

## SLIDE 1

TENNILLE: Hello, and welcome to our webinar, “New Withholding Requirements of Contractor Payments: The Ins and Outs of Internal Revenue Code Section 3402 (t).” I’m Tennille Francis, a Tax Law Specialist with the office of Federal, State and local Governments (otherwise known as FSLG) in the Tax Exempt Government Entities (TEGE) Division of the Internal Revenue Service. We in FSLG are responsible for promoting and enforcing federal tax compliance for all federal, state, and local governments and some instrumentalities. Joining me today is Stephen Tackney, Special Counsel in the office of TEGE Chief Counsel.

STEPHEN: This webinar is part of series of webinars presented by the IRS Tax Exempt and Government Entities division. Before we begin, let’s review some administrative items. First, tax professionals may receive a Certificate of Completion that can be used to request a Continuing Professional Education credit, if the event meets your organization’s or state’s CPE requirements. To receive a Certificate of Completion, you must have registered for today’s program by entering your email address on the registration page and used the same email address to attend, so we can verify your participation.

Second, this program will be archived on our Web site at [www.IRSvideos.gov/webinars](http://www.IRSvideos.gov/webinars) for later viewing. However, only those attending today’s session, July 14, 2011 will be able to receive a Certificate of Completion. Those entitled to certificates will receive them by email approximately one week following this webinar.

TENNILLE: We’d like to draw your attention to the “Ask A Question” button just below the slide screen on the right. During the video portion of this webinar, we’ll be taking your questions and, at the end of the webinar, Stephen will be sticking around to answer as many of them as possible. Today we are here to discuss some new guidance under a rather old statute, Internal Revenue Code Section 3402(t).

I-R-C section 3402(t) provides that all federal state and some local governments and instrumentalities thereof must withhold three percent of payments for property or services, unless an exception applies. Although this statute sounds basic there are some complexities involved and as with all federal tax rules there are exceptions. The goal of today’s presentation is to provide some clarification of the statute, its complexities and exceptions. The most important item to remember is that the recently issued final regulations extended the effective date one year, so that the withholding requirements become effective January 1, 2013. So you have about a year and a half to get prepared.

During this presentation we will look at the following:

- First, how did we get here, a brief look at I-R-C section 3402(t)’s legislative history.
- Second, who must withhold income tax under this provision?
- Third, what payments are subject to this three percent withholding of income tax?
- Fourth, how does the entity deposit the withheld amounts with the IRS and report the income tax withholding to both the IRS and the payee?
- Finally, we’ll discuss some a few other important items.

Let's get started.

---

## **SLIDE 2**

STEPHEN: So...how did we get here...I-R-C section 3402(t) was enacted on May 17, 2006 by Section 511 of the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005. Section 511 of TIPRA provided that, subject to certain exceptions, the government of the United States, every State, every political subdivision thereof, and every instrumentality thereof (including multi-state agencies) making any payment to any person providing any property or services (including any payment made in connection with government voucher or certificate program which functions as payment for property or services) shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment. This withholding was to be effective for payments made after December 31, 2010.

---

## **SLIDE 3**

Proposed Regulations under section 3402(t) were published in the Federal Register and open for comment on December 8, 2008. After the issuance of the proposed regulations Section 1511 of the American Recovery and Reinvestment Act of 2009 extended the effective date of I-R-C section 3402(t) to payments made after December 31, 2011.

Finally, after consideration of the many comments received on the proposed regulations and after a public hearing on April 16, 2009, final regulations were published in the Federal Register on May 9, 2011. The final regulations take into account the many comments received. Most importantly, the final regulations extend the effective date of withholding to payments made after December 31, 2012. Therefore all payments for property or services are subject to withholding starting on January 1, 2013, unless they are exempt from withholding.

---

## **SLIDE 4**

TENNILLE: Now that we know how this came about, let's look at whom it affects.

The requirement to withhold under section 3402(t) applies to payments made by all agencies and departments of the United States government. This includes units of the executive, legislative, and judiciary branches. All components of the Federal government are required to comply with these rules, regardless of their size, structure, or total payments.

Section 3402(t) also applies to all agencies and units of each state government, regardless of the total payments the agency or unit makes. This includes all administrative agencies, as well as state-controlled organizations such as public university systems. For this purpose, the District of Columbia is considered a state, but Indian Tribal Governments are not. As with the Federal government, there are no exceptions for any specific types of state government agencies or units.

