

SUMMARY

Final Regulations – 26 CFR Part 31.3402(t) Withholding by Government Entities

Section 3402(t) implements Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 which requires federal, state, and local governments to deduct and withhold three percent of any payment for property or services. There is a small entity exception for political subdivisions and their instrumentalities that make less than \$100,000,000 in payments. Certain other exceptions apply.

GENERAL

Effective Date: The final regulations are effective for payments made after December 31, 2012 (which represents an additional one-year extension). Payments under contracts existing on December 31, 2012, that are not materially modified are exempt from the withholding requirements. Material modification does not include a mere renewal of the contract that is not otherwise modified or that is required by applicable federal, state or local law. Treasury is also proposing that payments on existing and new contracts on or after January 1, 2014, be subject to 3402(t) withholding.

Entities Subject to the Withholding Requirement: All federal and state governments and their agencies are subject to the withholding requirement. The \$100,000,000 payment exception is applicable only for political subdivisions of a state (or instrumentality of that political subdivision) that make less than \$100,000,000 of payments for property or services annually. Generally eligibility for the exception is determined based on the amount of payments made during the accounting year ending with or within the second preceding calendar year. All payments are considered in determining the threshold amount (even those under the \$10,000 threshold) except certain excepted payments under 31.3402(t)-4(a)-(q) in the rule (employee salary payments, nontaxable fringe benefits). The final rule also provides an optional rule in determining the threshold amount that allows political subdivisions of a state to average payments made during any four of the five accounting years (ending with the accounting year that ends with or within the second preceding calendar year). This addresses years that may be unusual in terms of expenditures. Specific examples can be found in the final regulation under Section 31.3402(t)-4(g).

Instrumentality: The final rule adopts the six factor test for determining whether an entity is an instrumentality (until further definitions are issued). Revenue Ruling 57-128 lists the following factors to be taken into account in determining whether an entity is an instrumentality of one or more governmental units:

- (1) whether the organization is used for a governmental purpose and performs a governmental function;
- (2) whether performance of its function is on behalf of one or more states or political subdivisions;
- (3) whether there are any private interests involved, or whether the states or political subdivisions have the power and interests of an owner;
- (4) whether control and supervision of the organization is vested in a public authority or authorities;
- (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the organization, and whether this authority exists; and
- (6) the degree of financial autonomy of the entity and the source of its operating expenses.

Payment Cards: Payment card transactions (including credit, debit, stored value and other payment cards) are exempt from the withholding and reporting requirements until at least 18 months from the date future guidance is finalized applying the withholding and reporting to payment by payment cards. This provision essentially allows Treasury to require payment card reporting in the future.

\$10,000 Threshold: The withholding requirement does not apply to payments less than \$10,000. The threshold is on a payment-by-payment basis. The regulations also instate an anti-abuse rule disallowing the division of a payment into multiple payments to avoid the payment threshold. The anti-abuse rule is applicable only if the government entity knew or should have known that the payment was divided to avoid the withholding threshold.

Withholding on amounts below \$10,000: In order to address the anti-abuse rule, a government and a person providing property or services may contractually agree that the three percent withholding will apply to all payments regardless of the amount.

Payments to Subcontractors: The withholding requirement applies only to the contract with the prime contractor. Payments by the prime contractor to its subcontractors are not subject to the withholding.

Payments by Payment Administrators: The government entity is responsible for the required withholding and reporting even if a payment is made by a party acting as a payment agent of the government.

Advance and Interim Payments: Withholding and reporting apply when the funds are disbursed and not when the contract is settled or the services or property accepted.

Other Payment Issues: Generally, separately stated items such as fuel surcharges, late payment fees and shipping and handling are treated as part of the payment for property or services unless an exception applies. Additionally, a payee may agree to have withholding apply to a full payment even where a portion of the payment may be excepted from withholding. If a payment is offset, the withholding applies to the full amount of the payment prior to the offset.

Examples: Section 31.3402(t)-3(f) provides specific examples of payments subject to withholding.

PAYMENTS EXEMPTED FROM 3402(t) WITHHOLDING

Exempt Payees: Payments to other government entities, foreign governments, tax exempt organizations and tribal governments are exempt. Pass-through entities that are 80 percent or more owned by the above entities are also exempt. Additionally, non-resident aliens and foreign corporations that receive certain payments are exempt.

Interest Payments: Interest payments generally defined by case law as compensation for the use or forbearance of money are exempt from 3402(t) withholding.

Payments for Real Property: Payment for the purchase or lease of real property are exempt from the three percent withholding but construction of buildings and other public works projects are not. Payments to a lessor required under the lease agreement for utilities or insurance are **not** subject to 3402(t) withholding; however, payments to third parties (even if it is required by the lease) are subject

to the withholding. Payments for construction are subject to the 3402(t) withholding regardless if the construction is required by lease or paid to the lessor.

Payments Subject to Other Withholding: Payments subject to another withholding in Chapter 3 or 24 of the Internal Revenue Code are exempt. This would include backup withholding and other voluntary withholdings. Voluntary withholdings are exempt regardless of whether the payee elects to withhold.

