

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[TD 9524]

RIN 1545-BG45

Extension of Withholding to Certain Payments Made by Government Entities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to withholding by government entities. These regulations reflect changes in the law made by the Tax Increase Prevention and Reconciliation Act of 2005 that require Federal, State, and local government entities to withhold income tax when making payments to persons providing property or services. These regulations affect Federal, State, and local government entities that will be required to withhold and report tax from payments to persons providing property or services and also affect the persons receiving payments for property or services from the government entities.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §§31.3402(t)-1(d), 31.3402(t)-2(i), 31.3402(t)-3(g), 31.3402(t)-4(u), 31.3402(t)-5(e), 31.3402(t)-6(d), 31.3402(t)-7(b), 31.3406(g)-2(i), 31.6011(a)-4(d), 31.6051-5(g), 31.6071(a)-1(g), 31.6302-1(n), and 31.6302-4(e).

FOR FURTHER INFORMATION CONTACT: A. G. Kelley, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## **Background**

This document contains amendments to 26 CFR Part 31 under section 3402(t) of the Internal Revenue Code (Code). This document also contains amendments to 26 CFR Part 31 under sections 3406, 6011, 6051, 6071, and 6302 of the Code.

Section 3402(t) of the Code was added by section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109-222 (TIPRA), 120 Stat. 345, which was enacted into law on May 17, 2006. Section 3402(t)(1) provides that the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services (including any payment made in connection with a government voucher or certificate program which functions as a payment for property or services) shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment. Section 3402(t)(2) provides exceptions to withholding under section 3402(t).

Proposed regulations under sections 3402(t), 3406, 6011, 6051, 6071, and 6302 of the Code were published in the **Federal Register** on December 5, 2008 (REG-158747-06, 73 FR 74082, 2009-4 IRB 362).

After the issuance of the proposed regulations, section 1511 of the American Recovery and Reinvestment Act of 2009, Public Law 111-5 (ARRA), 123 Stat. 115, 355, extended the effective date of section 3402(t) withholding to payments made after

December 31, 2011.

Notice 2010-91, 2010-52 IRB 915, provided interim guidance on the application of section 3402(t) to payments by debit cards, credit cards, stored value cards, and other payment cards.

Written comments were received in response to the proposed regulations, and a public hearing was held on April 16, 2009. All comments are available at [www.regulations.gov](http://www.regulations.gov) or upon request. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision.

### **Summary of Comments and Explanation of Provisions**

The Treasury Department and the IRS received numerous comments in response to the proposed regulations, all of which were considered in formulating the final regulations. Commenters generally expressed concerns about the administrative burdens of compliance and the revenue effect on persons subject to section 3402(t) withholding. The final regulations are intended to balance the legislative intent to construct a withholding and reporting regime for payments by government entities for property and services (other than those specifically excepted under section 3402(t)(2)) with the goal of alleviating administrative burdens on both government entities required to withhold and persons receiving payments subject to withholding where appropriate.

As discussed in section IX of the preamble, these final regulations provide an additional one-year extension from the revised statutory effective date of payments made after December 31, 2011. Thus, under the final regulations, section 3402(t) withholding and reporting requirements apply to payments made after December 31, 2012, subject to an exception for payments made under contracts existing on December

31, 2012, that are not materially modified (but see section IX of this preamble for discussion of accompanying proposed regulations that would apply section 3402(t) withholding and reporting requirements to payments made under all contracts after December 31, 2013, regardless of whether the contract was existing on December 31, 2012, and had not been materially modified).

I. Government Entities Subject to Section 3402(t)

A. Exception for political subdivisions and instrumentalities making total payments under \$100,000,000 (section 3402(t)(2)(G))

Section 3402(t)(2)(G) provides that section 3402(t) withholding does not apply to payments by a political subdivision of a State (or any instrumentality of that political subdivision) that makes less than \$100,000,000 of payments for property or services annually (other than for payroll or of another type exempt from withholding under the regulations). Consistent with the proposed regulations, the final regulations provide as a general rule that eligibility for the exception for each calendar year is determined based on payments made during the accounting year ending with or within the second preceding calendar year. All payments for property and services during that accounting year, including payments that are less than the \$10,000 payment threshold, must be considered except payments qualifying for any of the exceptions under §31.3402(t)-4(a) through (q) of the final regulations (for example, payments to the employees of the government entity that are subject to income tax withholding and thus excludable under §31.3402(t)-4(a) (such as salary payments) and payments to employees of the government entity with respect to their services as an employee that are excludable under §31.3402(t)-4(i) (such as payments of nontaxable fringe benefits)).

Commenters stated that if the political subdivision's or instrumentality's yearly payments generally are near \$100,000,000, but do not always equal or exceed \$100,000,000, the entity could incur considerable expense and difficulty administering withholding in some years but not in others. In addition, providing for withholding in contracts would be problematic and uncertain. Other commenters noted that due to substantial unusual capital spending, a political subdivision or instrumentality could exceed the \$100,000,000 threshold in one year, even though the entity usually makes annual total payments well below the threshold. The burden of applying section 3402(t) withholding for a single year because of one year of unusual spending could be considerable.

In response to these comments, the final regulations provide an optional rule under which a political subdivision or instrumentality may average the payments made during any four of the five consecutive accounting years ending with the accounting year that ends with or within the second preceding calendar year. An entity applying this optional rule must keep adequate records for each of the five years for the period of limitations for assessment applicable to the calendar year for which it claimed the exception. This rule is intended to provide a reasonable alternative method of determining expenditures for a political subdivision or instrumentality with an unusually high year of expenditures.

This optional rule will give greater predictability for future years and will allow political subdivisions and their instrumentalities to moderate the effect of unusual years of expenditures. The entity may apply the optional rule at its discretion for any given taxable year and is not required to file a form or otherwise indicate to the IRS that it is

using the optional rule. Additionally, under the final regulations, if a political subdivision or instrumentality withholds under section 3402(t), pays (or deposits) the withheld tax, and reports this withholding on payments in any calendar year for which it does not qualify for the section 3402(t)(2)(G) exception under the general rule, but could have qualified under the optional rule, it will be deemed to have waived any right to use the optional rule for that year. Thus, an affected entity should decide before the beginning of the calendar year whether it will rely on the optional rule for that year.

One commenter requested a similar exception for Federal Government entities and State entities with total annual payments of less than \$100,000,000. By its terms, section 3402(t)(2)(G) does not apply to the United States Government, States, or instrumentalities of the United States Government or States. Therefore, this comment was not adopted.

**B. Determining whether an organization is an instrumentality**

The proposed regulations requested comments on how to determine whether an organization is an instrumentality of a government entity. Commenters did not request a definition. The final regulations do not define the term instrumentality, but reserve the issue for future guidance. See §31.3402(t)-2(e). Although the Code contains multiple references to government instrumentalities, neither the Code nor the regulations define the term instrumentality. Several revenue rulings provide guidance on determining whether an organization will be treated as an instrumentality of a government entity for purposes of other Code provisions. See Rev. Rul. 57-128, 1957-1 CB 311 (adopting a six-factor test for use in determining what is an instrumentality of a State or a political subdivision thereof for purposes of an exception from the requirement to pay tax under

the Federal Insurance Contributions Act (FICA)); Rev. Rul. 65-26, 1965-1 CB 444; Rev. Rul. 65-196, 1965-2 CB 388; and Rev. Rul. 69-453, 1969-2 CB 182. These rulings may be applied by analogy to determine whether an entity is an instrumentality for purposes of section 3402(t) withholding until final guidance is issued defining the term instrumentality for purposes of section 3402(t). See §601.601(d)(2)(ii)(b).

## II. Payments Subject to Section 3402(t) Withholding

### A. Payments by credit card or other payment card

The final regulations reserve for future guidance the issue of the potential application of section 3402(t) withholding to payment card transactions (including payments by credit, debit, stored value, and other payment cards). See Notice 2010-91 and §31.3402(t)-3(e). The Treasury Department and the IRS continue to study whether payments by payment card should be subject to section 3402(t) withholding and, if so, in what manner the withholding should apply. As provided in Notice 2010-91, the section 3402(t) withholding requirements and the related reporting requirements will not apply to any payment made by payment card for any calendar year beginning earlier than at least 18 months from the date further guidance is finalized applying section 3402(t) withholding to payments by payment card. This relief does not apply to convenience checks issued in connection with payment card accounts.

### B. The \$10,000 payment threshold

Consistent with the proposed regulations, the final regulations provide that a payment subject to withholding arises when the government entity or its payment administrator pays a person for providing property or services. The final regulations adopt the rule in the proposed regulations that withholding will not apply to any payment

that is less than \$10,000 (subject to the anti-abuse rule described in section II.B.3 of this preamble).

#### 1. Amount of Payment Threshold

Commenters generally approved of the concept of a threshold, and many commenters approved of the proposed \$10,000 threshold level. However, numerous commenters requested that the threshold be raised, and some commenters requested that the threshold be adjusted each year based on changes in the cost of living.

The final regulations adopt the payment threshold of \$10,000, which corresponds to a minimum withholding of \$300. This \$10,000 threshold level strikes a reasonable balance between alleviating administrative burdens and preserving the legislative intent that the withholding requirement apply broadly. The final regulations do not adopt an annual cost-of-living adjustment to the threshold. Computer processing and transaction systems are becoming increasingly cost-effective so that increasing the threshold annually is not warranted.

#### 2. Application of the Payment Threshold to Individual Payments

Some commenters requested that the payment threshold apply cumulatively rather than to individual payments. Under this suggestion, section 3402(t) withholding would begin to apply when the payee receives payments totaling \$10,000 in the aggregate from the government entity during the calendar year, and then apply to all subsequent payments to the payee during the remainder of the year. The final regulations do not adopt this suggestion. As other commenters noted, one section or division of a government entity may not be able to coordinate its billing with another section's or division's billing on a real-time basis. Thus, a requirement to withhold

immediately upon reaching an annual minimum payment threshold would require the establishment of new systems to track and coordinate payments.

### 3. Application of the Payment Threshold to Multiple Payments to the Same Recipient

The \$10,000 threshold applies on a payment-by-payment basis; therefore, if a government entity makes a single payment of \$10,000 or more for multiple items of property or services, the entity must withhold on the payment. For example, if a person 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.

Consistent with the proposed regulations, the final regulations provide that multiple payments by a government entity to a payee generally will not be aggregated in applying the \$10,000 threshold. The final regulations also adopt the anti-abuse rule in the proposed regulations providing that if a payment is divided into multiple payments primarily to avoid the payment threshold, the payments will be treated as a single payment made on the date of the first payment for purposes of applying the threshold. For example, if a government entity is scheduled to make a contractual payment for landscaping services of \$15,000 on July 2, 2013, but divides the payment into payments of \$7,000 and \$8,000 on July 1, 2013, and July 2, 2013, respectively, to avoid withholding, the government entity will be treated as having made a single payment of \$15,000 on July 1, 2013. This anti-abuse rule will not apply if the primary reason for making multiple payments is unrelated to section 3402(t).

Some commenters expressed concerns about the anti-abuse rule. Some argued that it was too subjective and would lead to conflicts between government entities and

payees. Commenters noted that in many cases, the payee controls the billing and the government entity cannot determine whether the payee manipulated the billing to avoid the threshold or engaged in a normal business practice. Commenters also requested guidance on which entity (the payor or the payee) determines whether the anti-abuse rule applies. Commenters asserted that theoretically every payment below \$10,000 will need to be examined to determine whether the anti-abuse rule applies.

An anti-abuse rule is necessary because the parties could potentially avoid the threshold by manipulating the amount of each payment. Because the government entity is responsible for withholding and may not have sufficient information regarding the payee's billing process, the final regulations provide that the anti-abuse rule applies only if the government entity knew or should have known that the payment had been divided (whether by the government entity or as a result of divided billing) with the primary purpose of avoiding the withholding requirements. The final regulations further provide that in determining whether the anti-abuse rule applies, a significant factor is whether the government entity has exhibited a pattern or practice of intentionally dividing payments (or intentionally permitting divided billing) to avoid withholding. Thus, the anti-abuse rule is intended to apply only in a limited number of cases.

Additionally, the final regulations permit a government entity and a person providing services or property to that government entity to contractually agree that the government entity will or may withhold in accordance with the rules governing withholding under section 3402(t), on specified payments not subject to section 3402(t) withholding, including payments below \$10,000. Therefore, the parties could contractually agree to permit the government entity to apply, in its discretion as it

deemed appropriate, the anti-abuse rule. This type of contractual provision would enable the parties to avoid disputes about whether the anti-abuse rule applies. This provision in the final regulations permitting additional withholding does not apply to payments already subject to section 3402(t) withholding notwithstanding the contractual provision, including amounts subject to section 3402(t) withholding solely due to the anti-abuse rule.

#### 4. Application of the Payment Threshold to a Single Payment Covering Multiple Billing Items

Commenters objected to applying the threshold to the payment amount where the government entity chooses for its convenience to make one payment for different “unrelated transactions” (which they termed “bundling” the payment), causing the payment to meet the \$10,000 threshold. Commenters suggested that if a single payment covers more than one “unrelated” transaction, the threshold should apply separately to each transaction, invoice, or billing item, rather than to the full payment amount. According to these commenters, applying the threshold to bundled payments makes the threshold difficult to program into accounts payable systems because the threshold amount cannot be applied at the time of the transaction but only at the time the payment is processed.

