

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Members, Subcommittee on Contracting and the Workforce, House Committee on Small Business
From: Mick Mulvaney, Chairman
Date: May 19, 2011
Re: Hearing: "Defer No More: The Need to Repeal the 3% Withholding Provision"

The Subcommittee on Contracting and the Workforce of the House Committee on Small Business will meet at 10:00 a.m. on Thursday, May 26, 2011 in Room 2360 of the Rayburn House Office Building for the purposes of reviewing the 3% tax withholding mandate and its impact on small businesses. The hearing will be divided into three panels. The first panel will feature Congressman Wally Herger. The second panel of government witnesses will include Curtis M. Loftis, Jr., Treasurer, State of South Carolina and Brian George, Deputy Director, Office of Cost, Pricing & Finance, Defense Procurement and Acquisition Policy, Department of Defense. The third panel will include small business representatives from the Associated General Contractors, Quality Construction Alliance, and the American Council of Engineering Companies. This memo will review the 3% withholding provision's legislative history, its projected impact on small firms, and some alternatives to it.

I. Background

The 3% withholding law was enacted in Section 511 of the Tax Increase Prevention Reconciliation Act of 2005¹ and was codified as Internal Revenue Code Section 3402(t). The provision originally required that payments by governmental entities for goods and services made after December 31, 2010 be subject to 3% income tax withholding. The American Recovery and Reinvestment Act² delayed the effective date of the withholding provision by one year. Thus, if not repealed, the provision would be effective for payments made after December 31, 2011. The Internal Revenue Service (IRS) issued the implementing regulations for Section 511 on May 9, 2011,³ which further delayed the implementation, making the provision effective for payments made after December 31, 2012.⁴

¹ Pub.L. No. 109-222.

² Pub.L. No. 111-5.

³ 76 Fed. Reg. 10760 (May 9, 2011).

⁴ The notice in the Federal Register fails to cite any authority for this extension. When asked to cite such authority, IRS said it had nothing official but was relying on "general administrative impracticability" under IRC § 7805(b).

Compliance with this law will impose significant, unnecessary financial burdens on both the public and private sectors, and adversely affect job creation and economic growth. Withholding will limit the cash flow of small companies that operate with thin margins in a difficult economy. Small businesses and governments are already expending scarce resources to make the computer system and other administrative changes needed to withhold, report and remit the payments made under the mandate. A broad coalition of industry groups support repeal of the measure, and barring that, another delay in implementation.

This hearing will provide Members with the chance to learn more about the 3% withholding provision and its impact on small companies.

II. The Statute: Section 511 of the Tax Prevention and Reconciliation Act of 2005 (25 U.S.C. §3402 (t))

Section 511 of the Tax Prevention and Reconciliation Act of 2005 provides that:

The Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services (including any payment made in connection with a government voucher or certificate program which functions as a payment for property or services) shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment.

25 U.S.C. § 3402(t).

There are several exceptions provided in the Act. Generally, the Act does not apply to any payment:

of interest, for real property, to any governmental entity, any tax-exempt entity, or any foreign government, made pursuant to a classified or confidential contract made by a political subdivision of a State which makes less than \$100,000,000 of such payments annually, which is in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test, and to any government employee.

25 U.S.C. § 3402(t)(2).

III. Rationale for Section 511: The Tax Gap

The 3% withholding provision was enacted to address the loss of revenue attributed to the government contractors and others who receive government payments but do not fully pay their taxes. These individuals and businesses fall into the "tax gap." The tax gap is the difference between the amounts taxpayers pay voluntarily and on time and what the Internal Revenue Service (IRS) believes

they owe under law.⁵ The tax gap is a long-standing problem, and was estimated by the IRS in 2001 to be nearly \$345 billion per year.⁶ IRS enforcement activities, along with late payments, reduced the net tax gap to \$290 billion.⁷

Most taxpayers pay their taxes on time, but when those who should be paying taxes fail to comply and pay their share, the burden falls more heavily on the taxpayers who are compliant. Underreported taxes account for the vast majority of the tax gap. Non-filing and underpayment of tax account for the remainder.⁸

