



# Compliance Responsibilities in Vendor Set Up



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## Introduction

New vendor onboarding is a complex process that starts with sourcing and approval and continues with vendor validation and set-up. Vendor set up is a critical phase in which organizations must obtain, check and validate vendor information in order to ensure accuracy and completeness, and to meet compliance obligations.

Organizations must comply with federal restrictions on doing business with certain organizations or individuals. They must also comply with federal and state tax requirements, and with other laws for which correct and complete vendor information is essential. By far, the most effective and least costly (i.e., least time-consuming) acquisition of the requisite vendor compliance information occurs at set up.

Compliance with the various tax and regulatory requirements is one of the ways to show that there is more to “paying the bills” than is commonly understood outside of procurement and payables. Organizations must protect themselves against error and fraud through effective internal controls delineated in policies and procedures. Control procedures include verification of vendors as valid trading partners, which includes running checks against government watch lists.

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Compliance with tax laws requires payment reporting to the U.S. government and individual states and withholding on certain payments. (Payers must also ensure they correctly pay state sales and use taxes and meet unclaimed property reporting and escheatment requirements, which requires complete and accurate vendor information.)

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Validation of vendor qualifications and capabilities is essential and applies to all vendors whether engaged by purchasing or personnel outside of purchasing. Part of this process involves checking the government's watch lists to ensure vendors are not restricted or sanctioned by the government. If a vendor is on a sanction list, the relationship ends there. So the check must be done at the start of set up.

Compliance with tax laws requires gathering tax identification numbers (TINs) and tax classification. This must be done in the set-up phase when the company has the leverage to obtain the information and because the successful apprehension and verification of tax information is critical to correct classification and a smooth reporting process downstream, and depending on classification, to avoiding backup withholding otherwise required.

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## Watch Lists

The federal government of the United States prohibits companies from doing business with certain organizations and individuals. These specific prohibitions are in addition to country sanctions and support the government's foreign policy, national security and crime prevention objectives.

Various government agencies maintain lists of the sanctioned or blocked entities. The Treasury Department's Office of Foreign Assets Control (OFAC) aggregates most of these lists. OFAC maintains the list of sanctioned countries — if a country is sanctioned, so are individuals and organizations within that country. That's straight forward enough. But it publishes the Specially Designated Nationals and Blocked Persons (SDN) list, which includes particular entities and individuals. This aggregated list specifically identifies entities engaged in terrorism, trafficking weapons of mass destruction, narcotics, illegal diamonds and other illegal activity or threats to security.

Companies with such innocuous-sounding names as American Tune Up, Pearl Energy Company Ltd., and VR Fruit Company are fronts connected to or owned by prohibited individuals or organizations. It is illegal to do business with them. Yet a number of American companies across industries are fined each year for inadvertently transacting business with a proscribed entity.

Risk varies by industry. While the financial services industry is probably the most likely to encounter a proscribed entity, it is far from the only one. The risk extends well beyond the financial sector. The top industries running afoul of U.S. sanctions in recent years include IT/Telecom, Medical/Pharmaceutical, Non-Profit Institutions, Offshore Services, Oil & Gas and the Professional Services sector. Others include the Airlines Industry, Electronics, Logistics & Shipping and Tourism. In the past, such companies as Johnson & Johnson and General Electric were found to have inadvertently run afoul of restrictions. Law firm Baker,

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Donelson, Bearman, Caldwell & Berkowitz, PC, says, “OFAC's recent enforcement trends reinforce the need for all U.S. persons to ensure they understand the risks and requirements of OFAC.”

Baker Donelson recommends that an OFAC compliance program include written policies and procedures, qualified personnel trained in OFAC issues, screening procedures to identify all parties including intermediaries and beneficial owners in a transaction; and regular training for a company’s officers, directors and staffs.

The laws are blind to industry or company. Generally, it is illegal for U.S. persons to trade with proscribed entities. The definition of U.S. person is: "all U.S. citizens and permanent resident aliens regardless of where they are located, all persons and entities within the U.S., all U.S. incorporated entities and their foreign branches." According to Jerry Livigni, Senior Compliance Officer in the Office of Foreign Assets Control (OFAC), “All means all.”

Some sanctions are complex. A good example is Cuba. Some transactions are illegal while certain activities are permitted. Companies must ensure they understand how the rules apply to what they are doing or plan to do. Exemptions may sometimes be obtained and a license for a particular transaction granted.

Along with the OFAC lists, there are other watch lists for other purposes. The GSA’s System for Award Management (SAM) identifies individuals and firms ineligible to participate in federal procurement and non-procurement programs. Federal agencies are the primary users of SAM, but the ineligibility of listed parties applies to all organizations contracted by or receiving money from the government. SAM includes the Excluded Parties List (EPLS), comprising federal contractors who have been debarred, sanctioned or excluded due to government contract issues or fraud.

