

ALERT

IRS Issues Final Rule on Three Percent Payment Withholding Requirement; Delays Implementation Date

May 9, 2011

On May 9, 2011, the Internal Revenue Service (IRS) published in the Federal Register its final rule to implement the current legislative requirement to withhold as income tax three percent of payments for supplies and services provided to governmental entities. See 76 Fed. Reg. 26583 (May 9, 2011). By way of background, section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Pub. L. No. 109-222, added section 3402(t) to the Internal Revenue Code (IRC) and, with certain limited exceptions, requires federal, state and local governments (including political subdivisions and instrumentalities with total annual payments in excess of \$100,000,000) to deduct and withhold as a tax three percent of any payment to any person providing property or services to federal, state, and local governments. Under TIPRA, the withholding was slated to go into effect for payments made after December 31, 2010. Section 1511 of the American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111-5, extended the effective date of section 3402(t) to payments made after December 31, 2011. The IRS published its proposed rule to implement the withholding on December 5, 2008. See 73 Fed. Reg. 74082 (Dec. 5, 2008). This alert highlights some of the key provisions of the final rule.

Effective Date for Withholding Extended, and Exception for Existing Contracts

Included. In response to public comment regarding administrative implementation burdens, the final rule provides for an additional one-year extension from the ARRA implementation date. Accordingly, under the final rule, the withholding will apply to payments made after December 31, 2012, subject to an exception for payments made under contracts existing on December 31, 2012, that are not materially modified. For contracts in effect on December 31, 2012, those contracts would cease to be "an existing contract" if the contract is modified materially after December 31, 2012, with respect to price or payment terms, services or property to be provided, but mere contract renewals or most change orders to existing contracts would not affect the exemption. On May 9, 2011, the IRS also issued a new proposed rule, see 76 Fed. Reg. 26678 (May 9, 2011), that includes a sunset provision, under which the "existing contract" exception would cease to apply to any payments made on any contract after December 31, 2013.

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\$10,000 Payment Threshold and Logistical Issues. Consistent with the proposed rule, the final rule applies the withholding requirement to payments above \$10,000 (subject to an anti-abuse rule). In addition, the IRS rejected comments to apply the withholding to cumulative payments, reasoning that it would be difficult for government agencies to coordinate their billings to determine cumulative payments to an entity. Thus, the withholding applies to individual payments. In addition, the withholding applies on a payment-by-payment basis, regardless of how the government is invoiced. Thus, if a governmental agency makes a single payment for multiple supply items or services, the withholding is applied to the single payment.

The final rule adopts the proposed anti-abuse measure providing that if a single payment is divided into multiple payments to avoid the \$10,000 threshold, the multiple payments will be treated as a single payment. This anti-abuse provision applies only if the governmental entity knew or should have known that payments were being divided to avoid the threshold. The final rule also permits the parties to agree contractually that the government may withhold, even if the payment is less than \$10,000. The IRS reasoned that such an agreement might avoid disputes about whether the anti-abuse rule applies.

Withholding Applies Only to Payments to Prime Contractors. Like the proposed rule, the final rule provides that the withholding of payments applies only to payments by the governmental entity to a prime contractor and does not apply to successive payments by the prime contractor to subcontractors.

Withholding Applies to Funds as They are Disbursed, Even for Interim Payments. Commenters requested that the IRS clarify that the withholding would not apply to contract financing payments, performance-based payments, commercial advance payments, interim payments, progress payments based on cost or percentage of completion, or interim payments on cost-reimbursement contracts, arguing that withholding would detrimentally affect cash flow and additional withholding was unnecessary where funds are withheld until contract completion. The IRS rejected these comments because it would add "administrative complexity." According to the IRS, "[t]reating the date the funds are disbursed as the payment date ensures that there will be funds upon which to withhold."

Certain Exceptions Apply. Exceptions to withholdings that may apply to contractors include:

- *Interest payments* are exempted under IRC § 3402(t)(2)(C).
- *Payments for the purchase and leasing of real property* are exempted. Although payments for utilities or insurance included in lease payments are exempted, utility or insurance payments by governmental entities directly to third parties (*i.e.*, not included in lease payments) are not, even if such payments are required under a lease agreement.
- *Payments for certain classified or confidential contracts*, as covered in section 6050M(e)(3).
- *Repayment of principal on a loan* will not be subject to withholding, except that government debt obligations issued as part of the purchase price to a person providing goods or services would be subject to withholding up to fair market value of the debt when issued.
- *Payments to certain S corporation passthrough entities* are exempted.

Grants Exempted; Other Exemptions Rejected, Including for Construction Contracts. Commenters requested that the IRS exempt all grant payments from the withholding requirement, noting that grants are "non-exchange" transactions and likely would be exempt from withholding under other exceptions in the IRC (including those for payments to Government entities or to non-profit organizations). The Notice accompanying the final rule reasons that because of the administrative difficulty of application of the withholding to grant recipients and "potential frustration of the intended use of the grant proceeds that may arise, the final regulations explicitly exempt all grants from the section 3402(t) withholding." This exclusion does not apply, however, to the use by a government entity of the proceeds of a grant received by that government entity, unless the proceeds are used to make another grant.

Commenters also requested that the IRS refrain from applying the withholding for industries with low profit margins or if the payee expected that it would not have any income tax liability (if, for example, it anticipated net operating losses). The IRS declined to establish such exceptions, noting that TIPRA did not include them and they would be complex to administer. Likewise, in cases where a

contractor is subject to payment offsets for other debts owed to a government entity, the three percent withholding is calculated based on the amount of the payment *before* any offset is applied. Moreover, although IRC § 3402(t)(2)(D) exempts payments for real property (including leases) from the withholding requirement, the IRS declined to extend the exemption to payments in connection with construction of buildings or other public works projects. Commenters had argued that governments were protected already under the Miller Act, but the IRS stated that Miller Act bonds relate to employment, not income, taxes. The IRS also rejected arguments that other provisions of the IRC equated real property with construction.

This aspect of TIPRA has been the subject of focused lobbying efforts by various interested industry organizations. Given current political and economic conditions, it is foreseeable that efforts to further delay, repeal or modify the legislation will be proposed. For example, the Obama Administration in March proposed delaying implementation for three years. In its current form, implementation of the withholding rule may pose a challenge to contractors that depend on the affected cash flow to finance operations. The timing of the implementation provides nearly 18 months for those contractors to prepare for the three percent withholding.

Wiley Rein LLP regularly monitors regulatory and legislative developments of interest to government contractors.