

# Backup Withholding and the Intentional Disregard Penalty

By Chaya Kundra\*

Chaya Kundra examines proper documentation and collection of withholding taxes for independent contractors.

There is a growing emphasis on the proper documentation and collection of withholding taxes for independent contractors. This may be because of the rise in questioning the proper documentation of workers, or it may be that it is easier to collect taxes from the Payor. Most every industry has workers that are not employees by federal or state standards. Such persons tend to be transient and hired for specific job(s) or project(s). The record of their remuneration is sent to the IRS by the Payor. When taxpayer identification numbers do not match up, often the IRS will send the Payor a somewhat benign notice that may be followed up with a penalty equal to the amount of back-up withholding tax.

Along with the IRS' National Research Project focusing on employment tax returns, Form 1099 information is being cross-checked. It starts with the Payor being audited and then being asked to prove that a backup withholding requirement does not exist for its independent contractors with mismatched tax identification numbers ("TINs"). If Payors are contacted by the IRS for consecutive tax years concerning the same workers, the IRS will look to impose the intentional disregard penalty. Among other things, this penalty can carry a fine of 10 percent of the amount required to be reported.

Reportable payments are defined under Code Secs. 6041 and 6051 as payments being made for services that benefit one's trade or business. Accordingly, payments to workers in excess of \$600 per annum for services performed as independent contractors are reported to the IRS on Forms 1099-MISC, *Miscellaneous Income*. The Form 1099 is filed annually,

with the total number of 1099s being equal to the amount identified on the annual Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*. The worker uses this same information to prepare its income tax return and pay self-employment taxes when required. The issue arises when the TIN reported by the Payor for 1099 payments cannot be cross-referenced with the Payee.

## Foundation

In the normal course of business, the Payor will ask the Payee for his or her taxpayer identification number. Ideally this response is provided on a Form W-9, *Request for Taxpayer Identification Number and Certification*. The Payor files the Form 1099-MISC reporting the amount of payment, name, address, TIN of the worker and the year in which remuneration is paid. The worker's copy is provided on or before January 31 of the following year. Forms 1099 are to be filed with the IRS on or before February 28 of the following year.<sup>1</sup> This deadline extends to March 31 if they are filed electronically.

When the identification number of the Payee is incorrect or cannot be verified, Code Sec. 3406 requires Payors to backup withhold at a rate of 28 percent. This requirement applies to certain reportable payments once the Payor is notified by the IRS that a Payee's TIN is incorrect. Notification appears on a "mismatch TIN notice," also known as a CP2100 or 2100A.<sup>2</sup> Large filers—those with 250 or more error documents—receive a CD or DVD data-file CP2100. Paper notices go to mid-size filers with greater than 50 but less than 250 error documents. Small filers (less than 50 error documents) receive a paper CP2100A. Typically, the IRS sends mismatch

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TIN notices beginning in September of the year in which the Forms 1099 are filed.

## What to Do Upon Receiving a “First” Mismatch TIN Notice

Once the Payor receives a mismatch TIN notice from the IRS, it must identify from its business records the specific Payee account that contains the same incorrect name and TIN combination.<sup>3</sup> Upon comparing the same with its business records:

- If the IRS listing and Payor business records agree, Payor sends the solicitation letter to the affected worker.
- Should the IRS and Payor’s business records not agree:
  - The IRS mismatch could be the result of an IRS processing error or a mistake by the Payor in submitting information on the Form 1099. In such circumstances, Payor should use its business record information on the next Form 1099 filing with IRS and on the next Payee statement to the worker. Here, Payor need not send a solicitation letter to the Payee, and should not write or call the IRS.
  - If Payor’s business records show something different from the IRS notice and the Payor’s records have been recently updated, the mismatch at IRS may exist because of a recent Social Security Administration (“SSA”) update of which the IRS is unaware. Again, the Payor is to use its business record information on the next Form 1099 filing and on the next Payee statement. No solicitation letter should be sent to the Payee; nor is it necessary for the Payor to write or call IRS in these circumstances.

If the number is indeed mismatched, IRS Treasury Regulations require the Payor to send a solicitation letter, commonly referred to as a “B” notice to the Payee within 15 business days of receiving a mismatch TIN notice from the IRS.<sup>4</sup> The solicitation letter must request from the Payee a signed Form W-9. It must also inform the Payee that if no such Form W-9 is received, backup withholding on reportable payments after a specified date will ensue. The date determined is to be set at 30 business days after the date the Payor receives the IRS notice.<sup>5</sup>

When the Payee does not respond to the solicitation letter with a signed Form W-9, the Payor is to begin backup withholding on all reportable payments no

later than 30 business days after the date it received notice from the IRS of the mismatch TIN.