The final regulations adopt the proposed rule applying the threshold on a payment-by-payment basis rather than a billing item basis. A billing item approach would require formulating a method for identifying a billing item or a similar term, which may not be easily identifiable in every case. As a result, disputes would likely arise about the number and amount of valid billing items, raising both compliance issues for

government entities and enforcement issues for the IRS. A billing item approach also would require the government entity to maintain records of the items covered by a particular payment, and the supporting documentation justifying the separate billing item treatment, increasing the administrative burden. This approach could also facilitate abuse by parties seeking to avoid the threshold by dividing billing items.

C. Payments to contractors, subcontractors, and payment administrators

Consistent with the proposed regulations, the final regulations provide that, if a government entity or its payment administrator makes a payment to a person that is subject to section 3402(t) withholding, no subsequent transfer of cash or property by that person to another person is treated as a payment for section 3402(t) purposes. Therefore, if the government entity contracts with a prime contractor for property and services, and that prime contractor separately contracts with subcontractors for delivery of certain property and services, section 3402(t) withholding applies only to payments by the government entity or its payment administrator to the prime contractor, and does not apply to successive payments by the prime contractor to its subcontractors.

Also consistent with the proposed regulations, the final regulations apply to payments made by the government entity or its payment administrator. A payment administrator is 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 to a person providing property or services to, or on behalf of, the government entity. The government entity is liable for the required withholding and responsible for all related reporting regardless of whether the government entity or its payment administrator makes the payment. Transfers of funds from a government entity to a payment

administrator to be used by the payment administrator, on the government entity's behalf, to pay persons for providing property or services are not payments subject to section 3402(t) withholding. However, if the government entity pays the payment administrator a fee for its services, the fee is a payment subject to withholding.

Many commenters requested additional guidance on the application of section 3402(t) to prime contractors, subcontractors, and payment administrators to specific factual situations. The final regulations adopt the rules in proposed regulations without change. These rules provide general guidance that can be applied to various specific situations and it is not practicable to describe all those situations explicitly in the regulations. However, the Treasury Department and the IRS may issue other forms of guidance in the future if it is determined that such guidance is necessary to assist with particularly problematic situations.

#### D. Advance and interim payments

Commenters requested guidance on whether section 3402(t) withholding applies to any of the following payments that are made before the final delivery and acceptance of service by the government entity: contract financing payments, performance-based payments, commercial advance payments, interim payments, progress payments based on cost, progress payments based on a percentage or stage of completion, or interim payments under a cost-reimbursement contract. Commenters requested exceptions for these types of payments because withholding would detrimentally affect the cash flows of contractors and could result in price increases for government contracts.

Commenters also argued that in some cases withholding is unnecessary because amounts are already withheld from contract payments until the completion of a contract.

Finally, commenters suggested that government entities are protected from loss through other provisions such as the Miller Act (40 USC 3131-3134, discussed in greater detail in section IV.E.1 of this preamble).

Commenters specifically requested that section 3402(t) withholding apply to contract financing payments on the date the government entity accepts the services or property provided under the contract. Under Federal Acquisition Regulations (FAR), a contractor is not entitled to liquidate contract financing payments until the government entity has accepted the property or services. On this basis, a commenter asserted that contract financing payments are not payments for property or services until the contract is settled and the property or services are “accepted” by the government entity. The commenter maintained that the payment date for section 3402(t) purposes should be the acceptance date because interest under the Prompt Payment Act (31 USC 3903) for late payments under a contract does not begin to run until the acceptance date.

The final regulations do not adopt these suggestions. Treating the acceptance date as the payment date would add administrative complexity to section 3402(t) withholding, as would any attempt to distinguish between payments in advance of performance by the contractor, interim payments for partial performance, and other designated payments for property or services. Treating the date the funds are disbursed as the payment date ensures that there will be funds upon which to withhold. For these reasons, the final regulations provide that payment is made and withholding applies when the funds are disbursed and not when the contract is settled and the services or property accepted.

#### E. Utility payments

The proposed regulations provided that, unless otherwise excepted, utility payments are subject to section 3402(t) withholding on the same basis as payments for other property and services. Commenters requested that utility payments be exempted from the withholding requirement on the ground that utilities are already subject to regulation and that government entities might lose utility services if forced to withhold on payment of the utility bill.

There is no statutory exception for utility payments. In addition, all persons receiving payments subject to section 3402(t) withholding, including utility companies, are paid the full amount charged, albeit in the form of a combination of a cash payment and a deposit of tax made to the IRS. Thus, unless otherwise excepted, utility payments are subject to section 3402(t) withholding.

#### F. Other payments

Commenters requested exemptions from withholding or lower rates of withholding based on a particular industry's profit margin or a particular payee's expectation that it will not have any income tax liability (because, for example, the payee had net operating losses). Commenters also requested exemptions for payees that are current in their Federal tax payments. The final regulations do not adopt these suggestions because differing rates for differing industries or taxpayers are not contemplated by the statute and would raise administrative complexities.

In addition, many commenters requested guidance on whether certain types of payments or designated portions of payments are payments for property or services subject to section 3402(t) withholding. The final regulations do not adopt most of these suggestions because the general rules provide sufficient guidance. For example,

commenters requested guidance on certain amounts that typically are part of a payment for a specific service or property, but generally are stated separately in invoices to government entities, such as fuel surcharges. The final regulations do not except separately stated costs (other than the optional rule permitting sales, excise, and value-added taxes to be excepted from the amount subject to section 3402(t) withholding). In general, separately stated items such as fuel surcharges are treated as part of the payment for property or services by the government entity, and therefore are subject to section 3402(t) withholding unless an exception applies. For example, the amount subject to withholding includes late payment fees (that are not interest) and shipping and handling costs in connection with the purchase of property that is subject to section 3402(t) withholding.

Commenters also requested guidance on determining the amount subject to withholding when a portion of one payment is subject to withholding, but the remainder of the payment is excepted from withholding. Commenters asserted that it would be difficult to identify which portion of the payment was excepted and to apply withholding only to the remainder. In response to these administrative concerns, the final regulations permit government entities to withhold on the full amount of a payment that combines an amount subject to withholding and an amount excepted from withholding, provided the payee has consented to this additional withholding.

Commenters requested guidance on determining the amount of withholding when a payment for property or services to a person is subject to offsets for the person's outstanding debt or other amounts owed to the government entity. Because there is no exclusion or other provision under section 3402(t) for offsets, the payment to

which the section 3402(t) withholding applies is not reduced by offsets. Rather, the amount of the payment subject to section 3402(t) withholding includes any portion of the payment that is offset to pay debt owed to the government entity or other offsets.

#### IV. Payments Excepted from the Section 3402(t) Withholding Requirements

##### A. Payments to certain exempt payees (section 3402(t)(2)(E))

Consistent with the proposed regulations, the final regulations except from section 3402(t) withholding payments to other government entities required to withhold, to foreign governments, and to tax-exempt organizations as provided in section 3402(t)(2)(E). A commenter asked whether the exception for payments to tax-exempt organizations extends to payments that are included in determining the organization's unrelated business income that is subject to income tax. A payment to a tax-exempt organization is excepted from section 3402(t) withholding regardless of whether it is treated as unrelated business income.

##### B. Payments to Indian tribal governments

Consistent with the proposed regulations, the final regulations exempt payments to Indian tribal governments. Because Indian tribal governments are not subject to United States income tax, subjecting payments made by government entities to Indian tribal governments to section 3402(t) withholding would be unduly burdensome. In response to comments, the final regulations also exempt payments to passthrough entities that are owned 80 percent or more by one or more persons each of which is an Indian tribal government or a person described in section 3402(t)(2)(E).

##### C. Identifying exempt payees

Commenters requested guidance on how to identify exempt payees. Exempt payees include: (1) government entities required to withhold under section 3402(t), foreign governments, tax-exempt organizations, and Indian tribal governments; (2) passthrough entities that are 80 percent or more owned by those types of entities; and (3) nonresident alien individuals and foreign corporations that receive certain types of payments (and partnerships that receive certain types of payments and that are 80 percent or more owned by nonresident alien individuals and foreign corporations). The Treasury Department and the IRS expect to issue additional guidance on how a payee can claim an exemption. The guidance is expected to provide that if the government entity receives a payee statement indicating under penalties of perjury that the payee qualifies for an exemption from section 3402(t) withholding and identifying the particular exemption, the entity will be able to rely on that statement unless it knew or had reason to know that the payee did not actually qualify for the exception. The guidance is also expected to provide that a government entity need not obtain a payee statement if the name of the payee reasonably indicates or the payor knows the payee to be a government entity (including an Indian tribal government) or foreign government. However, it is not anticipated that this "eyeball" test would apply to tax-exempt organizations, foreign corporations, nonresident alien individuals, or passthrough entities.

D. Payments of interest (section 3402(t)(2)(C))

Section 3402(t)(2)(C) excepts payments of interest from section 3402(t) withholding. Two commenters requested that a definition of interest be provided, and other commenters inquired whether certain specific types of payments are payments of

interest for purposes of this exception.

The Code and the regulations do not provide a general definition of interest. Rather, a definition of interest has arisen through case law. Generally, under long-standing case law, interest is compensation paid for the use or forbearance of money. See, for example, Old Colony R.R. Co. v. Commissioner, 284 U.S. 552 (1932), 1932-1 CB 274; Deputy v. DuPont, 308 U.S. 488 (1940), 1940-1 CB 118; see also Thompson v. Commissioner, 73 T.C. 878, 887 (1980) (interest is the charge per unit of time for the use of borrowed money); Dickman v. Commissioner, 465 U.S. 330, 337 (1984), 1984-1 CB 197 (interest is the equivalent of rent for the use of funds). The general standard, as developed through the case law, may be applied to particular facts and circumstances. Thus, the final regulations do not provide a definition of interest. However, the Treasury Department and the IRS continue to study whether any particular guidance with respect to the application of section 3402(t) to interest payments may assist taxpayers in complying with the section 3402(t) withholding and reporting requirements, and accordingly continue to reserve that section. See §31.3402(t)-4(c).

#### E. Payments for real property (section 3402(t)(2)(D))

##### 1. Construction Payments

Section 3402(t)(2)(D) excepts payments for real property from section 3402(t) withholding. Consistent with the proposed regulations, the final regulations provide that the term payments for real property includes payments for the purchase and the leasing of real property, but does not include payments for the construction of buildings or other public works projects, such as bridges or roads.

Commenters requested that payments for construction be treated as payments

for real property. One commenter interpreted 40 USC 3131-3134 (the “Miller Act”) as already protecting the Federal Government for taxes owed by the contractor. The commenter stated that the Miller Act mandates that the contractor provide a performance bond to protect the Government, and a separate payment and performance bond to protect all persons supplying labor and material in carrying out the work provided for in the contract. According to the commenter, the protection afforded by these bonds includes taxes due under the Code. See 40 USC 3131(c)(1).

The tax protection afforded by these bonds relates to employment taxes deducted from wages, not to income taxes which the contractor may owe. Therefore, these performance bonds do not protect against a contractor’s failure to pay its correct income tax liability, and the Miller Act does not provide the Federal Government protection for the contracting entity’s income tax liability.

Another commenter suggested that treating payments for construction as payments for real property would be consistent with other tax provisions, including section 460(e)(4) and §1.460-3(a) (defining the term construction contract for purposes of determining whether an exception from the required use of the percentage of completion method in determining taxable income applies), and §1.263A-8 (defining the term real property to include land, buildings, and inherently permanent structures, and the structural components of both buildings and inherently permanent structures for purposes of the requirement to capitalize interest under section 263A). Another commenter cited other Code sections and regulations, including: (1) section 469 (relating to passive activity losses and credits and providing that a “real property trade or business” includes “any real property development, redevelopment, construction,

reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business”); (2) section 856 (defining “interests in real property” to include “fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon”); and (3) §1.1031(a)-1(b) (relating to like-kind exchanges and providing that the fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class).

The final regulations do not adopt these suggestions. None of these authorities provides as a general rule that payments for construction are payments for real property. Moreover, the Code and regulations sections cited serve different purposes. The relevant distinction here is between payment for a completed building (a payment for real property), and payment for the services and materials used to construct a building (not a payment for real property). There is no evidence that Congress intended to exempt payments for construction. Additionally, an exemption for construction would substantially reduce the scope of payments subject to section 3402(t) withholding.

## 2. Lease Payments

The proposed regulations provided that the exemption for payments for real property extends to payments for the leasing of real property. A commenter asked whether payments for construction in leased buildings are treated as payments for real property if the government entity pays the person providing the property or services directly for facility improvements rather than the lessor. Commenters also asked whether payments to the lessor for services or property (such as for utilities or

insurance) or for services under the lease agreement (such as for utilities provided at the lessor's expense) are considered payments for the lease. In addition, commenters asked whether payments to third parties required by the lease agreement (such as payments for utilities and insurance) are considered payments for the lease.

