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## Regulations for U.S. Vendor Withholding May Give Clues to Foreign Vendor Withholding

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On January 2, 2011, §5000C became effective.<sup>1</sup> Section 5000C(a) generally imposes a 2% tax on payments made by federal agencies to foreign vendors of goods and services. However, goods produced in, and services performed in, a country that is a party to an international procurement agreement (IPA) with the United States are exempt from the §5000C(a) tax. The §5000C(a) tax applies to an estimated \$23 billion annually in goods and services, originating in the BRIC countries (Brazil, Russia, India, and China) and many other non-IPA countries, if such goods or services are sold by a foreign vendor (such as a foreign subsidiary of a U.S. defense contractor or a locally incorporated supplier to a U.S. embassy) to the federal government. Section 5000C(d)(1) requires payor federal agencies

<sup>1</sup> See generally Lederman, “‘Made in the U.S.A.’ Toll Charge Applies to Sales to U.S. Government of Foreign Items,” 114 *J. Tax’n* 276 (May 2011). All section (“§”) references are to the U.S. Internal Revenue Code of 1986, as amended (the “Code”), or the regulations thereunder, unless otherwise indicated.

to correspondingly withhold tax of 2% on payments taxable under §5000C(a).<sup>2</sup>

On May 9, 2011, T.D. 9524 promulgated final regulations under §3402(t). Section 3402(t)(1) generally would have required, subject to exceptions enumerated in §3402(t)(2), beginning in 2013, 3% withholding on payments made by federal (and state) agencies to U.S. vendors of goods and services. However, §3402(t) was repealed on November 21, 2011, so that neither §3402(t) nor its regulations will ever take effect.<sup>3</sup>

Under the §3402(t)(1) regulations, §3402(t)(1) withholding generally would only have applied against vendors that were U.S. persons and would not have applied against vendors that were foreign persons.<sup>4</sup> By contrast, §5000C(d)(1) generally only applies against vendors that are foreign persons and does not apply against vendors that are U.S. persons.

<sup>2</sup> Section 5000C(d)(1) provides: “Withholding- The amount deducted and withheld under chapter 3 shall be increased by the amount of tax imposed by this section on such payment.” The Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 111th Congress*, at p. 695, states that “collection [is] in a manner similar to the withholding taxes under chapter 3.” Section 1441(a) applies chapter 3 withholding obligations upon “all officers and employees of the United States.” IRS Policy Statement 2-4, IRM §1.2.20.1.2 provides: “Penalties and interest will not be asserted against agencies or instrumentalities of the United States [but] Federal agency compliance with the tax laws is required and will be monitored and enforced by Service personnel.” See also IRM §5.1.7.6.2.

<sup>3</sup> The legislation repealing §3402(t), P.L. 112-56, at §302, provides for a study to be undertaken during 2012 concerning ways to reduce the federal tax deficiencies of bidders on federal procurement contracts.

<sup>4</sup> See Regs. §31.3402(t)-4(j).

No regulations or other official guidance has been issued by the Treasury to date under §5000C(d)(1). Nevertheless, the resolution of numerous important administrative issues in the final §3402(t)(1) regulations may well provide clues as to how the Treasury will resolve analogous issues under §5000C(d)(1). Extrapolation from the §3402(t)(1) regulations to future §5000C(d)(1) regulations may be possible even though Congress repealed §3402(t)(1).

## DIFFERENCES BETWEEN §3402(t)(1) AND §5000C(d)(1)

Besides the fact that §3402(t)(1) generally would have applied only to U.S. persons and §5000C(d)(1) generally only applies to foreign persons, there are several other major differences between §3402(t)(1) and §5000C(d)(1). These differences arguably may lead the Treasury to be more adverse to vendors in interpreting §5000C(d)(1) than it was in interpreting §3402(t)(1). Section 3402(t)(1) was apparently intended to improve collectability of federal taxes applicable to the procurement payments, and therefore is to that extent identical in purpose to §5000C(d)(1).<sup>5</sup> However, even absent such §3402(t)(1) withholding, U.S. vendors arguably would be more compliant in self-assessing and paying their substantive U.S. tax liabilities on their payments from the federal government than foreign vendors, because U.S. vendors — generally unlike foreign vendors — historically have been and continue to be subject to the full range of U.S. audit and enforcement tools.

