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[Page 74082-74096]
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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[REG-158747-06]
RIN 1545-BG45

Withholding Under Internal Revenue Code Section 3402(t)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to

[[Page 74083]]

withholding under section 3402(t) of the Internal Revenue Code (Code). The proposed 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 proposed regulations provide guidance to assist the government entities in complying with section 3402(t). The regulations also provide certain guidance to persons receiving payments for property or services from government entities. This document also contains proposed amendments to regulations under sections 3406, 6011, 6051, 6071, and 6302 of the Code.

DATES: Written or electronic comments and requests for a public hearing must be received by March 5, 2009.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-158747-06), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-158747-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS REG-158747-06).

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Jean Casey, (202) 622-6040; concerning submissions of comments or to request a public hearing, Richard Hurst at Richard.A.Hurst@irsounsel.treas.gov or (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 31 under section 3402(t) of the Code. This document also contains proposed 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. Under the statute, section 3402(t) applies to payments made after December 31, 2010.

Exceptions to section 3402(t) withholding are contained in section 3402(t)(2). Section 3402(t)(2) provides that section 3402(t) withholding shall not apply to any payment--

(A) Except as provided in section 3402(t)(2)(B), which is subject to withholding under any other provision of chapter 24 (Collection of Income Tax at Source on Wages, sections 3401 through 3406) or chapter 3 (Withholding of Tax on Nonresident Aliens and Foreign Corporations, sections 1441 through 1464) of the Code;

(B) Which is subject to withholding under section 3406 (backup withholding) and from which amounts are being withheld under such section;

(C) Of interest;

(D) For real property;

(E) To any government entity subject to the requirements of section 3402(t)(1), any tax-exempt entity, or any foreign government;

(F) Made pursuant to a classified or confidential contract described in section 6050M(e)(3);

(G) Made by a political subdivision of a State (or any instrumentality thereof) which makes less than \$100,000,000 of such payments annually;

(H) Which is in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test; and

(I) To any government employee not otherwise excludable with respect to his or her services as an employee.

Section 3402(t)(3) provides for the coordination of section 3402(t) with other Code sections. 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, payments to any person for property or services which are subject to withholding shall be treated as if such payments were wages paid by an employer to an employee.

The legislative history in connection with section 3402(t) indicates that ``[t]he withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services.'' H.R. Conf. Rep. No.109-455, 109th Cong., 2d Sess. at 300 (2006). Further, the conference report also provides, with respect to the exception provided by section 3402(t)(2)(H), that ``payments under government programs to provide health care or other services that are not based on the needs or income of the recipients

are subject to withholding, including programs where eligibility is based on the age of the beneficiary.' H.R. Conf. Rep. No. 109-455 at page 301. In addition, with respect to section 3402(t)(2)(A), the conference report states that section 3402(t) withholding ``does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law.' H.R. Conf. Rep. No. 109-455 at page 301. The origins of the provision indicate that it was conceived to address tax noncompliance. See also, ``Options to Improve Tax Compliance and Reform Tax Expenditures'' (JCS-2-05), Joint Committee on Taxation, Jan. 27, 2005.

Notice 2008-38, 2008-13 IRB 683, published by the IRS on March 31, 2008, invited public comments regarding guidance under section 3402(t). In particular, Notice 2008-38 requested comments on the application of section 3402(t) to credit cards and payment cards, payments to payees not subject to United States taxation, passthrough entities in which a government entity is a partner or owner, government contractors and subcontractors, and de minimis payments. The Notice also requested comments on when and how amounts withheld under section 3402(t) should be transmitted to the IRS. See Sec. 601.601(d)(2)(ii)(b).

Many comments were received in response to Notice 2008-38, and the comments were taken into consideration in developing the proposed regulations.

Explanation of Provisions

The proposed regulations provide rules about which government entities are subject to the requirement of section 3402(t) withholding, which payments are subject to section 3402(t) withholding (and which are excepted from such withholding), when withholding is required on such payments, and how government entities pay and report the tax to the IRS. The proposed regulations also include transition rules providing relief from liability for the tax imposed by section 3402(t) with respect to payments under existing contracts. The proposed regulations also provide temporary relief from penalties and interest if a government entity makes a good faith effort but fails to withhold on payments as required under section 3402(t).

The regulations provide guidance primarily on what government entities

[[Page 74084]]

need to do to comply so that they can make timely preparations. The Treasury Department and IRS anticipate issuing further guidance to address questions raised by taxpayers who expect to receive payments subject to section 3402(t) withholding from government entities including, but not limited to, how to claim credits and how to claim the benefit of statutory exemptions from withholding under section 3402(t). Although some commenters requested that the Treasury Department and IRS issue guidance exempting payments from withholding where the 3-percent rate for withholding prescribed under section 3402(t) is expected to exceed either the profit margin in the taxpayer's industry or the income tax the taxpayer will owe for reasons particular to the taxpayer's business, the Treasury Department and IRS have determined that exemptions of this type would be contrary to the requirements of the statute. Commenters also requested that they be permitted to credit amounts withheld under section 3402(t) against Federal taxes other than income taxes, such as employment taxes. Consistent with the statute's purpose of addressing income tax

noncompliance, the Treasury Department and IRS propose to allow credits to be claimed only against income tax.

Government Entities Subject to Section 3402(t)

Section 3402(t)(1) applies to ``the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing.'' Section 3402(t) does not restrict the term the Government of the United States in any manner. Therefore, the entire Federal government, including the executive branch, the legislative branch, and the judicial branch, is subject to the requirements of section 3402(t). Thus, Congress, the Administrative Office of the United States Courts, the Executive Office of the President, Federal agencies, and all other components of the Federal government are included in the definition of Government of the United States and are required to withhold under section 3402(t).

