

Note - Any federal tax advice contained in this transcript is intended to apply to the specific situation described and should not be considered official guidance independent of the presentation. The tax advice and statements contained herein should not be relied upon for retirement planning purposes without first consulting a tax or retirement planning professional. This transcript has been edited for technical accuracy and may differ slightly from the audio recording of the Aug. 18, 2011 phone forum. This information is current as of August 18, 2011. Since changes may have occurred, no guarantees are made concerning the technical accuracy after that date.

Final Transcript

INTERNAL REVENUE SERVICE: Q&A on IRC 3402(t)

August 18, 2011/2:00 p.m. EDT

SPEAKERS

Tennille Francis
Stephen Tackney

PRESENTATION

Moderator Ladies and gentlemen, thank you for standing by. Welcome to the Question and Answer Session on the Internal Revenue Code Section 3402(t) Phone Forum. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session; instructions will be given at that time. As a reminder, today's call is being recorded. And now I'd like to turn the conference over to your host, Ms. Tennille Francis. Please go ahead.

T. Francis Thank you. Good afternoon, everyone, and thank you for joining us for our second phone forum on IRC Section 3402(t). As you all know, IRC Section 3402(t) requires all federal, state, and some local governments to withhold 3% of payments of \$10,000 or more for goods or services. Today on this call joining me will be Stephen Tackney from IRS Tax Exempt Government Entities Chief Counsel, and Stewart Rouleau, who's also a Tax Law Specialist here in the Federal, State, & Local Governments Division.

INTERNAL REVENUE SERVICE

Host: Carol Walters

August 18, 2011/2:00 p.m. EDT

Page 2

The goal of today's phone forum is to provide you with as much information as we can; however, we do recognize that we may not be able to answer all of your questions. But please be assured we are working to answer as many questions as we can, and we would like to get all the information we can out to you so that you are able to be compliant with the statute as of January 1, 2013.

During today's forum we would request that you ask questions that are more applicable to the general audience rather than those that are very fact-specific and unique to your situation. Those questions we would ask that you forward directly to the Federal, State, & Local Governments box at ask.FSLG which is located on the Federal, State, & Local Governments website via IRS.gov. Along with that you'll find on the Federal, State, & Local Governments website a link to some frequently asked questions regarding 3402(t). And we also ask you to stay tuned and visit the site frequently, as we are adding more FAQs to that list periodically.

Before we open the line up for questions, we have a few points of clarification we'd like to make, and with that I will turn the microphone over to Mr. Stephen Tackney from TEGE Chief Counsel to discuss a few of those points.

S. Tackney

Thank you. Before we get started we wanted to cover a few topics that we've gotten a lot of questions on, just so hopefully we can move through those topics quickly.

The first has to do with exactly what government entities are covered. Those will be federal government and federal instrumentalities, or instrumentalities of the federal government; those include state government and all instrumentalities of state government, so all of those are covered. It may also include a political subdivision of a state or an instrumentality of a political subdivision; however, those two types of government entities are only covered if they make \$100 million in annual payments that would be subject to 3402(t). We do have some rules on how to determine whether you have met the \$100 million payment threshold, and it is a lookback of two years so that you will be able to make that calculation and be prepared. But, again, I want to stress all state governments and instrumentalities of state government are covered regardless of the amount of payments they made, as are federal government and instrumentalities of federal government.

We recently posted a FAQ that discusses the definition of an instrumentality and we hope soon to post an FAQ discussing the definition of a political subdivision. So for those of you who aren't familiar with those terms, we hope that those will be helpful.

The next topic is that I think many people are wondering, always curious about, is – is this section going to be repealed. We don't know and we are not involved in any of those discussions. That is an issue for the Congress and we don't have really any power or any influence in that world. So we ask, if you do have concerns or requests for repeal, that your congressmen are really the folks to speak to.

Moving on, there are a number of exemptions from 3402(t) withholding. Those will generally fall into two categories; there are certain types of payments that are exempt such as payments for real property including the leasing of real property, for example. But there's also certain types of categories of ... of providers of goods and services that are exempt. And those, generally, are the types of entities that don't pay federal income tax so it would not make sense to apply income tax withholding. For example, tax exempt organizations, other federal, state, and local governments, and foreign governments are not going to be subject to 3402(t) withholding as the provider of the goods and services.

We have gotten a lot of questions on how am I going to be able to claim that exemption from the folks that would be exempt, and we've also gotten a lot of questions from government entities on when am I going to be able to receive and rely on; we are currently working on that guidance. As we said in the preamble we anticipate it would be—generally be through the submission of a form or a statement from the payee saying that they fit into one of the exempt statuses, signed under penalties of perjury. And we are working on getting you specific guidance on how that will work for the different types exempt payees.