- Backup withholding must be imposed on payments after:
  - payor has confirmed that both IRS and Payor’s business records show the same mismatch name and TIN combination;
  - a solicitation letter has been sent to the Payee, requesting a W-9; and
  - the Payee has failed to provide a signed W-9 within 30 business days as measured from the date of the IRS mismatch TIN notice.
- Payor will continue backup withholding until the Payee has provided a signed W-9.
  - Backup withholding will stop within 30 calendar days of Payor receiving the signed W-9.
  - Payor will use the Payee name and TIN information as provided on the W-9 on the next Form 1099 filing and on the next Payee statement.

The Payor is required to keep a record of the Payees for whom it has received IRS mismatch TIN notices in the event the Form W-9 provided by the Payee in response to the solicitation letter proves false, and the IRS sends a second mismatch TIN.

## Second Mismatch TIN Notice

If the Payor receives two mismatch TIN notices from the IRS with respect to the same Payee within three years, the Payor is to send a second “B” notice to the Payee within 15 business days of the Payor’s receipt of the IRS notice.<sup>6</sup> Here, the Payee must provide validation of his TIN from either the SSA or the IRS within 30 business days of the IRS notice in order to avoid backup withholding. A Form W-9 provided by the Payee will not be sufficient to stop backup withholding.

Pursuant to the instructions in Rev. Proc. 93-37, a Payee who needs to validate a TIN must contact the local SSA office to inquire about TIN validation. In doing so, it is to provide a copy of the B notice to SSA, request and authorize SSA to send Form SSA-7028, *Notice to Third Party of Social Security Number Assignment*, to the Payor to validate the Payee’s TIN. While in the past this was not necessary, IRS interim procedures state that individual Payees are to contact the local SSA office and request a Social Security Number Printout. This document is considered an acceptable form of validation of a TIN under Code Sec. 3406.

The second mismatched TIN notice from the IRS often fails to indicate if it is a second notification for a specific Payee. Therefore, the Payor must cross-check mismatch TIN notices received to identify if the same Payee account was previously reported by the IRS as having a mismatched TIN combination.<sup>7</sup>

## Reporting and Remittance of Backup Withholding

When the Payor is to backup withhold, it is reported as a “non-payroll” tax liability on the Form 945, *Annual Return of Withheld Federal Income Tax*. The specific amount withheld from each Payee appears on the Form 1099 and the Payee statement as “federal income tax withheld.” Deposits of the withheld tax are to be made biweekly/monthly to the Government at an authorized financial institution. The Payor may also voluntarily participate in the Electronic Federal Tax Payment System (EFTPS) to transfer these funds electronically. A monthly deposit schedule requires payments to the Government by the 15th day of the month following the month in which the tax was withheld from the workers’ pay.

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## Penalties

### Backup Withholding

Backup withholding is treated as a type of income tax withholding. Amounts withheld by the Payor are credited to the Payee for the year in which the amount is withheld. Failure to withhold and pay over backup withholding will subject the Payor to liability for these taxes. Under Reg. §31.3406(h)-2(g), a Payor is subject to the same penalties for failing to impose backup withholding as an employer who fails to withhold on a payment of wages. Hence, in addition to being liable for the tax, a Payor who fails to backup withhold when required may be subject to civil penalties under Code Secs. 6651, 6656 and 6672.<sup>8</sup> Code Sec. 6672 imposes a civil penalty on any person who is required to collect, truthfully account for and pay over any tax imposed, and if said person willfully fails to do so, or willfully attempts in any manner to evade or defeat any tax or payment of

tax, the penalty is equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Thus, under Code Sec. 3406(h)(10) and Reg. §31.3406(h)-2(g), payments that are subject to backup withholding are treated as if they were wages paid by an employer to an employee.<sup>9</sup> Code Sec. 3402 requires income taxes to be withheld from wages when paid. Employers are liable for the payment of tax required to be deducted and withheld under Code Sec. 3403.<sup>10</sup> By application of these statutes to the backup withholding regime, a Payor who fails to impose backup withholding is subject to the same treatment as an employer making a payment of wages. Hence, the Payor will be liable for the payment of backup withholding tax required to be deducted and withheld.

Backup withholding taxes owed by a Payor are subject to assessment and collection in the same manner as employment taxes. If the taxes cannot be collected from the Payor, Code Sec. 6672 penalties may be asserted against the responsible persons or officers of the Payor.

### Intentional Disregard

The other downfall to not responding to the IRS’ notices timely is the imposition of the Code Sec. 6721 penalty for failing to file correct informational returns. Code Sec. 6721(a) provides for the imposition of a penalty on any person who fails to file an information return on or before the required filing date or does not include all information required to be shown on the return. Providing incorrect information on a return will also subject one to a Code Sec. 6721 penalty. The penalty is \$50 per return, subject to a maximum of \$250,000 for any calendar year.