The term State includes the District of Columbia. See section 7701(a)(10) of the Code. For purposes of section 3402(t), the term State does not include Indian tribal governments. Section 7871(a) prescribes when an Indian tribal government is to be treated as a State under the Code, and section 7871(a) does not provide that Indian tribal governments will be treated as States for purposes of section 3402(t). Consequently, the term political subdivision also does not include a subdivision of an Indian tribal government. See section 7871(a) and (d). Accordingly, because Indian tribal governments and their subdivisions are not among the listed government entities subject to section 3402(t), payments by Indian tribal governments and their subdivisions are not subject to the withholding requirements of section 3402(t).

The definition of political subdivision in the proposed regulations follows the definition in the section 103 regulations. Section 1.103-1(b) of the Income Tax Regulations provides, in part, that the term political subdivision denotes any division of any State or local government unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit.

Although the Code makes references to government instrumentalities in multiple sections, the Code and regulations do not currently provide a definition of instrumentality. In Rev. Rul. 57-128, 1957-1 CB 311, the IRS adopted 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). The factors are: (1) Whether the organization is used for a government purpose and performs a government function; (2) whether performance of its function is on behalf of one or more States or political subdivisions; (3) whether there are any private interests involved, or whether the States or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses. A number of revenue rulings published by the IRS illustrate the application of this test. See, for example, 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. See Sec. 601.601(d)(2)(ii)(b). The Treasury Department and IRS invite comments on use of the same or a similar test for purposes of section 3402(t).

Persons Subject to Withholding Under Section 3402(t)

Section 3402(t) applies to government payments to ``persons'' providing any property or services. Section 7701(a)(1) of the Code provides that, when used in the Code, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term person shall be construed to mean and include an individual, a trust, estate, partnership, association, company, or corporation. Because no alternative definition of person is provided in section 3402(t), the definition in section 7701(a)(1) and the regulations under section 7701(a)(1) applies. Therefore, section 3402(t) withholding can apply to payments for property or services to individuals, trusts, estates, partnerships, associations, companies, or corporations.

Payments Subject to Section 3402(t) Withholding

The proposed 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. Under the proposed rules, the withholding requirements of section 3402(t) will not apply to any payment that is less than the payment threshold amount, which is \$10,000. The Treasury Department and IRS are proposing this payment threshold of \$10,000 because the burden of withholding on smaller transactions is likely to be substantial and outweigh the benefits of increased withholding. This threshold corresponds to a minimum withholding of \$300.

Under the proposed rules, multiple payments made by a government entity to any person generally would not be aggregated in determining whether the payment threshold amount has been met. However, the proposed regulations provide an anti-abuse rule to ensure that the payment threshold is not manipulated to avoid the required withholding. If a government entity divides a payment into two or more separate payments primarily to avoid the payment threshold for one or more payments, the separate payments would be treated as one payment made on the date that the first payment was made for purposes of this rule. For example, if a government entity is scheduled to make a contractual payment to a person for landscaping services of \$15,000 on July 2, 2011, but divides the payment into payments of \$7,000 and \$8,000 made on July 1, 2011, and July 2, 2011, respectively, the government entity would be treated as having made a single payment of \$15,000 on July 1, 2011. This anti-abuse rule would not apply if the primary reason for division into separate payments is unrelated to section 3402(t).

If a government entity makes a single payment of \$10,000 or more to any

[[Page 74085]]

person for more than one property or service provided by that person, the government entity would be required to withhold on the payment. For example, if a person bills a government entity \$5,000 each day for seven days for services provided each day, but the government entity makes one payment of \$35,000 in satisfaction of these bills, the payment threshold is applied to the \$35,000 payment.

Many commenters requested guidance on how the requirements of section 3402(t) apply to prime contractors and subcontractors. Under the proposed rules, if a government entity or its payment administrator makes a payment to a person that is subject to withholding under section 3402(t), no subsequent transfer of cash or property by that person to another person is treated as a payment for section 3402(t) purposes. Thus, if the government entity enters into a contract with a

prime contractor for property and services, and that prime contractor separately contracts with subcontractors for delivery of certain property and services, then withholding under section 3402(t) 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.

The proposed regulations apply to payments made by the government entity or its payment administrator. For purposes of the proposed regulations, 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. 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 withholding under section 3402(t). However, if the government entity pays the payment administrator a fee for its services, the government entity would treat the fee as a payment subject to withholding. The government entity 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 and regardless of when the payment for property or services is made under this section.

Credit Card Payments

Many commenters questioned how the requirements of section 3402(t) apply to payments made by government credit card or payment card. Under the proposed regulations, when a government entity or its payment administrator uses a credit card or payment card to pay a person for providing property or services, payment occurs at the point of sale when the government credit card or payment card is tendered and not when the government entity pays the credit card company. The government entity is liable for the withholding and reporting associated with the payment, and this liability is not transferred to any other party involved in the credit card or payment card transaction, including, but not limited to, the acquiring bank, the issuing bank, or the credit card association. (The acquiring bank may be separately required to report amounts it pays under new section 6050W, which was enacted as part of the Housing Assistance Tax Act of 2008, Div. C of Pub. L. 110-289.)

Section 3402(t)(2)(A)--Payments Subject to Withholding Under Chapter 3 or Chapter 24 and Section 3402(t)(2)(B)--Payments From Which Backup Withholding Is Withheld

Section 3402(t)(2)(A) provides an exception from the requirement of section 3402(t) for amounts that are subject to withholding under some other provision of chapter 3 or chapter 24 (other than section 3406). Thus, payments that are subject to withholding under the wage withholding regime or the regime for withholding of tax on nonresident aliens and foreign corporations are exempt from withholding under section 3402(t). Furthermore, consistent with the legislative history, amounts for which the payee may elect withholding are exempt from withholding under section 3402(t), regardless of whether the payee in fact makes such an election. These payments include: (1) Unemployment compensation as defined in section 85(b) (section 3402(p)(2)); (2) social security benefits as defined in section 86(d) (section 3402(p)(1)(C)(i)); (3) 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 (section 3402(p)(1)(C)(ii)); (4) 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 (section 3402(p)(1)(C)(iii)); and (5) any payment of an annuity to an individual.