Next topic is—we have also gotten a lot of questions about pass-through entities. The withholding will apply to pass-through entities unless another exception applies. The pass-through entity, itself, would be the entity receiving the 1099-Miscellaneous that would have the amount withheld, as a credit. Then the pass-through would allocate the credit out to the owners and the pass-through entity in accordance with the regular partnership tax allocation rules, so then the owners would have a credit that they would take on their particular tax returns. So, yes, pass-through

entities will be—can be subject to withholding unless another exception applies.

Finally, we had issued at the same time as we issued the final regulations, we issued some very, very narrow proposed regulations concerning the treatment of existing contracts as of 2013 and whether and to what extent the 3402(t) withholding rules will apply to those. We did receive—the comment period just closed, but in addition to the comments we did receive several requests for a hearing so there is currently scheduled a hearing for the morning of September 12, here in Washington, DC. After we have that hearing and are able to get all the testimony we'll start taking the testimony and the comments into consideration and hope to have resolution of that issue reasonably soon. Of course, speaking in government time after that. But again, we're not really—other than comments we're—it's not currently being considered because we need to wait and get through the hearing.

So those are some topics that we commonly get asked about and I just wanted to go ahead and get that information out before we got started.

So back to you, Tennille.

T. Francis

There are two other topics we wanted to briefly touch on that we received some additional questions about, and it's just regarding the general reporting and the depositing of the withholding. And we just want to make clear that the 3% withholding occurs on a payment by payment basis. So once you make the payment, the 3% holding, if it is applicable, will take place then. Along with that, the amounts that are withheld have to be remitted or deposited with the IRS and they're usually—they are required to be deposited with other non-payroll items, such as backup withholding, and those amounts will be reported to the IRS on a Form 945 which is an annual return of withheld federal income tax and that is an annual form which is generally due by January 31st of the succeeding year.

Also, we wanted to let you know that the rules for the depositing those amounts are the same as the rules for depositing non-payroll withheld amounts and those rules can be found in the Treasury Regulations at Section 31.6302-4 and also in Section 11 of Publication 15, as well as the Form 945 Instructions. So you have about three places you could go to get details to determine what your deposit schedule will be, for this 3% withholding.

To round that out, the payor will provide to the payee a form 1099-MISC, a miscellaneous form. And the payor will report to the payee the amount of tax withheld and that will be reported in box 4 of the form. And then the income for which the amounts were withheld upon will be reported in the appropriate income box. And that form must be provided to the payee by January 31st of the succeeding calendar year and a copy must also be filed with the IRS either on the last day of February or by March 31st if you file the forms electronically.

Along with that, any adjustments or corrections to withholding should generally be done within the calendar year and they follow the same procedures as income tax withholding for wage withholding, and that information can also be found in Publication 15.

So we just wanted to highlight those few things before we get started and another FYI, this phone forum does not qualify for continuing professional education, so CPE credit will not be granted.

Otherwise, operator you can open the line for questions.

Moderator Thank you. We'll first go to Suzie Erickson. Please go ahead.

S. Erickson Yes, hello. We have three questions. Our first question is will the FSLG respond to all email questions directly, or will the answers to those questions only appear in the FAQ?

T. Francis Generally, I can say that we will not respond specifically to each question; however, if the question you ask has an answer in the FAQ we will direct you to the FAQs; other more fact-specific questions we may email you to tell you that we can't answer them at this time but if you request additional guidance we suggest that you send in a request for additional guidance.

S. Tackney And just as an FYI to folks – we do not respond with substantive answers by email. As you can imagine the fear there is that it's published guidance and it can be forwarded on and also altered. So other than to tell you things like you may want to see the FAQ or we're not going to be able to answer this, you may be contacted by phone so I suggest if you are sending in a comment that you also give us a contact number.

Moderator And we'll move on to our next caller, Robyn Seaton.