The tax gap is based on the legal sector of the economy, partly because the tax associated with illegal activities is extremely difficult to determine. Equally important, according to the IRS, the tax gap does not arise solely from tax evasion or other illegal activity. It does, however, include a substantial amount of non-compliance due to tax law complexity that is attributable to ignorance of the law or carelessness.⁹

Importantly, a study prepared for the Small Business Administration (SBA) Office of Advocacy¹⁰ found that small firms are disproportionately affected by efforts to close the tax gap. SBA's analysis points out that the IRS inadequately measured corporate and international tax gaps, and focused on individual returns. This skewed the portion of the tax gap that is attributable to small businesses. The study also suggests that the IRS relied on data from the 1970s and 1980s.¹¹

IV. Other Efforts to Address the Tax Gap

Many have argued that existing law, perhaps coupled with increased enforcement, is sufficient to require compel companies to pay their tax liabilities. However, since the 3% withholding mandate was enacted in 2006, additional efforts have been made to address tax compliance and increase transparency of government contracts. For example, a final Federal Acquisition Rule issued on May 22, 2008 requires contractors to certify that they have no tax delinquencies.

On March 23, 2010, a final rule was issued to implement Section 872 of the Duncan Hunter National Defense Authorization Act for Fiscal Year 2009¹², which created a federal legal compliance database. The law requires contracting officers and grant officers to consult the database for contractor tax compliance before a federal contract is awarded. The Federal Funding Accountability and Transparency Act¹³ of 2006 required the establishment of a single, searchable website¹⁴ available to the

⁵ Government Accountability Office, *Tax Compliance: Multiple Approaches Are Needed to Reduce Tax Gap*, January 23, 2007, p. 1.

⁶ National Research Program, Internal Revenue Service, March, 2005, available at http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ Office of Advocacy, U.S. Small Business Administration, *An Examination of the 2001 IRS Tax Gap Estimates' Effect on Small Business*, available at: http://www.sba.gov/sites/default/files/2001%20IRS%20Tax%20Gap_0.pdf.

¹¹ *Id.*

¹² Pub.L. No. 110-417.

¹³ Pub.L. No. 109-282.

¹⁴ USAspending.gov, available at: <http://usaspending.gov/>.

public that includes information on all federal grants and contract awards. The database went live in 2007. In addition, an amendment to Federal Acquisition Regulation 52.209-5 Certification of Responsibility Matters¹⁵ requires offerors (and any principals) to certify their federal tax delinquency status for most government contracts. These measures directly address any tax issues of non-compliant contractors, and are more narrowly targeted than the broad language of the 3% mandate.

V. Origin and Operation of the 3% Withholding Provision

A 2004 Government Accountability Office (GAO) study¹⁶ found tax non-compliance among federal contractors was prevalent. Specifically, the study found that over 27,000 contractors owed \$3 billion in federal taxes as of September 30, 2002. In 2005, the Joint Committee on Taxation issued recommendations¹⁷ for increasing tax compliance, and included 3% tax withholding on payments for goods and services made by all federal, state and local contracts. Federal, state and local governments with total expenditures of goods and services below \$100 million are exempt from the withholding requirement.

The National Defense Authorization Act for Fiscal Year 2007¹⁸ required the Department of Defense to estimate the cost of implementing the 3% withholding provision. The resulting report¹⁹ revealed that compliance with the provision would cost DoD over \$17 billion for the first five years.²⁰ Said another way, the cost to implement the 3% withholding exceeds the revenue generated by it.

Generally, any government payments for goods and services made by federal, state or local governments with expenditures of \$100 million or more will be subject to 3% withholding. That means that the contractor receives 97% of the amount due from the government. The remaining 3% will be withheld by the government entity and remitted to the IRS toward the individual or company's tax liability. If the contract includes sub-contractors, the law provides no authorization to withhold 3% of those payments. The law applies to all payments pursuant to government contracts, Medicare payments, farm payments and grants to non-profits.