The final regulations distinguish between payments to the lessor as part of the lease and payments to a third party. Payments to the lessor that are required under the lease agreement, such as payments for utilities or insurance, are payments for leasing, and are not subject to section 3402(t) withholding. In contrast, payments to third parties for services or property are subject to section 3402(t) withholding, even if required by the lease. Thus, under the final regulations, the lease terms generally govern whether payments for leasehold improvements and for services or property in connection with a lease are subject to section 3402(t) withholding. However, because of the potential to avoid the application of withholding to payments for construction by temporarily leasing before purchasing, rather than simply purchasing, the property on which the construction will occur, payments for construction are subject to section 3402(t) withholding even if required by a lease and paid to the lessor.

F. Payments subject to other withholding (section 3402(t)(2)(A) and (B))

Section 3402(t)(2)(A) excepts from section 3402(t) withholding amounts that are subject to withholding under another provision of chapter 3 or chapter 24 (other than section 3406). Commenters asked whether unpaid compensation paid to beneficiaries or the estates of deceased employees is subject to section 3402(t) withholding.

Although such amounts generally are not subject to wage withholding under section 3402(a) (see Rev. Rul. 86-109, 1986-2 CB 196), the final regulations provide that these

payments are excepted from section 3402(t) withholding under section 3402(t)(2)(I) as payments to an employee.

G. Payments made pursuant to a classified or confidential contract (section 3402(t)(2)(F)).

Section 3402(t)(2)(F) excepts payments made pursuant to a classified or confidential contract described in section 6050M(e)(3). Commenters asked whether this exception applies to other government operations not specifically covered by section 6050M(e)(3), recommending that the exception apply to any contract whose subject matter contains any scope of work subject to the National Industrial Security Program Operating Manual (NISPOM). Because of the express statutory language describing the confidential contracts to which the exception applies, the final regulations do not extend the exception beyond contracts described in section 6050M(e)(3).

H. Payments in connection with a public welfare or public assistance plan (section 3402(t)(2)(H)).

Section 3402(t)(2)(H) excepts from section 3402(t) withholding any payment in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test. Consistent with the proposed regulations, the final regulations adopt a broad definition of in connection with to include payments made to third parties under a public assistance or public welfare program for the benefit of the recipient of benefits under the program. Consistent with the legislative history, a program for which eligibility is determined under a needs or income test does not include a program under which eligibility is based on age only (for example, Medicare). For purposes of this exception, a program providing disaster relief to victims of a natural or other disaster is considered to be a program for which eligibility is determined under

a needs test.

Many commenters asked that the regulations address specific benefits under various plans. Questions about specific plans can be resolved by applying the statute and these final regulations, and special rules are not needed. However, the Treasury Department and the IRS may issue other guidance in the future, as necessary to address arrangements to which it is particularly difficult to determine the application of the statute and these final regulations.

Commenters asked how section 3402(t) applies when a government office or portion of a government office is used to administer a public welfare program. Commenters asked whether payments for expenses of that office (utilities, property insurance, maintenance) that are attributable to administering the public welfare program qualify as payments made in connection with a public welfare program under section 3402(t)(2)(H). The final regulations provide that government entities may determine the portion of any payment that is attributable to expenses to administer the public welfare program using any reasonable allocation method (including, for example, using prospective budget allocations). To ease administration, the final regulations also provide that, if a government entity makes a reasonable, good faith determination that only an insignificant portion of the government office's payments are attributable to administering a public welfare program (or to functions other than administering a public welfare program), that insignificant portion may be disregarded.

I. Payments to a government employee for services as an employee (section 3402(t)(2)(I))

Section 3402(t)(2)(I) excepts payments to a government employee for the employee's services as an employee. Consistent with the proposed regulations, the

final regulations interpret this exception broadly to exclude any form of compensation that is paid to the employee or on the employee's behalf. For example, the final regulations exclude employer and employee contributions to employee benefit and deferred compensation plans, employer-provided fringe benefits, and employer payments for insurance under the Federal Employees Health Benefits Program.

The final regulations further provide that, consistent with the proposed regulations, the section 3402(t)(2)(I) exception applies to payments to employees under an accountable plan for the employee's business travel expenses, and to payments made by the employee to providers of the employee's travel, meals, and lodging when the employee is traveling on government business and is reimbursed under the accountable plan. Payments to an employee made under a reimbursement or other expense allowance arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and are not wages if the arrangement meets the requirements of section 62(c) and the expenses are substantiated within a reasonable period of time. See §31.3401(a)-4(a). In contrast, payments to an employee under a nonaccountable plan are includible in wages subject to income tax withholding under section 3402(a), and thus are excepted from section 3402(t) withholding by section 3402(t)(2)(A).

Commenters requested that payments by a government entity to third party providers (and not to an employee) for employee travel and lodging also be excepted from section 3402(t) withholding, arguing that these payments are another way to pay for employee business travel expenses and should be excepted in the same manner as payments made under accountable plans. Commenters argued that applying

withholding in this instance will complicate the travel arrangement process, reduce the use of more efficient central billing accounts, and create unjustified discrepancies in travel expense reimbursements based on the employer method of payment.

The section 3402(t)(2)(I) exception by its terms applies only to payments to employees (or their successors in interest). If the government entity pays a provider directly for employee travel expenses, there is no payment from the government entity to the employee to invoke this exception. Payments to the provider by the government entity are payments for property and services, and therefore subject to section 3402(t) withholding unless another exception applies. The exception for employee fringe benefits does not apply where a payment is made directly to the provider because, while related to the provision of a fringe benefit to the employee, the payment itself is not a fringe benefit and is made to a third party rather than to the employee. However, payments made by payment card are excepted pending future guidance. See Notice 2010-91.

#### J. Grants

The proposed regulations did not provide an explicit exception for grant payments. Commenters requested that all grant payments be excluded from section 3402(t) withholding because they are “non-exchange” transactions in which the government entity is not making a payment for property or services for the direct benefit or use of the government entity. According to commenters, grant payments are distinguishable from payments in a transaction with a vendor in which a government entity is directly purchasing property or services for its own benefit or use.

Commenters also recommended that section 3402(t) withholding not apply to the use of grant funds by grant recipients that are complying with the grant eligibility and award process. One commenter cited the example of a city or county fire department that receives a grant from a government entity specifically for the purchase of an emergency response vehicle. If the purchase of an emergency response vehicle by the local fire department were subject to section 3402(t) withholding, the commenter maintained the withholding would divert federal grant money from the authorized acquisition use into the three percent withholding process.

In cases where the grant recipient is another government entity or a tax-exempt organization, the grant payment will be excepted from section 3402(t) withholding under section 3402(t)(2)(E). In addition, grant payments may qualify as payments made in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test, and thus be excepted from withholding under section 3402(t)(2)(H). Thus, it seems likely that many grant payments will qualify for these statutory exceptions.

In light of the administrative difficulty and potential frustration to the intended use of the grant proceeds that may arise, the final regulations explicitly except all grants from section 3402(t) withholding. For this purpose, the final regulations define a grant as a transfer of funds by a government entity to a recipient (which may be a state government, local government, or other recipient) pursuant to an agreement reflecting a relationship between the government entity and the recipient when (1) 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 (by

purchase, lease, or barter) property or services for the direct benefit or use of the government entity; and (2) substantial involvement is not expected between the government entity and the recipient when carrying out the activity contemplated in the agreement.

The exception from section 3402(t) withholding for grants does not apply to the distribution of grant proceeds by a government entity. Commenters' suggestions that grant proceeds be permanently excepted from withholding if the grant recipient is using the proceeds for the purposes specified in the grant is not supported by the statute and would be difficult to administer. Tracing would be required to determine which government entity purchases had been made with grant proceeds. Tracing would be particularly difficult if the grant agreement does not identify specific uses for the proceeds (for example, to purchase items necessary to improve emergency response time, which may include an additional emergency response vehicle) or if only a portion of a payment consists of grant proceeds. Accordingly, the final regulations do not adopt this suggestion.

#### K. Sales tax, excise tax, and value-added tax

Commenters requested guidance on whether the payment subject to withholding includes the amount of any sales tax, excise tax, or value-added tax. Sales taxes are generally paid by the purchaser, collected by the vendor, and remitted to the state. The sales tax amount generally is not included in the vendor's gross income.

By comparison, information reporting under section 6041 and related backup withholding under section 3406 apply only to payments that are includible in the payee's income. Therefore, if the payee is liable for sales tax and the payor includes the

amount of sales tax in the total payment to the payee, the payor includes the amount of sales tax on Form 1099-MISC, "Miscellaneous Income," as part of the reportable payment. In contrast, if (as is generally the case) the payor is liable for any sales tax and the payee merely collects sales tax from the payor, the payor does not include sales tax in the total amount reported on Form 1099-MISC.

A different reporting rule applies to reportable payment card transactions under section 6050W. Section 1.6050W-1(a)(6) provides that the gross amount reportable on Form 1099-K, "Merchant Card and Third Party Network Payments," is the total dollar amount of aggregate reportable payment transactions for each participating payee without regard to any adjustments for credit, cash equivalents, discount amounts, fees, refunded amount or any other amounts. Thus, the gross amount reported on Form 1099-K includes the amount of sales tax, excise tax, or value-added tax paid as part of a payment transaction.

Similar to reporting under section 6050W, but in contrast to reporting under section 6041, section 3402(t) withholding does not depend on whether an amount is includible in gross income. The entire amount paid for property or services is subject to withholding regardless of whether the vendor realizes a profit on transactions covered by the payments. Accordingly, the final regulations provide that the amount subject to withholding and reporting includes any sales, excise or value-added tax. However, the final regulations also permit government entities to exclude the amount of any sales, value-added, or excise tax, for purposes of section 3402(t) withholding, provided the exclusion is applied consistently to all payments to a given payee during the calendar year. This rule is similar to the rules permitting payors to exclude the amount of the

wager from gambling winnings for reporting and withholding purposes under §31.3406(g)-2(d)(2) or to exclude commissions and option premiums in determining gross proceeds from securities sales for reporting purposes under §1.6045-1(d)(5).

L. Loan guarantees

Commenters requested guidance on whether loan guarantees provided by government entities and payments on loan guarantees are subject to section 3402(t) withholding. The final regulations provide that the loan guarantee itself (meaning a guarantee provided by a government entity on a loan by a lender) is not a payment subject to section 3402(t). The underlying amounts are still loans and guaranteeing a loan or making a loan that is expected to be repaid through the payment of principal and interest is not a payment for property or services.

Payments of principal and interest by the government entity as guarantor of the loan so that the borrower can continue performing services under the contract are also not subject to withholding under section 3402(t). The government entity is making these payments as guarantor of the loan, and the payments are being made to the lender, not to a third party contractor that is performing services or transferring property. Thus, the final regulations provide that government entity payments of principal and interest on a loan pursuant to a loan guarantee are not subject to section 3402(t) withholding.

Under some circumstances, borrowers use the funds from guaranteed loans to fund a specific project. As part of a loan guarantee, the government has the right to assume the operation of the underlying project if the borrower ceases making payments on the loan. If the government entity (through a right of subrogation) assumes the

operation of the underlying project, the government entity as the operator of the project makes payments to the contractors providing services and property for the project. In that case, payments by the government entity to third party contractors are payments for property or services. Although the government exercised its right of subrogation pursuant to the loan guarantee or the underlying loan, and not as a party to the underlying contract between the borrower and the third party contractors, the government is stepping into the borrower's shoes and making payments for property or services directly to the third party contractors. Accordingly, the final regulations provide that section 3402(t) withholding applies in that case.

M. Debt repayments and stock and bond purchases

Commenters requested clarification that a government entity's repayments of principal on a loan are not subject to section 3402(t) withholding. Generally, repayments of principal on a loan will not be subject to section 3402(t) withholding because they are not payments for property or services. However, if a 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 section 3402(t) withholding when the obligation becomes effective, unless an exception applies. If a government entity issues a debt obligation to a person providing property as part of the purchase price, the debt's issue price as determined under section 1273 or 1274, as applicable, is subject to section 3402(t) withholding unless an exception applies (for example, the exception for payments for real property will apply to a debt obligation issued as part of a government entity's purchase of real property). For administrative convenience, the regulations allow the government entity and the person providing property to agree to

use the stated principal amount of the debt obligation in lieu of the issue price as the amount of the payment attributable to the debt obligation that is subject to section 3402(t) withholding. Thus, for example under these rules, if a government entity pays a person in 2013 for the performance of services with \$50,000 cash and a 5-year note valued at \$50,000, then the note's fair market value would be subject to section 3402(t) withholding in 2013 along with the cash payment, but the repayment of the principal after the note matured in 2018 would not be subject to section 3402(t) withholding. If a government entity uses a third party debt obligation (a debt obligation issued by another government entity or by an entity other than a government entity) to pay for property or services, the fair market value of the debt obligation is subject to section 3402(t) withholding, unless an exception applies.

