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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 31 and 35

[TD 9920]

RIN 1545-BP69

Income Tax Withholding on Certain Periodic Retirement and Annuity Payments Under Section 3405(a)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document sets forth a final regulation that provides rules for Federal income tax withholding on certain periodic retirement and annuity payments to implement an amendment made by the Tax Cuts and Jobs Act. This regulation affects payors of certain periodic payments, plan administrators that are required to withhold on such payments, and payees who receive such payments.

DATES: Effective date: This regulation is effective **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability date: For the applicability date of this regulation, see §31.3405(a)-1(d).

FOR FURTHER INFORMATION CONTACT: Kara M. Soderstrom of the Office of

Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) at (202) 317-5234 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document sets forth an amendment to the Employment Tax Regulations (26 CFR Parts 31 and 35) under section 3405 of the Internal Revenue Code (Code).

1. Periodic Payments

Section 3405 provides Federal income tax withholding rules for payments of pensions, annuities, and certain other deferred income (retirement and annuity payments). Retirement and annuity payments that are subject to withholding under section 3405 include periodic payments, nonperiodic distributions, and eligible rollover distributions.

A periodic payment is defined in section 3405(e)(2) as “a designated distribution which is an annuity or similar periodic payment.” Subject to certain exceptions,¹ a designated distribution generally is defined in section 3405(e)(1)(A) as any distribution or payment from or under an employer deferred compensation plan, an individual retirement plan (as defined in section 7701(a)(37)), or a commercial annuity. For this purpose, an employer deferred compensation plan is defined in section 3405(e)(5) as any pension, annuity, profit-sharing, or stock bonus plan or other plan deferring the receipt of compensation, and a commercial annuity is defined in section 3405(e)(6) as

¹ Under section 3405(e)(1)(B), a designated distribution does not include any amount that is wages without regard to section 3405; the portion of a distribution or payment (excluding any distribution or payment from or under an individual retirement plan, other than a Roth IRA) which it is reasonable to believe is not includible in gross income; any amount that is subject to withholding under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount or which would be so subject but for a tax treaty; or any distribution described in section 404(k)(2) (relating to distributions of “applicable dividends” by an employee stock ownership plan).

an annuity, endowment, or life insurance contract issued by an insurance company licensed to do business under the laws of any State. Section 35.3405-1T, Q&A a-9, provides that a periodic payment includes an annuity or similar periodic payment, whether paid by a licensed life insurance company, a financial institution, or a plan, and that an “annuity” is a series of payments payable over a period greater than one year and taxable under section 72 as amounts received as an annuity, whether or not the payments are variable in amount.

2. Withholding on Periodic Payments

Section 3405(a) requires the payor of any periodic payment to withhold from the payment as if the payment were wages paid by an employer to an employee, unless an individual has elected under section 3405(a)(2) not to have withholding apply, subject to the following exceptions. First, section 3405(c)(1)(A) provides that section 3405(a) does not apply in the case of any designated distribution that is an eligible rollover distribution (as defined in section 402(f)(2)(A)). Second, section 3405(e)(12) provides that no election under section 3405(a)(2) will be treated as in effect (and the provisions of section 3405(a)(4) for determining the default rate of withholding will not apply) if a payee fails to furnish the payee’s Taxpayer Identification Number (TIN) to the payor in the manner required by the Secretary or the Secretary notifies the payor before any payment or distribution that the TIN furnished by the payee is incorrect. Third, under section 3405(e)(13), no election under section 3405(a)(2) may be made with respect to certain periodic payments to be delivered outside of the United States and its possessions.

3. Default Rate of Withholding on Periodic Payments and TCJA Amendment

Before amendment by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (TCJA), section 3405(a)(4) provided that, in the case of any periodic payment with respect to which a withholding certificate is not in effect, the amount withheld from the periodic payment is “determined by treating the payee as a married individual claiming 3 withholding exemptions.” TCJA amended section 3405(a)(4) to eliminate the requirement that the payee be treated as a married individual claiming three withholding exemptions and to provide instead that, in the case of any periodic payment with respect to which a withholding certificate is not in effect, the amount withheld from the periodic payment will be “determined under rules prescribed by the Secretary.” However, certain provisions of §35.3405-1T continued to reflect the rule under section 3405(a)(4) prior to amendment by TCJA.

Following enactment of TCJA, the Department of the Treasury (Treasury Department) and the IRS issued three notices addressing this change to section 3405(a)(4). These notices provide that, for calendar years 2018, 2019, and 2020, the default rate of withholding on periodic payments under section 3405(a) is based on treating the payee as a married individual claiming three withholding allowances. See Notice 2020-3, 2020-3 I.R.B. 330 (for 2020);² Notice 2018-92, 2018-51 I.R.B. 1038 (for 2019); and Notice 2018-14, 2018-7 I.R.B. 353 (for 2018).

