

Publication 1335

**Underreported Backup
Withholding
Questions and Answers**



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This publication explains how backup withholding applies to taxpayers who don't report and pay tax on all their dividend and/or interest income.

Different rules apply to backup withholding imposed because of a problem relating to taxpayer identification numbers (TINS).

1. Q What is underreporter backup withholding?

A. Internal Revenue Code section 3406(a) (1)(C) requires payers such as banks and corporations to deduct a certain percentage of dividend and/or interest payments made to a payee and to directly deposit the collected amount with the Internal Revenue Service (IRS). Backup withholding is only required if the payee didn't correctly report dividends and/or interest on an income tax return.

2. Q What kinds of payments are subject to underreporter backup withholding?

A. Any of the following payments that are reported to the IRS on an information return:

1. Certain interest reported on Form 1099-INT, Statement for Recipients of Interest Income.
2. Dividends reported on Form 1099-DIV, Statement for Recipients of Dividends and Distributions.
3. Patronage dividends reported on Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives.
4. Original issue discount reported on Form 1099-OID, Statement for Recipients of Original Issue Discount, if there is a payment in cash.

3. Q What kinds of payments are not subject to backup withholding?

- A. Payments not subject to backup withholding include the following:
1. Salary or wage payments
 2. Pensions
 3. IRA distributions
 4. “Window Transactions” such as redemption of coupons on bearer bonds, savings bonds, or similar instruments.

5. Any payment of less than \$10 (provided the total of such payments would not exceed \$10 for the year.)

Note: Because distributions from employee stock ownership plans are reported on Form 1099-DIV, the payer must still provide backup withholding notification to the payee, even though the distributions are exempt from backup withholding. The notice must state:

1. That IRS notified the payer that the payee underreported dividend or interest income and is subject to backup withholding;
 2. That the payee must get a determination letter from IRS to stop backup withholding, and, until then, may not certify to another payer that he/she isn't subject to backup withholding;
 3. That the distributions made by the plan are exempt from backup withholding.
- 4. Q How does a payee become subject to underreporter backup withholding?**

- A. When a payee doesn't correctly report his/her dividends or interest on an income tax return, the IRS will send at least four notices over a period of at least 210 days asking the payee to correct the underreporting. The final notice tells the payee that he/she is subject to backup withholding and the IRS will notify his/her payers to withhold.
5. **Q What must a payer do to begin backup withholding on a customer?**

A. The payer must have an Employer Identification Number (EIN) to conduct backup withholding. A payer who doesn't have an EIN can get one by completing a Form SS-4, Application for Employer Identification Number. The payer must backup withhold on any interest, dividend, or patronage dividend payments made to the person named in the IRS notice. The amounts withheld are to be deposited with the IRS. See Publication 15, Circular E-Employer's Tax Guide, for instructions. Both Form SS-4 and Publication 15 are available at most IRS offices as well as on the IRS web site www.irs.gov.

6. Q When are payments considered made?

A. Payments are considered made when a payment is credited to a payee's account (whether or not withdrawn).

7. Q How long must the payer continue backup withholding?

A. Backup withholding should continue until the IRS notifies the payer to stop or until the payee shows written certification from the IRS that he/she is no longer subject to backup withholding. The written certification must have been issued after the start notice.

8. Q What is the backup withholding rate?

A. The rates are as follows: 31% for payments made through August 6, 2001; 30.5% for payments made after August 6 through December 31, 2001; 30% for payments made in 2002; and 28% for payments made in 2003 through December 31, 2012. For payments made after December 31, 2012, the rate increases to 31%.

9. Q Does the payer have to notify the payee that he/she is withholding? If so, what must the notice include?

A. Yes. The payer must notify the payee within 15 days after the first payment subject to backup withholding is made. The payer's notice should state that:

1. IRS notified the payer that the payee has underreported dividend and/or interest income;

2. The payer now must backup withhold dividend or interest payments to the payee;
3. The payee must get a determination letter from the IRS to stop the withholding; and
4. The payee may not certify to another payer that he or she isn't subject to backup withholding while subject to it.

10. Q What if a payee claims he/she had no notice of backup withholding?

A. The IRS mails the notices to the payee's last address shown in its files. If the mail is not returned, the IRS assumes it was delivered. If the payee has changed his or her address, he or she may never receive the notice. In such cases, the payee should contact IRS directly to resolve the problem.

11. Q What if the payer has no record or account for a payee from whom the IRS had requested backup withholding?

- A. The payer need not take any action.
- 12. Q Do payers withhold on an account if the payee is a joint owner of the account?**
- A. Currently the payer is required only to withhold on an account when the payee specified by the IRS is shown as the first name on the account. However, after the payer begins withholding, if the sequence of names is changed on any account, the payer should continue to withhold unless the IRS notifies the payer to stop.
- 13. Q How should payers handle withholding if the notice from the IRS lists co-owners?**
- A. If the IRS notice to start withholding names several payees or co-owners, withhold on all accounts in joint names and any in which either payee is named first. If the IRS notice names only one payee, withhold on all accounts showing that payee's name first.
- 14. Q What if the payer's payroll department receives the IRS notice?**

A. The payees named on these notices usually aren't the payer's employees, although they may be. The names listed on the notice were reported to IRS on Forms 1099 as recipients of dividend or interest payments from your organization. If the name of a payer's employee does appear on the notice, remember backup withholding doesn't apply to salary or wages.

15. Q Why can't backup withholding notices be sent to another address within the payer's organization?

A. The address used on the notices is the address IRS received from the payer's organization for tax purposes. IRS can use only that address.

16. Q How should the payer report the funds it withholds?

A. The payer should report the funds withheld on Form 945, Annual Return of Withheld Federal Income Tax. The payer may obtain this form from most IRS offices as well as from the IRS web site www.irs.gov. Also, the payer should report the amount withheld for each payee on the appropriate Form 1099.

17. Q How should a payer deposit withholding?

A. See Publication 15, (Circular E), Employer's Tax Guide, for rules regarding deposits of backup withholding.

18. Q What action should the payer take for amounts wrongly withheld?

A. The payer has the option to refund the amount to the payee before the end of the calendar year if the payer has yet to furnish the payee with a Form 1099. If the payer has already deposited the withholding, it may adjust subsequent deposits in the same calendar year to account for the refund.

19. Q What does a payer do if a payee is already subject to backup withholding for another reason?

A. The payer must continue to withhold until the payee is no longer subject to backup withholding for any reason.

20. Q Why is information, such as the payee's name, social security number, or account number sometimes missing from the IRS notice?

A. The IRS computer takes its data from the Form 1099 filed by the payer's organization. If items are missing or if they are on the wrong lines of Form 1099, the computer will leave those items blank on the notice.

21. Q Is withholding still required after the payee dies?

A. In general, no, because in the case of an individual, the payee no longer owns the account after death.