- R. Seaton Hi, my name is Robyn Seaton and I'm with SAP and I've got a couple of questions if I can but real quick, what happens if there's an adjustment to a payment such as a refund that we need to make or a credit memo, perhaps because goods were returned, that takes you back below the \$10,000 threshold. So for example, I paid them \$12,000 I now need to refund them \$3,000 – do we need to give all of the withholding back?
- S. Tackney The quick answer to that is no, you do not need to give it back. The \$10,000 threshold applies to the payment that's actually made, whether it's correct or incorrect. So if you overpay and you go over the \$10,000 limit then withholding applies. Similarly, if you underpay and you're under the \$10,000 limit that applies, I will stress, of course, that's assuming you have a—it's a bonafide and good-faith failure to underpay and not to avoid withholding but we do—it all is based on the amount actually paid. Now how you would actually account for this inside the withholding will depend on whether you correct it in the same year that you made the mistake in payment, or whether you're doing it in a subsequent year. And for the same year you can basically true up in several ways; the point is that by the end of the year you should have the correct amount paid to them and the correct amount of withholding deposited with us. After that year, you can't correct an over-withholding; any amounts over-withheld will be credited to the payee so they would get the money back either through a refund or a credit against taxes if they do owe taxes so it will matter. And where, again, I would look is it will be the same procedures that apply for income tax withholding with respect to wages. The statute for 3402(t) incorporates those procedures. I would stress that is not the FICA rules. They are much more generous and different because of the way FICA works. So make sure if you are looking at the wage rules that you're looking at the income tax withholding rules, but that's how the correction would apply.
- Moderator And we'll move on to our next question from Gwendolyn Holmes.
- G. Holmes Did you address about credit card payments since that happens automatically?
- T. Francis As the regulations stand now, credit card payments, payments by credit card/debit card are excluded from 3402(t) withholding however the regulations do offer that the IRS reserves the right to bring in credit cards into 3402(t) withholding and if that does happen, there will be an 18-month implementation period from the time that the regulations are final which provide that payment cards will be subject to withholding.

However, if you do use convenience checks associated with those credit cards, convenience checks, payments made with convenience checks, are subject to the 3% withholding.

Moderator Our next questions will come from Jasmine Anderson.

J. Anderson So just actually this is kind of a—maybe this is very simple question, but does the 3%—is the 3% deducted from the payment to the vendors?

T. Francis Yes, the 3% is deducted from the payments of the vendors and that 3% is deducted off the gross payment at the time that the payment is made. The 3% is not deducted after any offsets, garnishments, or levies. So therefore, the 3% is applied to the gross amount. Any garnishments or levies will have to come out after the 3% is applied.

Moderator Our next question will be from Patricia Hampson.

P. Hampson-Bennett Hi, this is Pat Hampson-Bennett from Digital Systems Group. My questions is when paying a single vendor, it is possible to be paying multiple invoices at the same time and treasury usually wants us to consolidate those payments onto a single transaction. Do we use the single transaction that we are sending to treasury to determine the threshold, or do we do it based on the individual invoice in our system?

S. Tackney Yes, the \$10,000 threshold is based on the actual amount of payment so bundled payments, which would include multiple invoices that are paid with one payment, you base it on the amount of the payment. This is not an invoice-based threshold. So four \$3,000 invoices that are paid with a \$12,000 check would be subject to withholding. Now that, of course, leads to well then maybe I'll just pay them in separate checks. Just know we do have an anti-abuse rule that says if you're dividing up your billing or your payments in order to avoid—with the primary purpose of avoiding withholding we can treat them as a single payment that would be subject to withholding. Again, that's an anti-abuse rule so you should just bill the way you've always billed historically. But again, bundled payments that cover multiple invoices, we look at the actual amount of that single payment. We are not going to be looking at the invoices.

Moderator And our next questions will come from Backer Ali.

B. Ali Hello. My question has to do with whether this applies to GSEs, Government Sponsored Entities?

- S. Tackney I can't speak directly to any specific Government Sponsored Entity. If it's treated as either a part of the government, whether—I'm assuming you're talking federal, but presumably this could be part of the state government, or it's treated as an instrumentality, you would be covered. And we have guidance—or we have guidance in both areas. But we have an FAQ on the definition of instrumentality and we will soon be coming out with an FAQ on the definition of a political subdivision of a state. What I suggest—for everyone out there who has questions about whether they're an entity or not, the very same issues may have arisen for other tax purposes, including the ability to issue a tax exempt bond or the ability to sponsor a government employee retirement plan which are subject to a separate set of rules. So you may—your entity may already have made the determination of their status as a government entity or not under the same standards. So you should check that out and see if any of that has been applicable before. But again that's a very factual, fact and circumstances-based issue of whether you are an instrumentality or actually part of the federal or state government so it's not really something we can answer specifically here.
- Moderator Our next question will come from Brian Wolcott.
- B. Wolcott Yes. As I understand this—I work for a municipal government and this would not apply, this standard would not apply. Is that correct?
- S. Tackney A municipal government, generally, is a political subdivision of a state. I stress, generally, because again you'd need to do the analysis of what type of entity you are. If you are a political subdivision of a state it can apply to you if your political subdivision makes payments that would be subject to 3402(t), has an annual amount of \$100 million or more. So there's \$100 million payment threshold; we do have more rules on how to calculate that. We also have an FAQ on the type of payments you include and the type of payments you exclude as far as determining whether you're \$100 million. The thing I would want to stress is that the basic rule for calculation has the 2-year lookback, so the amount of payments you make this year will determine whether you are subject to it in 2013. Again, 2011 is the year that you would use, and the idea there is you would be able to calculate that early next year and know well in advance whether you will be subject to this in 2013. But yes, political subdivisions of states, which generally include cities and counties, may be subject to Section 3402(t) withholding.