A special rule applies for payments subject to backup withholding. Section 3402(t)(2)(B) provides that a payment that is subject to 28 percent withholding under section 3406 (backup withholding) is not excepted from the requirement of 3 percent withholding under section 3402(t) unless backup withholding is actually being deducted from the payment. Thus, if backup withholding is required with respect to a payment made by a government entity and the government entity performs backup withholding on the payment, section 3402(t) does not apply. If the government entity fails to backup withholding on such a payment, the government entity would remain liable for backup withholding regardless of whether it imposed withholding under section 3402(t) with respect to the payment. Proposed amendments to the regulations under section 3406 clarify that if backup withholding is required, withholding under section 3402(t) is not required.

Under the proposed regulations, payments made to nonresident aliens or foreign individuals that are exempt from United States taxation pursuant to a treaty would be exempt from withholding under section 3402(t) because such payments are subject to withholding absent application of the treaty. Specifically, absent a treaty, United States source fixed or determinable, annual or periodical (FDAP) income paid to a nonresident alien individual or foreign corporation is subject to withholding under chapter 3, except for income that is effectively connected with a U.S. trade or business (other than compensation for personal services) pursuant to sections 1441 and 1442. Relevant examples of FDAP include salaries, compensation and emoluments.

Imposing a new withholding requirement on nonresident aliens and foreign corporations that owe no United States tax would serve no purpose. Foreign persons that are exempt from withholding under sections 1441 and 1442 by reason of an income tax treaty are not the source of the tax noncompliance problem that section 3402(t) was enacted to address. Further, our existing documentation procedures are intended to ensure that those claiming treaty benefits are in fact entitled to treaty benefits. See, for example, Form W-8BEN, ``Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding,`` and Form 8233, ``Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.`` Accordingly, the

[[Page 74086]]

proposed regulations under section 3402(t) provide that the ``subject to withholding under chapter 3`` exception in section 3402(t)(2)(A) applies to payments with respect to which a foreign person claims a zero rate of tax under an income tax treaty. Thus, if a foreign person furnishes documentation establishing entitlement to an exemption from withholding under chapter 3 by reason of an income tax treaty, government entities would not be required to withhold under section 3402(t) from payments to such person.

Section 3402(t)(2)(C)--Interest

Section 3402(t)(2)(C) provides that payments of interest are exempt from withholding. The proposed regulations do not provide a definition

of interest. The Treasury Department and IRS request comments concerning whether a definition of interest is needed and if so, what that definition should be.

Section 3402(t)(2)(D)--Payments for Real Property

Section 3402(t)(2)(D) provides that payments for real property are not subject to section 3402(t). Because the exception is not limited to payments for fee ownership, the proposed regulations provide that payments for real property include payments for leasing real property and leasehold improvements.

Commenters asked whether real property included payments made under contracts for the construction of buildings or other public works. Neither the statute itself nor the legislative history defines ``real property'' for purposes of section 3402(t).

The proposed regulations adopt the position that payments for the construction of buildings or public works are not payments for real property excepted by section 3402(t)(2)(D). Payments for the construction of a building are payments for services to build the building and personal property to be used in the construction of the building rather than payments for real property. This position is consistent with statutes governing construction contracts of the Federal government. See, for example, 40 U.S.C. 3131-3134 (the ``Miller Act'').

Section 3402(t)(2)(E)--Payments to Government Entities Subject to Section 3402(t), Tax-Exempt Organizations, and Foreign Governments

Section 3402(t)(2)(E) provides exceptions from section 3402(t) withholding for payments to any government entity subject to the requirements of section 3402(t)(1), payments to any tax-exempt entity, and payments to any foreign government. The determination of whether an entity is a government entity such that payments it receives are exempt parallels the determination whether the entity is a government entity required to withhold on payments it makes. Thus, if a government entity is required to withhold under section 3402(t)(1), payments to that government entity are not subject to withholding under section 3402(t). The proposed regulations also clarify that, even if no withholding is required on payments from a government entity because the government entity qualifies for the exception of section 3402(t)(2)(G) for political subdivisions and instrumentalities making total payments of less than \$100 million (discussed later in this preamble), payments to that government entity are not subject to withholding.

The proposed regulations define the term tax-exempt entity for purposes of section 3402(t)(2)(E) as any organization exempt from federal income tax under section 501(a) as an organization described in section 501(c), 501(d), or section 401(a).

Section 3402(t)(2)(F)--Payments Made Pursuant to a Classified or Confidential Contract

Section 3402(t)(2)(F) provides an exception from section 3402(t) withholding for payments made pursuant to a classified or confidential contract described in section 6050M(e)(3). Section 6050M(e)(3) describes a contract between a Federal executive agency and another person if--

(A) The fact of the existence of such contract or the subject matter of such contract has been designated and clearly marked or clearly represented, pursuant to the provisions of Federal law or an Executive order, as requiring a specific degree of protection against

unauthorized disclosure for reasons of national security, or

(B) The head of such Federal executive agency (or his designee), pursuant to regulations issued by such agency, determines, in writing, that filing the required return under section 6050M (related to information returns required to be filed by any Federal executive agency with respect to persons receiving contracts) would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity.

Section 3402(t)(2)(G)--The Exception for Political Subdivisions and Instrumentalities Making Total Payments Under \$100,000,000

Section 3402(t)(2)(G) provides that payments made by certain smaller government entities are not subject to withholding under section 3402(t). Specifically, a political subdivision of a State (or any instrumentality thereof) 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 these proposed regulations) is not required to withhold under section 3402(t) on any of its payments. The proposed regulations provide a simple rule for determining before each year starts whether the exception provided by section 3402(t)(2)(G) applies to a given political subdivision or instrumentality. The determination would be based on the payments made during the accounting year of the political subdivision or instrumentality ending with or within the second preceding calendar year. For example, to determine whether the political subdivision or instrumentality is subject to withholding with respect to payments made in 2011, the proposed regulations would look to whether payments made by the political subdivision or instrumentality for its accounting year ending with or within the calendar year 2009 equaled or exceeded \$100,000,000. For this purpose, the accounting year is considered to be the year used by the political subdivision or instrumentality to keep its accounting books and determine budgets. In most cases, political subdivisions and instrumentalities would be able to make a reasonably accurate estimate whether the exception applies before the end of the accounting year ending in 2009 based on budgetary projections. However, in cases where the payments are expected to be near the \$100,000,000 threshold, the time between the end of the accounting year in 2009, when a definitive determination could be made, and December 31, 2010, should give the political subdivision or instrumentality sufficient time to prepare for withholding under section 3402(t) for payments made in 2011.