In addition, other local or regional units of government are subject to the requirement if they meet a threshold of total payments. Withholding is required for every subdivision or instrumentality of a state government, if the annual total payments by the subdivision or instrumentality are more than \$100 million.

Generally, any city, county, township, borough, school, water or fire district, etc., is considered a subdivision of a state government.

---

## **SLIDE 5**

An instrumentality is an organization created by, or pursuant to, a state statute, operated for public purposes, and expressly declared by statute to be an instrumentality. An interstate instrumentality is organized by two or more states, and is also potentially subject to these requirements. In some cases, the determination as to whether an entity is an instrumentality of government may be a difficult one. The IRS has addressed this question in published guidance on several occasions. If you are uncertain whether your organization is considered a government entity for tax purposes, you may contact the office of Federal, State, and Local Governments for assistance.

---

## **SLIDE 6**

**STEPHEN:** For purposes of this presentation, we'll refer to a subdivision or instrumentality of a state government as a local government entity. A local government entity is subject to the requirements for a given year if the local government entity's total payments for property and services are \$100 million or more in the "lookback year." The lookback year is the local government entity's accounting year ending in the second preceding calendar year. For example, for a local government using the calendar year as the accounting year, the lookback period for 2013 is 2011. If total payments in 2011 equaled or exceeded \$100 million, the entity is subject to the withholding requirements under section 3402(t) during 2013.

"Total payments" refers to all payments the government entity makes that are subject to the section 3402(t) withholding, plus any payments that are not subject to section 3402(t) withholding only because the payment is less than \$10,000. Total payments do not include payments that fall under one of the other exceptions to section 3402(t) withholding that we will discuss later, such as payments of wages or other employee compensation. Total payments include payments for property and for services, regardless of whether the amounts are considered gross income to the payee.

If a local government entity makes total payments close to \$100 million each year, the local government entity may be faced with uncertainty as to whether the requirements apply for a given year. This can create administrative difficulty in preparing for and applying the withholding. Or, a local government entity may normally make annual payments well below the \$100 million threshold, but have one year above \$100 million in payments, due to an unusually large expenditure such as the construction of a municipal building. To allow these entities to

better predict and prepare for implementing the withholding requirements, the final regulations provide an alternative lookback rule to determine whether the requirement applies. Under this rule, a local government entity may average the payments made during any four of the five consecutive accounting years, ending with the accounting year that ends within the second preceding calendar year. For example, for a local government entity with a calendar year accounting year, the local government entity could determine whether section 3402(t) applies to it for the year 2013 by averaging the total payments for four of the five years running from 2007 through 2011. So if, for example, a municipal building was built in 2011 which would cause the local government entity payments to exceed \$100 million for that year, that year could be ignored. This optional rule will give greater predictability and relieve the requirement for a local government entity with one year of unusually high payments.

A local government entity must decide before the beginning of the calendar year whether it will use the alternative look-back rule, so that it knows at the beginning of the year whether it will apply the withholding or not. The local government entity also must keep records to substantiate that it qualified for the exception under the alternate rule if it chooses to use that exception.

---

## **SLIDE 7**

TENNILLE: So let's look at the types of payments subject to withholding.

Individual payments of \$10,000 or more for property or services are subject to the three percent withholding. To make the application of the withholding more easily administrable, the final regulations provide that individual payments of less than \$10,000 are not subject to withholding under I-R-C section 3402(t). This test is applied separately to each payment; it does not matter how many payments have been made or how much tax has been withheld previously from that payee. It also does not matter whether the payment applies to multiple invoices, often referred to as a bundled payment, or is intended to pay for one specific purchase. For example, if a vendor bills a government entity \$5,000 each day for seven days of daily services, but the entity pays the bills by making one \$35,000 payment, the payment threshold is applied to the \$35,000 payment.

Even if the payment made to the provider of property or services is later determined to be incorrect, the withholding requirement still applies to the amount of the original payment. For example, if a government entity makes an \$11,000 payment, withholding applies, even if it is later determined that the payment should have been for \$9,000.