Moderator And we'll move next to Colleen Scott.

C. Scott Hi, this is Colleen Scott. I already had the question answered; I was inquiring about the bundled payments.

Moderator We'll move next to KC Tran.

K. Tran Hi, I have a question about the payment made under a recent ... contract. So there's little confusion about that. We have several contracts here so we have to look at each contract to determine if it is an existing contract or not. ... some we have a contract here we ... every contract we may, we may not renew the contract for at least five or six years. So can you give me more guidance on that?

S. Tackney Yes. The—here's the rough up on this one. There's a current final regulation rule; however, at the same time that we issued that rule we proposed to change it and have received comments and we'll be having a hearing. So what I'm first going to describe to you is what would be the current rule if it remained unchanged, and that is that contracts existing as of the end of the 2012 will not be subject to 3402(t) withholding even if they're renewed, unless they are materially modified. Meaning that you materially change the price to be paid, the amount of property or services to be provided, or the type of property or services to be provided. So if there's a material change it's—basically treated as a new contract. So under the current final regulations, if they remained unchanged, contracts existing as of the end of 2012 will not be subject to 3402(t) including if they're renewed; a renewal that does not otherwise constitute a material modification, but would be if they're materially modified which again would be a—generally would be an increase, an increase in price, a material increase in price, a material increase in the amount of goods or services to be provided, or a material change in the goods or services to be provided. That is the current rule.

What has been proposed, due to comments from government entities, that dividing up the world between current and new—or existing and new contracts would be very difficult to administer, is to turn that rule off as of January 1, 2014 and make all contracts, regardless of whether existing or not, subject to Section 3402(t). We have received some supporting comments from government entities. We have received some non-supporting comments from a few government entities, and we've received quite a few comments from contractors, generally also contrary. So we have scheduled for September 12th a public hearing; it will be at the IRS

Building in DC where people—we have three people who have asked to speak, but anybody can speak if you do want to attend. And after we get all the comments in, including all of the testimony, all of that's taken into account and we'll go through our process of determining whether to finalize the regulations, whether to change them, or whether to simply pull them and stay with the current regulations that we had. But that's all I can really tell you until we get through that process, that the treatment of existing contracts is the one area of the regulations left to finalize.

Moderator And we'll move next to Meggie Chan.

M. Chan Yes, this is Meggie from the California Lottery and I have two questions. One of them is that we have retailers that we ship tickets to. They have specific bank accounts set up and once a week they deposit the money for the tickets, and it's less their commission. So we don't actually write the retailers a check for their commission. Would that be considered a payment, or would retailers—would that actually be considered a payment to retailers, the way we pay them? Or the way they pay us?

S. Tackney Historically yes, that has been and you should be giving them a Form 1099 at the end of the year indicating the payments that they received by withholding their commission. As far as the exact timing, we would have to look at your specific fact and circumstances and it may not be the same across all lottery systems so the how—the timing of your actual payments and how the collection and disbursement works it's just something we'd need to look more at, but for purposes of the tax code we have guidance out that treats you, the lottery system, as paying those vendors the amounts and actually already requires you to provide them a Form 1099.

Moderator Our next question will come from Sherah Mikler-Richard.

S. Richard Hi, this is Sherah Richard. I had a question regarding payments that we make when—with regard to bundled payments. We do some public assistance payments to utility vendors, and when we pay our utility bill those would be subject to the withholding. But when we're making public assistance payments to the same vendor, how are we going to figure out what amount should actually be withheld?

S. Tackney I can't really answer too much of the specifics. One is that you need to make sure that your payment qualifies for the public assistance or public welfare program exception, including the fact that you actually make the payment to the utility that that can still qualify for the exception.

Assuming that it does, you will need to be able to allocate that out; you can use any reasonable method of allocating it out based on the information that you have. If you cannot allocate it out then you need to do withholding on the full payment. So, again, if any reasonable method of allocation, and that's pretty much what we ask of any payments that are mixed between an exempt portion and a non-exempt portion of the type of payment. We don't dictate your method of doing the allocation but if you, for some reason, cannot come up with a method that you can apply then you would need to do withholding on the entire payment and then the utility would, of course, would be able to get the money back through refund or credit on their income taxes.

Moderator And our next question will come from Joan Simms.

A. Merkle Hi, this is Avis Merkle with Joan Simms. My question is with all the vendors that are going to be coming through the government and paying, are they going to require CCR to be updated with this exempt flag? Will they go through CCR as exempt or non-exempt?