In determining whether the political subdivision or instrumentality has made \$100,000,000 of total payments, the proposed regulations would require that all payments for property and services made during the accounting year be considered with the exception of those payments qualifying for any of the exceptions provided by Sec. 31.3402(t)-4(a) through (l) of the proposed regulations.

[[Page 74087]]

For this purpose, payments that are less than the \$10,000 payment threshold count toward the \$100,000,000 test.

This exception provided by section 3402(t)(2)(G) does not apply to the United States Government, States, or instrumentalities of the United States Government or States.

The Treasury Department and IRS request comments on the application of section 3402(t)(2)(G), particularly with regard to whether the rules for determining whether the exception applies would provide adequate time to modify systems for compliance with section 3402(t), whether a

special rule should be considered allowing the averaging of multiple accounting years for political subdivisions and instrumentalities that have unusually high expenditures in a given accounting year, and whether the determination of total payments under the proposed regulations is practicable.

Section 3402(t)(2)(H)--Payments in Connection with a Public Welfare or Public Assistance Plan

Section 3402(t)(2)(H) provides an exception from section 3402(t) withholding for any payment in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test. The proposed 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. The proposed regulations also are consistent with the legislative history in providing that 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). The proposed regulations provide that, 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.

Section 3402(t)(2)(I)--Payments to a Government Employee With Respect to Services as an Employee

Section 3402(t)(2)(I) provides an exception from section 3402(t) withholding for payments to any government employee not otherwise excludable with respect to the employee's services as an employee. The proposed regulations broadly interpret this exception to exclude from section 3402(t) withholding any form of compensation that is paid to the employee or on the employee's behalf. For example, the proposed regulations exclude employer contributions to employee benefit and deferred compensation plans as well as employee contributions to such plans. This exception applies to any payments by an employer for fringe benefits or deferred compensation to, or for the benefit of, an employee.

The proposed regulations provide that the section 3402(t)(2)(I) exclusion from section 3402(t) withholding also applies to: (a) Travel reimbursements paid by a government entity to a government employee under accountable plans within the meaning of section 62(c) for the individual employee's travel, lodging, and meal expenses; and (b) the government employee's payments to third parties that provide travel, lodging, and meals that are reimbursable under such travel reimbursement plans. Most payments for individual travel, lodging, and meal expenses would fall beneath the \$10,000 payment threshold. Nevertheless, this exception may be significant in determining whether the government entity making the payments qualifies for the exception under section 3402(t)(2)(G) for political subdivisions of a State (or their instrumentalities) making payments under \$100,000,000, as payments under section 3402(t)(2)(I) are excluded when calculating the total amount of payments.

Section 31.3401(a)-4(a) of the Employment Tax Regulations provides that if a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) and Sec. 1.62-2 and the expenses are substantiated within a reasonable period of time, payments made under the arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and are not wages. Thus, these payments would qualify for the exception under section

3402(t)(2)(I).

By comparison, if the travel reimbursement or payment by the employer is not paid under an accountable plan, the reimbursement would be treated as paid under a nonaccountable plan. Payments to the employee under a nonaccountable plan are includible in gross income and wages and subject to income tax withholding under section 3402(a). Thus, such payments would be excepted from withholding under section 3402(t) by section 3402(t)(2)(A).

Exception for Certain Payments Received by Nonresident Alien Individuals and Foreign Corporations

In general, in the case of a nonresident alien individual or a foreign corporation (foreign person), sections 872(a) and 882(b) provide that gross income for United States income tax purposes consists of (1) gross income derived from sources within the United States; and (2) gross income derived from sources outside the United States (foreign source income), but only if it is effectively connected with a trade or business within the United States. The source of income is determined under sections 861 through 865. The source of income derived from the performance of services is the place where the services are performed as provided in sections 861(a)(3) and 862(a)(3), whereas the source of income from the purchase and sale of inventory property (other than unprocessed timber) is the location where the sale takes place as described in Sec. 1.861-7(c) of the Income Tax Regulations (see also sections 861(a)(6) and 862(a)(6)). Therefore, if a foreign person provides services or sells inventory property in a foreign country, it will have no United States income tax liability with respect to the income earned from providing the services or selling the property--even to a United States government entity--provided that the income is not effectively connected with the conduct of a trade or business within the United States.

Accordingly, the proposed regulations exclude such payments made to foreign persons from 3-percent withholding under section 3402(t). For administrative reasons, subjecting these foreign source payments to withholding under 3402(t) would be unduly burdensome to the foreign persons receiving such payments and the IRS. The foreign persons, most of whom are not presently United States income tax filers, would have to get taxpayer identification numbers (TINs) and file refund claims. Likewise, the IRS would have to issue TINs, process the claims, and refund all of the funds collected. Withholding on foreign source payments to foreign persons has no potential to reduce tax noncompliance because the potential income resulting from the payments is not subject to United States income taxation. Procedures to be followed by government entities and foreign persons for purposes of claiming this exception from section 3402(t) withholding will be issued at a later date.

Exception for Payments to Indian Tribal Governments

Indian tribal governments are not subject to United States income tax. Subjecting payments made by government entities to Indian tribal governments to withholding under section 3402(t) would be unduly burdensome for the same reasons

[[Page 74088]]

discussed above with respect to certain payments made to foreign persons. Therefore, the proposed regulations except these payments from 3-percent withholding under section 3402(t).