VI. The Impact of 3% Withholding on Small Businesses

The withholding provision imposes significant costs and administrative burdens on the public and private sectors. In the private sector, added costs arise from the financing that is needed due to reduced cash flow from the 3% withholding, additional employees needed to make administrative changes, and capital needed to modify financial systems. Some companies have already begun the

¹⁵ Federal Acquisition Regulation 52.209-5, Certification of Responsibility Matters, May 22, 2008, available at: https://www.acquisition.gov/far/html/52_207_211.html#wp1140910.

¹⁶ *Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, Testimony of Gregory D. Kutz, Steven J. Sebastian and John J. Ryan before the Senate Permanent Subcommittee on Investigations, Government Accountability Office, available at: <http://www.gao.gov/new.items/d04414t.pdf>.

¹⁷ Options to Improve Tax Compliance and Reform Tax Expenditures, Joint Committee on Taxation, 2005, available at: <http://www.jct.gov/s-2-05.pdf>.

¹⁸ Pub.L. No. 109-364.

¹⁹ Report by the Deputy Under Secretary of defense for Acquisition and Technology, April 14, 2008, available at: <http://www.withholdingrelief.com/files/2http://www.jct.gov/s-2-05.pdf.010/12/DoDReportonCostImpact.pdf>.

²⁰ *Id.*

steps needed to implement the changes for withholding tax, since the provision is scheduled to become effective for payments after December 31, 2012.

For companies that have multiple government contracts, the changes and tracking can be substantial and complicated, particularly when the businesses receive numerous payments in multiple locations. These changes would disproportionately affect small firms, which generally have fewer employees, lower capital reserves and higher administrative costs. Additional costs may be passed from contractors on to subcontractors, many of whom are small firms. Smaller companies are even less equipped to function well when receiving only part of the contract payment. As a witness²¹ at the Committee's 2007 hearing attested, 60% of companies in the construction business are organized as S corporations.²² The shareholders of these companies pay the business tax on their personal income tax returns. This means that the shareholders would be required to keep detailed records of the 3% withholding each year, and the IRS would be required to increase its enforcement activities.

Firms who do a great deal of government contracting would be severely penalized. Startups or small firms with a high volume of government contracts would be particularly disadvantaged. When the Committee held a hearing on the 3% withholding issue in 2007, witness testimony addressed the hardship that 3% withholding imposes on small construction companies, when the typical pre-tax profit margin rarely exceeds 3%.²³ At a time when businesses should be expanding their companies and creating jobs, implementation of 3% withholding is not a good use of a small company's scarce resources.

In the public sector, additional costs for businesses may be passed on to the government through higher contract bids. Because the withholding affects not only payments for government contracts but also farm payments, Medicare payments and grants, the reach and impact of the provision is extensive. In addition to businesses and the private sector, withholding 3% from payments to farmers, physicians and non-profit organizations could also strain their cash flow. Small medical practices and those with high Medicare or Medicaid caseloads would be particularly disadvantaged.

Government entities commonly use credit cards for many purchases. If banks and other processors are unwilling to change their processing systems to account for 3% withholding, the provision would be difficult to enforce. Indeed, the issue of withholding on credit card payments is so complicated, that the IRS has "reserve[d] for future guidance the issue of the potential application of [Section 511] to ...payments by credit, debit, stored value and other payment cards."²⁴ If the provision becomes effective, government entities would withhold 3%, but it is likely that contractors would expect to be made whole, since the 3% withholding law would not have been in effect when the contract was signed.

There are other implications for implementation. In public sector projects, retainage (holding back a certain percentage of the contract price until the project is completed) encourages the contractor to complete the project on time. In many cases, the contractor must also purchase a bond to ensure that the project is completed on time and on budget. Adding 3% withholding to these other costs, and an already limited cash flow, would severely impair small contractors, subcontractors and their

²¹ Vincent Iannelli.

²² Testimony of Vincent Iannelli before the House Committee on Small Business, March 22, 2007 at 5.