S. Tackney We can't speak to that. We are the IRS and not the Federal—any of the federal acquisition rules or agencies or any of those programs. So we can speak to the tax form filing requirements, but we can't speak to any of the specific federal acquisition programs.

Moderator And we'll move next to Barbara Wong.

B. Wong Hello. My question is regarding meeting the \$100 million threshold for political subdivisions. There is a portion where benefit payments are made by the employer on behalf of the employee and it is paid directly to the, like for a medical benefit; it is paid directly to the provider of the medical benefit. Is withholding to be applied to these payments? Hopefully I explained it right.

S. Tackney We are actually—that doesn't, it's somewhat a secondary issue about the \$100 million payment exception. But we are currently hoping to get some more clarification out and are looking at this specific issue. Contributions to employee plans are out and we are looking at the boundaries of the actual, where the purchase of benefit that the plan is providing, whether that's included there as well. And we hope to get some clarifying guidance out reasonably soon. But that is actually an issue that is being discussed.

INTERNAL REVENUE SERVICE

Host: Carol Walters

August 18, 2011/2:00 p.m. EDT

Page 12

Moderator Our next questions will come from David Wilson.

S. Tackney Do you have a question?

D. Wilson Yes, one question is before the forum started I wanted to know if all of the forums are CPE credit approved?

T. Francis No. This phone forum here is not eligible for CPE credit. It will not be granted for this.

D. Wilson It will not be granted for this session, for this forum?

T. Francis Yes. You're correct. It will not be granted for this forum.

D. Wilson So any future forums?

T. Francis If CPE is to be granted for any future forums, it will be explicit on the publication for the specific forum; however, this forum does not qualify for CPE credit and if we are to give qualifying CPE credit, that will be disclosed up front.

D. Wilson Oh, okay.

T. Francis Okay. Thank you.

D. Wilson Thanks.

Moderator We'll move next to Thomas Rowe. Mr. Rowe your line is open.

T. Rowe My question is if you do, as a contractor, do business with a federal or state or local entity that meets the \$100 million criteria, as a prime contractor does the 3% withholding apply to subcontractor payments under that prime contractor?

T. Francis First, if you do business with any federal, state, or local government agency or instrumentality, any payment of \$10,000 or more that you receive as a contractor will be subject to the 3% withholding. That 3% withholding only takes place between the contractor and the federal government; it does not trickle down. So therefore you will not have to withhold the 3% for any subcontractors.

Moderator We'll move next to Suzie Erickson.

- S. Erickson Yes. Our question is, is the FSLG aware of any states where 3402(t) withholding would trigger state withholding? For example, California?
- S. Tackney We can only speak to federal taxes. We are not really able to speak to any implication on state withholding taxes. So it's not really in our authority and we don't want to speak for any particular states' Department of Revenue.
- Moderator And next we have Burbank Renie.
- R. Burbank Hi. This Renie Burbank. I have a question regarding Medi-Cal and Medicaid payments. We are a political subdivision and we have members that receive help from the Medi-Cal and Medicaid—I'm sorry, Medi-Cal because we are in California, as well as Medicare. Some of these payments qualify and I'm speaking really to—okay, the Medicare payments, some of them are based on age. Some of them are based on disability. So does the payment to the Medicare—relating to the Medicare line of business, does it meet the exception for needs-based program? And what happens if we actually get—pay it on one check, the Medi-Cal and the Medicare on one check? Do we need to bifurcate that out if some of the Medicare does not qualify underneath the needs-based programs?
- S. Tackney The requirements for the needs-based program do require that it be based on economic factors and cannot be age-based only. And since Medicare is an age-based only program those would be subject. I can't speak at all to Medi-Cal. I don't know the specifics of the program to be able to apply that. Now so your payments could possibly be subject to 3402(t) withholding to the extent you're buying services. Again, you could allocate—you should try to allocate under any reasonable allocation method and if that's not doable you would withhold on the entire payment but it would be any reasonable allocation method if, in fact, the Medi-Cal payment was not subject to 3402(t) withholding and you were either bundling or somehow had a payment that was covering both. If you could allocate between the two under a reasonable method you should do that. And if not, you should withhold on the whole payment.
- Moderator And we'll move next to Brian Anthony.
- B. Anthony Hello. I'm a non-profit consultant. And I think my question's been answered but I'll ask it anyway. Are the payments made by an NPO to vendors using federal funds subject to withholding? For example, an NPO

INTERNAL REVENUE SERVICE

Host: Carol Walters

August 18, 2011/2:00 p.m. EDT

Page 14

gets a HUD contract to do a capital project and then retained or hired a construction company to actually do that work. Would they be subject to the withholding? And ... guidance on that?