---

## **SLIDE 8**

Under an anti-abuse rule, payments that are divided for the primary purpose of avoiding the \$10,000 threshold will be regarded as a single payment. The government entity in general is responsible only for withholding if the payment equals or exceeds the \$10,000 threshold, or if it is aware of an intention to avoid the withholding. For example, if a vendor delivers a product with a total cost of \$15,000, but divides the bill into two invoices of \$7,500 each, specifically to avoid the withholding under section 3402(t), the two payments are considered to be one

payment, subject to withholding. The anti-abuse rule applies only if the government entity knew or should have known that the payment had been divided with the primary purpose of avoiding the section 3402(t) withholding requirements.

To avoid uncertainty and disputes between the government entity and the payee about whether the anti-abuse rule applies, the government entity and the person providing services or property may contractually agree to withhold on all payments, or to withhold on payments under \$10,000 when the government entity has determined that the anti-abuse rule should apply.

You should also note that payments that are not subject to withholding solely because they are less than \$10,000 are counted toward the \$100 million annual total payment threshold for purposes of determining whether a local government entity is subject to the section 3402(t) requirements.

---

## **SLIDE 9**

STEPHEN: As we previously stated all rules have exceptions. Now that we know who must withhold and what payments they must withhold on, let's turn to the exceptions to the general rule.

There are a number of exceptions to the general rule of I-R-C section 3402(t). These exceptions come in two categories: exempt payees and exempt payments.

First exempt payees - payments to other federal, state and local government entities, foreign government entities, tax-exempt organizations, and federally recognized Indian Tribal governments are exempt from section 3402(t) withholding. In addition, payments to nonresident alien individuals and foreign corporations may be exempt from section 3402(t) withholding in certain circumstances. These exceptions are intended to apply because the recipients of the payments generally are not subject to federal income tax, so that income tax withholding is not necessary.

---

## **SLIDE 10**

Payments to pass-through entities and corporations that are at least 80 percent owned by a government entity, a foreign government, tax exempt organization, or Indian Tribal government are also exempt from 3402(t) withholding. Along with that payments from a pass through entity that is at least 80 percent owned by a government entity that is required to withhold under section 3402(t), are also exempt from section 3402(t) withholding.

---

## **SLIDE 11**

Payments to partnerships that are at least 80 percent owned by nonresident aliens or foreign corporations are exempt from section 3402(t) withholding if the payment is not effectively connected with the conduct of a US trade or business and is not US sourced. Further payments to non resident aliens and foreign corporations are exempt as well if the payments are not effectively connected to a US trade or business and are not US sourced income.

To date there is not a bright line test nor a form designated for an exempt recipient to identify themselves as exempt. However, as stated in the preamble to the final regulations, the Treasury Department and the IRS expect to issue additional guidance on how a payee can claim an exemption.

TENNILLE: The second category of exceptions includes payments that by their nature are exempt from I-R-C section 3402(t) withholding. These payments include:

---

## **SLIDE 12**

Wages and other payments to employees of the government entity - Included here are wages, retirement plan contributions, other employee benefit plan contributions, fringe benefits, and expense reimbursements under an accountable plan. Expense reimbursements under non-accountable plans are not subject to section 3402(t) withholding because these amounts are considered wages and therefore exempt as wages.

Payments that are subject to backup withholding under Code section 3406 are also excepted from section 3402(t) withholding, if such back-up withholding was performed.

---

## **SLIDE 13**

Payments for real property are exempt from section 3402(t) withholding. This includes payments for the purchase or lease of land or a completed building. However, payments for real property do not include payments for the construction of a building or for improvements to an existing building, so those payments are subject to section 3402(t) withholding.

---

## **SLIDE 14**

Grants are exempt from section 3402(t) withholding. For this purpose, a grant is a transfer of funds from the government to a recipient pursuant to an agreement where the principal purpose is to carry out a public purpose and substantial involvement between the parties is not expected when carrying out the activity. Note that grants do not include the use of the grant proceeds. For instance, if the federal government makes a grant to a state government, and the state government uses the grant proceeds to purchase property or services, the state government purchases will be subject to section 3402(t) withholding unless another exception applies.

---

**SLIDE 15**

Under the general rule, payments for taxes such as sales tax, excise tax, or value-added tax are included in the amount of the payment subject to section 3402(t) withholding. However, in some cases it may be easier for a government entity not to apply section 3402(t) withholding to the portion of the payment covering these types of taxes. In that case, the government entity may choose to exclude the portion of the payment covering the sales tax or other tax in the payment subject to section 3402(t) withholding. If it chooses to do so, the government entity must exclude the tax in the amount subject to section 3402(t) withholding in all payments to that particular payee during the calendar year. Choosing to exclude taxes in the amount subject to 3402(t) must be done consistently with each payee.