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

In determining rules for reporting amounts withheld under section 3402(t), the Treasury Department and IRS have considered the administrative burden on government entities imposed by reporting, the need for payees to receive timely and accurate information about the amounts withheld, and the need for IRS systems to process the information reported. Many comments reflected a preference for using an existing system and adapting current forms and procedures to accommodate section 3402(t) withholding, rather than creating a new system and forms for such withholding. The commenters indicated that using an existing system would ease compliance by government entities and would ease the processing of the payment and reporting of such tax.

The Treasury Department and IRS believe the existing procedure for reporting nonwage withholding on Form 945, ``Annual Return of Withheld Federal Income Tax,`` and reporting payments subject to withholding on Form 1099-MISC, ``Miscellaneous Income,`` with slight modifications to existing forms, would provide the most satisfactory method of payment and reporting. Because most government entities have a system for issuing Form 1099-MISC, using this system with modifications for reporting section 3402(t) withholding should ease compliance. Additionally, using Form 1099-MISC would give payees the information they need to timely file their income tax returns claiming credit for the withholding. Because this system would be similar to the system used currently for reporting and paying nonwage income tax withholding, the IRS would be able to process the withholding timely and on a cost-effective basis.

Accordingly, the proposed amendments to the regulations under section 6011 provide that payors required to withhold amounts under section 3402(t) must file Form 945 reporting the amounts withheld. Proposed amendments to the regulations under section 6302 further provide that the amounts withheld under section 3402(t) must be deposited and reported in the same manner as other nonwage withheld amounts, such as withholding on gambling winnings and pensions. Pursuant to existing regulations, such 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, as provided in Sec. 31.6302-4.

Additionally, proposed amendments to 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 reporting such payments and tax withheld. Because this reporting would be done pursuant to regulations under section 6051, the exceptions provided in the regulations under section 6041 relating to Form 1099 would not apply (for example, the exception for payments to corporations).

Payments for Jury Duty, Utilities, and Fuel Surcharges

Commenters asked whether jury duty pay is subject to withholding under section 3402(t). Jury duty pay generally will not meet the \$10,000 payment threshold provided in the proposed regulations. No special rule for jury duty pay is provided.

Commenters also requested guidance about utility payments. Rates for utility services are generally prescribed through a State regulatory process. Commenters expressed concern about the consequences of paying something less than the regulatorily prescribed rate to the utility. In fact, utility companies--like all persons receiving payments subject to withholding under section 3402(t)--would be 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. Therefore, unless otherwise excepted, utility payments are subject to withholding under section 3402(t) on the same basis as payments for other property and services.

Commenters also requested that fuel surcharges be exempted from withholding, arguing that a fuel surcharge provided under a contract is merely a cost recovery mechanism used to garner the lowest possible rates for the government by controlling volatile cost components in bid calculations. Although the use of separately stated charges for certain costs may well serve this purpose in contracting, section 3402(t) provides no exception for fuel surcharges or any other separately stated cost item. Section 3402(t) requires withholding on payments made regardless of how the payee may apply them against costs. Therefore, the proposed regulations do not provide an exception for payments allocated to fuel surcharges or any other separately stated costs.

Application of Section 3402(t) to Passthrough Entities

Commenters requested guidance with respect to the application of section 3402(t) where either the payor or the payee is a partnership or S corporation ('passthrough entities'). With respect to payments from a passthrough entity, the proposed regulations provide that such payments are not generally subject to withholding under section 3402(t) unless 80 percent or more of the passthrough entity is owned by government entities that are required to withhold under section 3402(t)(1). With respect to payments to a passthrough entity, the proposed regulations provide that such payments are generally subject to withholding under section 3402(t) unless 80 percent or more of the passthrough entity is owned 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). An 80-percent threshold is consistent with similar thresholds in various areas of the tax law. See, for example, section 775(b)(3) and Sec. Sec. 1.414(c)-2(b)(2) and 301.7701(i)-1(d)(3)(i)(A). The proposed 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 entity's taxable year. The Treasury Department and IRS believe that this general rule simplifies compliance and administration by requiring one annual determination of whether a passthrough entity's payments are subject to withholding under section 3402(t). However, the proposed regulations provide that any manipulation of the ownership percentage with an intent to avoid application of section 3402(t) would be recharacterized as appropriate to reflect the actual ownership percentage.

Effective Date and Transition Relief for Existing Contracts

The proposed regulations provide that the regulations will generally be effective for payments made after the later of December 31, 2010, or the date that is 6 months after the publication of final regulations. Commenters questioned whether section 3402(t) would apply to payments made under contracts in existence prior to the effective date of section 3402(t). They noted that many government entities are party to multi-year contracts. These contracts did not contemplate the withholding of income tax from payments under the contracts. Future

[[Page 74089]]

contracts can address the withholding requirement and its effect on the

contractor's cash flow. Accordingly, the proposed regulations provide that payments made under written binding contracts in effect on the later of December 31, 2010, or the date that is 6 months after the publication of final regulations are not subject to withholding under section 3402(t), unless such contract is materially modified. Payments pursuant to contracts entered into after the later of December 31, 2010, or the date that is 6 months after the publication of final regulations will be subject to section 3402(t).

Under the proposed regulations, if there is a material modification to an existing contract after the later of the effective date of the legislation or six months after the issuance of final regulations under section 3402(t), the contract would cease to be an existing contract for purposes of this transition relief and payments under the contract would become subject to the withholding requirements of section 3402(t). The Treasury Department and IRS are considering whether contracts that contain the option of renewal should be considered new contracts as of the date of renewal. The final regulations may provide that a contract that is renewable as of a certain date is treated as a new contract on the first date the contract is renewed. The Treasury Department and IRS request comments on how option terms in contracts, including, but not limited to, options to renew, should affect the transition relief for payments under written binding contracts.

Credit Against Income Tax

The Treasury Department and IRS received numerous comments from taxpayers expecting to receive payments subject to section 3402(t) withholding. Most of these comments asked how taxpayers would take the credit for the section 3402(t) withholding. Section 31 provides the general crediting rule for withholding of income tax. Specifically, 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) and allows a credit against income tax only.