S. Tackney The NPO and I don't exactly know what an NPO would be—

B. Anthony I'm sorry. Non-profit organization.

S. Tackney Oh, okay. I probably should've figured that one out. If you have a 501 tax exempt status you will not be subject to 3402(t) withholding, for instance even if you're supplying construction services which would normally be subject to the withholding. And we are currently writing guidance that will talk about the procedure for you to claim that exemption. In other words, what would you need to give the government that you're contracting with, what types of representation that they could rely on to not do the withholding and not be liable for any failure to withhold? We have similar types of forms in other areas where we have either withholding or reporting. So we are looking at that process but the quick answer to your question is as a tax-exempt organization, you should not be subject to Section 3402(t) withholding.

Moderator And our next question will come from Heather Wright. And Ms. Wright, your line is open.

H. Wright Hello?

T. Francis Yes, hello? Do you have a question?

Moderator We'll move next to Melissa Johnson.

M. Johnson Yes. I have a question regarding ACH payments or payments by wire transfer. Are those payments subject to 3402(t)?

T. Francis Yes. Those payments would be subject to 3402(t).

Moderator Our next question will come from Maria Wong.

M. Wong Yes. My question is on one of those items that's listed under the Frequently Asked Questions. We are a management of a health care; this number five, are Medicare payments subject to the 3402(t) withholding? So we receive Medicare payments, like to the hospital and to the doctors.

Now, those would—it says it may be subject to the withholding. How do we get more guidelines as to exactly what it is, instead of the maybe?

S. Tackney I think the largest excepted payment would be for the \$10,000 exception. I mean a payment that you make under Medicare that's less than \$10,000 would not be subject to 3402(t) withholding. But you are going to have to go through the exceptions. I would imagine, for instance, a Medicare payment's not going to pay for real property but if you happen to buy or lease real property that would be through the Medicare program so there is a series of exceptions for types of payments probably I would assume the most common in this area will be payments of less than \$10,000 but you will need to go through and make sure another exception doesn't apply. But that's why there's a "may" in there is it would need to—first of all, it needs to be a payment from a government entity and second of all, it would need to be above \$10,000 and third of all, another exception would not apply.

Moderator And we'll move next to Steve Hoffman.

S. Hoffman Yes, I want to get back to the adjustments made if we paid somebody \$12,000 and we've already withheld the 3% on that and then we find out we should have only paid them \$9,000 so we shouldn't have withheld. And we've deposited that money with the IRS on Form 945 and suppose we don't discover this until the next calendar year. How is it that we, being the institution withholding, obtain either some credit for that or a refund of that?

S. Tackney Okay, to answer first of all even if—that's not something you would fix in the same year. It's based on the \$12,000 withholding threshold so you paid them \$12,000 – that's what we—to apply the \$10,000 threshold to, you met it, withholding applied. That was correct. You deposited with it. If you subsequently find out that you only owed them \$9,000 you can pay them back, net of the withholding but the withholding should have occurred and will not be—shouldn't be taken credit for. Where over-withholding would occur is, for instance, you applied it to a payment that it shouldn't have applied to or you applied it a payee that it shouldn't have applied to or you, for some reason, withheld more than 3%, that's something you can straighten out but this issue not an over or under withholding because you actually did pay them \$12,000 and that's what you measure it by, that actual payment on that payment date.

Now, ultimately at the end the contractor—you will give them a 1099-Miscellaneous and for a \$12,000 payment that would presumably have a credit of \$360. So the next year they would use that 1099-Miscellaneous and claim that credit on their income tax return and that is how they will either get it as a credit it, or if they don't actually owe up to \$360 in taxes they'll receive part of it as a refund. But that's how they'll get the \$360 back the next year. So you would need to have the \$360 on your 945. You have correctly withheld it and deposited it, and you would need to have it on the 1099-Miscellaneous and that's how the contractor would then turn around and either get it back or get credit for it against their otherwise owed income taxes.

Moderator

And Kathy Heaton will have our next question.

K. Heaton

Hi. My question has to do with the contractors—you started to mention that it is going to be looked at and that there'll be a hearing in September; however, you said there's a distinction between existing and current isn't—and then you stopped. Isn't it that the applicable period for withholding is different, not that one is exempt and the other isn't?

S. Tackney

No. Under the current regulations all withholding starts on January 1, 2013. Including under the proposed regulations the withholding will actually turn on on January 1, 2013. However, for existing contracts they would be exempt unless and until they're materially modified under the existing rule. So they would basically fall into an exempt-type of payment unless and until the contract is materially modified. Now, what the proposed rule would say is that that rule I just described applies only for 2013, so that even an existing contract that hadn't had any material modification would have withholding start in January 1, 2014. So if I had an existing contract under—as of in 2012, and I did not touch it and we finalized the proposed rule I would not have withholding in 2013 but it would start in January 1, 2014; but otherwise if you're not even thinking about the existing contract exception all the withholding starts on January 1, 2013. So, again, it's whether and when it turns on as to existing contracts that are not materially modified. That's the question that's at issue with the proposed regulations and that we'll be having a hearing on.

