

# IRC SECTION 3402(t)

New Contractor Withholding  
Requirements: the Ins and Outs of  
IRC 3402(t)

# Tax Increase Prevention and Reconciliation Act of 2005

- Added section 3402(t) to Internal Revenue Code
- Generally requires 3% income tax withholding by government entities on payments for property and services
- Originally applied to payments made after December 31, 2010

# IMPLEMENTATION DELAYS

- American Recovery and Reinvestment Act of 2009 delayed implementation for one year, to payments after December 31, 2011
- Final regulations May 9, 2011, delays implementation until after December 31, 2012

# AFFECTED GOVERNMENT ENTITIES

- All U.S. Government agencies, including judicial and legislative branches
- All state governments (including the District of Columbia, but excluding Indian tribal governments and U.S. possessions)
- All subdivisions or instrumentalities of state government that make annual payments for property and services (excluding wages) of \$100 million or more

# INSTRUMENTALITY

- Statute and regulations do not provide a definition for this purpose
- Final regulations indicate that general published guidance on definition of instrumentality should be consulted (see Revenue Rulings 57-128, 65-26, 65-196)

# SMALL SUBDIVISION OR INSTRUMENTALITY EXCEPTION

- Less than \$100 million in payments per year
- Eligibility for this exception is based on payments for a “lookback period” of the accounting year ending with or within the second preceding calendar year
- Under an optional rule, an entity may average payments made during any four of the previous five accounting years ending with the accounting year ending with or within the second preceding calendar year

# PAYMENT THRESHOLD

- All governmental entities (including Federal and state agencies) are not required to withhold on payments of less than \$10,000.
- \$10,000 threshold is applied separately to each payment and each payee
- 3% withholding applies to total amount paid in any form
- Payor and payee may agree to have withholding apply to payments that are not subject to withholding (including those under \$10,000)

# ANTI-ABUSE RULE

- Withholding is required if a payment is divided solely for the purpose of avoiding the withholding requirements
- Government entity payer is not liable for failure to withhold unless it knew or had reason to know that payee was structuring payments to avoid withholding



# EXCEPTIONS

- To other government entities, foreign governments, Indian tribes, or tax-exempt organizations
- To nonresident aliens and foreign corporations in certain situations

# PASS-THROUGH ENTITIES

- Payments from pass-through entities are exempt from withholding unless at least 80% of entity is owned by government entities required to withhold under section 3402(t)
- Payments to pass-through entities are subject to withholding unless at least 80% of entity is owned by governments required to withhold under 3402(t), tax-exempt organizations, tribal organizations, or foreign governments

# EXCEPTION

- Applies with respect to payments to partnerships that are 80 percent owned by nonresident aliens and foreign corporations if payment is not effectively connected with conduct of US trade or business by partnership and not US source income

# EXCEPTION FOR EMPLOYEES

Payments to employees in connection with service are excepted:

- Wages
- Retirement plan contributions
- Fringe benefits
- Expense reimbursements under accountable plans

# REAL PROPERTY

- Real property includes land or completed buildings
- Payments for construction or improvements to existing buildings are subject to the requirement

# GRANTS

A transfer of funds from government to recipient pursuant to agreement, when

- (1) Principal purpose is to carry out a public purpose, and
- (2) Substantial involvement between parties not expected when carrying out the activity.

# SALES TAXES

- Amount of payment subject to withholding and reporting includes any sales tax, excise tax, or VAT; but
- Government entities may exclude these from reportable payments and withholding if applied consistently to all payments to a payee during a calendar year

# EXCEPTIONS TO 3402(t)

- For retirement benefits, unemployment compensation, or social security
- Subject to backup withholding, if performed
- For real property, interest or repayment of principal, public assistance or welfare, loan guarantees, grants, taxes, or investment securities
- Made in emergency, disaster or hardship situations
- Made under confidential or classified contracts under IRC 6050M(e)(3)



# PAYMENT CARDS

- Notice 2010-91- Payments made by payment card are exempt from the requirements if made for any calendar year beginning earlier than at least 18 months from the date of final regulations, if any, requiring withholding on payments by payment card.

# EXISTING CONTRACTS

- Under the final regulations, withholding is not required under existing written contracts in effect on December 31, 2012
- Exception does not apply through 2013 if there are material modifications to the contract after that date
- Contract renewal is not material modification
- Companion proposed regulations [REG-151687-10] provide that existing contract exception does not apply after 2013

# HOW TO REPORT

- Withholding required at time of payment (by entity or payment administrator)
- Withheld amounts are shown on Form 945
- Included with other Form 945 liabilities in applying deposit rules
- Payee takes credit for withholding on income tax return

# HOW TO REPORT

- Withholding reported to recipients on Form 1099-MISC, Miscellaneous Income
- Withholding may not be used by payee as a credit against employment or other taxes
- 3402(t) withholding may be taken into account in making estimated tax payments

# ADJUSTMENTS

- Rules for adjustments of overwithholding or underwithholding on wages apply to 3402(t) payments
- Withholding applies to amount actually paid, even if incorrect
- Withholding applies to amount without regard to governmental offsets

# FAILURE TO WITHHOLD

- In general, a government required to withhold under this provision that fails to do so is liable for the tax
- If government entity failed to comply, it is not liable for the withholding if it can establish that the payee included the payment on its income tax return and paid the income tax due on that payment.
- “Good faith” exception for interest and penalties for payments before 2014

# SUBCONTRACTORS

- The party contracting with the government to provide goods and services is subject to the 3402(t) withholding
- Subcontractors of the contracting party are not subject to the 3% withholding
- Agents acting as payment administrators for the government are required to withhold

# PAYMENT ADMINISTRATOR

- Any person that acts with respect to a payment solely as an agent for a government entity by making the payment on behalf of the government entity
- Payments to an administrator for payment services provided on behalf of government entity are subject to the withholding
- Government entity remains liable for tax