Section 31(a)(2) provides the general rule on the timing of the allowance of the credit: "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, the rule of 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. Congress did not provide a similar exception for the timing of the credit for section 3402(t) withholding. Section 31(c) is limited by its terms to section 3406 withholding only. Thus, the general rule of section 31(a)(2) applies to section 3402(t) withholding rather than the special rule of section 31(c).

The effect of section 31(a)(2) is that fiscal year taxpayers may be entitled to take credit for withholding under section 3402(t) only in a taxable year subsequent to the taxable year in which the amount was withheld. For example, if amounts were withheld under section 3402(t) from a June 30 fiscal year taxpayer during the period from January 1, 2011, to June 30, 2011, the taxpayer will be entitled to take credit

for the withheld tax on its income tax return for the fiscal year ending June 30, 2012, rather than its income tax return for the fiscal year ending June 30, 2011.

The Treasury Department and IRS recognize that, in the case of fiscal year taxpayers, the application of the rule in section 31(a)(2) requiring that the credit be taken in the second of two possible taxable years may be burdensome for taxpayers. The Treasury Department and IRS request comments on what impact the timing rule in section 31(a)(2) described above for income tax credits will have on taxpayers that have tax withheld under section 3402(t).

Crediting Against Estimated Income Tax Liability

Taxpayers may take into account the income tax withheld under section 3402(t) and allowed as a credit under section 31 in determining estimated tax liability pursuant to sections 6654 and 6655. With respect to individual taxpayers, section 6654(g)(1) provides that, for purposes of determining the application of the penalty for an individual's failure to pay estimated tax, the amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax. As with other income tax withheld, an individual recipient may account for income tax withheld in computing estimated income tax liability on Form 1040-ES, "Estimated Tax for Individuals." Because most individuals are calendar year taxpayers, the section 3402(t) withholding would generally be treated as a payment of estimated tax for the same calendar year, and the individual's liability for other payments of estimated tax for that year would be reduced. However, if the individual is a fiscal year taxpayer, the individual may not take into account the withholding for estimated tax purposes until the fiscal year that begins in the calendar year in which the tax is withheld.

Similar rules apply to corporate taxpayers. In determining the amount of estimated tax required to be paid to avoid the section 6655 penalty applicable to corporations for failure to pay estimated tax, section 6655(g)(1)(B) provides in effect that credits against tax under section 31 are taken into account. Thus, corporate taxpayers can also take into account the amount of credit allowed under section 31(a) in determining income tax liability and in computing estimated income tax liability. As with individual taxpayers, corporate taxpayers on a fiscal year could have the problem of delay in taking account of the credit if withholding occurs in the part of the calendar year before the beginning of the fiscal year that begins in that calendar year.

Credit Against Employment Taxes or Other Taxes

Many commenters requested that taxpayers be allowed to take credit for section 3402(t) withholding with respect to employment taxes or other taxes. The statute directs that crediting follow the rules under section 31(a), which provide for crediting against income tax. Where the 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 3507(d) (providing for the treatment of advance payments of the earned income credit as payments of the income tax withholding and FICA liability of the employer); 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 tax contribution and benefit base). The

[[Page 74090]]

Code does not provide for withholding under section 3402(t) to be treated as payments of the taxpayer's employment tax liability.

Rate of Income Tax Withholding

Some taxpayers requested that the Treasury Department and IRS provide for lower withholding rates for taxpayers with lower profit margins or lower marginal income tax rates. The statute provides for a uniform 3-percent rate of withholding. Thus, the proposed regulations apply withholding at the 3-percent rate to all payments for services and property from which withholding under section 3402(t) is required to be made.

Liability for Section 3402(t) Withholding in the Event of Failure To Withhold

If a government entity fails to withhold the tax imposed by section 3402(t), section 3403 applies. Under section 3402(t)(3) and section 3403, the government entity is generally liable for the payment of the tax to the IRS unless it can prove that the payee has paid its income tax liability.

Section 3403 provides that the employer shall be liable for the payment of tax required to be deducted and withheld under chapter 24, and shall not be liable to any person for the amount of any such 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 the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee by the employer. If, for example, the employer deducts less than the correct amount of tax, or if the employer fails to deduct any part of the tax, the employer is nevertheless liable for the correct amount of the tax. Section 3402(t)(3) provides that for purposes of section 3403, payments to any person for property or services that are subject to withholding under section 3402(t) are treated as if such payments were wages paid by an employer to an employee.

Thus, sections 3402(t)(3) and 3403 establish the liability of the government entity for the amount of the tax imposed by section 3402(t) if it fails to withhold.

However, section 3402(d) provides an exception to the entity's liability for income tax withholding in certain cases. Under this exception, if the entity required to withhold fails to do so, and thereafter the tax is paid, the tax will not be collected from the entity that failed to withhold. Thus, for purposes of section 3402(t), the government entity generally will be liable if it fails to withhold unless it is able to demonstrate, consistent with IRS procedures, that the taxpayer reported the amounts that were subject to withholding on its income tax return and paid the income tax due.

Transition Rule for Penalties and Interest on Underpayments

The proposed regulations provide a special transition rule for a government entity's liability for interest and penalties with respect to the failure to pay the tax on payments for property and services made before January 1, 2012. Under the transition rule, a government entity would not be liable for penalties and interest with respect to liability for withholding imposed by section 3402(t), on payments for

property or services made before January 1, 2012, if the entity made a good faith effort to comply with the requirements of section 3402(t). However, this transition rule would not provide relief from liability for the amount of tax required to be withheld under section 3402(t).

Proposed Effective Date

These regulations are proposed to apply to payments made after the later of December 31, 2010, or six months after the date of publication of final regulations. In addition, the regulations will not apply to payments under contracts existing on the later of December 31, 2010, or six months after the date of publication of final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking 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, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed 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, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social Security, Unemployment compensation.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be 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. The following Sec. Sec. 31.3402(t)-0, 31.3402(t)-1, 31.3402(t)-2, 31.3402(t)-3, 31.3402(t)-4, and 31.3402(t)-5 are added, Sec. 31.3402(t)-6 is added and reserved, and Sec. 31.3402(t)-7 is added to read as follows:

Sec. 31.3402(t)-0 Outline of the Government withholding regulations.