The final regulations also except payments to purchase stock, bonds, and other negotiable instruments primarily for investment purposes. Although these payments are for intangible property, withholding on purchases in stock and bond markets is not practicable given the functioning of the investment markets in which buyers and sellers are paired on a virtually anonymous basis. However, a government entity's payment of investment advisory fees to investment advisors (including a payment from the government entity's account) is a payment for services subject to section 3402(t) withholding. In contrast, investment advisory fees paid, for example, by a mutual fund in which a government entity owns shares are not subject to section 3402(t) withholding, since these payments are not made by the government entity.

#### V. Application of Section 3402(t) to Passthrough Entities

The final regulations generally adopt the same basic rules as the proposed regulations on applying section 3402(t) where either the payor or the payee is a partnership or S corporation (a passthrough entity). Payments from a passthrough entity generally are not subject to section 3402(t) withholding unless 80 percent or more of the passthrough entity is owned in the aggregate by government entities required to withhold under section 3402(t)(1). Similarly, payments to a passthrough entity generally are subject to section 3402(t) withholding unless 80 percent or more of the passthrough entity is owned in the aggregate by persons described in section 3402(t)(2)(E) (government entities required to withhold under section 3402(t)(1), tax-exempt entities, and foreign governments) and Indian tribal governments. Expanding on the exceptions in the proposed regulations, the final regulations additionally provide that certain payments to a partnership that is 80 percent or more owned by foreign corporations or nonresident alien individuals are not subject to section 3402(t) withholding. This exception does not apply to S corporations because nonresident alien individuals and foreign corporations are not permissible shareholders of an S corporation under section 1361(b)(1). The regulations also provide that, as a general rule, whether a passthrough entity is subject to section 3402(t) is determined on the first day of the passthrough entity's taxable year. However, any manipulation of the ownership percentage with intent to avoid application of section 3402(t) will be recharacterized as appropriate to reflect the actual ownership percentage. Because the government entity is responsible for withholding and may not have sufficient information regarding the payee's ownership structure, the final regulations provide that this rule applies only if the government entity

knew or should have known that the payee's ownership percentage had been manipulated with intent to avoid application of section 3402(t).

Commenters requested that payments to all passthrough entities be excepted from section 3402(t) withholding. The final regulations do not adopt this suggestion. A passthrough entity exemption would create opportunities for payees to circumvent section 3402(t) by using passthrough entities to receive government payments.

#### VI. Deposits and Reporting of Amounts Withheld Under Section 3402(t)

The final regulations adopt the same reporting and payment rules for section 3402(t) withholding purposes as the proposed regulations. Final regulations under section 6011 provide that the payor required to withhold under section 3402(t) must file Form 945, "Annual Return of Withheld Federal Income Tax," reporting the amounts withheld. Final regulations under section 6302 provide that the amounts withheld under section 3402(t) must be deposited and reported in the same manner as other nonpayroll withheld amounts, such as withholding on gambling winnings and pensions. Pursuant to existing regulations, these amounts are treated as if they were employment taxes for purposes of the deposit rules, but are subject to special rules for determining the payor's deposit schedule. See §31.6302-4. Additionally, final regulations under section 6051 provide that payors required to withhold amounts under section 3402(t) must file information returns and furnish payee statements on Form 1099-MISC, "Miscellaneous Income" (or any successor form), reporting such payments and tax withheld. Because this reporting is pursuant to regulations under section 6051, the exceptions provided in the regulations under section 6041 relating to Form 1099 do not apply.

#### VII. Crediting of Amounts Withheld

## A. Credit against income tax

Commenters requested that the regulations permit fiscal year taxpayers to credit amounts withheld against their income tax liability for the fiscal year in which the tax is withheld. The final regulations do not adopt this suggestion because it is inconsistent with the statute. Section 31 governs the taxable year against which a taxpayer may credit income tax. Section 31(a)(1) provides that “[t]he amount withheld as tax under chapter 24 shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.” Chapter 24 includes section 3402(t), and section 31(a)(1) is in subtitle A, income taxes. Thus, by its terms, section 31(a)(1) applies to persons who have had income tax withheld from a payment pursuant to section 3402(t). Section 31(a)(2) provides the general rule on the timing of the allowance of the credit allowed under section 31(a)(1): “The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.” Thus, absent a special rule, section 31(a)(2) generally applies for purposes of withholdings required under chapter 24, which includes section 3402(t).

Section 31(c) provides a special rule solely for backup withholding. Under section 31(c), any credit allowed by section 31(a) for backup withholding under section 3406 must be allowed for the taxable year of the recipient of the income in which the income is received. Section 31(c) is limited by its terms to section 3406 withholding only, and thus does not apply to section 3402(t) withholding.

Practical considerations also support the section 31(a)(2) crediting rule.

Taxpayers generally will have received Forms 1099-MISC reporting the withholding prior to filing income tax returns crediting the income tax withheld, promoting accuracy in return filing.

B. Credit against estimated income tax liability

Commenters requested that taxpayers be permitted to credit the income tax withheld against the estimated tax liability for the specific tax quarter in which the income tax is withheld. However, the Code specifically provides that crediting for estimated tax purposes occurs in the taxable year in which the tax withheld may be taken as a credit against income tax liability. See sections 6654(g)(1) and 6655(g)(1)(B). Thus, the final regulations do not adopt this comment.

C. Credit against employment taxes or other taxes

Many commenters requested that taxpayers be permitted to credit their section 3402(t) withholding against employment taxes on wages or other taxes. The final regulations do not adopt this suggestion. Section 3402(t)(3) directs that crediting occur under the rules in section 31(a), which provides for crediting against income tax. As noted in the preamble to the proposed regulations, if a statute permits income tax payments to be treated as employment tax payments, or vice versa, it makes specific provision for that treatment. See, for example, section 3510(b) (providing that domestic employment taxes are treated as taxes due for estimated tax purposes under section 6654); and section 31(b) (providing for the crediting against income tax of the special refund of social security tax under section 6413(c) applicable when an employee receives wages from two or more employers in excess of the social security contribution

and benefit base). The Code does not provide for section 3402(t) withholding to be treated as payments of the taxpayer's employment tax liability. In addition, payments of income tax and employment taxes occur under different processes, using different forms, and are subject to different procedures for corrections of underpayments and overpayments, as well as different audit procedures and potential penalties. Therefore, the crediting of an amount withheld for income tax against an employment tax obligation is not administratively feasible.

D. Credits for amounts withheld on payments to passthrough entities

Amounts withheld on payments to passthrough entities are subject to the same crediting rules as payments made to other entities. Thus, a passthrough entity with a fiscal year may only claim the credit for its fiscal year beginning in the calendar year during which the amount was withheld pursuant to section 31(a)(2). The timing of when the owners of the passthrough entity take into account the credit would then be determined under the rules applicable to that type of passthrough entity (for example, section 706 for a partnership). Commenters specifically asked how the credit would be allocated by a partnership. This allocation is governed by the rules set forth in §1.704-1(b)(4)(ii), with appropriate adjustments under section 705.

VIII. Correction of Errors and Liability of Government Entity

Commenters requested clarification that a government entity is liable for tax that the entity was required to withhold under section 3402(t) but did not withhold, unless the entity can demonstrate that the payee has paid its income tax liability. Commenters also requested clarification of the rules applicable to corrections of overwithholding and

underwithholding, and guidance on the effect of repayments, underpayments, or overpayments for services or property on the determination of section 3402(t) liability.

A. Corrections of overwithholding and underwithholding

Section 3402(t)(3) provides that, for purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to Chapter 24, Collection of Income Tax at Source, 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. If a government entity fails to withhold the tax imposed by section 3402(t), section 3403 applies to determine the government entity's liability.

Section 3403 provides that the employer is liable for the payment of tax required to be deducted and withheld under Chapter 24, and is not liable to any person for the amount of that payment. Section 31.3403-1 of the Employment Tax Regulations provides that every employer required to deduct and withhold the tax under section 3402 from an employee's wages is liable for the payment of the tax whether or not the employer collects the tax from the employee. If the employer fails to withhold all or part of the amount required to be withheld, and thereafter the employee pays the tax, section 3402(d) provides that the tax will not be collected from the employer. Thus, for purposes of section 3402(t), the government entity generally will be liable if it fails to withhold unless under section 3402(d) it can demonstrate that the contractor reported the amount subject to section 3402(t) withholding on its return and paid the income tax due (which may include payment through an amended return or settlement of an audit).

Pursuant to section 3402(t)(3), the rules for adjustments of overpayments or underpayments of income tax withholding on wages also apply to section 3402(t)

withholding. See section 6413, §31.6413(a)-2(c)(1), and §31.6413(a)-1(b)(1)(i) (repayments and reimbursements to employees of overwithholding, and correction of overpayments of income tax withholding); section 6205 and §31.6205-1 (corrections of underpayments of income tax withholding). If an error is discovered before a return is filed, the payor must report on the return and pay to the IRS the correct amount of income tax withholding. Corrections of overwithholding or underwithholding of income tax before the return is filed are not adjustments, and a payor that discovers an error before a return is filed but does not report and pay the correct amount of tax to the IRS may not later correct the error through an adjustment.

For purposes of correcting overpayments of income tax withholding, a payor must repay or reimburse the overwithheld income tax to the payee in the same calendar year as the original payment in order to make an adjustment. The payor can then make that adjustment on its return at any time before the period of limitations on credit or refund under section 6511 expires for that calendar year. If the amount of the overwithheld income tax is not repaid or reimbursed to the payee in the same calendar year as the original payment, there is no overpayment to be adjusted; rather the amount withheld will be credited to the payee and subject to a potential tax refund. However, an adjustment may be made to correct an administrative error (that is, an inaccurate reporting of the amount actually withheld).

For purposes of correcting underpayments of income tax withholding, an adjustment can generally only be made in the same calendar year as the original payment. An exception to this general rule applies to corrections for administrative errors (that is, an inaccurate reporting of the amount actually withheld).

Pursuant to section 3402(t)(3), the rules for claims for refund of income tax withholding on wages also apply to section 3402(t) withholding. See section 6414 and §31.6414-1. Section 6414 permits refunds of income tax withholding only to the extent the amount of the overpayment was not actually deducted and withheld from the payee.

Amounts withheld under section 3402(t) are reported on an annual Form 945. Accordingly, any corrections of overwithholding or underwithholding during the calendar year are not adjustments; the government entity must report and pay to the IRS the correct amount of tax on Form 945. For example, if a government entity pays an amount subject to section 3402(t) withholding in error to a contractor and the contractor repays the net amount to the government entity within the same calendar year, the government entity should not report the amount and the related withholding on the annual Form 945 (that is, the government entity should report and pay the correct amount of tax on Form 945). Because the correction is made before the return is filed, the correction does not constitute an adjustment. The government entity may reduce its deposit of other withholding reportable on Form 945 for that calendar year to account for the deposit of section 3402(t) withholding on the amount repaid by the contractor. If the contractor repays the government entity an amount in a later calendar year, no adjustment can be made because an adjustment is permitted only in the case of an administrative error (an inaccurate reporting of the amount actually withheld) discovered after the filing of the Form 945. The contractor already received a credit for the amount withheld under the general rules for crediting income tax withholding.

Similarly, the government entity can collect underwithholding only during the same calendar year as the payment (except corrections made in the case of

administrative errors). If the underpayment is discovered in a later calendar year, the government entity is liable under section 3403 for any amount that should have been withheld, unless under section 3402(d) it can demonstrate that the contractor reported the amount subject to section 3402(t) withholding on its return and paid the income tax due (which may include payment through an amended return or settlement of an audit). The contractor is liable for any income tax due on any payment subject to withholding regardless of whether the government entity actually withholds any amount from the payment.

**B. Application of the \$10,000 threshold to corrections of erroneous payments**

The final regulations provide that the \$10,000 payment threshold applies to the actual payment made by the government entity, even if the amount of the actual payment is incorrect. For example, if an excessive payment is subject to section 3402(t) withholding, the subsequent repayment of all or a portion of the initial payment does not affect whether the \$10,000 threshold was met with respect to the initial payment. Any correction of income tax withholding applies only to the withholding on the amount repaid and not to the remaining portion of the original payment, even if that remaining portion is less than \$10,000. Similarly, if the payment was less than \$10,000 due to an insufficient payment to the payee, the \$10,000 threshold applies separately to the initial payment and the subsequent payment (to make up for the insufficient payment) unless the anti-abuse rule applies (that is, unless the payment was divided into two or more payments primarily to avoid the \$10,000 payment threshold).

**IX. Extension of Applicability Date and Transition Relief for Existing Contracts**

Numerous commenters indicated that an extended period of time following the

issuance of final regulations would be necessary for government entities to adopt the systems and processes necessary to comply with the § 3402(t) withholding and related reporting requirements. Noting the necessity to formulate government acquisition rules that are consistent with the final regulations, as well as the infrastructure needed to apply those rules, some commenters stated that government entities would need at least 18 months from the issuance of final regulations under section 3402(t) to be able to comply.

In response to these practical considerations, the final regulations provide that the withholding and reporting requirements under these regulations apply to payments made after December 31, 2012, subject to an existing contract exception. Thus, under the regulations, payments made under written binding contracts in effect on December 31, 2012, are not subject to section 3402(t) withholding, while payments made after December 31, 2012, under contracts entered into after December 31, 2012, are subject to section 3402(t) withholding unless otherwise excepted. In addition, if an existing contract is materially modified after December 31, 2012, the contract ceases to be an existing contract and payments under the contract become subject to section 3402(t) withholding. With respect to payments before January 1, 2013, government entities are not required to apply section 3402(t) withholding and the related reporting, and accordingly will not be subject to any liability, penalties or interest for failure to do so.