Viewed another way, unlike §3402(t)(1) withholding, §5000C(d)(1) withholding may be the Internal Revenue Service's sole practical opportunity to collect the federal tax liability applicable to the federal procurement payment. This greater possibility of revenue loss if a regulatory exception to §5000C(d)(1) withholding is created by the Treasury could lead the Treasury to deny exceptions from §5000C(d)(1) withholding (e.g., a *de minimis* rule) that the Treasury granted in the §3402(t)(1) regulations.

Section 3402(t)(1) withholding would have applied to U.S. vendors, whose executives and owners and trade associations are vocal in Congress. Indeed, Congress responded to criticisms of §3402(t)(1) by postponing its effective date from 2011 to 2012 and eventually repealing it altogether. By contrast, foreign vendors are arguably less politically powerful. However, §5000C applies to foreign subsidiaries of major U.S. defense contractors and other politically powerful U.S.-based multinationals. Moreover, as shown by

Notices 2010-60<sup>6</sup> and 2011-53,<sup>7</sup> narrowing the scope of, and postponing implementation of, withholding under the Foreign Account Tax Compliance Act (FATCA), the IRS has been responsive to criticism of withholding obligations by even foreign payees.

Section 3402(t)(1) would have applied equally to state and large local government payors, as well as federal payors, unlike §5000C(d)(1), which applies only to federal payors. The Treasury arguably may be less inclined to impose expensive administrative obligations on state and local governments than on a coordinate agency of the federal government. That is, the Treasury may be more inclined to impose on the federal government, under §5000C(d)(1), an administrative obligation if it could be readily coordinated with the federal procurement regulations. If imposed under §3402(t)(1), such an obligation might have required a significant departure from the procurement practices of a myriad of state and local agencies.

Section 3402(t)(1) was not in a Code section imposing liability on the U.S. vendor. Rather, §3402(t)(1) was merely a means of assisting collection relating to any income tax imposed by other Code sections, which generally reach income from all worldwide transactions, whether or not related to government procurement, and irrespective of the place of origin of the goods and services. By contrast, §5000C(d)(1) implements only the §5000C(a) tax, which applies to a more limited set of transactions, namely those involving goods and services sold to the federal government and originating in a non-IPA country. Therefore, §5000C(d)(1) should be interpreted by carefully incorporating substantive exemptions from the underlying §5000C(a) tax, such as by providing for the ability of federal agency payors to accept exemption certificates based on the fact that the goods or services originated in IPA countries. By contrast, the preamble to T.D. 9524 stressed that §3402(t)(1) withholding applied even if a vendor expected that its sale to the federal government would not trigger any income tax liability, e.g., because the vendor had net operating loss carryforwards.

Moreover, §5000C implicates foreign trade policy considerations not present in §3402(t)(1), such as Congress's apparent desire to expand foreign government procurement opportunities for U.S. exporters by encouraging foreign governments to enter into IPAs. However, despite differences between the §5000C(d)(1) withholding and §3402(t)(1) withholding statutes, such as those enumerated above, the §3402(t)(1) regulations reveal some major policy decisions by the Treasury that one may speculate may be

<sup>5</sup> See Bickley, CRS Report, "Tax Gap: Should the 3% Withholding Requirement on Payments to Contractors by Government Be Repealed?" (BNA TaxCore, 10/25/11).

<sup>6</sup> 2010-37 I.R.B. 329.

<sup>7</sup> 2011-32 I.R.B. 124.

reflected in future §5000C(d)(1) withholding regulations.

## POSSIBILITY OF POSTPONEMENT OF EFFECTIVE DATE

The general statutory effective date of §3402(t)(1) was for payments made on or after January 1, 2012. Perhaps in recognition of the fact that the adoption of new administrative procedures by the accounts payable departments of government procurement agencies might take more than six months, Regs. §31.3402(t)-2(i) in effect delayed the statutory withholding requirement for one year, until January 1, 2013. Thus, Regs. §31.3402(t)-2(i) demonstrates that the Treasury believes it has the authority to postpone the imposition of vendor withholding obligations on federal agencies, notwithstanding an earlier statutory effective date.