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As a part of the effort to guard against corruption internationally, the CIA compiles an international list of “politically exposed persons” (PEP) that global organizations may interact with. Financial services companies, in order to counter money laundering under the BSA and the Patriot Act, must also check names against the politically exposed persons list, along with the Financial Action Task Force on Money Laundering (FATF) list of Non-cooperative Countries and Territories (NCCT).

Some lists are geared more specifically toward a specific industry, such as the Office of Inspector General’s List of Excluded Individuals and Entities (OIG-LEIE). This aggregates Department of Health and Human Services exclusions with those of the individual states (though there are some discrepancies related to the timely reporting by the states). And there are state and local level exclusions such as Casino Banned Patron lists that may or may not apply to your organization.

### **Responsibility Regarding Watch-List Entities**

OFAC and other agencies are not prescriptive — they don’t tell you what you must do or how to do it. They list whom you may not do business with. You simply must not transact with sanctioned, blocked or excluded entities, unless you specifically have applied for and been granted a license from the federal government. It is up to each organization to have a procedure to check their vendors against the lists. It is a huge undertaking.

Nor is it a “once and done” action. The lists are dynamic. So, when you do a batch check, as Richard Burke, CTO of Financial Operations Networks says, “That’s for your present snapshot right there at that point in time. Tomorrow, a new list comes out.”

A company’s starting point is to ensure that its entire vendor list has been checked against the entire applicable sanction list. Once this is done, there are two subsequent events that require further attention. The first is to check any new candidates for addition to your

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vendor file against applicable lists. The other is to check the new watch list additions against your vendors.

The question for organizations is “Are you compliant, or do you just think you are?” If an organization has compared its entire list once and then compares each new vendor it adds, it still has not addressed that third situation in which a new entity has been added to the blocked list. That newly blocked entity might already be in your vendor master file. So new blocked entities must be checked against your existing vendors.



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## Tax Status and Identification Verification

Tax identification and classification is the other task that should be done at the start of a new vendor relationship. This need derives from the requirement to report certain types of payments to certain vendors to the IRS (and states) on IRS form 1099-MISC (or 1042-S, for certain foreign payments). In some cases, the payer must withhold a percentage of the payment and remit it to the IRS.

The purpose of payment reporting is to ensure that payees report and pay taxes on all their income. Payments made in the course of your trade or business must be reported on Form 1099-MISC, Miscellaneous Income. Specifically, from the IRS Instructions for Form 1099-MISC<sup>1</sup>, you must report, for each person whom, in the course of your business, you have paid during the year at least \$10 in royalties, or at least \$600 in:

- Rents
- Services performed (excluding employees, for whom you issue a W-2)
- Prizes or awards

Other 1099-MISC reportable income payments include: medical and health-care payments; crop insurance proceeds; cash payments for fish (or other aquatic life) you purchase from anyone engaged in the trade or business of catching fish; generally, the cash paid from a notional principal contract to an individual, partnership or estate; and any fishing boat proceeds. Companies must also report direct sales of at least \$5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment.

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<sup>1</sup> <https://www.irs.gov/pub/irs-pdf/i1099misc.pdf>

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Exceptions to 1099-MISC reporting include payments for merchandise, along with telegrams, telephone, freight, storage and “similar items.” Additional exceptions can be found on page 2 of the Instructions for Form 1099-MISC.<sup>2</sup>

Companies must also file Form 1099-MISC for each person from whom they have withheld any federal income tax under the backup withholding rules regardless of the amount of the payment. The exact reporting requirements are intricate and beyond the scope of this paper. See the *IRS Instructions for Form 1099-MISC*.<sup>3</sup> Reporting requirements apply to payers that are tax-exempt as well as to businesses.

*[The requirements and exceptions identified here are according to the current set of IRS instructions as of this writing. Requirements occasionally change, as in the fairly recent change to reporting deadlines for box 7 reporting on the 1099-MISC. Therefore, it is important to keep up with your responsibilities.]*

**IRS Form W-9** — In order to comply with reporting requirements, a payer must obtain the payee’s tax identification number (TIN). It also needs documentation of the vendor’s tax classification, since certain classifications are reportable while others (for example, most corporations) may be exempt from reporting and withholding.

The best way to obtain the requisite information from a U.S. payee, as well as a resident alien, is to have the payee complete an IRS Form W-9 Request for Taxpayer Identification Number and Certification. In the case of non-resident aliens, the payee should complete the appropriate Form W-8 or Form 8233 (see below).