For a taxpayer with a history of not correcting TIN information, the IRS likes to add penalties. Code Sec. 6721(e) set higher penalties for failures due to intentional disregard of the information reporting requirements. If the failure is due to intentional disregard of the filing requirement, the penalty imposed is either \$100 per return or 10 percent of the aggregate amount of the items required to be reported, whichever is greater. There is no maximum limit on the amount of penalties for intentional failure to file.

“Intentional disregard” is defined by Reg. §301.6721-1(f)(2) to exist when there is knowing or willful failure to file or failure to include correct information. Code Sec. 6723 states that the information reporting requirements include a correct taxpayer identification number.

Code Sec. 6724(a) explains that any information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect. For this purpose, reasonable cause will exist if certain placating factors are present. Reg. §301.6724-1(a)(2) provides for the existence of reasonable cause when the Payor establishes that either (1) there are significant mitigating factors for the failure, or (2) the failure arose from events beyond the Payor’s control. The Payor must establish further that it acted in a responsible manner both before and after the failure occurred.

Reg. §301.6724-1(b) cites significant mitigating factors as, but not limited to:

- the filer is a first-time filer of the particular type of return or Payee statement with respect to which the penalty arises; or
- the filer has an established history of compliance with the information reporting requirements with respect to which the failure occurs.

In determining a Payor’s history of compliance, the Payor’s prior penalty history and the success in reducing its error rate from year to year are taken into account. The IRS will also look to the issue of timeliness of its notification to the Payor of the incorrect TINs, as well as the corrective action taken by the Payor once the failure is discovered. Essentially, the IRS has to have provided the Payor with a reasonable opportunity to review and correct. Hence, if your Payor does not have a plan of action moving forward with regard to such penalties, help it to create one.

### Summary

Given the increasing government scrutiny and need for funds, it is best for your Payor to be confident in the documentation provided by its workers. To do so, it can attempt to verify taxpayer third-party documentation through the SSA Web site which has become increasingly reliable in recent years. To play it even safer, it is better to account or otherwise plan for the 28-percent cost when submitting and/or planning for jobs. Thus, good business records, a working knowledge of IRS notice and solicitation requirements and timely imposition of backup withholding will have a significant impact on compliance. It will help avoid liabilities for the Payor and responsible persons.

### ENDNOTES

\* Since its inception in 1999, Kundra & Associates, PC has continued to focus on the resolution of civil and criminal domestic and international tax issues. Armed with both an accounting and finance background, Ms. Kundra’s clients are sophisticated businesses, entrepreneurs and individuals. Among other activities, she currently serves as the Vice Chair of the ABA Employment Tax Section and the Chair of the Tax Section of the Montgomery County Bar Association, Maryland. Ms. Kundra received her J.D. from the Washington College of Law at the American University.

<sup>1</sup> An automatic 30-day extension of time to file the Forms 1099 is available, if the Payor files a timely Form 8809, *Request for Extension of Time To File Information Returns*. An additional 30-day filing extension may also be sought using a Form 8809.

<sup>2</sup> See Code Sec. 3406(a)(1)(B) & (e)(2). See also, Reg. §31.3406(d)-5.

<sup>3</sup> If the Payee no longer works for the Payor, no further action needs to be taken with respect to that Payee, although IRS guidance in Publication 1281 suggests that a correct TIN should nevertheless be solicited from the former worker in case he is rehired.

<sup>4</sup> Reg. §31.3406-5(d)(2).

<sup>5</sup> Under the regulations, the date set forth in the IRS notice is considered the date of receipt. However, if the Payor can demonstrate that the actual date of receipt is later than the date of the notice, then the actual date of receipt triggers the 30-day period that must lapse before backup withholding is imposed.

<sup>6</sup> A template for the second B Notice can be found in IRS Publication 1281.

<sup>7</sup> See Code Sec. 3406(h)(2).

<sup>8</sup> Code Secs. 6651 and 6656 address failure-to-pay and failure-to-deposit penalties. Failure-to-pay penalties are imposed for a failure to pay an amount required to be shown on a tax return or failure to pay an assessment within the requisite time frame. See Code Sec. 6651(a)(3). Failure-to-deposit penalties are imposed for a failure to deposit amounts as required by the Internal Revenue Code or regulation. See Code Sec. 6656. While not discussed herein, criminal penalties may also be imposed.

<sup>9</sup> See Code Sec. 3406(h)(10).

<sup>10</sup> See also, Reg. §31.3403-1 (“Every employer required to deduct and withhold the tax under section 3402 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee by the employer”).

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