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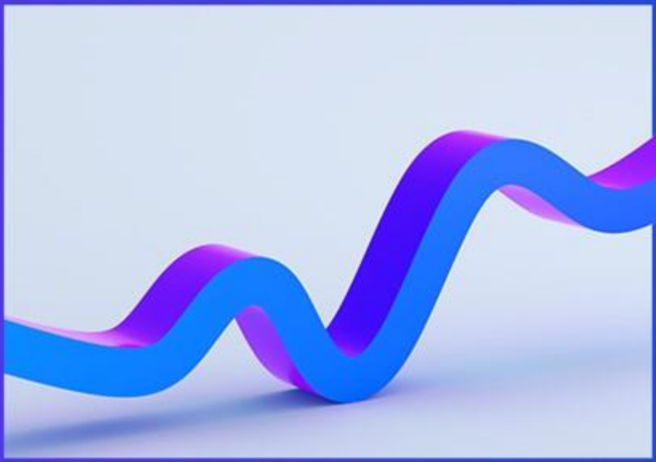

Back to Basics: Periodic and Nonperiodic Withholding Certificates

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> In early 2022, the IRS issued a new withholding certificate, Form W-4R, which decoupled nonperiodic payments from the prior version of Form W-4P. Beginning January 1, 2023, payors will be required to collect updated forms that are specific to periodic and nonperiodic payments. Though the IRS granted a phase-in year, many payors are still updating their software and processes for this change while others may not yet be aware of the requirement. In *Back to Basics: Periodic and Nonperiodic Withholding Certificates*, we discuss the basics of periodic and nonperiodic withholding certificates, the reason for the new forms, and steps that businesses should be taking now to ensure that they are compliant in the new year.

Historical Overview

During the second downturn of the early 1980s recession, President Reagan sought legislation to reduce the budget deficit as tax revenue fell by 6%. Rather than raise income taxes, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[1] which was designed to generate revenue by closing certain tax loopholes. Notably, the legislation introduced section 3405, creating a new withholding regime for certain nonwage income. Specifically, payors were required to withhold on periodic payments as if they were wages. Distributions considered to be nonperiodic payments were divided into “nonqualified” and “qualified” total distributions, with 10% withholding required for the former and amounts set by Treasury issued tables for the

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[1] The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) can be found at https://www.congress.gov/bill/97th-congress/house-bill/4961.

latter. In all cases, the legislation provided for an election not to withhold, as well as default rules to apply when withholding certificates were not provided. The legislation ensured compliance by putting the burden of payment on the payor (or plan administrator), making them responsible for reporting and ultimately liable for withholding. This new reporting and withholding regime went into effect beginning with payments made on January 1, 1983.

Prior to TEFRA, payees with annual nonwage income over $500, and expected tax liabilities of $200 or more, were required to report and pay estimated taxes in installments throughout the year.[2] However, payees that opted into voluntary withholding on pension and annuities were not subject to this obligation. Payees were instructed to submit Form W-4P to the payor, signifying a flat dollar amount to withhold. Following TEFRA, Treasury issued a set of questions and answers, in the form of temporary regulations, to assist in the transition to the new mandatory withholding regime. In particular, Treasury specified that payors could continue relying on the Form W-4P certifications which payees had submitted for voluntary withholding.[3] As TEFRA required withholding on periodic payments to be treated similar to wage withholding, the post-TEFRA withholding certificate required roughly the same information as the Form W-4,[4] a trend that continued until 2020.

Under the Tax Cuts and Jobs Act of 2017 (TCJA),[5] personal exemptions were eliminated, making certain information required under Form W-4 obsolete. For the 2020 tax year, the IRS issued a new Form W-4, updated from *Employee's Withholding Allowance Certificate* to *Employee's Withholding Certificate*, which contained a number of updates to address this issue, notably the elimination of personal allowances claimed by a payee. However, the IRS did not update Form W-4P, creating a discrepancy in information for the first time in four decades. This presented an issue, as payors of periodic payments were still required under section 3405(a) to withhold similar to employee wages yet were required to collect outdated information on Form W-4P. In recognition of this problem, the IRS issued Notice 2020-3,[6] providing an online tax withholding estimator to help payees determine their entries on the 2020 Form W-4P. The IRS noted that it would continue to look into solutions and would provide additional guidance in the 2020 version of Publication 15-A, *Employer's Supplemental Tax Guide*,[7] on completing the 2020 Form W-4P using the new withholding tables and computational procedures in Publication 15-T, *Federal Income Tax Withholding Methods*. However, the 2021 form remained largely unchanged, likely due to reprioritization during the Covid pandemic.

