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Information Reporting & Withholding

Middleman Rules Refresher – Part I

Who is Impacted

Any persons who may be considered a middleman and obligated to perform U.S. tax information reporting or any payor making payments to a third party or agent, will be interested in a quick two-part refresher on the rules governing payments for or on behalf of others.

As a reminder of the general reporting rules for payments of $600 or more made in the course of a trade or business, the payor is required to report payments of salaries, wages, compensation, fees, and other forms of fixed or determinable income. This rule does not include payments made outside of a trade or business or payments that are not treated as gross income to the payee. This reporting requirement is that of the payor. The question arises when a party makes a payment to a third party or agent, who makes the payment to the ultimate recipient. In this situation, the rules guide us to determine if the third party or agent is to be treated as a middleman with the obligation to do the information reporting and withholding.

What changed

Although nothing has changed, per se, the middleman rules never seem to at the top of anyone's mind. When a question arises as to whether a payor making a payment to a third party and that third party will be making payment for or on behalf of another is a middleman, most have to take a moment to research and confirm the answer. For example, a book publisher is paying a royalty to a writer's agent, who in turn pays the writer. Who is the payor? The book publisher or the writer's agent. This article will provide a quick refresher to those rules and provide a few key examples. Look for our next article, Part 2, where we will delve into some of the nuances to this rule.

So, how do the middleman reporting rules apply? Under the general reporting rules, a person making payments to a third party who then makes the payment for or on behalf of another will trigger the application of the middleman rules. The focus here is to identify 'who is the payor?' Determining who that payor is will lead us to the person responsible or obligated to report these types of payments. The middleman rules tell us that a person making a payment in the ordinary course of its trade or business on behalf of another person is the payor that must report the payment on a U.S. tax information return. That person will qualify as a payor if the income is treated as gross income to the payee and if either of the following apply:

- The person performs management or oversight functions in connection with the payment.
- Has a significant economic interest in the payment. This could be an economic interest that would be compromised if the payment were not made.

In the next few sections we will walk through what qualifies for each of these conditions.

What are management or oversight functions?

Management or oversight functions have been defined by example in the regulations. We know that these functions would not include a person who performs mere administrative or ministerial functions, such as writing a check at the discretion of someone else. The function would have to be more substantive, such as directing or approving payments, hiring, and making other management type decisions. Let's walk through a few examples to tie in this definition with the middleman rule.

For our first example, assume that a Bank finances a new neighbourhood development for a Developer. In its duties, the Bank agrees to make disbursements from the account of the Developer to pay for labour, materials, services, and other related expenses. The Bank also agrees to approve payments to all contractors and ensure that loan proceeds are applied correctly and that all approved bills are paid to avoid any liens. Finally, the Bank will conduct site inspections to determine whether the work has been completed, but will not assess the quality of the that work.

In this case, the Bank is performing management or oversight functions in connection with the payments and is subject to U.S. tax information reporting requirements with respect to payments.

In a second example, assume a Property Manager handles rental property on behalf of the Owner. The Property Manager agrees to find tenants, arrange leases, collect rent, respond to maintenance inquiries from the renters, and hires and pays any repairmen to maintain the property.

In this case, the Property Manager is performing management or oversight functions and is subject to U.S. tax information reporting requirements.

Finally, in the third example, assume the Property Manager only paid the invoices for the property at the discretion of the property owner. In this case, the Property Manager does not perform management or oversight functions.

Let's move on to the second possible condition for being a middleman, having a significant economic interest in the payment.

What is significant economic interest in the payment?

A significant economic interest in a payment is not clearly defined; however, we are able to narrow the definition based on examples provided in the regulations. Some examples include the creation of a mechanic's lien on property to which the payment relates, or a loss of collateral.

Below are a few examples to put this rule into a practical experience:

First, assume a Mortgage Company holds a mortgage on business property owned by a Debtor. When the property is damaged by a storm, the debtor's insurance company issues a check payable to both the Mortgage Company and the Debtor in settlement of the claim made by the Debtor. In accordance with their contract, the Mortgage Company holds the insurance proceeds in an escrow account. The Mortgage Company only makes disbursements according to instructions from the Debtor. These disbursements may be to contractors and subcontractors performing repairs on the property.

In this case, we can see that the Mortgage Company does not perform management or oversight functions; however, it does have a significant economic interest in the payments. This is because the purpose of the arrangement is to be sure that property on which the Mortgage Company holds a mortgage is repaired or replaced. The Mortgage Company is subject to U.S. tax information reporting requirements with respect to the payments to contractors.

It is important to note that even though a person might not qualify as a middleman and may not be required to make an information return, that person may elect to do so pursuant to certain

procedures. This procedure might apply to paying agents wishing to report and deposit amounts withheld for payors under the statutory provisions of backup withholding.

How to Implement

If there are any possibilities of triggering the middleman rules, it is important to make note of when those situations could arise and implement procedures to carry out U.S. tax information reporting obligations. Below are a few items to consider:

- For payments your organization may make to third parties, review your contracts to determine if the third party's contractual obligations include management and oversight of the payments or if the third party has a significant economic interest making them the middleman.
- Clearly document all middlemen that your organization makes payments to and the corresponding rationale.
- Confirm with suspected middleman that the information reporting and withholding will take place.
- Controls, approvals, or sign off procedures for making payments. Implement controls for all business areas that are able to make payments – or, consolidate that ability to make payments to few or one business department.
- For organizations receiving payments as potential middlemen, confirm that no one is making management or oversight decisions and that there is no economic interest in those payments.
- For payments that your organization is treated as a middleman and as such, responsible for reporting, make sure you have coordinated with the originator of the payment that you receive all information needed.
- Communication with business units to identify areas that could trigger middleman rules. Overcommunication is never a problem when you are looking out for your business and identifying areas of risk that could trigger an obligation for your business for which you are no aware.
- Be sure you have processes and procedures for reporting where you do find yourself to be a middleman.
- Review your internal training to make sure you are adequately covering middleman rules if your organization pays or could pay third party agents.

Do you have the possibility of becoming a middleman? Share your experiences with us in the comments on LinkedIn or email us! Also, look for Part 2 of this article where we will delve into some of the nuances related to the middleman rules!

Resources

- IRC §6041 and 6045
- Treas. Reg. §1.6041-1