

New FAQs explain 3% withholding rule for government payments to contractors

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IRS FAQs on Section 3402(t) Withholding

IRS has issued additional guidance, in the form of frequently asked questions (FAQs), on the Code Sec. 3402(t) requirement for government entities to withhold 3% from nearly all contract payments made to persons providing them with property or services. The FAQs explain the nuts-and-bolts of the withholding requirement, such as which payments are and aren't subject to withholding, and how withholding applies to contract hold-backs.

Observation: The Code Sec. 3402(t) withholding requirement has come under heavy fire from industry groups who fear it will impose expensive compliance burdens both on businesses and on governments large and small.

Background. Code Sec. 3402(t) provides that, once effective, the federal government and the government of every state, political subdivision of a state, and instrumentality of a state or state subdivision (including multi-state agencies) making certain payments to a person providing any property or services (e.g., payments from a political subdivision to a government contractor) will have to deduct and withhold tax from that payment in an amount equal to 3% of the payment. The withholding requirement will also apply to a payment made in connection with a government voucher or certificate program that functions as a payment for property or services. (Code Sec. 3402(t)(1)) Payments subject to withholding under this rule will also be subject to information reporting requirements. (Code Sec. 3402(t)(3))

Under final regs, the withholding obligation generally will apply to payments made after Dec. 31, 2012 (see Federal Taxes Weekly Alert 05/12/2011).

Withholding under the above rules won't apply to any payment: (1) except as provided at (2), below, that's subject to withholding under any other provision of Chapter 3 (dealing with withholding on nonresident aliens and foreign corporations), or Chapter 24 (dealing with collection of income tax at source on wages); (2) that's subject to backup withholding under Code Sec. 3406 and from which amounts are being withheld under that section; (3) of interest; (4) for real property; (5) to any governmental entity subject to these withholding rules (i.e., intra-governmental payments), any tax-exempt entity, or any foreign government; (6) made under a classified or confidential contract described in Code Sec. 6050M(e)(3); (7) made by a political subdivision of a state (or any state instrumentality) that makes less than \$100 million of these payments annually; (8) that's made in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test; or (9) to any government employee that is not otherwise excludable from these withholding rules with respect to his services as an employee. (Code Sec. 3402(t)(2); Notice 2008-38, 2008-13 IRB 683)

The withholding requirement won't apply to any payment that's less than a threshold amount of \$10,000. (Reg. § 31.3402(t)-3(b)(1)) And in Notice 2010-91, 2010-52 IRB, IRS said that the Code Sec. 3402(t) requirement will not apply to payments made by payment cards—including credit cards, debit cards, and stored value cards—for any calendar year beginning earlier than at least 18 months from the date further guidance is finalized on Code Sec. 3402(t) withholding for payment card payments.

Payments subject to or exempt from withholding. IRS's new FAQs address the following issues related to payments subject to or exempt from the Code Sec. 3402(t) rules:

- Payments of interest, including payments of late payment interest, are excluded from Code Sec. 3402(t) withholding. However, amounts paid as late payment penalties that are not interest are subject to withholding. IRS says that whether a specific payment represents interest or a penalty that is not interest must be determined under the particular facts and circumstances. (FAQ 3)
- Although amounts paid for sales, excise, or value-added taxes generally are included in the amount subject to withholding, government entities may exclude the amount of any sales, value-added, or excise tax from withholding, provided that the exclusion is applied consistently to all payments to a given payee during the calendar year. (FAQ 4)
- Payments made to providers of medical services under Medicare provider agreements may be subject to Code Sec. 3402(t) , but reimbursements to individual healthcare recipients for Medicare expenses are excluded. (FAQ 5)
- An arrangement for the acquisition or use of an easement related to real property, or water rights related to real property, generally will be treated as an exempted purchase or lease of real property and a result won't be subject to Code Sec. 3402(t) withholding. (FAQ 6)

Withholding where portion of payment is held back. The amount to withhold, and the application of the \$10,000 payment threshold, are determined on a payment-by-payment basis and are based on the actual amount paid to a contractor. Thus, any amount of retainage (i.e., a hold-back of part of the payment as security to ensure contract completion), is excluded, regardless of the purpose of the payment or its relationship to other payments to that payee. If and when the retainage is paid to the contractor, Code Sec. 3402(t) withholding and the application of the \$10,000 payment threshold applies separately to that payment. However, if payments are divided for the primary purpose of avoiding withholding, they will be treated as one payment for purposes of applying the \$10,000 payment threshold. (FAQ 9)

Withholding on payments to passthroughs. IRS says Code Sec. 3402(t) withholding is required with respect to non-exempted payments to a passthrough entity (unless the entity itself is exempt because it is at least 80% owned by Indian tribal governments,

foreign governments, tax exempt organizations, or other government entities). IRS says it is currently are working on guidance that will address how the owners of a passthrough entity such as a partnership or S corporation will claim the credit for their allocation of any amount withheld under Code Sec. 3402(t) from a payment to the passthrough entity. (FAQ 14)

Other guidance. IRS says that the types of payments exempt from Code Sec. 3402(t) withholding should not be counted towards the \$100 million exemption threshold (FAQ 1). It also explains that the term “instrumentality” for purposes of Code Sec. 3402(t) withholding is to be determined based on the six-factor test carried in Rev Rul 57-128, 1957-1 CB 311. (FAQ 2) The FAQs also explain other reporting and deposit details.