---

**SLIDE 16**

STEPHEN: Some other exceptions to note:

Payments for unemployment compensation, social security benefits or retirement benefits are not subject to 3402(t) withholding.

Payments of interest or principal on a loan are also not subject to 3402(t) withholding. This includes the payment of late payment interest.

Payments as part of a public assistance or public welfare program for which eligibility is determined by a needs or income test are not subject to 3402(t) withholding. This includes payments to victims of a natural or other disaster.

The Treasury Department and the IRS may also provide additional exceptions from section 3402(t) for other types of payments in the case of an emergency or disaster. Taxpayers will be notified of the provision of any of these exceptions through the publication of a notice or other guidance indicating the extent to which section 3402(t) withholding is not required.

Payments pursuant to loan guarantees and payments for investment securities generally are also not subject to section 3402(t) withholding.

Payments made for classified or confidential contracts described in Code section 6050M(e)(3) are not subject to section 3402(t) withholding.

---

**SLIDE 17**

Also, purchases made with payment cards currently are not subject to Section 3402(t) withholding. However, payments made with convenience checks are subject to Section 3402(t) withholding unless another exception applies. Notice 2010-91, issued December 3, 2010, provides the guidance regarding this exemption for purchases by payment card. Notice 2010-91 provides that if the Treasury Department and the IRS subject payments made with payment cards to section 3402(t) withholding, the requirement to withhold will not be effective until 18 months after the date of publication of the final regulations that provide for withholding on payments by payment card. Therefore, taxpayers will be provided a chance to comment on proposed regulations proposing to implement such a requirement, and if such a requirement is adopted government entities will be provided at least 18 months to prepare.

---

## **SLIDE 18**

Lastly, another hot topic concerns existing contracts. The final regulations provide that payments made on contracts that are in existence as of December 31, 2012 will be exempt from section 3402(t) withholding, unless the contract is materially modified after December 31, 2012. If the contract is materially modified after December 31, 2012, then all payments made after the material modification will be subject to section 3402(t) withholding. A material modification includes only a contract modification that materially affects the property or services to be provided under the contract, the terms of payment for the property or services under the contract, or the amount payable for the property or services under the contract. A mere contract renewal is not a material modification, nor is a modification required by the applicable federal, state or local law.

STEPHEN: As part of the comment process to the original proposed regulations, some commenters stated that applying the standard on an ongoing basis would be administratively burdensome, and that it would be easier to apply withholding to all contracts rather than determining whether the contract was existing as of December 31, 2012 and whether it had been materially modified. In response, the Treasury Department and the IRS have issued new narrow proposed regulations that propose only one change to the recently issued final regulations. That proposed change would eliminate the exception for existing contracts as of January 1, 2014, so that all contracts would be subject to section 3402(t) withholding as of January 1, 2014 regardless of whether the contract was existing on December 31, 2012 and regardless of whether the contract had been materially modified. These proposed regulations are subject to comment, and the Treasury Department and the IRS will be considering all of the comments received in determining whether to adopt this change to the final regulations.

---

## **SLIDE 19**

TENNILLE: Well, now that you know what's in and what's out, the next question is how this withholding is reported to both the IRS and the payee.



Any entity required to withhold under I-R-C section 3402(t) is responsible for filing Form 945, Annual Return of Withheld Federal Income Tax, reporting the amount withheld. A government entity may already file this form to report other non-payroll income tax withholding. The amounts withheld under section 3402(t) are added to any other Form 945 withholding for purposes of applying the deposit rules. Form 945 deposit dates are determined separately from payroll withholding on Form 941 or Form 944.

---

## **SLIDE 20**

In addition, the government entity should file Form 1099-MISC, Miscellaneous Income, annually for each payee from whom tax has been withheld under this provision. This form will show amounts paid and total withholding for the calendar year. The amount of tax withheld becomes a credit against the income tax liability of the person or payee providing services. Fiscal year taxpayers may not apply the tax withheld to a fiscal year ending before the calendar year in which it is withheld. The tax withheld may be treated as an estimated tax payment, but only for the fiscal year the begins in the calendar year in which the amount was withheld.

The amount withheld under section 3402(t) can only be credited against income tax liabilities. The amount withheld may not be treated as a credit against any other Federal tax liabilities, such as employment taxes.