It is difficult to see how §5000C(d)(1) can be implemented quickly. The most fundamental questions raised by §5000C — such as which countries are parties to an IPA (and thus payments for goods or services originating in those countries are not subject to §5000C(a) tax or to §5000C(d)(1) withholding) — have never been addressed by the Treasury. This may indicate that the Treasury may, as it did in the §3402(t)(1) regulations, postpone withholding under §5000C(d)(1), perhaps at least until several months after final §5000C(d)(1) regulations are issued.

## DOLLAR THRESHOLD

Section 3402(t)(1) did not have, and §5000C(d)(1) does not have, a dollar threshold. Nevertheless, to eliminate undue administrative burdens, Regs. §31.3402(t)-3(b) provided that no §3402(t)(1) withholding was to apply to any payment of less than \$10,000. The exemption would have been generally available even if the vendor had received payments, separately or in the aggregate, of more than the payment threshold earlier in the year. However, the regulation also provided that a payment of at least \$10,000 was subject to §3402(t)(1) withholding, even if the payment was for more than one product or service, each of which cost less than \$10,000.

The government agency could obtain from the vendor a waiver of the availability of this exception. Moreover, the regulations provided an anti-abuse rule under which, if the federal procuring agency knew or had reason to know, that a vendor had divided requests for payments aggregating at least \$10,000 into payments for less than \$10,000 for the purposes of avoiding withholding, even those payments of less than \$10,000 would have been subject to withholding.

Regs. §31.3402(t)-3(b) demonstrates that the Treasury believes it has the authority to grant a dollar

threshold on vendor withholding, notwithstanding that the underlying Code section has no such threshold.<sup>8</sup> Thus, it seems possible that a dollar threshold will be provided for purposes of §5000C(d)(1). For example, the threshold could be the \$10,000 amount in Regs. §31.3402(t)-3(b). Indeed, perhaps a higher threshold, such as \$15,000, could be justified. The Preamble to the final regulations under §3402(t) referred to exempting amounts of less than \$10,000 because those amounts would generate less than \$300 of withholding tax (3% of \$10,000). In the context of §5000C(d)(1), amounts of less than \$15,000 would generate less than \$300 of withholding tax (2% of \$15,000).

## GENERAL CONTRACTORS

Regs. §31.3402(t)-3(f) Example (1) described a situation where a government agency contracted only with a general contractor, which in turn, entered into contracts with various subcontractors. While the engagement of any particular subcontractor was subject to approval by the government agency, the subcontractors were not parties to the contract between the general contractor and the government agency, and the government agency was not a party to the contracts between the general contractor and the subcontractor. Example (1) concluded that only the general contractor, and no subcontractor, was a person receiving withholdable payments under §3402(t)(1). Thus, the entire payment (if above the dollar threshold) paid by the government agency to the general contractor was subject to §3402(t)(1) withholding, including amounts corresponding to ultimate payments by the general contractor to the subcontractors, but no payment to the subcontractor from the general contractor was subject to §3402(t)(1) withholding.

This suggests that forthcoming §5000C(d)(1) regulations may contain a similar rule treating the general contractor as the sole person whose payments are withholdable. If so, withholding on subcontractor payments may be avoidable. However, foreign general contractors will have to negotiate with their subcontractors for the general contractor to avoid absorbing the entire economic burden of the §5000C(a) tax on the project. Conversely, it may be possible for foreign vendors to avoid §5000C(a) tax and withholding by supplying goods and services through a product distributor or general service contractor that is a U.S. person.