² Notice 2020-3 also provides that the Treasury Department and the IRS are considering whether the default rate of withholding on periodic payments that is in effect for 2020 will continue to be appropriate for calendar years after 2020 and requests comments on whether the adoption of a new default rate of withholding on periodic payments that applies prospectively would present any administrative challenges. One comment was received on this issue (available at: <https://www.regulations.gov/document?D=IRS-2019-0051-0004>). The commenter provides suggestions regarding the effective date and prospective application of any change to the default rate of withholding on periodic payments and suggestions regarding the applicable withholding tables for periodic payments for calendar years after 2020.

4. Notice of Proposed Rulemaking

On May 27, 2020, the Treasury Department and the IRS published a notice of proposed rulemaking (proposed regulation) (REG-100320-20) in the Federal Register (85 FR 31714) that proposed to update certain provisions of §35.3405-1T to conform to the TCJA change to section 3405(a)(4). Specifically, the notice of proposed rulemaking proposed to remove from §35.3405-1T Q&As a-10, b-3, and b-4, which each provided that the default rate of withholding on periodic payments is determined by treating the payee as married and claiming three withholding allowances, and to update and replace the provisions of each of these three Q&As with new §31.3405(a)-1. These changes are explained in detail in the preamble to the proposed regulation.

The IRS did not receive any requests for a public hearing on the proposed regulation, and therefore no public hearing was held. All written comments responding to the proposed regulation are available for public inspection and copying at <http://www.regulations.gov> or upon request. After consideration of the comments received on the proposed regulation, this Treasury decision adopts the proposed regulation as final with no modifications, as explained in the Summary of Comments and Explanation of Provisions.

Summary of Comments and Explanation of Provisions

The Treasury Department and the IRS received two written comments that responded to the proposed regulation. As explained in this Summary of Comments and Explanation of Provisions, these comments make recommendations regarding the default rate of withholding on periodic payments that would not require a change to the proposed regulation. Accordingly, the proposed regulation is adopted as final without

modification. However, the comments remain under consideration for future revisions to forms, instructions, publications, and other guidance relating to withholding on periodic payments, including revisions to the Form W-4P, “Withholding Certificate for Pension or Annuity Payments.”

1. Default Rate of Withholding on Periodic Payments

The proposed regulation proposed to remove Q&As a-10, b-3, and b-4 from §35.3405-1T because they prescribed the substantive default rate of withholding rule under section 3405(a)(4) prior to amendment by TCJA. Specifically, the proposed regulation proposed to update and replace the provisions of each of these three Q&As with new §31.3405(a)-1, which provides that the default rate of withholding on periodic payments made after December 31, 2020, is determined in the manner described in the applicable forms, instructions, publications, and other guidance prescribed by the Commissioner.

Both responsive comments recommend that the default rate of withholding on periodic payments be a flat 10 percent rate, rather than a rate based on Federal income tax withholding on wages, to simplify the default rate of withholding on periodic payments and provide transparency, flexibility, efficiency, and accuracy.

The proposed regulation did not set forth a specific default rate of withholding on periodic payments, instead providing a flexible and administrable rule that leaves the communication and mechanical details of the default rate of withholding on periodic payments to be provided in applicable forms, instructions, publications, and other guidance prescribed by the Commissioner. This approach enables the Treasury Department and the IRS to make updates more quickly, including to address legislative

changes, to provide payors and plan administrators processing payments adequate time to program their systems to withhold the proper amount of income tax.

Accordingly, this final regulation adopts the proposed regulation without modification.

2. Implementation of a New Default Rate of Withholding on Periodic Payments

As an alternative to a flat 10 percent rate for the default rate of withholding on periodic payments, both comments recommend that a new default rate of withholding on periodic payments apply prospectively only and have a January 1 (rather than a mid-year) effective date. The comments additionally recommend a January 1 effective date that is at least two full years after the end of the 2020 calendar year (or at least two full years after the end of the calendar year for which Form W-4P is redesigned to mirror Form W-4, "Employee's Withholding Certificate," if later), in order to provide payors time to update their systems, forms, and procedures. (The comments also recommend avoiding a mid-year implementation deadline for any revised version of Form W-4P that reflects changes made to Form W-4 in light of TCJA.)

The proposed regulation did not specify an effective date for a new default rate of withholding on periodic payments or how a new default rate of withholding should be applied. Although the proposed regulation was proposed to apply to periodic payments made after December 31, 2020, this applicability date describes the periodic payments for which the default rate of withholding is determined in the manner described in the applicable forms, instructions, publications and other guidance prescribed by the Commissioner. The effective date and application of a new default rate of withholding on periodic payments, like the default rate of withholding on periodic payments itself, would be described in that guidance. The proposed approach provides a flexible and

admininstrable rule that leaves the communication and mechanical details of the default rate of withholding on periodic payments to be provided in applicable forms, instructions, publications, and other guidance prescribed by the Commissioner that may be updated more quickly, including to address legislative changes. Accordingly, this final regulation adopts the proposed regulation without modification.