Moderator

And we'll move next to Shari Sobek.

S. Sobek

Yes, my question is regarding the purchase of foreign currency. Would the 3% apply to this whenever you purchase foreign currency from a bank or any other institution?

- S. Tackney We are currently looking at that very issue and I would suggest that you—we hope to have some—another round of FAQs out in the next week or two that would address that issue so I'm not really able to answer it today, but I am hopeful that we will have an explicit answer out for you in the next round of FAQs, so do look at the FSLG website where those are posted and do look for it.
- Moderator And we'll move next to Sherry Gates
- S. Gates Hi, our question has to do with the P-Card transactions and those transactions being exempt from the withholding, at least initially. And we're looking into something called an E-Payable Solution through our bank that does our credit card. And this is basically similar to a P-Card; it's on a P-Card platform, but the question is whether this would be considered a P-Card payment and therefore exempt from the withholding?
- S. Tackney I would ask that you actually send that in; there's also the issue whether for another reporting section called 6050W which is—in common parlance is known as the credit card reporting, where credit card companies will need to be giving 1099-Ks. We have the same payment card definition, so we will need to look at it in conjunction with them to see also whether you, for instance, under this same arrangement would they say that it's subject to the 1099-K reporting so—or would it be treated as a payment card transaction for the 1099-K so—because generally if it would be a 1099-K reporting it will not be 3402(t). If it is not 1099-K reporting it would be 3402(t) so we need to do it in conjunction with them. So again, and the more description of this program, including if there's something we can look at, the better, as far as understanding whether it fits the payment card, debit card, credit card definition.
- Moderator And next we have Ilze Abolins.
- I. Abolins Can you define material modification in just those two words?
- S. Tackney No.
- T. Francis No.
- I. Abolins Okay. How are we supposed to do anything with that if we don't know what you mean?

- S. Tackney Material modification includes a material change in the price of the goods or services, a material change in the amount of good or services, or a material change in the services or goods to be provided. This is actually more guidance than we have provided in many other areas in code where this type of contract entered into standard has been applied. We are aware, however, that government entities especially are uncomfortable with having that discretion to make the determination of whether a change is—and again, that would normally be would a reasonable person consider this change to be material or not—uncomfortable making that determination, those comments have been heard and are being looked at, but again this is a—I stress to folks that this has been a common standard, applies in many other areas of tax law which is where it arose, and we tried to provide it even more guidance than we usually would in the regulations but we have heard that an objective test is what you—what has been requested by many government entities. It's not normally the way we think about it because it's hard to say that an X% change in every single circumstance will or won't be material; it may depend on other facts and circumstances. But again, your concern has been heard and we'll be looking more at that.
- Moderator We'll move next to Teresa Johnson.
- T. Johnson Yes, my question is regarding discounts. If we take advantage of discounts based on payment and quick returns, is the 3% before or after the discount?
- T. Francis The 3% would be before the discount. The 3% is on the—after the discount, I'm sorry. For the net amount of the payment, I'm sorry.
- S. Tackney It's not like—this is not like a garnishment. I mean, if it's actually the price you're paying for the goods then you base the 3% withholding on the price you're actually paying. So if they put it on sale, more power to you, but it's the price you pay for the goods and how they price it, and if you happen to get a discount on that price by how you pay or any other thing, it's the price you paid. We just want to make sure that people understand that's distinguished from something that—it's taken out of what you pay such as a garnishment or something after the pay, but it's based on the amount of the price—the actual price of the goods. So if you've got a coupon or a discount or something like that, you would calculate that first, if you calculate what's the price you're actually paying.