Commenters requested that the material modification rule be removed because of the difficulty in determining whether it applies. Commenters anticipated disputes between parties about what constitutes a material modification and questioned how such disputes would be resolved. Certain commenters also requested that a mere

contract renewal not be considered a material modification. Some commenters suggested that, in lieu of a material modification rule, withholding should apply to all contracts after a certain effective date, including those that have not been materially modified.

In response to these comments, at the same time that these final regulations are being issued, the IRS and the Treasury Department are proposing regulations to provide that the exception for payments made under existing contracts will not apply to payments made on or after January 1, 2014. See REG-151687-10. Thus, under these proposed regulations, payments on or after January 1, 2014, under all contracts (existing and new) would be subject to withholding under section 3402(t) unless an exception applies.

The final regulations retain the material modification rule but provide that a mere contract renewal will generally not be considered a material modification. For this purpose, a modification is not a material modification unless it materially affects either the payment terms of the contract or the services or property to be provided under the contract. Thus, for example, a change order (meaning a change in the specifications of a contract that the government entity is authorized to make under the contract without the contractor's consent) generally would not be a material modification unless the change materially affected the price or other payment terms, or the services or property to be provided. The final regulations also provide that modifying a contract to conform to changes in the applicable law is not a material modification.

Several commenters requested guidance on the application of section 3402(t) withholding to payments under Medicare provider agreements. Under the final

regulations, Medicare provider agreements in effect as of December 31, 2012, are existing contracts for purposes of the existing contract exception unless materially modified after December 31, 2012. Additionally, renewals of Medicare provider agreements will not be treated as material modifications to the extent the agreement is modified to conform to federal law. As with other existing contracts, the proposed regulations issued with these final regulations would provide that payments made by government entities on or after January 1, 2014, under both existing and new Medicare provider agreements will be subject to section 3402(t) withholding.

#### X. Transition Rule for Interest and Penalties on Underpayments

Consistent with the proposed regulations, the final regulations provide a transition rule for payments for property and services made before January 1, 2014. Under this rule, a government entity 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 with section 3402(t). However, this rule does not relieve the entity from liability for the amount of tax required to be withheld under section 3402(t).

#### **Effective/Applicability Date**

These regulations apply to payments made after December 31, 2012. In addition, the regulations will not apply to payments under a contract existing on December 31, 2012, unless the contract is materially modified after December 31, 2012.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not

required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal author of these final regulations is A. G. Kelley, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 31**

Employment taxes, Fishing vessels, Gambling, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 31 is amended as follows:

#### **PART 31--EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE**

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 □ □ □

Par. 2. Sections 31.3402(t)-0, 31.3402(t)-1, 31.3402(t)-2, 31.3402(t)-3, 31.3402(t)-4, 31.3402(t)-5, 31.3402(t)-6, and 31.3402(t)-7 are added to read as follows:

## **§31.3402(t)-0 Outline of the Government withholding regulations.**

This section lists paragraphs contained in §§31.3402(t)-1 through 31.3402(t)-7.

### **§31.3402(t)-1 Withholding requirement on certain payments made by government entities.**

- (a) In general.
- (b) Special rules.
- (c) Deposit and reporting requirements.
- (d) Effective/applicability date.

### **§31.3402(t)-2 Government entities required to withhold under section 3402(t).**

- (a) In general.
- (b) Government of the United States.
- (c) State.
- (d) Political Subdivision.
- (e) [Reserved].
- (f) Possessions of the United States.
- (g) Passthrough entities.
- (h) Small entity exception.
- (i) Effective/applicability date.

### **§31.3402(t)-3 Payments subject to withholding.**

- (a) In general.
- (b) Payment threshold of \$10,000.
- (c) No withholding on successive payments.
- (d) Payments made through a payment administrator or to a contractor.
- (e) [Reserved].
- (f) Examples.
- (g) Effective/applicability date.

### **§31.3402(t)-4 Certain payments excepted from withholding.**

- (a) Payments subject to withholding under chapter 3 or chapter 24 (other than section 3406).
- (b) Payments subject to withholding under section 3406 with backup withholding deducted.
- (c) [Reserved].
- (d) Payments for real property.
- (e) Payments to government entities, tax-exempt organizations, and foreign governments.
- (f) Payments made pursuant to a classified or confidential contract.
- (g) Exception for political subdivisions or instrumentalities thereof making less than \$100,000,000 of payments for property or services annually.
- (h) Payments made in connection with a public assistance or public welfare program.
- (i) Payments made to any government employee with respect to his or her services.
- (j) Payments received by nonresident alien individuals and foreign corporations.

- (k) Payments to Indian tribal governments.
- (l) Payments in emergency or disaster situations.
- (m) Grants.
- (n) Sales tax, excise tax, value-added tax, and other taxes.
- (o) Loan guarantees.
- (p) Debt.
- (q) Investment securities.
- (r) Partially exempt payments.
- (s) Determination of eligibility for exemption.
- (t) Withholding relief for 2012.
- (u) Effective/applicability date.

**§31.3402(t)-5 Application to passthrough entities.**

- (a) In general.
- (b) Definitions.
- (c) Payments from a passthrough entity.
- (d) Payments to a passthrough entity.
- (e) Effective/applicability date.

**§31.3402(t)-6 Crediting of tax withheld under section 3402(t).**

- (a) Crediting against income tax liability only.
- (b) Taxable year of credit.
- (c) Estimated tax.
- (d) Effective/applicability date.

**§31.3402(t)-7 Transition relief from interest and penalties.**

- (a) Good faith exception for interest and penalties on payments before January 1, 2014.
- (b) Effective/applicability date.

**§31.3402(t)-1 Withholding requirement on certain payments made by government entities.**

(a) In general. Except as provided in §§31.3402(t)-3(b) and 31.3402(t)-4, the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services must deduct and withhold from the payment a tax in an amount equal to 3 percent of such payment.

(b) Special rules. See §31.3402(t)-2 for government entities required to withhold under this section, §31.3402(t)-3 for what constitutes a payment to a person for property

or services and when such payment is deemed to occur for purposes of this section, and §31.3402(t)-4 for payments that are excepted from withholding under this section.

(c) Deposit and reporting requirements. See §31.6302-4 for deposit requirements with respect to withholding under section 3402(t). See §§31.6011(a)-4(b) and 31.6051-5 for the reporting requirements with respect to withholding under section 3402(t).

(d) Effective/applicability date. (1) Except as provided in paragraph (d)(2) of this section, this section applies to payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after December 31, 2012.

(2) Payments made under a written binding contract that was in effect on December 31, 2012, are not subject to the withholding requirements of this section. The preceding sentence does not apply to payments made under any contract that is materially modified after December 31, 2012. For this purpose, a material modification includes only a 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. Notwithstanding the foregoing, a material modification does not include a mere renewal of a contract that does not otherwise materially affect 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

material modification also does not include a modification to the contract to the extent required by applicable Federal, State or local law.

**§31.3402(t)-2 Government entities required to withhold under section 3402(t).**

(a) In general. The requirement to withhold under section 3402(t) and §31.3402(t)-1(a) applies to the Government of the United States (see paragraph (b) of this section) and every State (see paragraph (c) of this section), as well as instrumentalities of the foregoing. The requirement also applies to political subdivisions of every State (see paragraph (d) of this section) and their instrumentalities, unless the small entity exception of §31.3402(t)-4(g) applies.

(b) Government of the United States. The Government of the United States includes the legislative branch, the judicial branch, and the executive branch, and all components of the United States Government. Thus, departments and agencies are included within the definition of United States Government.

(c) State. The term State includes the District of Columbia. However, an Indian tribal government is not considered a State for purposes of section 3402(t) and §31.3402(t)-1(a). See section 7871(a).

(d) Political subdivision. The term political subdivision for purposes of section 3402(t) and §31.3402(t)-1(a) is defined as a political subdivision within the meaning of §1.103-1(b) of this chapter, except that a subdivision of an Indian tribal government is not considered a political subdivision. See section 7871(a) and (d).

(e) [Reserved].

(f) Possessions of the United States. For purposes of section 3402(t) and §31.3402(t)-1(a), the government of a possession or territory of the United States is not

treated as a government entity subject to the withholding requirements of section 3402(t)(1).

(g) Passthrough entities. See §31.3402(t)-5(c) for the treatment of payments from certain passthrough entities as subject to the withholding requirements of §31.3402(t)-1.

(h) Small entity exception. See §31.3402(t)-4(g) for the exception from the withholding requirements of §31.3402(t)-1 for political subdivisions and instrumentalities thereof making less than \$100,000,000 of payments for property or services annually.

(i) Effective/applicability date. This section applies to amounts paid on or after January 1, 2013.

### **§31.3402(t)-3 Payments subject to withholding.**

(a) In general. A payment is subject to withholding for purposes of §§31.3402(t)-1 through 31.3402(t)-7 when paid by a government entity to any person, as defined in §301.7701-6(a) of this chapter, for property or services. If, however, the government entity uses a payment administrator to pay a person for property or services, payment occurs when the payment administrator pays such person. The government entity subject to the withholding requirements of §31.3402(t)-1 is liable for the withholding required and responsible for all related reporting regardless of whether the government entity or its payment administrator makes the payment for property or services. For this purpose, if a government entity makes an advance payment, interim payment, financing payment, or similar payment, the amount is treated as paid by the government entity at the time the funds are disbursed, regardless of whether the government entity has received or accepted the property or services at that time.

(b) Payment threshold of \$10,000--(1) In general. The term payment threshold means an amount equal to \$10,000. The withholding requirements of §31.3402(t)-1 will not apply to any payment that is less than the payment threshold. Whether a payment is equal to or in excess of the payment threshold is determined when the payment is made. Thus, the payment threshold applies to the actual payment even if the amount of the actual payment is incorrect (except to the extent the anti-abuse rule in paragraph (b)(3) of this section applies). A later determination that the amount of the payment was in error does not affect the application of the payment threshold (except to the extent the anti-abuse rule in paragraph (b)(3) of this section applies), so that the payment threshold applies to the erroneous payment when made, and separately to any additional payment intended to correct an erroneous underpayment.

(2) Payment threshold applied per payment. If a government entity makes a single payment to a person for property or services combining charges for more than one transaction with the person, the determination of whether the payment threshold provided by paragraph (b)(1) of this section is met is based on the amount of the single payment, rather than the amount attributable to each separate transaction. Thus, if a government entity makes a single payment of \$10,000 or more to a person, the government entity is required to withhold on the payment, even if the payment is for more than one property or service. The same rule applies if a government entity enters into multiple transactions with a single person, each of which would result in a payment of less than \$10,000 if paid separately, but elects to make a single payment covering all the transactions such that the aggregated payment is \$10,000 or more. Under these

circumstances, the government entity is required to withhold on the aggregated payment.

(3) Anti-abuse rule. If a government entity or payment administrator divides a payment or payments to any person for property or services into two or more payments (or permits a person providing property or services to divide a request for payment into two or more requests for payments) primarily to avoid the \$10,000 payment threshold provided in paragraph (b)(1) of this section on one or more of these payments, the divided payments will be treated as a single payment made on the date that the first of these payments is made. This rule will not apply to a government entity or payment administrator that makes a payment in accordance with the contractual terms, including any requests for payments submitted by the person providing property or services in compliance with the contractual terms, unless it knows, or has reason to know, that the contractual terms regarding payments were adopted, or the person providing property or services implemented such contractual terms, with the primary purpose of avoiding the \$10,000 payment threshold. In determining whether this paragraph (b)(3) applies, a significant factor is whether the government entity or payment administrator has exhibited a pattern or practice of dividing payments to avoid the \$10,000 payment threshold.

(4) Withholding on excepted payments. A government entity and a person providing property or services to that government entity may agree in writing that the government entity will or may apply section 3402(t) withholding to payments not subject to section 3402(t) withholding, or an identified portion of payments not subject to section 3402(t) withholding (for example, only such payments made from a specified agency of

the government entity), including payments below the payment threshold provided in paragraph (b)(1) of this section. This paragraph (b)(4) does not apply to government entity payments that are subject to section 3402(t) withholding notwithstanding a contractual provision between the parties.

(c) No withholding on successive payments. If a government entity or its payment administrator makes a payment that is subject to the withholding requirements of §31.3402(t)-1 to a person, no subsequent transfer of cash or property from that payment by such person to another person is treated as a payment subject to withholding for purposes of §§31.3402(t)-1 through 31.3402(t)-7.

(d) Payments made through a payment administrator or to a contractor--(1)

Definition. The following rules apply for purposes of this section:

(i) A payment administrator is 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 to a person providing property or services to, or on behalf of, the government entity.

(ii) A payment administrator is treated as a person providing property or services for purposes of the withholding requirements of section 3402(t) to the extent it receives a fee from the government entity for its services as a payment administrator for the government entity.