This section lists paragraphs contained in Sec. Sec. 31.3402(t)-1 through 31.3402(t)-5, and Sec. 31.3402(t)-7.

Sec. 31.3402(t)-1 Withholding requirements on certain payments made by government entities.

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

Sec. 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.

[[Page 74091]]

- (g) Passthrough entities.
- (h) Small entity exception.
- (i) Effective/applicability date.

Sec. 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) Payments by credit card or payment card.
- (f) Examples.
- (g) Effective/applicability date.

Sec. 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) Effective/applicability date.

Sec. 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.

Sec. 31.3402(t)-6 Crediting of tax withheld under section 3402(t) [Reserved].

Sec. 31.3402(t)-7 Effective date and transition rules.

(a) General rule.

(b) Exception for payments made under existing written binding contracts.

(c) Good faith exception for interest and penalties on payments before January 1, 2012.

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

(a) In general. Except as provided in Sec. Sec. 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 shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment.

(b) Special rules. See Sec. 31.3402(t)-2 for government entities required to withhold under this section, Sec. 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 Sec. 31.3402(t)-4 for payments that are excepted from withholding under this section.

(c) Deposit and reporting requirements. See Sec. 31.6302-4 for deposit requirements with respect to withholding under section 3402(t). See Sec. Sec. 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 is effective for 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 the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

(2) Payments made under a written binding contract that was in effect on the later of December 31, 2010, or the date that is 6 months after the publication in the Federal Register of final regulations under section 3402(t), 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 the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Sec. 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 Sec. 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 Sec. 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 Sec. 31.3402(t)-1(a). See section 7871(a).

(d) Political subdivision. The term political subdivision for purposes of section 3402(t) and Sec. 31.3402(t)-1(a) is defined as a political subdivision within the meaning of Sec. 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 Sec. 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 Sec. 31.3402(t)-5(c) for the treatment of payments from certain passthrough entities as subject to the withholding requirements of Sec. 31.3402(t)-1.

(h) Small entity exception. See Sec. 31.3402(t)-4(g) for the exception from the withholding requirements of Sec. 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 is effective the later of January 1, 2011, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Sec. 31.3402(t)-3 Payments subject to withholding.

(a) In general. A payment is subject to withholding for purposes of Sec. Sec. 31.3402(t)-1 through 31.3402(t)-7 when paid by a government entity to any person, as defined in Sec. 301.7701-

[[Page 74092]]

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 Sec. 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.

(b) Payment threshold of \$10,000--(1) In general. The term payment threshold means an amount equal to \$10,000. The withholding requirements of Sec. 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.

(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 applies will be 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 will be 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 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.

(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 Sec. 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 Sec. Sec. 31.3402(t)-1 through 31.3402(t)-7.

(d) Payments made through a payment administrator or to a contractor--(1) Definition--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 funds to the payment administrator.

(e) Payments by credit card or payment card. For purposes of section 3402(t), a payment made by a government entity by credit card or payment card to a person for property or services occurs when the credit card or payment card is tendered at the point of sale. The government entity is liable for withholding under section 3402(t) and reporting associated with such withholding. See section 6050W of the Internal Revenue Code for separate reporting obligations imposed on the acquiring bank of the person receiving payment by credit card or payment card.

(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 \$1,440.

(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 \$1,440 withholding required under section 3402(t) on its payment to X and is

[[Page 74093]]

responsible for the related reporting required under Sec. 31.6051-5. See paragraph (a) of this section. X is the person receiving the payment for purposes of reporting under Sec. 31.6051-5. Thus, the government entity is responsible for providing X with a Form 1099 including the entire amount of the payment (\$48,000) and the entire amount of the withholding (\$1,440).

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 is made at the time of the

payment from the government entity to Z. 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 Sec. 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 with respect to which withholding is required, not Z, is the person receiving the payment for purposes of the reporting required under Sec. 31.6051-5 if withholding under section 3402(t) applies. Thus, the government entity is responsible for issuing P a Form 1099 reflecting the amount of the payment from Z to P of \$18,000 and the amount of withholding of \$540.

(g) Effective/applicability date. This section is effective for 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 the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Sec. 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 Sec. 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 of the Code (other than section 3402(t)).

(2) Payments subject to withholding under chapter 3. Payments subject to withholding under chapter 3 include those payments that are subject to, but exempt from, withholding under chapter 3 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 Sec. 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 Sec. 31.3402(t)-1. For purposes of this exception, the term payments for real property includes the purchase and the leasing of real property. 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 Sec. 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

[[Page 74094]]

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. The determination of whether an entity is a political subdivision of a State is made under Sec. 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. The determination of whether the exception provided by paragraph (g)(1) of this section applies is made for each calendar year. For purposes of any calendar year, the determination of whether a political subdivision or instrumentality makes less than \$100,000,000 of payments for property or services annually is 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 purposes of this paragraph (g), payments that would have qualified for the exceptions from withholding under Sec.

31.3402(t)-4(a) through (l) had these regulations been in effect shall not be included in calculating the total payments made. However, payments that would have been excepted from withholding only because such payments were less than the \$10,000 payment threshold contained in Sec. 31.3402(t)-3(b) are included in calculating the total payments for purposes of this paragraph (g). Also, payments that were not subject to withholding under section 3402(t) solely based on the effective date rules or transition rules contained in Sec. 31.3402(t)-1(d), Sec. 31.3402(t)-2(i), Sec. 31.3402(t)-3(g), Sec. 31.3402(t)-4(m), Sec. 31.3402(t)-5(e), or Sec. 31.3402(t)-7 are included in calculating total payments for purposes of this paragraph (g). For purposes of this determination, 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, the determination of whether this exception applies for a calendar year shall be based on the total payments as projected for the accounting year consisting of 12 months ending in that calendar year.