²³ *id.*

²⁴ 76 Fed. Reg. at 26584.

suppliers.²⁵ Small contractors may be unwilling to bid on public projects, and their inability to compete at the federal, state, or local level could even put them out of business.²⁶

VII. The Problem of Implementation

The IRS regulation is just the first of many complex and costly regulatory and administrative changes necessary to implement Section 511. In order for implementation to take place additional changes must be made, yet despite the fact that this legislation was passed in 2006, these regulations have not yet been issued. While the full scope and cost of the changes is not yet fully known, evidence indicates that these costs will outweigh any savings to the government.

It took the IRS two and a half years after it issued the proposed implementing regulation to issue the final rule – six years after the passage of Section 511. The fact that it took the IRS so much time to develop implementing regulations is a testament to the complex issues that businesses and government entities will face when attempting to implement the rule. Indeed, the IRS actually deferred issuing regulation as they relate to several areas of Section 511 compliance, because they add additional complexity – specifically, issues involving the use of credit cards²⁷ and whether an entity is a government instrumentality.²⁸

However, this is just the beginning of the adjustments necessary to navigate implementation of Section 511. In addition to the IRS regulations, the Federal Acquisition Regulations (FAR) will need to be changed, and regulations for Medicare payment, farm payments, and grants will also need to be modified. These are merely the federal regulations that will need to be changed, but since this requirement flows down to state and local governments, every state and many city, county, and municipal governments will need to change their regulations and companies will have to learn to comply with these numerous and likely divergent implementing regulations.

Implementation will be costly. The Department of Defense alone estimates that it alone will need to spend \$17 billion to comply with the withholding provisions.²⁹ Considering that at the time Section 511 was enacted, the government-wide tax recoupment was estimated at \$6.9 billion, this provision will cost more than it collects.³⁰

It is also important to understand that after the first year of Section 511 implementation, any revenue collected is anticipated to be interest on the monies withheld. During the first year, the government would collect monies due from delinquent taxes, and in 2006 the Joint Committee on Taxation estimated that this would amount to about \$6 billion dollars.³¹ Given the other steps the

²⁵ *Id.* at 4.

²⁶ *Id.*

²⁷ 76 Fed. Reg. at 26584

²⁸ *Id.* This is a central question that needs to be addressed, otherwise a small business will not be able to assess whether the withholding provisions will be triggered.

²⁹ The National Defense Authorization Act for Fiscal 2007 (Pub. Law 109-364) required DoD to estimate the cost to implement the 3% withholding. DoD reported to Congress on April 14, 2008 that it would cost DoD \$17 billion over five years to implement.

³⁰ Joint Committee on Taxation, “Estimated Revenue Effects of the Conference Agreement for the ‘Tax Increase Prevention and Reconciliation Act,’” JCX-18-06, May 9, 2006.

³¹ *Id.*

government has taken to close the tax gap, this number should now be lower. In any case, in the subsequent four years, the revenue estimate drops to between \$215 and \$235 million per year.³² This estimate is based on the interest the Treasury would earn on the funds withheld. Hence, the long-term revenue gains to the Treasury are based on interest-free loans from small businesses.

VIII. The Problem of Deferral

While Section 511 was originally schedule to take effect for payments made after December 31, 2010, through a series of legislative and regulatory changes, it has been delayed for two calendar years. While the delay provides temporary relief to small businesses, it does not address the underlying concerns and without the assurance of wholesale repeal, small businesses, federal, state, and local governments are all currently expending funds to prepare for the implementation of Section 511.

IX. Legislative Proposals

On February 11, 2011, Representative Wally Herger (R-CA) introduced H.R. 674, legislation to repeal the imposition of the 3% withholding on payments to government contractors. Rep. Herger's bipartisan bill has 116 cosponsors, but no action has been scheduled on it. Senator David Vitter (R-LA) introduced S. 89, and Senator Scott Brown (R-MA) introduced S. 164, similar bills to repeal the provision. No action has been scheduled.

X. Conclusion

Section 511 of the Tax Increase Prevention Reconciliation Act of 2005, scheduled to become effective for payments made after December 31, 2012, would have significant impact on the public and private sectors, including small businesses. This hearing will give Members the opportunity to learn more about the provision and its deleterious effect on small firms.

³² *Id.*