

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE (IRPAC)

1111 Constitution Avenue, NW, Room 7563, Washington, D.C. 20224

Jon Lakritz
Chairperson

March 5, 2009

Ad Hoc

Sub-Group:
Stephen LeRoux,
Chair
James Driver
Joan Hagen
Kathy Ploch
Ron Whitney

Mr. A.G. Kelley
Office of the Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)
CC:PA:LPD:PR (REG-158747-06), Room 5205
Internal Revenue Service
PO Box 7604

Burden Reduction

Sub-Group:
Barbara McArthur,
Chair
Nadine Hughes
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Ben Franklin Station
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Re: Proposed Regulations under IRC 3402(t) - Withholding on Certain Payments Made by Government Entities

Emerging

Compliance Issues

Sub-Group:
Richard Hollingsworth,
Chair
Douglas Borisky
Lisa Maria Chavez
Maria Murphy
Paula Porpilia
Susan Segar

Dear Mr. Kelley:

On behalf of the Information Reporting Program Advisory Committee (IRPAC)¹, we submit the following comments on regulations recently proposed under IRC §3402(t) (the "Proposed Regulations")². The Proposed Regulations address changes in the law made by Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, requiring government entities to withhold income tax when making payments to persons providing property or services, and provide guidance to government entities that must comply with IRC §3402(t).

Modernization

Sub-Group:
Philip Kirchner, Chair
Elizabeth Dold
Lisa Germano
Emily Lindsay
Timothy McCutcheon
Suzanne Sullivan

Payments Subject to IRC §3402(t) Withholding

The Proposed Regulations provide for withholding on certain payments made by government entities or their payment administrators to persons providing property or services. The legislative history³ of IRC §3402(t) states that 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." We recommend the IRS clarify that IRC §3402(t)

Office of Professional Responsibility

Sub-Group:
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Conrad Davis
Mark Castro
Thomas DeGeorgio
Teresa Douglass
William Frazier
Larry Gray
Karen Hawkins
Ronald Larson
Joan Le Valley
Brian Yacker

¹ IRPAC was established in 1991 in response to an administrative recommendation in the final Conference Report of the Omnibus Budget Reconciliation Act of 1989. Since its inception, IRPAC has worked closely with the IRS to provide recommendations on a wide range of issues intended to improve the information reporting program and achieve fairness to taxpayers. IRPAC members are drawn from and represent a broad sample of the payer community, including major professional and trade associations, colleges, and universities, and state taxing agencies.

² See REG-158747-06, 73 FR 74082 (Dec. 5, 2008).

³ See H.R. Conf. Rep. No. 109-455.

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withholding does not conflict with the treatment of qualified plan and deemed IRA distributions to participants and beneficiaries subject to withholding under IRC §3405, and provide assurance that Form 1099-R reporting will not be impacted by requirements under IRC §3402(t).

Additionally, the payment card industry has expressed concern that the \$10,000 threshold would discourage affected government entities from using payment cards for transactions over that amount thereby putting the payment card industry at a competitive disadvantage. A higher threshold would ameliorate this bias. In addition, affected government entities have begun using payment cards for expediency, tracking, and logistics. The \$10,000 threshold likely would alter the way they transact large purchases, thus increasing administrative costs. We recommend that the \$10,000 threshold be reconsidered and adjusted upward to create a more level playing field and to save the government entities administrative costs.

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

Payments to certain types of entities⁴ are not subject to withholding under IRC §3402(t). The IRS should issue guidance to provide government entities with a mechanism to ascertain whether a payee is exempt from withholding under IRC §3402(t)(2)(E). Absent such a mechanism, excessive withholding will occur which will create an additional burden for persons whose receipts are diminished unnecessarily, and the IRS will be burdened with processing additional filings and requests for refunds from these exempted entities.

The IRS should consider allowing government entities to ascertain the status of a payee using one or more of the tests in Treas. Reg. §1.6049-4(c)(1). For example, under Treas. Reg. §1.6049-4(c)(1)(ii)(F), a foreign government may be treated as an exempt recipient (for purposes of certain types of information reporting) without requiring a withholding certificate provided that:

“...its name reasonably indicates that it is a foreign government or provided that is known to the payor to be a foreign government... (for example, an account held in the name of “Government of V” may be treated as held by a foreign government).”

Allowing government entities to “eyeball” exempt payees in this manner would avoid the need to obtain redundant an unnecessary certifications from payees, and would prevent over-withholding.

⁴ Under IRC §3402(t)(2)(E), payments to the following entities are exempt from withholding under IRC §3402(t):

- Government entities subject to the requirements of IRC §3402(t)(1);
- Tax-exempt entities that are exempt from federal income tax under IRC §501(a) as an organization described in IRC §501(c), 501(d), or 401(a); and
- Foreign governments.

Payers currently use Form W-9⁵ to obtain information necessary to file information returns and to obtain certification from payees regarding their Taxpayer Identification Number (“TIN”) and status as a U.S. person. Form W-9 allows payees to indicate their status as an individual/sole proprietor, corporation, partnership, etc. However, Form W-9 does not allow a payee to indicate that it is the type of entity which is exempt from withholding under IRC §3402(t)(2)(E).