(2) Payments to a contractor. If a person provides property or services to a government entity under a contract and is not a payment administrator, the person, who is in privity with the government entity, is treated as the person providing property or services subject to withholding under section 3402(t) for all payments received from the

government entity, regardless of whether some payments the person receives relate to invoices for property or services provided by subcontractors.

(3) Application of payment threshold. Where a government entity uses a payment administrator to make a payment, the determination of whether the payment meets the payment threshold is made at the time the payment administrator makes the payment to the person providing property or services. If a government entity makes one transfer of funds to a payment administrator that is composed of a fee to compensate the payment administrator for its services and other funds that are to be paid to persons providing property or services, the determination of whether the payment threshold is met on the portion that is the fee is made at the time of the transfer of the funds to the payment administrator.

(e) [Reserved].

(f) Examples. This section is illustrated by the following examples:

Example 1. (i) Prime contractor X has a contract with a government entity to provide services and property to the government entity. X contracts with numerous subcontractors to provide services and property in connection with the contract. While the engagement of any particular subcontractor is subject to approval by the government entity, the subcontractors are not parties to the contract between X and the government entity, and the government entity is not a party to the contracts between X and subcontractors. Under its contract with the government entity, X submits an invoice for \$48,000 for providing services and property to the government entity, including charges for services and property provided by two subcontractors, M and N. The invoice reflects charges of \$16,000 for M and \$2,000 for N. The government entity pays X the entire amount of the invoice in one payment of \$48,000. X pays M for M's billed portion of the invoice in a single payment of \$16,000, and X pays N for N's billed portion of the invoice in a single payment of \$2,000.

(ii) Under the facts of this Example 1, X is the person providing property or services to, or for the benefit of, the government entity with respect to the entire amount of the \$48,000 payment under the invoice, including the charges for services or property provided by its subcontractors M and N. X is not a payment administrator (as defined in paragraph (d)(1)(i) of this section) because X is not making payments solely as an agent of the government entity to persons providing property or services. Instead, X

makes payments to subcontractors M and N pursuant to X's separate contracts with these subcontractors to which the government entity is not a party. Therefore, under paragraphs (a) and (d)(2) of this section, the entire amount of the \$48,000 payment to X under the invoice, including the charges for services and property provided by its subcontractors M and N, is the payment subject to withholding for purposes of section 3402(t).

(iii) Under paragraph (b)(1) of this section, the determination whether the payment meets the payment threshold is based on the entire amount of the payment from the government entity to X. Withholding under section 3402(t) applies to the government entity's \$48,000 payment to X because the payment meets the payment threshold and is not otherwise excepted from section 3402(t) withholding. Thus, the payment is subject to withholding of 3 percent, or \$1440.

(iv) Payments made by X to the subcontractors, M and N, are not payments by the government entity or its payment administrator. Thus, X's \$16,000 payment to M and X's \$2,000 payment to N for services or property under the contract are not subject to withholding under section 3402(t). See paragraphs (c) and (d)(2) of this section.

(v) The government entity is liable for the \$1440 withholding required under section 3402(t) on its payment to X and is responsible for the related reporting required under §31.6051-5. See paragraph (a) of this section. X is the person receiving the payment for purposes of reporting under §31.6051-5. Thus, the government entity is responsible for furnishing X with a Form 1099-MISC, "Miscellaneous Income" (or successor form), including the entire amount of the payment (\$48,000) and the entire amount of the withholding (\$1440) and filing a Form 1099-MISC with the Internal Revenue Service.

Example 2. (i) Z has a contract with a government entity to make payments as an agent of the government entity to persons providing services or property to, or on behalf of, the government entity. The only services Z provides under the contract are its services in acting as an agent for the government entity in making payments to persons providing property or services to, or on behalf of, the government. The government entity transfers funds of \$71,000 to Z, which includes a fee of \$1,000 to Z for its services as an agent under the contract. Z then makes payments of the \$70,000 remainder of the funds to persons providing property or services to, or on behalf of, the government entity, including a single payment of \$18,000 to P and a single payment of \$7,000 to R.

(ii) Under the facts of this Example 2, Z is a payment administrator (as defined in paragraph (d)(1)(i) of this section) because Z makes payments solely as an agent for the government entity to persons providing property or services to, or on behalf of, the government entity. Under paragraphs (a) and (d) of this section, Z is not treated as a person providing property or services with respect to \$70,000 of the transfer of funds (the amount of the funds to be paid to persons providing property or services to, or on behalf of, the government entity). Because Z is not treated as a person providing property or services with respect to this \$70,000 portion of the funds, this portion of the

transfer of funds by the government entity to Z is not subject to withholding under section 3402(t) when transferred to Z.

(iii) Under paragraph (d)(1)(ii) of this section, the payment administrator is treated as a person providing property or services with respect to the portion of the \$71,000 fund transfer that is a fee for its services as a payment administrator, or \$1,000. Under paragraph (d)(3) of this section, the determination of whether the payment threshold is met with respect to the fee portion of the payment from the government entity to Z at the time of the payment from the government entity to Z is made. Because the \$1,000 fee portion of the payment falls beneath the \$10,000 payment threshold, withholding under section 3402(t) is not required with respect to that portion of the payment.

(iv) P and R are persons providing services or property to, or on behalf of, the government entity with respect to the payments they receive from Z.

(v) Withholding is required under section 3402(t) on the payment by Z, a payment administrator, to a person providing property or services to, or on behalf of, a government entity provided the payment meets the payment threshold and is not otherwise excepted. Under paragraph (d)(3) of this section, the determination of whether the payment threshold is met on the payment Z makes to a person providing property or services is made at the time Z pays the person providing property or services. Under the facts of this Example 2, Z's payment to P of \$18,000 meets the payment threshold, and therefore withholding of \$540 under section 3402(t) applies. Z's payment to R of \$7,000 does not meet the payment threshold, and therefore, no withholding under section 3402(t) is required.

(vi) The government entity, not Z, is liable for any withholding required under section 3402(t) on the payments from Z to persons providing property or services. Also, the government entity, not Z, is responsible for any reporting required under §31.6051-5 on the payment from Z to persons providing property or services. See paragraph (a) of this section. Each person providing property or services for which withholding is required, not Z, is the person receiving the payment for purposes of the reporting required under §31.6051-5 if withholding under section 3402(t) applies. Thus, the government entity is responsible for furnishing P Form 1099-MISC reflecting the amount of the payment from Z to P of \$18,000 and the amount of withholding of \$540 and filing a Form 1099-MISC with the Internal Revenue Service.

Example 3. (i) On March 1, 2013, a government entity makes a payment of \$12,000 to Y for providing property or services. The payment for property or services is not excepted from withholding under §31.3402(t)-4. On March 20, 2013, it is determined that the payment should have been \$9,000, and therefore, Y owes the government entity \$3,000 to repay the excess payment.

(ii) The facts are the same as in paragraph (i) of this Example 3, except that, in addition, on April 30, 2013, the government entity makes a net payment of \$6,000 to Y for providing property or services, which is based on the payment of a bill for property or

services equal to \$11,000, which is offset by the repayment of the \$3,000 debt that Y owes with respect to the erroneous March 1, 2013, payment, and the repayment of a \$2,000 unrelated debt to the Federal Government. No exception from withholding under §31.3402(t)-4 applies to the \$11,000 amount.

(iii) The facts are the same as in paragraph (ii) of this Example 3, except that, in addition, on May 31, 2013, the government entity makes a single payment of \$14,000 to Y that consists of a \$9,000 portion that is subject to section 3402(t) withholding (without regard to the payment threshold) and a \$5,000 portion that is excepted from section 3402(t) withholding under §31.3402(t)-4.

(iv) Under the facts of paragraph (i) of this Example 3, the payment on March 1, 2013, is subject to withholding under section 3402(t) because it meets the payment threshold under paragraph (d) of this section. The government entity is liable for withholding section 3402(t) tax on the payment equal to 3% of \$12,000, or \$360. The subsequent determination on March 20, 2013, that an incorrect amount was paid to Y does not affect the application of the \$10,000 payment threshold to the payment on March 1, 2013. If there were no additional payments or repayments between the government entity and Y during 2013, and if the government entity correctly withheld \$360 under section 3402(t), the government entity would issue Y a 2013 Form 1099-MISC (or successor form) reporting \$12,000 of payments subject to section 3402(t) withholding and \$360 of withholding.

(v) Under the facts of paragraph (ii) of this Example 3, the payment on April 30, 2013, is also subject to withholding under section 3402(t). As an initial matter, the government entity calculates its liability for withholding section 3402(t) on the payment equal to 3% of \$11,000, or \$330, because the amount of the payment for purposes of section 3402(t) and the payment threshold is not reduced by the amount of offsets for debts owed the government. Thus, the payment exceeds the payment threshold under paragraph (d) of this section. However, the repayment within the same calendar year of the \$3,000 excess amount which was paid on March 1, 2013, means that the government is entitled to correct its income tax withholding liability with respect to Y by the amount of section 3402(t) withholding paid with respect to the \$3,000, or \$90. Thus the net withholding amount deducted from the \$6,000 net payment is \$240. The offset of \$2,000 for other unrelated debt owed the Federal Government has no effect on section 3402(t) liability. Neither the offset for the \$3,000 repayment nor the offset for the \$2,000 other debt affects the application of the payment threshold to the March 1, 2013, payment or the April 30, 2013, payment. If there were no additional payments or repayments between the government entity and Y during 2013, and if the government entity withheld properly, the government entity would be required to furnish Y a Form 1099-MISC (or successor form) reporting \$20,000 of payments subject to section 3402(t) withholding (\$12,000 plus \$11,000 less \$3,000 repayment) and \$600 withholding (\$360 plus \$330 less \$90) and to file a Form 1099-MISC with the Internal Revenue Service.

(vi) Under the facts of this paragraph (iii) of this Example 3, the government entity is not required to withhold on the payment because only \$9,000 of the payment is potentially subject to section 3402(t) withholding and this amount does not meet the payment threshold. However, under the optional rule of §31.3402(t)-4(r), because only a portion of the payment is exempt from section 3402(t) withholding, the government entity may treat the entire amount of the payment as subject to section 3402(t) withholding provided the payee has agreed to this withholding. If the government entity applies the optional rule of §31.3402(t)-4(r), the payment threshold would be met and the government entity would withhold under section 3402(t) the amount of \$420, or 3% of the \$14,000 payment. If the government entity treats the entire amount of the payment as subject to section 3402(t) withholding and withholds, the entire amount of the payment (\$14,000) plus the \$420 withholding would be reported on Form 1099-MISC (or successor form).

(g) Effective/applicability date. This section applies to payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after December 31, 2012.

**§31.3402(t)-4 Certain payments excepted from withholding.**

(a) Payments subject to withholding under chapter 3 or chapter 24 (other than section 3406)--(1) In general. Payments are excepted from withholding under section §31.3402(t)-1(a) if they are subject to withholding under chapter 3 of the Internal Revenue Code (Code) or under sections 3401 through 3405 (other than section 3402(t)).

(2) Payments subject to withholding under chapter 3. Payments subject to withholding under chapter 3 of the Code include those payments that are subject to, but exempt from, withholding under chapter 3 of the Code on the ground that the payments are exempt from United States income tax pursuant to an income tax convention to which the United States is a party.

(3) Payments subject to withholding at election of payee. For purposes of this exception from section 3402(t), payments for which the payee may elect withholding are exempt from withholding under §31.3402(t)-1(a) regardless of whether the payee in fact makes such an election. These payments include--

(i) Unemployment compensation as defined in section 85(b) (see section 3402(p)(2));

(ii) Social security benefits as defined in section 86(d) (see section 3402(p)(1)(C)(i));

(iii) Any payment referred to in the second sentence of section 451(d) that is treated as insurance proceeds, relating to certain disaster payments received under the Agricultural Act of 1949, as amended, or Title II of the Disaster Assistance Act of 1988 (see section 3402(p)(1)(C)(ii));

(iv) Any amount that is includible in gross income under section 77(a), relating to amounts received as loans from the Commodity Credit Corporation that the taxpayer has elected to treat as income (see section 3402(p)(1)(C)(iii)); and

(v) Any payment of an annuity to an individual.

(b) Payments subject to withholding under section 3406 with backup withholding deducted. A payment is not subject to withholding under section 3402(t) if the payment is subject to withholding under section 3406, relating to backup withholding, and if backup withholding is actually being withheld from such payment.

(c) [Reserved].

(d) Payments for real property. Payments for real property are not subject to the withholding requirements of §31.3402(t)-1. For purposes of this exception, the term

payments for real property includes the purchase and the leasing of real property (including payments made by a lessee to a lessor related to the use or occupancy of the leased property and made in accordance with the terms of the applicable lease, but not including either a payment for construction, or payment to a person other than the lessor, even if related to the use or occupancy of the leased property and required by the terms of the lease). However, payments for the construction of buildings or other public works projects, such as bridges or roads, are not payments for real property.