Payments Pursuant to Classified or Confidential Contract: Payments pursuant to a classified or confidential contract as defined in 6050M(e)(3) are exempt. A classified or confidential contract **under** 6050M(e)(3) is a contract between a federal executive agency and another person if:

- (A) the fact of the existence of such contract or the subject matter of such contract has been designated and clearly marked or clearly represented, pursuant to the provisions of federal law or an Executive order, as requiring a specific degree of protection against unauthorized disclosure for reasons of national security; or
- (B) the head of such federal executive agency (or his designee) pursuant to regulations issued by such agency determines, in writing, that filing the required return under this section would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity.

Payments in Connection with a Public Welfare or Public Assistance Plan: Payments made in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test are exempt from 3402(t) withholding. Programs based solely on age are not exempt. The exception applies to payments made to third parties for the benefit of the recipient.

Payments Made to a Government Employee for Services as an Employee: Any form of compensation to a government employee for service as an employee is exempt from section 3402(t) withholding. Examples of such compensation could include employer and employee contributions to an employee benefit and deferred compensation plan, employer-provided fringe benefits and employer payments under the Federal Employees Health Benefits Program. Reimbursement of employee travel expenses is an exempt payment; however, instances where a government entity pays a provider directly for employee travel expenses are not exempt from withholding.

Grants: Grant funds are explicitly exempt from withholding and are defined as:

- a transfer of funds by a government entity to a recipient pursuant to an agreement reflecting a relationship between the government entity and the recipient (includes state and local government) when:
 - the principal purpose of the relationship is to transfer a thing of value to the recipient to carry out a public purpose of support or stimulation authorized by law instead of acquiring property or services for the direct benefit or use of the government entity; and
 - substantial involvement is not expected between the government entity and the recipient when carrying out the activity contemplated in the agreement.

The exclusion does not apply to use of proceeds of a grant by a government entity unless the proceeds of the grant are used to make a grant (i.e., the state receives a grant and then sub-grants the funds).

Sales, Excise and Value Added Tax: The entire amount paid for property or services is subject to 3402(t) withholding. Therefore, the required withholding and reporting includes the amount of any sales, excise or value added tax. A government may choose, however, to exclude the amount of any sales, excise or value added tax so long as it is applied consistently.

Loan Guarantees: Government entity payments of principal and interest on a loan pursuant to a loan guarantee are not subject to 3402(t) withholding.

Debt Repayment and Stock and Bond Purchases: Repayments of principal on a loan are not subject to 3402(t) withholding. However, if the government entity issues a debt obligation to a person providing services as part of the purchase price, the debt's fair market value is subject to withholding at the time the obligation becomes effective. If the debt is issued to a person providing property as part of the purchase price, the debt's issue price **could** be subject to withholding. (See final regulations for more specifics.)

Payments to purchase stock, bonds and negotiable instruments are exempt from 3402(t) withholding; however, the payment of investment advisory fees are not.

Pass Through Entities: Generally, payments from pass through entities are not subject to 3402(t) withholding unless 80 percent or more of the entity is owned by the government entity that is required to withhold. The final regulations provide more detail on payments to a partnership owned by a foreign corporation or nonresident alien.

Additional Rules for Exempt Payees and Payments:

The IRS may provide additional exceptions for which the IRS determines the withholding would impede a government's ability to respond to an emergency, disaster or other hardship.

The IRS Commissioner is also authorized to provide rules and procedures concerning payments exempt from 3402(t) withholding including classification of additional types of payees or payments exempt from withholding. See Section 31.3402(t)-4(s).

DEPOSITS AND REPORTING

Amounts withheld under 3402(t) must be deposited and reported in the same manner as other non-payroll withheld amounts, such as withholding on gambling winnings and pensions. Form 945 - Annual Return of Withheld Federal Income Tax should be utilized. Amounts under 3402(t) are to be treated as employment taxes for purposes of the deposit rules but are subject to special rules for the deposit schedule. Amounts withheld must be reported on a Form 1099- Misc with a copy of the information provided to the payee.

Crediting of Amounts Withheld: The amount withheld during any calendar year is allowed as a credit against income tax for the taxable year beginning in such calendar year.

Correction Errors and Liability: Payments to any person for property or services that are subject to withholding are treated as if the payments were wages paid by an employer to an employee. Therefore, a government entity will be liable if it fails to withhold unless it can be demonstrated that the contractor reported and paid the tax.

Generally, the rules for underpayments and overpayments of income tax withholding are the same as those applicable to wages. Amounts withheld under section 3402(t) are reported on Form 945. See regulations for details on how to account for under and over withholding.

The \$10,000 payment threshold applies to the actual payment even in that payment amount was in error.

Transition Rule: Government entities will not be liable for interest and penalties for failure to withhold on payments for property or services made before January 1, 2014, if the entity made a good faith effort to comply. Government entities are not, however, relieved from liability for the amount of taxes that should have been withheld.

*Select text found in this summary is taken directly from the final regulation 31.3402(t).