In March 2021, the IRS issued draft 2022 Form W-4P, *Withholding Certificate for Periodic Pension or Annuity Payments*, removing the entries for personal allowances and realigning the requisite information with Form W-4. In addition, the IRS issued a 2022 draft version of new Form W-4R, *Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions.* In doing this, the IRS simplified the withholding process by bifurcating the treatment of periodic and nonperiodic payments, thus requiring separate certifications depending on the type of payment received by the payee. It was expected that both forms would be required beginning with the 2022 tax year; however, the forms were not finalized until early 2022. Due to this delay, the IRS provided payors a phase-in year, encouraging taxpayers to adopt both as soon as possible, but allowing payors to continue using the 2021 Form W-4P for both periodic and nonperiodic payments until transitioning to the updated forms. Beginning January 1, 2023, both forms must be used, as applicable.

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[2] See 1982 Form W-2P, Statement for Recipients of Periodic Annuities, Pensions, Retired Pay, or IRA Payments, at https://www.irs.gov/pub/irs-prior/fw2p--1982.pdf.
[3] See Treas. Reg. 35.3405-1T, Question A-7.
[4] Compare the earliest IRS archived versions of the Form W-4, https://www.irs.gov/pub/irs-prior/fw4--1990.pdf, and Form W-4P, https://www.irs.gov/pub/irs-prior/fw4p--1990.pdf.
[5] The Tax Cuts and Jobs Act of 2017 can be found at https://www.congress.gov/bill/115th-congress/house-bill/1.
[6] See Notice 2020-3 at https://www.irs.gov/pub/irs-drop/n-20-03.pdf.
[7] The 2020 Publication 15-A, ***Employer's Supplemental Tax Guide***, can be found at https://www.irs.gov/pub/irs-prior/p15a--2020.pdf

Periodic and Nonperiodic Withholding and Reporting Requirements

As discussed above, payors are required to withhold on certain nonwage distributions on behalf of payees. Withholding treatment hinges on the classification of the payment and any elections that the payee may have made. Treatment of nonwage payments hinges on the classification, which is generally categorized as periodic payments, nonperiodic payments, and eligible rollover distributions.

Periodic Withholding Generally

A periodic payment is defined as an annuity, or a similar periodic payment, that is further defined as a series of payments payable over a period greater than one year and taxable under section 72, whether the payments are variable in amount.[8] These payments may be received from a licensed insurance company or financial institution, or under an employer deferred compensation plan. Payors are generally required to withhold an amount equal to that which would be withheld if the payments were wages. If no withholding certificate is provided, or an invalid certificate is provided, the statute tasks the Secretary of the Treasury with setting forth a default withholding method. The current default method will be transitioning from treating the payee as if they are married and claiming three allowances (using the 2021 Form W-4P) to treating the payee as if they are single, with no additional entries for multiple pensions, dependent claims, or other adjustments.[9] Payees may request that the payor adjust the withholding amount by submitting Form W-4P, which is now specific to periodic payments.

As previously mentioned, Form W-4P typically follows Form W-4, as payors are generally required to treat periodic payments as if they were wages for withholding purposes. Although the IRS made updates to Form W-4 in 2020, due to changes under the TCJA, without making corresponding changes to Form W-4P, the forms have now been realigned. The current version helps payors estimate the proper withholding amount by collecting payee wage information, such as the payee's income tax filing status, additional income streams from a spouse or other job, and any dependents or credits. The form also permits payees to specify whether they would like to increase or decrease the amount of withholding. For example, a payee receiving interest or capital gains which are not otherwise subject to withholding may be required to make estimated payments throughout the year. By disclosing additional income streams in box 4(a) or specifying an additional flat dollar amount to withhold in box 4(c), the payee may be able to avoid the additional quarterly burden associated with estimated payments. Conversely, a payee may elect to have the withholding amount reduced by calculating a separate deduction, using the Deductions Worksheet, and inputting that number on box 4(b).