(e) Payments to government entities, tax-exempt organizations, and foreign governments--(1) Government entities. Payments are not subject to withholding under section 3402(t) if the payments are made to government entities that are subject to the withholding requirements of section 3402(t)(1) pursuant to §31.3402(t)-2. For purposes of this exception, payments to government entities that qualify for the exception for political subdivisions and instrumentalities making less than \$100,000,000 of payments for property and services annually, as provided by section 3402(t)(2)(G) and paragraph (g) of this section, are treated as payments to government entities that are subject to the withholding requirements of section 3402(t)(1).

(2) Tax-exempt organizations. Payments to an organization that is exempt from taxation under section 501(a) as an organization described in section 501(c), 501(d), or 401(a) are not subject to withholding under section 3402(t).

(3) Foreign governments. Payments to foreign governments are not subject to withholding under section 3402(t). For purposes of this paragraph (e), a government of a possession or territory of the United States is treated as a foreign government.

(f) Payments made pursuant to a classified or confidential contract. Payments made pursuant to a classified or confidential contract described in section 6050M(e)(3) are not subject to withholding under section 3402(t).

(g) Exception for political subdivisions or instrumentalities thereof making less than \$100,000,000 of payments for property or services annually--(1) In general. Section 3402(t) withholding is not required on payments made by a political subdivision of a State (or any instrumentality of a political subdivision of a State) that makes less than \$100,000,000 of payments for property or services annually.

(2) Determination of whether an entity is a political subdivision of a State. Whether an entity is a political subdivision of a State for purposes of paragraph (g)(1) of this section is determined under §31.3402(t)-2(d).

(3) Determination of whether a political subdivision or instrumentality makes less than \$100,000,000 of payments for property or services annually--(i) General determination rule. In general, whether a political subdivision or instrumentality makes less than \$100,000,000 of payments for property or services annually for purposes of paragraph (g)(1) of this section is determined for each calendar year based on the total payments made by the entity for property or services in the entity's accounting year ending with or within the second preceding calendar year. For this purpose, payments that qualify for the exceptions from withholding under §31.3402(t)-4(a) through (q) (or would have qualified had these regulations been in effect) are not included in determining total payments made. However, payments that are not subject to withholding because the payments are less than the \$10,000 payment threshold described in §31.3402(t)-3(b), or based on the applicability date rules or transition rules

contained in §31.3402(t)-1(d), §31.3402(t)-2(i), §31.3402(t)-3(g), §31.3402(t)-4(u), or §31.3402(t)-5(e), or based on the withholding relief for 2012 provided in §31.3402(t)-4(t), but are not otherwise excepted, are included in determining total payments. For this purpose, the accounting year refers to the fiscal year (consisting of 12 months) or calendar year used by the government entity in setting its budgets and keeping its accounting books. If a political subdivision or instrumentality was not in existence in the second preceding calendar year or if no 12-month accounting year exists ending in the second preceding calendar year, eligibility for this exception is determined based on the total projected payments for the accounting year consisting of 12 months ending in that calendar year.

(ii) Optional determination rule. A political subdivision of a state or an instrumentality of that political subdivision may treat itself as eligible for the exception provided in paragraph (g)(1) of this section for a calendar year if the average of the total payments calculated under the rules of paragraph (g)(3)(i) of this section for four of the five successive accounting years, the fifth year of which is the entity's determination year, is less than \$100,000,000. For this purpose, for a calendar year the political subdivision's or instrumentality's determination year is the accounting year ending with or within the second preceding calendar year. If a political subdivision or instrumentality withholds and pays (or deposits) tax under section 3402(t) for a calendar year and files a return reporting the withheld tax under section 3402(t) for that calendar year based on the general determination rule of paragraph (g)(3)(i) of this section, it is deemed to have waived any right to use the optional determination rule of this paragraph (g)(3)(ii) of this section for that calendar year.

(4) Examples. The following examples illustrate the provisions of paragraph (g) of this section:

Example 1. (i) Government entity X, which qualifies as a political subdivision or instrumentality of a political subdivision for calendar years 2013 and 2014, uses a fiscal year ending June 30 to determine its budgets and to keep its accounting books. During its fiscal year ending June 30, 2011, X made payments to persons for property and services of \$200,000,000, including \$102,000,000 of payments that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(ii) During its fiscal year ending June 30, 2012, X made payments for property and services of \$210,000,000, including \$106,000,000 that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect. The payments X made for property or services during the fiscal year ending June 30, 2012, included \$15,000,000 of payments below the \$10,000 payment threshold described in §31.3402(t)-3(b).

(iii) For the calendar year 2013, the general determination rule of paragraph (g)(3)(i) of this section applies to determine whether X is eligible for the exception provided in paragraph (g)(1) of this section based on the total payments X made for its accounting year ending June 30, 2011. Because total payments for this purpose exclude payments that would be excepted under §31.3402(t)-4(a) through (q), total payments were \$200,000,000 less \$102,000,000, or \$98,000,000. Therefore, for calendar year 2013, X would be eligible for the exception provided in paragraph (g)(1) of this section, and would not be required to withhold under section 3402(t).

(iv) For the calendar year 2014, the general determination rule of paragraph (g)(3)(i) of this section applies to determine whether X is eligible for the exception provided in paragraph (g)(1) of this section based on the total payments it made for its accounting year ending June 30, 2012. Because total payments for this purpose exclude payments that would have been excepted under §31.3402(t)-4(a) through (q), but include payments below the \$10,000 payment threshold described in §31.3402(t)-3(b), total payments were \$210,000,000 less \$106,000,000, or \$104,000,000. Therefore, for calendar year 2014, X would not qualify for the exception provided in paragraph (g)(1) of this section and would be required to withhold under section 3402(t), provided it is not eligible for or does not use the exception under the optional determination rule provided in paragraph (g)(3)(ii) of this section.

Example 2. (i) Government entity Y, which qualifies as a political subdivision or instrumentality of a political subdivision for calendar years 2013 and 2014, uses a fiscal year ending June 30 to determine its budgets and to keep its accounting books. During its fiscal year ending June 30, 2007, Y made payments to persons for property and services of \$195,000,000, including \$110,000,000 of payments that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(ii) During its fiscal year ending June 30, 2008, Y made payments to persons for property and services of \$204,000,000, including \$115,000,000 of payments that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(iii) During its fiscal year ending June 30, 2009, Y made payments to persons for property and services of \$215,000,000, including \$124,000,000 of payments that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(iv) During its fiscal year ending June 30, 2010, Y made payments to persons for property and services of \$225,000,000, including \$130,000,000 of payments that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(v) During its fiscal year ending June 30, 2011, Y made payments to persons for property and services of \$275,000,000, including \$135,000,000 of payments that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(vi) During its fiscal year ending June 30, 2012, Y made payments for property and services of \$235,000,000, including \$140,000,000 that would have been excepted under §31.3402(t)-4(a) through (q) if section 3402(t) had been in effect.

(vii) For the calendar year 2013, the general determination rule of paragraph (g)(3)(i) of this section applies to determine whether Y is eligible for the exception provided in paragraph (g)(1) of this section based on the total payments Y made for its accounting year ending June 30, 2011. Because total payments for this purpose exclude payments that would be excepted under §31.3402(t)-4(a) through (q), total payments were \$275,000,000 less \$135,000,000, or \$140,000,000. Therefore, for calendar year 2013, Y would not qualify for the exception provided in paragraph (g)(1) of this section and would be required to withhold under section 3402(t), unless it was eligible for, and used, the optional determination rule provided in paragraph (g)(3)(ii) of this section.

(viii) For the calendar year 2013, under the optional determination rule of paragraph (g)(3)(ii) of this section, Y would have total payments for this purpose in the accounting year ending June 30, 2007, of \$85,000,000; in the accounting year ending June 30, 2008, of \$89,000,000; in the accounting year ending June 30, 2009, of \$91,000,000; in the accounting year ending June 30, 2010, of \$95,000,000; and in the accounting year ending June 30, 2011, of \$140,000,000. The average of four of those years (excluding the highest year of \$140,000,000) would be \$90,000,000 (85,000,000 plus 89,000,000 plus 91,000,000 plus 95,000,000 equals 360,000,000; 360,000,000 divided by 4 equals 90,000,000). Thus, for the calendar year 2013, under the optional determination rule of paragraph (g)(3)(ii) of this section, Y is eligible for the exception provided in paragraph (g)(1) of this section and is not required to withhold under section

3402(t). Alternatively, Y could apply the general determination rule, ignore the optional determination rule, and withhold under section 3402(t).

(ix) For the calendar year 2014, under the general determination rule of paragraph (g)(3)(i) of this section, Y has total payments of \$95,000,000. Thus, Y is eligible for the exception provided in paragraph (g)(1) of this section and is not required to withhold under section 3402(t).

(h) Payments made in connection with a public assistance or public welfare program--(1) In general. Section 3402(t) withholding does not apply to payments made in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test.

(2) Needs or income test. Eligibility for a public assistance or public welfare program is not considered to be determined by a needs or income test if eligibility for the program is based solely on the age of the beneficiary. A public assistance program providing disaster relief to victims of a natural or other disaster is considered to be a program for which eligibility is determined under a needs test. Payments under government programs to provide health care or other services that are not based on the needs or income of the recipient are subject to section 3402(t) withholding, including programs where eligibility is based on the age of the beneficiary.

(3) Payments to third parties. The exception provided by this paragraph (h) also applies to payments made to third parties to provide benefits to beneficiaries under a public assistance or public welfare program for which eligibility is determined by a needs or income test.

(4) Allocation of payments. If only a portion of a payment is made in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test, the portion that is made in connection with the program and

therefore is not subject to section 3402(t) withholding may be determined using any reasonable allocation method. If the government entity makes a reasonable, good faith determination that either the excudable or the nonexcludable portion is insignificant in comparison to the entire payment, the insignificant portion may be disregarded for purposes of this paragraph (h) (so that the entire payment is either eligible or ineligible for the exception provided by this paragraph (h)).

(i) Payments made to any government employee with respect to his or her services. Section 3402(t) withholding does not apply to payments made to any government employee with respect to his or her services as an employee of the government. This exception applies to contributions to deferred compensation plans on behalf of an employee, contributions to employee benefit plans on behalf of an employee, fringe benefits provided to employees, and payments to employees under accountable plans for expenses incurred by the employee for the employee's travel while on government business. This exception also applies to payments made by the government employee under accountable plans (as defined in §1.62-2(c)(2) of this chapter) to providers of the employee's travel, meals, and lodging when the government employee is traveling on government business.

(j) Payments received by nonresident alien individuals and foreign corporations. Section 3402(t) withholding does not apply to any payment received by a nonresident alien individual or foreign corporation for providing services or property if the payment is derived from sources outside the United States, as determined under sections 861, 862, 863, and 865, and is not effectively connected with the conduct of a trade or business within the United States by the nonresident alien individual or foreign corporation.

(k) Payments to Indian tribal governments. Section 3402(t) withholding does not apply to any payment made to an Indian tribal government or its political subdivisions.

(l) Payments in emergency, disaster, or hardship situations. The Internal Revenue Service may provide by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter) for additional exceptions from section 3402(t) withholding for certain payments made in an emergency, disaster, or hardship situation if the Internal Revenue Service determines that withholding from the payments would impede a government entity's efforts to respond to the emergency, disaster, or hardship.

(m) Grants--(1) In general. Section 3402(t) withholding does not apply to any grant as defined in paragraph (m)(2) of this section. This exclusion does not apply to the use by a government entity of the proceeds of a grant received by that government entity (unless the government entity uses the proceeds to make a grant).

(2) Definition of grant. For purposes of this paragraph (m), a grant is a transfer of funds by a government entity to a recipient (which may be a state government, local government, or other recipient) pursuant to an agreement reflecting a relationship between the government entity and the recipient 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 (by purchase, lease, or barter) 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.

(n) Sales tax, excise tax, value-added tax, and other taxes. For purposes of this section, section 3402(t) withholding applies to any payment of sales tax, excise tax,

value-added tax, or other tax made as part of a payment to any person providing property or services. Notwithstanding the foregoing, the payment of sales tax, excise tax, value added tax, or other tax may be excluded from section 3402(t) withholding, provided this exclusion is applied consistently to all payments to a given payee during the calendar year.

(o) Loan guarantees. Section 3402(t) withholding does not apply to a loan guarantee or the payment of principal and interest on a loan pursuant to a loan guarantee. However, if a government entity (through a right of subrogation or similar right) assumes the operation of a project or activity funded by the loan, section 3402(t) withholding applies to payments by the government entity for property or services relating to the project or activity unless otherwise excepted under this section.

(p) Debt. Section 3402(t) withholding does not apply to payment of principal on a loan. However, if a government entity issues a debt obligation to a person providing services as all or part of the purchase price, the debt obligation's fair market value is subject to section 3402(t) withholding, unless an exception applies. If a government entity issues a debt obligation to a person providing property as all or part of the purchase price, the debt obligation's issue price as determined under section 1273 or section 1274, whichever is applicable to the debt obligation, is subject to section 3402(t) withholding, unless an exception applies. In lieu of the issue price, the government entity and the person providing property may agree to treat the stated principal amount of the debt obligation as the payment amount attributable to the debt obligation that is subject to section 3402(t) withholding. If a government entity uses a third party debt obligation (a debt obligation issued by any entity other than that government entity) to

pay for property or services, the fair market value of the debt obligation is subject to section 3402(t) withholding, unless an exception applies.