- Moderator Next we will move to Melissa Belhorn.
- M. Belhorn Hello. I was wondering if subject—or settlement payments would be subject to withholding.
- S. Tackney Settlement payments, it could be or might not be. And the reason that is—I'm assuming you're speaking about litigation and damages-type settlement payments. It all depends on the tax treatment of those settlement payments, which depends on what you're settling. So, for instance, one of the rules under 3402(t) is that if the amount paid is subject to any other withholding it will not be subject to 3402(t) withholding. So, for instance, a back—a payment of back wages or similar item that's treated as compensation subject to income tax withholding is part of the settlement will not be subject to 3402(t) withholding. So that's the easiest one, is if what you're paying for in that settlement is not—is already going to be subject to withholding, there's no double withholding.
- Second thing is it does need to be treated as a payment for property or services. So we need to look at is what you're paying actually a substitute, for instance, an amount you should have paid for the property, an amount you should have paid for the services, is it that type of damages. On the other hand, something like pain and suffering is not a payment for services and is not a payment for property, so presumably it would be out. But whether or not a specific settlement payment or portion of a specific settlement payment is subject to withholding, again is going to depend on what it's actually—what damages or other item it's actually paying a settlement for. So we can't really give you any more specifics but that's kind of the general guideline.
- Moderator And Doris Kwok has our next question.
- D. Kwok Hi. I was wondering if the regulation is applicable to K-12 school districts and county offices of education.
- S. Tackney That we can't answer directly because it's all based on the facts and circumstances because school districts and specific schools and school systems can all be set up differently depending on the state or local jurisdiction. So it will depend on whether you are somehow a state entity, or part of the state, or an instrumentality of the state. Typically a school will not be part of the state but it's not unheard of. However, then it depends on whether you are a part of the political subdivision of the state, such as a city or county, or are you a separate instrumentality and once

you determine that you would need to apply the \$100 million payment threshold if you're part of the political subdivision or an instrumentality of the political subdivision so you'll need to go through that analysis. We do have the instrumentality factors up in an FAQ and we are hoping to get some—we do reference the actual regulations in the preamble to the final regulations, but we're hoping to actually get that up in an FAQ so that people don't have to search for the regulations about the definition of a political subdivision. So soon hopefully you will see a definition of the political subdivision in an FAQ and hopefully that will be helpful in determining your status.

Moderator

Our next question will come from Connie Gee.

C. Gee

Hi. We have a question. Actually how—which payment that would be include—we have two payments but we want to know are they included into the calculation of \$100 million; the housing payments which is we pay on behalf of the tenants who qualify under Section 8 Housing Subsidy Program, and another payment is for the medical service provider to the Worker Comp Claim. Are those payments will be included in our calculation of the \$100,000—million dollars? \$100 million dollars?

T. Francis

Generally, any payment that is subject to the 3402(t) requirements would be included in your calculation of the \$100 million rule; however, 3402(t) provides explicitly a list of payments that are excepted from 3402(t) and those payments would not be included in the calculation of the \$100 million, so we would suggest that you look and see if either of those payments that you're describing fall within one of those exceptions. However, we can't give you a specific answer to those two specific payment types without further detail; it'll be based on the facts and circumstances to see if either of those payment types qualify for one of the exceptions. However, the general rule is that if the payment is subject to 3402(t) then it would be included in your \$100 million calculation. If it meets one of the exceptions it would be excluded from your \$100 million calculation.

S. Tackney

The one big exception to that general rule is if a payment's excluded only because it's less than \$10,000 that does get added in to the \$100 million payment calculation so basically the \$10,000 threshold does not apply for purposes of that rule but, for instance, if one of your payments does meet the requirements to be a public assistance or welfare exception, then it would be excluded as well from the \$100 million threshold.

INTERNAL REVENUE SERVICE

Host: Carol Walters

August 18, 2011/2:00 p.m. EDT

Page 21

- Moderator And at this time we do have time for one final question. Our final question will come from Megan Nguyen.
- M. Nguyen I need some clarification on how do we apply 3% withholding when we have the state, non-resident withholding, the 7% that we also take. Which one would come first, the 3% or the 7%? I know you said the 3% would be at the gross but how about if we have that 7% to also apply?
- S. Tackney Presumably both of those percentages would be applied on the gross so I can't speak to your state. I'm assuming it applies on the gross. So, for instance, let me give you a calculation. If you paid \$100, let's for a moment forget the \$10,000 threshold, \$3 would be withheld and paid to the federal government and \$7 would be withheld and paid to the state government. So neither of those withholdings—I know the federal withholding should not be impacted by the state withholding so it will apply to the full \$100 payment, and usually it's the same for the state rules; however, again, we do not have authority to speak for the states so you'd need to check with them.
- Moderator And this does conclude today's question and answer session. At this time, I'd like to turn the conference back over to our speakers...for their closing remark.
- T. Francis Thank you, everyone, for joining us for this phone forum today. We hope it was helpful. It was, indeed, helpful for us as we take back some of your comments and questions. We will continue to formulate FAQs and other additional guidance that will be helpful to you in implementing this withholding as of January 1, 2013.
- We do suggest and encourage you to please visit the Federal, State, & Local Governments website via the IRS website. For additional information on IRC Section 3402(t) or any other concerns you may have as a government entity. With that, we want to thank you, again, for joining us, and we encourage you to please continue to visit the website as we continue to do more outreach regarding 3402(t).
- Thank you and have a wonderful day.
- Moderator And that does conclude our conference for today. Thank for your participation and for using AT&T Teleconference Service. You may now disconnect.