Effective and Applicability Dates

This regulation is effective **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. This regulation applies to periodic payments made after December 31, 2020.

Special Analyses

1. Regulatory Planning and Review

This final regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

2. Paperwork Reduction Act

Any collection of information associated with this final regulation has been submitted to the Office of Management and Budget for review under OMB control number 1545-0074 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). In general, the collection of information is required under section 3405 of the Code. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to this final regulation, including estimates for how much time it would take to comply with the paperwork burdens described in OMB

control number 1545-0074 and ways for the IRS to minimize the paperwork burden. An agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a valid OMB control number.

3. Regulatory Flexibility Act

Under the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that this final regulation will not have a significant economic impact on a substantial number of small entities that are directly affected by the final regulation. This final regulation will apply to all payors of periodic payments, including small entities, and is likely to affect a substantial number of small entities. The economic impact, however, will not be significant. The primary change is to effect a TCJA legislative amendment to remove the reference in section 3405(a)(4) to a married individual claiming three exemptions as the default withholding rate and to provide, in its place, that the amount to be withheld is determined pursuant to the applicable forms, instructions, publications, and other guidance prescribed by the Commissioner. Accordingly, this rule would conform the current regulation to the statute and will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Statement of Availability of IRS Documents

IRS Notices cited in this preamble are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS web site at <http://www.irs.gov>.

Drafting Information

The principal author of this final regulation is Kara M. Soderstrom, Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in its development.

List of Subjects

26 CFR Part 31

Employment taxes, Fishing vessels, Gambling, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

26 CFR Part 35

Employment taxes, Income taxes, Pensions, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 31 and 35 are amended as follows:

PART 31--EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 is amended by adding an entry for §31.3405(a)-1 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 31.3405(a)-1 also issued under 26 U.S.C. 3405(a)(4).

* * * * *

Par. 2. Section 31.3405(a)-1 is added to read as follows:

§31.3405(a)-1 Questions and answers relating to Federal income tax withholding on periodic retirement and annuity payments.

(a) The following questions and answers relate to Federal income tax withholding on periodic payments under section 3405(a), as amended by section 11041(c)(2)(G) of the Tax Cuts and Jobs Act (Public Law 115-97, 131 Stat. 2054 (2017)). The withholding rules of section 3405(a) do not apply to periodic payments that are eligible rollover distributions (as defined in section 402(f)(2)(A)). See generally section 3405(c) and §31.3405(c)-1 for Federal income tax withholding rules applicable to eligible rollover distributions. See section 3405(e)(13) for additional rules applicable to certain periodic payments under section 3405(a) and nonperiodic distributions under section 3405(b) that are to be delivered outside the United States and its possessions. For additional guidance regarding periodic payments, see §§35.3405-1 and 35.3405-1T of this chapter.

(b)(1) Q-1: How will Federal income tax be withheld from a periodic payment?

(2) A-1: In the case of a periodic payment that is subject to withholding under section 3405(a), amounts are withheld as if the payment were a payment of wages by an employer to the employee for the appropriate payroll period. If the payee has not furnished a withholding certificate, the amount to be withheld is determined in the manner described in the applicable forms, instructions, publications, and other guidance prescribed by the Commissioner. The rules for withholding when the payee has not

furnished a withholding certificate apply regardless of whether the payor is aware of the payee's actual marital status or actual Federal income tax filing status.

(c)(1) Q-2: Do rules similar to those for wage withholding apply to the furnishing of a withholding certificate for periodic payments?

(2) A-2: Yes. Unless the rules of section 3405 specifically conflict with the rules of section 3402, the rules for withholding on periodic payments that are not eligible rollover distributions will parallel the rules for wage withholding. Thus, if a withholding certificate is furnished by a payee, it will generally take effect in accordance with section 3402(f)(3) and as provided in applicable forms, instructions, publications, and other guidance prescribed by the Commissioner. If no withholding certificate is furnished, the amount withheld must be determined in the manner described in the applicable forms, instructions, publications, and other guidance prescribed by the Commissioner for withholding on periodic payments when no withholding certificate is furnished.

(d)(1) Q-3: What is the applicability date of this section?

(2) A-3: This section applies with respect to periodic payments made after December 31, 2020.

PART 35--EMPLOYMENT TAX AND COLLECTION OF INCOME TAX AT SOURCE
REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF
1982

Par. 3. The authority citation for part 35 continues to read in part as follows:

Authority: 26 U.S.C. 6047(e), 7805; 68A Stat. 917; 96 Stat. 625; Public Law
97-248 (96 Stat. 623)* * *

§35.3405-1T [Amended]

Par. 4. Section 35.3405-1T is amended by removing and reserving Q&A a-10,
Q&A b-3, and Q&A b-4.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: September 25, 2020.

David J. Kautter,
Assistant Secretary of the Treasury (Tax Policy).