---

## **SLIDE 21**

Section 3402(t) provides that the rules for making corrections to amounts withheld are the same under section 3402(t) as they are for income tax withholding under employment tax rules. Therefore, if the government entity fails to withhold income tax, it is liable for paying the tax that should have been withheld, unless the government entity can demonstrate that the contractor reported the amount on its return and paid the tax.

If the government entity withheld more income tax than was correct, the amount overwithheld can be returned to the payee during the same calendar year without an adjustment on the Form 945. If it is not returned to the payee during the same calendar year, the actual amount withheld should be shown on Form 945 and Form 1099-MISC. In this way, the contractor will receive credit for the overwithheld amount against the contractor's income taxes for the year.

---

## **SLIDE 22**

If the government entity withheld too little income tax, the amount underwithheld can be corrected during the same calendar year without an adjustment on the Form 945. If the withholding is not corrected during the same year with the payee, the government entity should

report only the amount actually withheld. In addition, the government entity is liable for the underwithholding unless the government entity can demonstrate that the contractor included the payment in its gross income and paid the appropriate taxes.

The payee will use the amount of income tax reported on Form 1099-MISC as a credit when it files a tax return for that year. Therefore, you cannot make an adjustment to Form 945 for income tax withholding for amounts withheld (or amounts that should have been withheld) during a previous year, unless it is for an administrative error. An administrative error occurs if the amount reported as withheld on the return is not the actual amount withheld. In this case, you may make an adjustment in a later year, up until the time the statute of limitations expires for the erroneous Form 945.

Any corrections to amounts withheld made during the calendar year, before the return is filed, do not need to be shown as adjustments on Form 945. Form 945 should show the correct amount of tax.

STEPHEN: As we said earlier, the withholding requirement applies regardless of whether the original payment amount is correct. For example, if you made a payment of \$11,000 subject to section 3402(t) withholding to a contractor, then three percent, or \$330, should be withheld from this amount. If it is later determined that the payment should have been \$9,000, then for purposes of reporting and depositing, you must make deposits based on the withholding of \$330 on the date of payment. The \$10,000 threshold applies to each payment, regardless of any errors in previous payments or corrections payments. However, you can adjust the amount of withholding on future payments in the same calendar year to the same person by the amount of erroneous withholding on the previous payment.

---

### **SLIDE 23**

The three percent withheld should be applied to the entire amount of the payment, even if part of will be paid by the contractor to a subcontractor or other party. The withholding applies only to the payment by the government entity; subsequent payments by the contractor to subcontractors or other entities are not affected.

Remember, the withholding is based on the amount of the payment, not the income realized by the provider of goods and services, or the amount of federal income tax that the provider of goods and services may ultimately owe.

---

### **SLIDE 24**

A government entity remains liable for the tax even if a payment administrator is used to make the payments. Amounts transferred from the government entity to the payment administrator for purposes of paying obligations of the government entity are not subject to withholding; the

payment administrator should withhold on its payments to the providers of property and services according to the 3402(t) rules (or the government entity may provide that payment administrator funds net of the withholding, and process the withholding itself). However, the amount of any payment the government entity makes to the payment administrator for its services as a payment administrator is subject to section 3402(t) withholding.

TENNILLE: Before we go, we would like to remind you that companion proposed regulations were issued with the final regulations. These proposed regulations address the issue of existing contracts and provides that section 3402(t) withholding would apply to payments made under all contracts after December 31, 2013 regardless of whether the contract was in existence as of December 31, 2012. Thus under the proposed regulations payments made under all contracts would be subject to section 3402(t) withholding as of January 1, 2014. We encourage you to provide comments on these proposed regulations. All written or electronic comments should be sent to the address posted here and they must be received by August 8, 2011.

STEPHEN: Don't forget, in a moment, I'll be answering some of the questions you've been providing us throughout this webinar. I'll be answering those questions live, but through audio only, so you won't see me on camera. And, remember, if you are interested in earning CPE credit, please stay with us until the end of the session.

TENNILLE: For more information about I-R-C 3402(t) or other tax issues affecting federal, state and local governments, visit our website, I-R-S-DOT-GOV slash G-O-V-T slash F-S-L-G. Also, Stephen and I will be hosting two phone forums on this topic on August 4th and August 18th. Please click on one of the "Info on Phone Forums" link below the slide window.

We hope you'll consider joining us for future webinars. Thanks again and have a great day.