual amount of foreign tax paid or withheld is only the starting point in determining the creditable tax and the allowable foreign tax credit. Detailed information regarding the payee's other types and sources of income, other taxes paid, actions in various taxing jurisdictions, the period of time the stock was held, and possible entitlement to tax treaty benefits is necessary to make this determination. It is impossible for a paying agent, which may make tens of thousands of payments on foreign issues and frequently has no direct relationship with the security holders, to determine the amount of creditable tax without all the specific details for each payee's tax position.

In addition, as a practical matter, reporting any amount other than the actual foreign tax paid may be unnecessarily confusing for payees. Payees know the amount of tax that actually has been withheld from their dividend check, but if Form 1099-DIV reports some other amount as foreign tax paid, the two documents will not reconcile and investors may assume an error has been made. By reporting the actual amount withheld, the payee will be able to reconcile the withholding and accurately calculate his or her allowable foreign tax credit or deduction.

As mentioned above, IRPAC met with members of the IRS Forms and Publications Division in August to discuss this issue. All agreed that reinstating the language provided in the 2007 Instructions for Form 1099-DIV would be appropriate. On August 30, 2010, the IRS published a correction to the 2010 Instructions for Form 1099-DIV in the "What's Hot" section of IRS.gov because the form instructions had already been published for this year.³² The IRS also agreed to make the language change for the 2011 Instructions for Form 1099-DIV.

³² <http://www.irs.gov/formspubs/article/0,,id=109875,00.html>

Appendix

- Appendix A: IRPAC Comments on Notice 2009-93 Taxpayer Identification Number Truncation (December 17, 2009)
- Appendix B: IRPAC Request for Form 5500/5330 Automatic Extension for August 2, 2010 Deadline (July 8, 2010)
- Appendix C: Sample FAQ: Electronic Delivery of Form 1098-T, Tuition Statement
- Appendix D: Announcement 2010-41: New Backup Withholding Procedures: Social Security Number Validation following Receipt of Second B Notice
- Appendix E: IRPAC Comments on Cost Basis Proposed Regulations (February 26, 2010 and March 3, 2010)
- Appendix F: Cost Basis Current Industry Practice – Supplement to Comments on Examples Involving the DVP and Multiple Broker Rules (June 8, 2010)
- Appendix G: IRPAC Additional Comments on Cost Basis Proposed Regulations (July 6, 2010)
- Appendix H: IRPAC Comments on Notice 2010-28: Stripping Transactions for Qualified Tax Credit Bonds (May 21, 2010)
- Appendix I: Additional Comments on Notice 2010-28 and Form 1097-BTC (July 26, 2010)
- Appendix J: IRPAC Comments on Notice 2010-43: Recommendation for 2010 2011 Guidance Priority List (June 11, 2010)
- Appendix K: IRPAC Comments on IRC § 6050W Proposed Regulations (January 20, 2010)
- Appendix L: IRPAC Comments on Changes to IRC § 6041 (May 24, 2010)
- Appendix M: IRPAC Comments on Notice 2010-51: Information Reporting Under the Amendments to Section 6041 for Payments to Corporations and Payments of Gross Proceeds and With Respect to Property (August 19, 2010)