## ADVANCE PAYMENTS AND SURCHARGES

Under Regs. §31.3402(t)-3(a), the following payments would have been subject to §3402(t)(1) with-

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<sup>8</sup> See also Program Manager Technical Advice 2011-001 (3/1/11).

holding at the time of payment, even if made before final delivery by the vendor and acceptance by the federal government: (1) interim payments under a cost-reimbursement contract; (2) progress payments made on a percentage or stage of completion; and (3) performance-based payments. The Preamble to Regs. §31.3402(t)-1 clarified that the amount paid for surcharges — such as fuel surcharges, late payment fees that are not interest, or shipping and handling costs — that were paid in connection with the purchase of property were subject to §3402(t)(1) withholding. Similarly, amounts paid that were offset by amounts owed by the vendor to the federal government were also subject to §3402(t)(1) withholding. Where a portion of one payment was subject to §3402(t)(1) withholding, but another portion was not, Regs. §31.3402(t)-4(r) treated the exempt portion as exempt from withholding, but allowed the payee to agree with the government agency to waive the exemption from withholding on the exempt amount and so permit withholding on the entire amount. All the foregoing rules could similarly be applied to §5000C(d)(1) withholding.

## SMARTPAY2

Under the federal government's Smartpay2 credit card system, federal agencies (such as the IRS) are issued a credit card for purchases (a Mastercard in the case of the IRS) by one of three contracting banks (Citibank in the case of the IRS) to buy goods and services,<sup>9</sup> and individual federal government employees (such as IRS agents) are issued a credit card for travel and other reimbursable expenses.<sup>10</sup> Apparently more than \$7 billion in Smartpay2 transactions, taking into account only those individual transactions exceeding the Regs. §31.3402(t)-3(b) \$10,000 threshold, are made annually.<sup>11</sup>

Smartpay2 credit card purchases presented daunting problems for §3402(t)(1) withholding. This is because vendors receive payment from their merchant banks (which often are not any of the three federally contracted issuing banks) around the time they scan the government agencies' or federal employees' credit cards. These merchant banks are reimbursed by the federal agencies' issuing banks, which are then reimbursed by the federal agency.

In order to implement §3402(t)(1) withholding on the vendor, the merchant bank would have had to de-

termine whether the purchase was for a type of government procurement subject to withholding under the §3402(t)(1) regulations, withhold on the merchant bank's disbursement to the vendor, and, if the merchant bank were not coincidentally also the issuing bank, transmit the withheld funds (through the issuing bank, or through the purchasing government agency, or directly) to the IRS. In connection with hearings held on the possible application of §3402(t)(1) withholding to Smartpay2 payments, it was noted that this was not practical under the existing technological, contractual, and legal framework.<sup>12</sup> Accordingly, IRS Notice 2010-91<sup>13</sup> and the Preamble to T.D. 9524, reserved Smartpay2 transactions for prospective future regulations.

Application of §5000C(d)(1) foreign vendor withholding to Smartpay2 credit card purchases is even more problematical, because foreign vendors' merchant banks are even less likely to coincidentally be one of the three U.S. issuing banks, or even be subject to future U.S. regulation. Therefore, one would expect §5000C(d)(1) regulations to be even less likely than the §3402(t)(1) regulations to reach Smartpay2 transactions. In order to effectively implement §5000C(d)(1), the Treasury might have to seek changes to the Federal Acquisition Regulations and the federal agency contracts with the Smartpay2 issuing banks, and related software, to generally prohibit the use of Smartpay2 cards on foreign vendor purchases perceived by the Treasury as having a high risk of being subject to §5000C(d)(1) withholding.

## SECTION 3402(t)(2) EXCEPTIONS

Section 3402(t)(2) contained various statutory exceptions to §3402(t)(1) withholding. These withholding exceptions were generally implemented by Regs. §31.3402(t)-4. None of the §3402(t)(2) statutory exceptions has any equivalent in the text of §5000C(d).

On the one hand, foreign vendors could fear that the absence of a §3402(t)(2) exception in §5000C(d)(1) could lead the Treasury to conclude that Congress intended no such exception. On the other hand, foreign vendors could comment to the Treasury that exceptions in §3402(t)(2) are indicative of a Congressional policy that should as a policy matter likewise be applied to §5000C(d)(1).

## AMOUNTS OTHERWISE WITHHELD UPON

Section 3402(t)(2)(A) and (B) excepted from §3402(t)(1) withholding: (1) payments subject to

<sup>9</sup> IRM §1.32.6.

