

Federal, state and local government entities required to withhold three-percent on payments for services

In Brief

The Internal Revenue Service has issued proposed treasury regulations under Section 3402(t) of the Internal Revenue Code (the "Code") relating to the withholding of income tax by federal, state and local government entities when making certain payments to persons providing property or services. Law firms that perform services for government entities, such as bond offerings, will be impacted by these new regulations.

Discussion

Section 3402(t) of the Code generally requires federal, state, and local government entities to deduct and withhold from payments made to any person (including partnerships) providing property or services an amount equal to three percent of such payment, subject to certain exceptions. Section 3402(t) was added by Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), effective for payments made after December 31, 2010.

The proposed regulations provide guidance about which government entities and types of payments are subject to the withholding requirement or are exempt, when withholding is required on such payments, and how government entities should pay and report the withholding tax to the IRS. The proposed regulations also include transition rules to provide relief from liability with respect to payments under existing contracts, and temporary relief from penalties and interest if the government entity makes a good faith effort to comply with the requirements of Section 3402(t).

Under the proposed regulations, the withholding requirements will not apply to any payment that is less than \$10,000 per payment. However, if a payment schedule is devised to avoid the application of the reporting and withholding provision then an anti-abuse rule applies. The following are the primary exceptions to reporting and withholding:

- payments made by the prime contractor to its subcontractors;
- need-based payments, such as those made through a public assistance or public welfare program where eligibility is determined through a needs or income test;

Contacts

Stanley Kolodziejczak
(646) 471-3160

Gregg Sincoff
(646) 471-1335

Nancy Regan
(646) 471-6104

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- payments under classified or confidential contracts (as defined in IRC § 6050M(e)(3));
- payments for the purchase of real property;
- payments of interest; and,
- payments by political subdivisions that make total payments under \$100 million are not required to report and withhold under this provision.

Special provisions will apply to U.S. source payments to non-resident aliens. Estimated income tax payments can be reduced by the three percent withholding. However, partners of firms reporting on a fiscal year may encounter a delay in taking the credit.

Effective date

The proposed regulations would apply to payments made after the latter of December 31, 2010, or the date that is six months after the publication date of final regulations. The regulations would not apply to payments under contracts existing on the later of December 31, 2010, or six months after the publication date of final regulations.

Reporting

Every government entity required to withhold amounts under Section 3402(t) must file and furnish an information return using Form 1099-MISC, *Miscellaneous Income*.

Form 1099-MISC is due to the IRS by February 28 (paper filers) or March 31 (electronic filers). Every government entity required to withhold under Section 3402(t) must file by January 31st Form 945, *Annual Return of Withheld Federal Income Tax*, to report the tax withheld.

The income taxes withheld under this provision must be deposited based on the employment tax deposit rules. Accordingly, withheld taxes must be deposited the next day to the extent the accumulated withholding is \$100,000 or more. There are other rules for payments less than \$100,000.

In practice, law firm partnerships will need to track withheld amounts in their internal accounting systems. A system of allocating withholdings and reporting the amounts to partners will also be required. Quarterly estimated tax payments made by partners can be reduced by amounts withheld and firms will need to determine if it makes sense to distribute information on the amount of withholdings on a quarterly basis to their partners. Comparison of withholding amounts as reported on Form 1099 should be reconciled to the firm's internal accounting of amounts withheld.

Finally, the Treasury and IRS are seeking specific comments on several issues where government entities and their paying agents will need guidance in order to implement the withholding requirements of Section 3402(t).

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Conclusion

Law firms that routinely provide services to government entities or that are contemplating entering into government contracts should consider the impact of the three percent withholding on their cash flow and contract accordingly.

Similarly, firms that are subject to withholding under Section 3402(t) may need assistance in establishing systems, policies and procedures to address these new provisions.

Our professionals at PwC have extensive experience assisting our clients with these issues. If we can assist your firm, please contact Stanley Kolodziejczak at 646-471-3160, Gregg Sincoff at 646-471-1335, or Nancy Regan at 646-471-6104.

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