(q) Investment securities. Section 3402(t) withholding does not apply to any payments to purchase stock, bonds, or other securities primarily for investment purposes.

(r) Partially exempt payments. If a payment includes both an amount subject to section 3402(t) withholding and an amount that is not subject to section 3402(t) withholding, section 3402(t) withholding applies only to the relevant portion of the payment. Notwithstanding the foregoing, a government entity may apply section 3402(t) withholding to the entire payment provided the payee has agreed to this withholding.

(s) Authorization for additional rules and procedures on payees and payments exempt from section 3402(t) withholding. The Commissioner is authorized to provide rules and procedures concerning payments that are exempt from withholding, including the classification of additional types of payees or payments as exempt from section 3402(t) withholding, and procedures under which a government entity may determine the eligibility of a payee for an exemption from section 3402(t) withholding (and may rely on this determination notwithstanding the payee's eligibility for this exemption), in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(t) Withholding relief for 2012. Withholding under section 3402(t) is not required with respect to payments made before January 1, 2013. Any person that deducts and withholds tax under section 3402(t) from payments made in 2012 shall deposit and report such tax withheld pursuant to §31.6302-4 and §31.6011(a)-4(b), and include the

payment and the amount withheld on Form 1099-MISC, "Miscellaneous Income," or successor form, unless the amount of tax withheld under section 3402(t) is repaid to the payee before January 1, 2013.

(u) Effective/applicability date. This section applies to payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after December 31, 2012, except that paragraph (t) of this section applies to payments made after December 31, 2011, and before January 1, 2013.

**§31.3402(t)-5 Application to passthrough entities.**

(a) In general. Section 3402(t)(1) does not apply to payments made by passthrough entities except as described in paragraph (c) of this section. In addition, section 3402(t)(1) applies to payments made to passthrough entities except as described in paragraph (d) of this section.

(b) Definitions. The following definitions apply for purposes of this section:

(1) Passthrough entity. The term passthrough entity means a partnership (for Federal income tax purposes) or an S corporation.

(2) Owner. The term owner means a partner (for Federal income tax purposes) or an S corporation shareholder.

(3) Ownership percentage. The term ownership percentage means an owner's interest, as a percentage, in partnership profits or capital (whichever is greater) in the case of a partnership, or an owner's interest, as a percentage, in S corporation stock in the case of an S corporation.

(4) Testing day. The term testing day refers to the first day of a passthrough entity's taxable year.

(c) Payments from a passthrough entity--(1) General rule. Section 3402(t)(1) does not apply to payments made by passthrough entities during the taxable year, except as provided in paragraph (c)(2) of this section.

(2) Exception. Section 3402(t)(1) applies to any payment during the taxable year from a passthrough entity if the aggregate ownership percentage held, directly or indirectly, in the entity on the testing day by one or more of the government entities described in section 3402(t)(1) is at least 80 percent. For purposes of this paragraph (c)(2), any manipulation of the ownership percentage with an intent to avoid application of section 3402(t) will be recharacterized as appropriate to reflect the actual ownership percentage.

(d) Payments to a passthrough entity--(1) General rule. Section 3402(t)(1) applies to payments made to passthrough entities during the taxable year, except as provided in paragraph (d)(2) of this section.

(2) Exception--(i) In general. Section 3402(t)(1) does not apply to any payment during the taxable year to a passthrough entity if the aggregate ownership percentage held, directly or indirectly, in the entity on the testing day by one or more persons each of which is described in section 3402(t)(2)(E) or is an Indian tribal government is at least 80 percent. For purposes of this paragraph (d)(2)(i), any manipulation of the ownership percentage with an intent to avoid application of section 3402(t) will be recharacterized as appropriate to reflect the actual ownership percentage, if the government entity

making the payment knew or should have known that the payee's ownership percentage had been manipulated with intent to avoid application of section 3402(t).

(ii) Payments derived from sources outside the United States. Section 3402(t)(1) does not apply to any payment during the taxable year to a partnership if the aggregate ownership percentage held, directly or indirectly, in the partnership on the testing day by one or more persons each of which is a nonresident alien individual or foreign corporation is at least 80 percent, and the payment to the partnership is not effectively connected with the conduct of a trade or business within the United States by the partnership, and is derived from sources outside the United States, as determined under sections 861, 862, 863, and 865. For purposes of this paragraph (d)(2)(ii), any manipulation of the ownership percentage with an intent to avoid application of section 3402(t) will be recharacterized as appropriate to reflect the actual ownership percentage, if the government entity making the payment knew or should have known that the payee's ownership percentage had been manipulated with intent to avoid application of section 3402(t).

(e) Effective/applicability date. This section applies to payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after December 31, 2012.

**§31.3402(t)-6 Crediting of tax withheld under section 3402(t).**

(a) Credit against income tax liability only. Tax withheld under section 3402(t) is allowable as a credit against the tax imposed by Subtitle A of the Internal Revenue Code (Code) upon the recipient of the income in accordance with the rules set forth in

section 31(a) and §1.31-1 of this chapter. Tax withheld under section 3402(t) is not allowable as a credit against taxes imposed on wages or compensation of employees under Chapters 21, 22, 23, or 24 of the Code.

(b) Taxable year of credit. Tax withheld under section 3402(t) during any calendar year is allowed as a credit against the tax imposed by Subtitle A in accordance with section 31(a)(2) of the Code and §1.31-1(b) of this chapter.

(c) Estimated tax. The tax withheld under section 3402(t) and allowable as a credit under section 31(a) may be taken into account in determining estimated tax liability under sections 6654 and 6655 for the taxable year against which the taxes may be credited under paragraph (b) of this section.

(d) Effective/applicability date. This section applies with respect to amounts withheld under section 3402(t) after December 31, 2012.

**§31.3402(t)-7 Transition relief from interest and penalties.**

(a) Good faith exception for interest and penalties on payments made before January 1, 2014. Government entities that make a good faith effort to comply with the withholding requirements in §31.3402(t)-1 will not be liable for interest and penalties with respect to income tax withholding under section 3402(t) that the government entity failed to withhold from payments made before January 1, 2014. However, this provision does not relieve the government entity of liability for income tax that it failed to withhold. See, however, §31.3402(d)-1.

(b) Effective/Applicability Date. This section applies with respect to payments made after December 31, 2012.

Par. 3. Section 31.3406(g)-2 is amended by adding paragraphs (h) and (i) to read as follows:

**§31.3406(g)-2 Exception for reportable payment for which withholding is otherwise required.**

\* \* \* \* \*

(h) Certain payments made by government entities. A government entity that is required to withhold both on reportable payments pursuant to section 3406(a) and on certain payments pursuant to section 3402(t) must comply with the withholding requirements of section 3406, and not section 3402(t), for each payment to which both types of withholding would apply. Pursuant to section 3402(t)(2)(B), withholding under section 3402(t) does not apply to a given payment if amounts are being withheld under section 3406 for that payment. If a government entity fails to withhold as required under section 3406, the payment will not be deemed to be subject to withholding under another provision of the Internal Revenue Code for purposes of this paragraph (h). Thus, even if the government entity withholds on such payment pursuant to section 3402(t), it will remain liable for the amount required to be withheld under section 3406.

(i) Effective/applicability date. Paragraph (h) of this section relating to certain payments made by government entities applies to payments made by government entities under section 3402(t) made after December 31, 2012.

Par. 4. Section 31.6011(a)-4 is amended by revising paragraphs (b)(4) and (5) and adding paragraph (b)(6) and revising paragraph (d) to read as follows:

**§31.6011(a)-4 Returns of income tax withheld.**

\* \* \* \* \*

(b) \* \* \*

(4) Pensions, annuities, IRAs, and certain other deferred income subject to withholding under section 3405;

(5) Reportable payments subject to backup withholding under section 3406; and

(6) Certain payments made by government entities subject to withholding under section 3402(t).

\* \* \* \* \*

(d) Effective/applicability date. Paragraph (b)(6) of this section (relating to certain payments made by government entities subject to withholding under section 3402(t)) applies to payments made by government entities under section 3402(t) made after December 31, 2012.

Par. 5. Section 31.6051-5 is added to read as follows:

**§31.6051-5 Statement and information return required in case of withholding by government entities.**

(a) Statements required from government entities. Every government entity required to deduct and withhold tax under section 3402(t) must furnish to the payee a written statement containing the information required by paragraph (d) of this section.

(b) Information returns required from government entities. Every government entity required to furnish a payee statement under paragraph (a) of this section must file a duplicate of such statement with the Internal Revenue Service. Such duplicate constitutes an information return.

(c) Prescribed form. The prescribed form for the statement required by this section is Form 1099-MISC, "Miscellaneous Income," or any successor form.

(d) Information required. Each statement on Form 1099-MISC (or any successor form) must show the following--

(1) The name, address, and taxpayer identification number of the person receiving the payment subject to withholding under section 3402(t);

(2) The amount of the payment withheld upon;

(3) The amount of tax deducted and withheld under section 3402(t);

(4) The name, address, and taxpayer identification number of the government entity filing the form;

(5) A legend stating that such amount is being reported to the Internal Revenue Service; and

(6) Such other information as is required by the form and the instructions.

(e) Time for furnishing statements. The statement required by paragraph (a) of this section must be furnished to the payee no later than January 31 of the year following the calendar year in which the payment subject to withholding was made.

However, the February 15 due date under section 6045 applies to the statement if the statement is furnished in a consolidated reporting statement under section 6045. See §§1.6045-1(k)(3), 1.6045-2(d)(2), 1.6045-3(e)(2), 1.6045-4(m)(3), and 1.6045-5(a)(3)(ii) of this chapter.

(f) Cross references. For provisions relating to the time for filing the information returns required by this section with the Internal Revenue Service and to extensions of the time for filing the returns, see §§31.6071(a)-1(a)(3), 1.6081-1 of this chapter, and 1.6081-8 of this chapter. For penalties applicable to failure to file information returns and furnish payee statements, see sections 6721 through 6724.

(g) Effective/applicability date. This section applies for calendar years beginning on or after January 1, 2013.

Par. 6. Section 31.6071(a)-1 is amended by revising paragraphs (a)(3)(i) and (g) to read as follows:

**§ 31.6071(a)-1 Time for filing returns and other documents.**

(a) \* \* \*

(3) Information returns--(i) General rule. Each information return in respect of wages as defined in the Federal Insurance Contributions Act or of income tax withheld from wages as required under §31.6051-2 or of income tax withheld from payments by government entities as required under §31.6051-5 must be filed on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which it is made, except that, if a tax return under §31.6011(a)-5(a) is filed as a final return for a period ending prior to December 31, the information return must be filed on or before the last day of the second calendar month following the period for which the tax return is filed.

\* \* \* \* \*

(g) The requirement under paragraph (a)(3)(i) of this section pertaining to the information return in respect of income tax withheld by government entities as required by §31.6051-5 of this part applies for calendar years beginning on or after January 1, 2013.

Par. 7. Section 31.6302-1 is amended by:

1. Revising paragraph (e)(1)(iii)(C).
2. Adding paragraph (e)(1)(iii)(E).

3. Revising paragraph (n).

The revisions and additions read as follows:

**§31.6302-1 Deposit rules for taxes under the Federal Insurance Contributions Act (FICA) and withheld income taxes.**

\* \* \* \* \*

(e) \* \* \*

(1) \* \* \*

(iii) \* \* \*

(C) Certain annuities described in section 3402(o)(1)(B);

\* \* \* \* \*

(E) Certain payments made by government entities under section 3402(t); and

\* \* \* \* \*

(n) Effective/applicability date. Except for the deposit of employment taxes attributable to payments made by government entities under section 3402(t), §§31.6302-1 through 31.6302-3 apply with respect to the deposit of employment taxes attributable to payments made after December 31, 1992. Paragraph (e)(1)(iii)(E) of this section applies with respect to the deposit of employment taxes attributable to payments made by government entities under section 3402(t) made after December 31, 2012.

\* \* \* \* \*

Par. 8. Section 31.6302-4 is amended by:

1. Revising paragraph (b)(4).
2. Revising paragraph (b)(5).
3. Adding paragraph (b)(6).

4. Revising paragraph (e).

The revisions and additions read as follows:

**§31.6302-4 Deposit rules for withheld income taxes attributable to nonpayroll payments.**

\* \* \* \* \*

(b) \* \* \*

(4) Amounts withheld under section 3405, relating to withholding on pensions, annuities, IRAs, and certain other deferred income;

(5) Amounts withheld under section 3406, relating to backup withholding with respect to reportable payments; and

(6) Amounts withheld under section 3402(t), relating to certain payments made by government entities.

\* \* \* \* \*

(e) Effective/applicability date. Section 31.6302-4(d) applies to deposits and payments made after December 31, 2010. Paragraph (b)(6) of this section relating to certain payments made by government entities applies to payments made by government entities under section 3402(t) made after December 31, 2012.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

Approved: April 26, 2011

Michael Mundaca

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2011-10760 Filed 05/06/2011 at 8:45 am; Publication Date: 05/09/2011]