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<sup>2</sup> Ibid

<sup>3</sup> Ibid

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For individuals, the TIN is the payee’s social security number (SSN). For partnerships and corporations, the TIN is the employer identification number (EIN). For sole proprietors, it can be either an SSN or an EIN, though the IRS prefers the SSN.

The tax classification is noted in box 3 of the form, and can be:

- Individual/sole proprietor or single-member LLC
- C Corporation
- S Corporation
- Partnership
- Trust or Estate

If the vendor is an LLC that is not a single-member, they may select a separate “LLC” but *must* also indicate tax classification, i.e. C-corp., S-corp. or Partnership.

Tax classification is important because classification is part of what determines whether the vendor is reportable. Individuals, sole proprietors, and single-member LLCs are always reportable. Some payments, though taxable to the recipient, do not have to be reported on a 1099-MISC. Payments to most corporations are not reportable on a 1099-MISC.

However, some payments to corporations are reportable. These include the following:

- Medical and health-care payments
- Fish purchases for cash
- Attorneys' fees (reported in box 7)
- Gross proceeds paid to an attorney (reported in box 14)
- Substitute payments in lieu of dividends or tax-exempt interest
- Payments by a federal executive agency for services (vendors)

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Regarding foreign payees, payment for activities (e.g. rents or royalties) within the U.S. are generally reportable, as are payments for services performed in the U.S. Foreign Corporations are *not* exempt. Withholding of 30 percent (currently) from a FDAP (Fixed, Determinable, Annual or Periodic income) payment is the default situation, but the vendor can claim a reduced withholding rate or exemption from withholding if its country has a tax treaty with the U.S. Payments for merchandise shipped from abroad are not reportable, and payments for services performed outside the U.S. are not reportable.

In recent years, the Foreign Account Tax Compliance Act (FATCA) has added to the complexity of reporting and withholding. It was designed to capture information regarding U.S. persons who may be investing and earning income through non-U.S. financial institutions. Foreign Financial Institutions (FFIs) have been asked to enter into an agreement with the IRS to share information on U.S. account holders. Those FFIs that have not entered into an agreement are called Non-participating FFIs, and companies making payments to them are required to withhold 30 percent.

For nonfinancial foreign entities or NFFEs, you usually do not have to withhold, except where they fail to disclose any U.S. ownership.

**IRS Forms W-8 and 8233** — The information forms W-8 and 8233, therefore, are very important in determining foreign status of a vendor. For most entities, the form you must get is the W-8BEN-E, but there are a few alternate forms that are sometimes required instead, depending on the nature of the foreign entity. Following is a summary of the various forms, all of which are for foreign entities:

- Form 8233 – for individuals who are being paid for services and want to claim treaty benefits.
- W-8BEN – for individuals, reporting passive income such as rents, royalties, dividends, and for claiming treaty benefits on non-service-related payments.

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- W-8BEN-E – for entities; certifies that the payee is the non-U.S. beneficial owner of an income payment for withholding tax purposes (Chapter 3 & 61, governing typical AP payments); provides payee’s FATCA status as either payee or account holder of a foreign financial institution (under Chapter 4); for nonemployee compensation – entities either claiming or not claiming treaty benefits.
  - W-8ECI – ECI stands for “effectively connected income” and refers to income connected to a foreign business doing business in and with a physical presence in the United States that files a U.S. tax return; documents non-U.S. status; no withholding is required, and ECI income is exempt from FATCA.
  - W-8IMY – IMY stands for “intermediary” and refers to foreign agents and intermediaries receiving income for foreign persons providing services in the U.S.; requires a W-9 or W-8BEN for the beneficial owner of the income as well.
  - W-8EXP – EXP stands for “exempt” and refers to foreign governments, foreign central banks of issue, foreign tax-exempt organizations, and international organizations per the IRS code. W-8EXP has limited application and is used to claim reduced withholding or exemption from withholding.

Most accounts payable (AP) payments are subject to chapter 3 reporting and not to chapter 4 (FATCA-related). It’s important that payers know the status of foreign vendors to ensure they comply with reporting and withholding requirements.

**Form Requirements** — There is not a statute that requires payees to submit or payers to obtain form W-9, though many AP managers wish there was. Rather, the laws govern reporting and withholding. You must have the correct tax ID, name and classification information to report and withhold correctly. The W-9 is designed to capture and document the information you need and protects you if a question comes up. You must have a TIN and tax classification, and while you can gather that over the phone or some other way

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(which you should document), it is best to get it from the vendor on a W-9 or substitute W-9 (see page 2 of the Instructions for the Requester of Form W-9<sup>4</sup> for information on use of a substitute W-9). Substitute forms are particularly useful in enabling electronic collection of the information.

