

IRS Delays Implementation of 3% Withholding on Payments for Goods and Services

By Matt Hill

In May 2011, the Internal Revenue Service (IRS) issued final regulations on Section 3402(t) of the Internal Revenue Code, further postponing implementation of a mandatory 3% withholding on payments from government entities to contractors. The final regulations also adopt a \$10,000 withholding threshold for any single payment and provide a transition rule under which penalties and interest will not apply for a failure to withhold on payments made before January 1, 2014. The \$10,000 payment threshold applies to each payment to a person, regardless of the number of items of property or services a payment covers. Under an anti-abuse rule, withholding may not be circumvented by dividing a payment.

The implementation of the requirements under the code section was originally scheduled to be effective for payments made after December 31, 2010. However, implementation was delayed one year by the American Recovery and Reinvestment Act of 2009, and the final regulations have delayed implementation another year, and now **the provision will become effective for payments made after December 31, 2012.**

Besides extending the effective date, under the final regulations the withholding requirement does not apply to payments made after December 31, 2012, if the payments are made under a written binding contract in effect on December 31, 2012. However, if an existing contract is materially modified after that date, subsequent payments will be subject to withholding. The final regulations provide guidance on what constitutes material modification of a contract for purposes of the exception.

The statute excludes from the withholding requirements the following:

- Payments made to other governmental entities;
- Payments made to tax-exempt entities (regardless of whether the payment is treated as unrelated business income to the tax-exempt entity);
- Payments made to foreign governments;
- Payments made by political subdivisions of states or instrumentalities of those subdivisions that make less than \$100 million of such payments annually;
- Payments to government employees for services as an employee, including employer-provided fringe benefits;
- Payments for interest or real property (real property does not extend to construction of buildings, roads, or other public works projects);
- Grants made by government entities for certain public purposes; and
- Payments subject to withholding under other Code provisions

The date of a payment subject to withholding is considered to be that on which payment is made, regardless of the date on which the government entity accepts the services or property, or whether the payment is made under various forms of advance, interim, or performance-based measures.

Despite the delay, governmental entities should begin reviewing the provisions of this new law in anticipation of the implementation in January 2013 as it could create a significant amount of recordkeeping to comply with the provisions.



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