<sup>10</sup> IRM §1.32.4.

<sup>11</sup> See "Transcript of IRS April 16, 2009, Hearing on Proposed Rules (REG-158747-06) on 3 Percent Withholding From Government Payments to Contractors, Vendors" (BNA TaxCore, 4/21/09).

<sup>12</sup> *Id.*

<sup>13</sup> 2010-52 I.R.B. 915.

chapter 24 withholding (relating to wages and certain other payments); (2) payments subject to chapter 3 withholding (relating to certain payments to foreign persons); and (3) payments upon which back-up withholding is being applied. No such exception appears in §5000C. Nevertheless, sales of goods by, and services performed abroad by, foreign corporations and nonresident aliens are generally not subject to chapter 24 withholding, chapter 3 withholding, or back-up withholding.<sup>14</sup> Thus, only in rare cases would §5000C(d)(1) withholding apply in circumstances described in §3402(t)(2)(A) and (B).

## INTEREST

Section 3402(t)(2)(C), implemented by Regs. §31.3402(t)-4(p), generally excluded interest — including original issue discount created under §1273 or §1274 — from §3402(t)(1) withholding. While §5000C does not contain a similar statutory exception for interest, foreign vendors could comment to the Treasury that interest they receive — such as pursuant to the federal Prompt Payment Act, 31 USC §§3901–3907 — should similarly be viewed as distinct from the underlying payment for goods and services, and be excluded from §5000C(a) tax and §5000C(d)(1) withholding.

## CONSTRUCTION CONTRACTS

Section 3402(t)(1) applied to payments for “property or services,” but §3402(t)(2)(D) specifically provided that payments for “real property” are not subject to §3402(t)(1) withholding. Thus, §3402(t)(1) applied to personal property and services. This is quite similar to the scope of §5000C(d)(1), which applies to payments for the provision of “goods” or services.

By analogy to Regs. §31.3402(t)-3(d) (discussed below), it seems likely that the Treasury will take the adverse position that construction contracts performed for the federal government are not contracts for the purchase of real property, but rather are contracts for the purchase of goods or services, and thus are subject to §5000C(a) tax and to withholding under §5000C(d)(1). Regs. §31.3402(t)-3(d) provided that payments for the construction of buildings, bridges, and roads are not payments for real property and are entirely subject to withholding. The Preamble characterized such payments as “payments for the services and materials used to construct a building.” The Preamble noted that there is no evidence that Congress intended to exempt payments for construction, and concluded that an exemption for construction would

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<sup>14</sup> Regs. §31.3401(a)(6)-1(b), 1.1441-1(b)(4)(v), -2(b)(2)(i), -3(d)(1), and -1(b)(5).

substantially reduce the scope of payments subject to withholding.

Given that the Preamble to Regs. §31.3402(t)-3(d) characterized payments for construction contracts as payments for “services and materials,” the Treasury seems likely to view payments on construction contracts as withholdable payments for services and goods described in §5000C(d)(1). Moreover, given that U.S. access to foreign government construction contracts is a major focus of the U.S. negotiating position in IPAs, and the purpose of §5000C(a) is to pressure foreign governments into entering into such IPAs by imposing such tax unless the foreign government enters into an IPA, it is likely that the Treasury will likewise view Congressional intent as including construction contracts within §5000C.

## GRANTS

Section 3402(t)(2)(E) and Regs. §31.3402(t)-4(e) exempted, from §3402(t)(1) withholding, payments to tax-exempt entities (such as §501(c)(3) organizations) and payments to foreign governments. Section 3402(t)(2)(H) and Regs. §31.3402(t)-4(h) exempted from §3402(t)(1) withholding payments made in connection with a public assistance or public welfare program for which eligibility was determined by a needs or income test, including payments to third parties to implement such programs.