The Exception for Political Subdivisions and Instrumentalities Making Total Payments under \$100,000,000

The Proposed Regulations provide a threshold of \$100,000,000 of annual payments for determining if a political subdivision of a State (or any instrumentality thereof) is subject to the withholding obligations under IRC §3402(t). The Proposed Regulations provide that the determination of this exception is to be made each year based on payments made during the accounting year of the political subdivision or instrumentality ending with or within the second preceding calendar year. This requirement will affect smaller entities - those organizations that are near the \$100,000,000 threshold. These organizations would potentially face a situation in which they are required to make major revisions to, or implement new, accounting and payment systems. The cost of these system changes would be a significant burden on these organizations and strain already scarce resources. Additionally, political subdivisions and instrumentalities are likely to experience significant fluctuations in levels of payments for property or services, particularly when building projects or when other major projects are undertaken. These entities would face the possibility of exceeding the threshold for only one year, and then being required to make costly and significant changes to payment systems, or developing or acquiring new systems in order to meet the requirements for only one year. For these reasons, IRS should consider a special rule allowing the averaging of multiple accounting years for the purposes of determining the threshold for instrumentalities and political subdivisions.

Payments to a Government Employee With Respect to Services as an Employee

IRC §3402(t)(2)(I) provides that withholding shall not apply to payments to government employees not otherwise excludable with respect to the employee’s services as an employee. The Proposed Regulations interpret this exception to exclude employer contributions to employee benefit and deferred compensation plans, including any payments by an employer to, or for the benefit of, an employee. Government entities offer a variety of employee benefit plans under many different arrangements, including self insured health plans. Therefore, we recommend the final regulations include examples illustrating the application of this exception under different benefit plan arrangements.

Exception for Certain Payments Received by Nonresident Alien Individuals, Foreign Corporations, and Indian Tribal Governments

The Proposed Regulations provides that a payment to a foreign person is exempt from withholding under IRC §3402(t) where the payment is derived from sources outside the United States and is not effectively connected with the conduct of a trade or business

⁵ Request for Taxpayer Identification Number and Certification

within the United States⁶. The proposed regulations also provide that payments to Indian tribal governments are exempt from withholding under IRC §3402(t)⁷. Government entities that make payments to foreign persons and Indian tribal governments require guidance from the IRS on how to determine whether these payees qualify for the withholding exemptions. In addition, foreign persons and Indian tribal governments require written procedures for claiming these exceptions, and for obtaining refunds of tax erroneously withheld.

Application of Section 3402(t) to Passthrough Entities

Payments to a passthrough entity are not subject to withholding under IRC §3402(t) if 80 percent or more of the passthrough entity is owned by persons described in IRC §3402(t)(2)(E) as determined on the first day of the entity's taxable year⁸. Government entities require guidance to develop acceptable methods of obtaining ongoing or annual assurance that passthrough entities meet the terms of this exception. Exempted passthrough entities require written procedures for claiming this exemption, and for claiming refunds of erroneously withheld tax.

Effective Date and Transition Relief for Existing Contracts

The Proposed Regulations provide that payments made under written or binding contracts in effect before issuance of final regulations are not subject to IRC §3402(t) withholding, unless such contract is materially modified⁹. A material modification to an existing contract would cause the contract to cease to qualify for this transitional relief. In addition, the IRS has indicated that the final regulations may consider a contract that is renewable as of a certain date to be treated as a new contract on the first day the contract is renewed. Government entities will require time to negotiate these renewal options and draft contractual amendments to reflect the impact of the withholding requirements, including terms of retention amounts and potential adjustments to the overall contract pricing. The date set by the regulations relating to contract renewals should take into consideration this additional time required. In addition, many government entities are subject to statutory requirements favoring the use of minority-owned and other small contractors who will be especially sensitive to the adverse cash flow impact of the withholding requirements. A multi-year phase-in approach based on the size of the contractor might mitigate the impact on small contractors.

General Recommendation

We also recommend that the IRS provide assurance that the withholding requirements of IRC §3402(t) do not apply to certain payments related to investments, including (1) annual distributions made by public colleges and universities as trustees to beneficiaries of

⁶ See Proposed Regulation §31.3402(t)-4(j).

⁷ See Proposed Regulation §31.3402(t)-4(k).

⁸ See Proposed Regulation §31.3402(t)-5(c).

⁹ See Proposed Regulation §31.3402(t)-7(b).

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charitable remainder trusts, and (2) capital contributions made by endowments from public colleges and universities to limited partnerships for investment purposes.

Transition Rule for Penalties and Interest on Underpayments

The Proposed Regulations provide a transition rule for interest and penalties for failure to withhold on payments made in the first year the regulations are effective¹⁰. The transition rule applies to entities that make a good faith effort to comply with the requirements of IRC §3402(t). Government entities will be required to implement significant payment and accounting system changes, or in cases where existing systems will not accommodate such changes, entirely new systems must be put in place. These systems are complex and vary greatly from one entity to another. We recommend the IRS provide clarification of the conditions necessary to meet the standard of “good faith effort to comply”.

Withholding under IRC §3402(t) will create significant hardship for government entities, particularly at a time when resources are constrained and severe budget cuts are widespread. The costs of implementation in terms of systems and staffing requirements will be enormous. Vendors that provide property and services to government entities, already operating in an uncertain economic environment, will experience decreased cash flows, further straining their ability to pay for labor and supplies. Furthermore, a government entity’s constituencies might experience reduced services as governments are forced to increase spending on administrative systems to comply with the withholding requirements. We recommend the IRS consider additional relief provisions in recognition of these economic factors.

Thank you for the opportunity to provide comments on the Proposed Regulations. If you have any questions, please contact the undersigned. We look forward to working with you to ensure that the new withholding regime under IRC §3402(t) is implemented in a manner that is fair to all stakeholders.

Sincerely,

Jon W. Lakritz
2009 IRPAC Chair

cc: Douglas H. Shulman, Commissioner, Internal Revenue Service

¹⁰ See Proposed Regulation §31.3402(t)-7(c).