(4) Example. (i) Government entity X, which qualifies as a political subdivision or instrumentality thereof for the calendar years 2011 and 2012, uses a fiscal year ending June 30 to determine its budgets and to keep its accounting books. During its fiscal year ending June 30, 2009, 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 Sec. 31.3402(t)-4(a) through (l) if section 3402(t) had been in effect.

(ii) During its fiscal year ending June 30, 2010, X made payments for property and services of \$210,000,000, including \$106,000,000 that would have been excepted under Sec. 31.3402(t)-4(a) through (l) if section 3402(t) had been in effect. In addition, during the fiscal year ending June 30, 2010, X made \$15,000,000 of payments that were below the payment threshold of \$10,000 in Sec. 31.3402(t)-3(b) if section 3402(t) had been in effect.

(iii) For the calendar year 2011, X determines whether it is eligible for the exception provided by this paragraph (g) based on the total payments X made for its accounting year ending June 30, 2009. Because total payments for this purpose exclude payments that would be excepted under Sec. 31.3402(t)-4(a) through (l), total payments were \$200,000,000 less \$102,000,000, or \$98,000,000. Therefore, for calendar year 2011, X would qualify for the exception provided by this paragraph (g), and would not be required to withhold under section 3402(t).

(iv) For the calendar year 2012, X determines whether it is eligible for the exception provided by this paragraph (g) based on the total payments it made for its accounting year ending June 30, 2010. Because total payments for this purpose exclude payments that would have been excepted under Sec. 31.3402(t)-4(a) through (l),

but include payments below the payment threshold of \$10,000 provided under Sec. 31.3402(t)-3(b), total payments were \$210,000,000 less \$106,000,000, or \$104,000,000. Therefore, for calendar year 2012, X would not qualify for the exception provided by this paragraph (g) and would be 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 shall 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.

(i) Payments made to any government employee with respect to his or her services. Section 3402(t) withholding shall 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 the individual travel expenses of the employee. This exception also applies to payments made by the government employee under accountable plans 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 shall not apply to any payment received by a nonresident alien individual or foreign corporation (foreign person) 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 foreign person.

[[Page 74095]]

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

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

(m) Effective/applicability date. This section is effective for 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 the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Sec. 31.3402(t)-5 Application to passthrough entities.

(a) In general. This section sets forth rules that provide that section 3402(t)(1) does not apply to payments made by passthrough entities except as described in paragraph (c) of this section. In addition, the rules provide that 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 set forth the meaning of certain terms 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) shall 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) shall apply 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 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) shall apply to payments made to passthrough entities during the taxable year, except as provided in paragraph (d)(2) of this section.

(2) Exception. Section 3402(t)(1) shall not apply to any payment during a taxable year to a passthrough entity if the aggregate ownership percentage held, directly or indirectly, in the entity on the testing day by persons described in section 3402(t)(2)(E) is at least 80 percent. For purposes of this paragraph (d)(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.

(e) Effective/applicability date. This section is effective for 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 the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

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

[Reserved].

Sec. 31.3402(t)-7 Effective date and transition rules.

(a) General Rule. Except as provided in paragraph (b) of this section, the requirement to withhold under Sec. 31.3402(t)-1(a) applies to payments made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

(b) Exception for payments made under existing written binding contracts. Payments made under a written binding contract that was in effect on the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t), are not subject to the withholding requirements in Sec. 31.3402(t)-1. The preceding sentence does not apply to payments made under any contract that is materially modified after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

(c) Good faith exception for interest and penalties on payments made before January 1, 2012. Government entities that make a good faith effort to comply with the provisions of these regulations will not be liable for penalties and interest with respect to income tax withholding under section 3402(t) that the government entity failed to withhold from payments made before January 1, 2012. However, this provision shall not relieve the government entity of liability for income tax that it failed to withhold. See, however, Sec. 31.3402(d)-1.

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

Sec. 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), with respect to a payment to which both types of withholding would apply. Pursuant to section 3402(t)(2)(B), withholding under section 3402(t) shall not apply if amounts are being withheld under section 3406 with respect to a 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 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) relating to certain payments made by government entities applies to payments made by government entities under section 3402(t) made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

[[Page 74096]]

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

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

* * * * *

(b) * * *

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

* * * * *

(d) Effective/applicability date. Paragraph (b)(6) 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 the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

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

Sec. 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 Secretary. Such duplicate shall constitute an information return.

(c) Prescribed form. The prescribed form for the statement required by this section is Form 1099-MISC, ``Miscellaneous Income.''

(d) Information required. Each statement on Form 1099-MISC 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.

(e) Time for furnishing statements. The statement 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.

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

(g) Effective/applicability date. This section is effective on the later of January 1, 2011, or the date that is 6 months after the date of publication in the Federal Register of final regulations under

section 3402(t).

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

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

* * * * *

(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 which is required to be made under Sec. 31.6051-2 or of income tax withheld from payments by government entities as required under Sec. 31.6051-5 shall 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 Sec. 31.6011(a)-5(a) is filed as a final return for a period ending prior to December 31, the information statement shall be filed on or before the last day of the second calendar month following the period for which the tax return is filed.

* * * * *

Par. 7. Section 31.6302-1 is amended by adding paragraph (e)(1)(iii)(E) and revising paragraph (n) to read as follows:

Sec. 31.6302-1 Federal tax deposit rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA) attributable to payments made after December 31, 1992.

* * * * *

(e) * * * (1) * * *

(iii) * * *

(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), Sec. Sec. 31.6302-1 through 31.6302-3 apply with respect to the deposit of employment taxes attributable to payments made after December 31, 1992. Section 31.6302-1(e)(1)(iii)(E) applies with respect to the deposit of employment taxes attributable to payments made by government entities under section 3402(t) made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Par. 8. Section 31.6302-4 is amended by revising paragraph (b)(5) and adding paragraphs (b)(6) and (e) to read as follows:

Sec. 31.6302-4 Federal tax deposit rules for withheld income taxes attributable to nonpayroll payments made after December 31, 1993.

* * * * *

(b) * * *

(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. Paragraph (b)(6) relating to certain payments made by government entities applies to payments made

by government entities under section 3402(t) made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.
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