In addition to these exemptions based on the language of §3402(t)(2)(E) and (H), Regs. §31.3402(t)-4(m) broadly exempted grants from withholding. A grant was defined by Regs. §31.3402(t)-4(m) as a payment where the government is primarily intending to transfer value to the recipient rather than acquiring goods and services for the government’s own benefit, and the government is not actively involved in carrying out the activity contemplated in the grant agreement. Regs. §31.3402(t)-4(m) thus tracks the language of 31 USC §6304, which describes the circumstances in which a federal agency should use a grant agreement as the legal instrument reflecting the relationship between the federal government and recipient, as distinguished from using a cooperative agreement described in 31 USC §6305 or a procurement contract described in 31 USC §6303.

Regs. §31.3402(t)-4(e), (h), and (m) suggest that some, though perhaps not all, forms of federal government foreign aid could be exempted by the Treasury from withholding under §5000C(d)(1). For example, arguably payments made by the U.S. Agency for International Development for humanitarian purposes, documented by a grant agreement described in 31 USC §6304, should be viewed as not for goods and services and thus exempt from §5000C(a) tax and §5000C(d)(1) withholding.

## CONFIDENTIAL CONTRACTS

Section 3402(t)(2)(F) and Regs. §31.3402(t)-4(f) excused from withholding any payment made pursuant to certain confidential contracts, such as those contracts for which the head of the federal payor agency has determined that tax reporting would interfere with a foreign counter-intelligence activity. The Preamble rejected expanding this confidential contract exception beyond the scope of contracts specifically described in §3402(t)(2)(F). However, even in the absence of specific statutory direction in §6041, Regs. §1.6041-3(l) excuses from Form 1099 reporting payments by a federal agency for informing on criminal activity. Thus, there may be precedent for the Treasury to likewise not insist on §5000C(d)(1) withholding for certain highly confidential contracts.

## EMPLOYEES

Section 3402(t)(2)(I) excluded, from §3402(t)(1) withholding, payments to government employees for services rendered. By contrast, §5000C does not excuse from withholding the salaries of nonresident alien federal employees, such as local employees working in U.S. consulates and U.S. military bases located in non-IPA countries. However, a *de minimis* exception (e.g., \$10,000 or \$15,000 per payment) would typically eliminate such withholding, unless the Treasury applied annual aggregation.

## BINDING CONTRACT EXCEPTION

Regs. §31.3402(t)-1(d)(2) excused from withholding payments made by the federal government under a written contract in effect before the effective date of the withholding obligation, including a renewal of such contract, unless such contract was materially modified after such effective date. A contract was characterized as materially modified if there was a material change in the goods or services to be provided under the contract, or in the price or terms of payment, and such change was not required by appli-

cable federal or other law. (However, *Prop. Regs.* §31.3402(t)-1(d)(2) would have disallowed the binding contract exception for payments made more than one year after the effective date of the withholding obligation, even if there had been no material modification during the preceding year.)

The legislation enacting §5000C exempts, from both tax and withholding, payments made by the federal government under a written contract in effect before the January 2, 2011 effective date of the withholding obligation.<sup>15</sup> Similar to the favorable approach taken in the §3402(t)(1) regulations, the Treasury may view renewals of contracts entered into before the §5000C(d)(1) withholding obligation becomes effective — including immaterial modifications of such contracts — as not resulting in loss of the withholding exemption, at least for a one-year period after the final §5000C(d)(1) regulations become effective.

## CONCLUSION

Foreign vendors selling goods and services to the federal government can hope that certain favorable administrative approaches taken by the Treasury in the §3402(t)(1) regulations will likewise be applied in forthcoming §5000C(d)(1) regulations. Especially favorable were: (1) the administrative postponement of the statutory effective date for §3402(t)(1) withholding; (2) the requirement of at least a \$10,000 purchase before §3402(t)(1) withholding applies; (3) absence of duplicative §3402(t)(1) withholding on subcontractor transactions; (4) excusing of Smartpay2 transactions from §3402(t)(1) withholding; and (5) allowing voluntary renewals of pre-existing contracts to qualify for the binding contract exception from §3402(t)(1) withholding. However, whether the Treasury will in fact apply any of such rules to §5000C(d)(1) transactions is now far from certain.

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<sup>15</sup> P.L. 111-347, §301(a)(3).