Nonperiodic and Eligible Rollover Distribution Withholding Generally

A nonperiodic payment is defined simply as any designated distribution which is not a periodic payment.[10] However, Treasury has clarified that payments from an individual retirement account (IRA) that are payable on demand will be treated as nonperiodic payments, even if they are distributed in periodic intervals.[11] The default rate of withholding is 10%. Payees can make adjustments to their withholding using the new Form W-4R, which is specific to nonperiodic payments and eligible rollover distributions. Unlike the previous all or nothing approach, the new form now allows payees to elect a lower rate of withholding, rather than opting out of withholding altogether. Notably, rather than specifying a flat dollar amount to be withheld from each payment, payees can now request a higher rate of withholding. This is particularly useful for payees seeking to align the withholding amount with their marginal rate without doing the calculations on a payment-by-

[8] See Treas. Reg. 35.3405-1T, Question A-9.
[9] See 2022 Publication 15-T, section Form W-4P at https://www.irs.gov/pub/irs-pdf/p15t.pdf.
[10] IRC 3405(e)(3).
[11] See Treas. Reg. 35.3405-1T, Question F-15.

payment basis. Note that the form even provides a marginal rate table to help payees determine the appropriate rate.

Under the statute, designated distributions deemed to be eligible rollover distributions are not subject to periodic or nonperiodic withholding rules.[12] Generally speaking, this includes distributions received from qualified retirement plans, such as 401(k) plans and section 457(b) plans, or tax-sheltered annuities that are eligible to be rolled over to an IRA or qualified plan. Payors are required to withhold at a default rate of 20% on such distributions. If the payee elects to have a distribution rolled over into an eligible retirement plan, then the 20% default withholding only applies to the portion that is not directly rolled over.[13] Payees who receive the funds directly have 60 days to redistribute them into an eligible retirement plan.[14] Using Form W-4R, payees can elect a higher rate of withholding, but may not elect a lower rate. The instructions note that payees should not submit Form W-4R unless they want more than 20% withheld from the distribution.

Periodic and Nonperiodic Withholding Certificate Requirements

Payors are generally required to withhold at the rate specified by the payee, including any special elections (though, as noted above payees may not elect to withhold below certain rates on specified payments). A payee may experience personal or financial situational changes and may request changes to their withholding elections simply by submitting a new, valid withholding certificate.

If a payee fails to provide a valid withholding certificate, then the payor is required to withhold at the default rate specified for each type of payment. Importantly, the payee must sign the certificate and provide a valid social security number (SSN), or the certificate will be deemed invalid. If the IRS notifies the payor that the payee provided an incorrect SSN, then the payor is required to withhold at the default rate. The IRS also notes that any unauthorized changes or additions to a withholding certificate will render it invalid, such as removing language by which the payee certifies that the form is correct, materially defacing the form, or any writing on the form other than the entries requested.[15] If a payor receives an invalid certificate, the payor should request that the payee submit another one and, if not received, withhold at the default rate.

The payor may create substitute forms, if provided in the correct format. Specifically, if using an electronic system as a substitute, the IRS requires that it provide the exact same information as the paper form, including rate tables for Form W-4R,[16] with very limited exceptions.[17] Notably, for data and cyber security concerns, the electronic form is not required to collect certain personal information, including the name, address, and SSN of a payee, when the information is electronically stored in an account tied to the payee and the election is linked to the account. The payee must sign the substitute certification with an electronic signature, which must be the final entry in the submission.

There are particular procedural requirements that must also be followed. The system must document all occasions that a payee accesses the system when it results in a submission and must make it reasonably certain that the person is the correct individual as identified on the form. IRS guidance notes that no pop-ups or hoverboxes may be used, and toggles which limit the viewable text must be switched off. To the extent that the system is setup with separate pages, the system must require payees to go to each page before signing the form. Payors must be prepared to furnish hard copies to the IRS upon request and must meet all

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[12] IRC 3405(c)(1)(A).

[13] See Treas. Reg. 31.3405(c)-1, Question 6.

[14] IRC 402(c)(3).