The time to get the vendor to complete and provide you the form is before you pay them — especially if they are one-off vendors! By requiring by policy without exception all vendors to submit W-9s, W-8s or 8233s up front, and certainly prior to payment, you improve your chances of having the records you need to comply with the tax reporting and withholding laws. You may always have to track down some vendors before tax reporting time, but they should be few.

### **TIN Verification**

Once you have obtained a vendor's TIN, it is important to verify it. The wrong tax ID will generate an IRS form CP2100 or CP2100-A, starting the B-notice process in which you must notify the vendor, request a correct TIN, and begin backup withholding until the correct TIN is received. An incorrect TIN also likely will generate a proposed penalty notice, 972-CG. This penalty notice is issued for late 1099 filings, but also for filing 1099s with missing or incorrect TINs.

IRS penalties became more consequential in 2016 when the penalty amounts were significantly increased. Penalties, which had been \$30 to \$100 per return initially increased to \$50 - \$260 (now \$270, see below) per return, with much higher maximums. The penalty for intentional disregard rose to \$530 per return (now \$540, see below), with no maximum limit.

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<sup>4</sup> <https://www.irs.gov/pub/irs-pdf/iw9.pdf>

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The various penalties, which now may be adjusted each year for inflation, are based on when you file a correct information return. As of December 2018, the penalties are as follows:

- \$50 per information return if you correctly file within 30 days of due date, maximum penalty \$547,000 per year (\$191,000 for businesses with gross receipts of \$5 million or less).
- \$100 per information return if you correctly file more than 30 days after the due date but by August 1; maximum penalty \$1,641,000 per year (\$547,000 for businesses with gross receipts of \$5 million or less).
- \$270 per information return if you file after August 1 or you do not file required information returns; maximum penalty \$3,282,500 per year (\$1,094,000 for businesses with gross receipts of \$5 million or less).
- \$540 for intentional disregard, with no maximum

For more, including exceptions to penalties, see the current IRS General Instructions for Certain Information Returns.<sup>5</sup>

### **IRS TIN Match System**

The IRS several years ago introduced its TIN check program for verification of TINs. Payers can look up individual TIN/Vendor name combinations online or submit bulk TIN/name pairings via a batch process. Payers must first enroll in IRS e-Services, requiring an officer of the company to submit some personal tax information. Once registered, the officer can authorize a user within the organization to be the TIN match user.

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<sup>5</sup> <https://www.irs.gov/pub/irs-pdf/i1099gi.pdf>

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In the IRS TIN match system, you submit a vendor name and TIN combination, and it will tell you whether that combination matches its records. (It will not give you the TIN belonging to a name or a name belonging to a TIN.)

There is an IRS lookup program for EINs, which will return the company name associated with a given EIN.

So in addition to collecting the appropriate tax identification form, companies should verify that the vendor name and TIN match, to ensure correct tax reporting and withholding, and avoid unnecessary B-notices and penalties.



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## Conclusion

Companies' supply interactions are surrounded by a number of compliance requirements that add complexity to the procure-to-pay process and the supposed simplicity of paying the bills. A few vendor-related tasks that are driven by compliance requirements must be completed in the initial stages of a new vendor relationship. These include vendor trading status validation and verification of critical vendor information including tax identification number and tax classification. Best practice is to include appropriate steps in the vendor onboarding process to ensure compliance with trade and tax laws.

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## About VendorInfo

VendorInfo enables companies to onboard new vendors electronically in one convenient location, eliminating paperwork. VendorInfo houses your new vendor welcome kit and vendor forms and enables updates to vendor information. In addition, if there are forms that expire, such as an insurance certificate or a W-8, InvoiceInfo Vendor Management will notify you that the expiration is coming up.

The Compliance module handles the complexities of validating and managing new vendors. Vendors complete and submit their W-9s and W-8s online and VendorInfo automatically does a TIN check to verify that the social security or employer ID number, name and address provided match the Internal Revenue Service files.

Once a vendor is validated, clients receive a notice that the W-8 or W-9 has been received and whether it is accurate or if there are problems with some of the data that need to be addressed. VendorInfo stores the forms where they are easily accessible to you, reducing costs and paper while increasing productivity.

Of course, that's just the beginning. InvoiceInfo's Vendor Inquiry offers vendors easy self-service lookup of invoice and payment status, taking up to 80 percent of vendor inquiries away from your busy staff. You avoid interruptions and vendors quickly get what they want on their schedule.

To see more about VendorInfo's modular vendor self-service, onboarding, and compliance services, email [info@VendorInfo.com](mailto:info@VendorInfo.com) or call 678-335-5735.



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