[15] See IRS *Topic No. 753 Form W-4 – Employee's Withholding Certificate*, dealing with Form W-4 specifically, at https://www.irs.gov/taxtopics/tc753.

[16] Note that the IRS issued subsequent guidance stating that the electronic form may contain a link to a webpage with the rate tables, rather than providing the tables themselves. For further information, including additional text that must be included, go to https://www.irs.gov/forms-pubs/additional-guidance-for-substitute-and-telephonic-submissions-of-forms-w-4p-and-w-4r.

[17] See Publication 15-A at https://www.irs.gov/pub/irs-pdf/p15a.pdf. Payors using electronic systems for Form W-4R may tailor the certificate to either nonperiodic payments or ERDs by removing the alternative bullet from the first line.

recordkeeping requirements that apply to the paper form. The IRS notes that payors seeking to use a paper substitute form must generally follow all the instructions for the electronic substitute form, with the exception that those instructions apply only to electronic substitutes, such as pop-ups. The IRS will be releasing additional guidance for payors that would like to provide telephonic submissions for Forms W-4P and W-4R.[18]

State Withholding Certificates

Generally speaking, many states have historically relied on federal withholding elections when periodic and nonperiodic withholding is required at the state level. Payors were able to collect federal forms, or state versions that mirrored the federal form, and apply exemptions made at the federal level for broader state purposes. This made the onboarding process relatively painless for payors with payees located across the U.S. However, a federal/state disconnect occurred after Form W-4 was updated for TCJA changes. Although the designations for personal exemptions and standard deductions were no longer applicable for federal purposes, many states still relied on this information for state withholding calculations. States began to adjust their guidance and withholding calculations to accommodate the federal changes, effectively maintaining the status quo for the onboarding process. However, some states began to update their state specific certifications, or issued state specific certifications for the first time, requiring these versions for any new or updated withholding submissions.

Following the realignment of federal Form W-4P with Form W-4, the ripple effect continued, with more states creating their own forms. The impact has been significant, as payors are required to subject payees to additional documentation requirements. The issue is particularly problematic for payors with broader payee footprints, as they must now navigate nuanced technicalities when creating and providing consolidated state/federal electronic forms. Despite the federal exemption of personal data for cyber security concerns, many states require that this information be provided with the substitute form. In some cases, payors are required to include additional state options on the form, e.g., North Carolina requires the form to have a separate marital status checkbox for married filing separately, meaning it cannot be combined as it is on the federal version. In addition, state specific language is required in many cases. This can be particularly problematic for the penalties of perjury section, where a failure to include the exact state language may not only render the certification invalid, but may result in a contractual transgression. In other cases, states simply do not accept substitute forms, requiring a new state specific form for each update. The recent bifurcation of Form W-4R will likely make the onerous process even trickier to navigate as more states issue updates, forcing payors and payees to adjust to ever expanding state requirements.

Going Forward, 2023 Withholding Certificates

As noted above, issuance of the new bifurcated versions of Forms W-4P and W-4R was delayed. The IRS subsequently modified its guidance, stating that use of the certificates would be optional in 2022, but mandatory in 2023. In September, the IRS posted a draft version of the 2023 version of Form W-4R, signaling that final versions of the certificates would be issued well before the end of the year. However, earlier this month, the IRS issued a second 2023 draft version of Form W-4R[19] and an initial 2023 draft version of Form W-4P.[20] The draft versions contain minimal updates, primarily inflation adjustments and cosmetic changes. With limited time remaining in the year, this makes it tougher for payors to update their processes and, for those utilizing electronic substitutes, their software. Although the IRS does not require use of the new

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[18] The IRS has provided tentative scripts that payors will be required to follow. See https://www.irs.gov/forms-pubs/additional-guidance-for-substitute-and-telephonic-submissions-of-forms-w-4p-and-w-4r.

[19] See December 2, 2022, version of 2023 draft Form W-4R at https://www.irs.gov/pub/irs-dft/fw4r--dft.pdf.

[20] See December 2, 2022, version of 2023 draft Form W-4P at https://www.irs.gov/pub/irs-dft/fw4p--dft.pdf.

certificates until the later of the new year or 30 days after the final version has been issued, payors should begin planning now to avoid any complications in the new year.

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