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THREE PERCENT TAX WITHHOLDING

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), extended various tax provisions scheduled to expire, including alternative minimum tax relief and lower capital gains and dividend tax rates. Section 511 of TIPRA required all government entities to deduct and withhold three percent of the total from all payments made to any individual or business providing goods or services.

ABC strongly opposes the three percent withholding provisions of the Tax Increase Prevention and Reconciliation Act, as well as any subsequent regulation implementing these provisions.

Read ABC's Legislative Position on Three Percent Withholding

Background

TIPRA Section 511:

- Requires withholding of three percent on all government payments for products and services made by the federal, state, and local governments with total expenditures of \$100 million or more.
- Affects payments for goods and services under government contracts.
- Applies to payments beginning in 2011 (subsequently delayed to **2012** as a result of an amendment in the American Recovery and Reinvestment Act of 2009).

Key Points for Construction:

- Withholding applies to the total contract, not to the net revenue generated from a project. For construction contractors, this means the government is withholding funds necessary to complete a project, such as those necessary to pay for subcontractors, material and suppliers.
- The withholding provision will restrict cash flow, resulting in higher bond costs (which all construction contractors are legally required to carry) or denial of coverage. This drives up the cost of construction, which, in turn forces smaller firms out of the public sector market.

Recent Activity

IRS Three Percent Withholding Proposed Rule

On March 5, 2009, ABC submitted comments with the U.S. Department of Treasury and the Internal Revenue Service (IRS), in response to a proposed rule seeking to implement the three percent tax withholding found in Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The proposed regulations reflect changes in the law required by section 3402(t). In addition, on April 16, 2009, ABC testified at an informal public hearing regarding the proposed OSHA rulemaking.

For more information on this and other rulemakings, visit ABC's [Regulatory Affairs](#) page.

IMPACT ON OUR FY 11/12

SEC. 511. IMPOSITION OF WITHHOLDING ON CERTAIN PAYMENTS MADE BY
GOVERNMENT ENTITIES.

(a) In General.--Section 3402 is amended by adding at the end the following new subsection:

“(t) Extension of Withholding to Certain Payments Made by Government Entities.--

“(1) General rule.--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.

“(2) Property and services subject to withholding.-- Paragraph (1) shall not apply to any payment--

“(A) except as provided in subparagraph (B), which is subject to withholding under any other provision of this chapter or chapter 3,

“(B) which is subject to withholding under section 3406 and from which amounts are being withheld under such section,

“(C) of interest,

“(D) for real property,

“(E) to any governmental entity subject to the requirements of paragraph (1), any tax-exempt entity, or any foreign government,

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“(F) made pursuant to a classified or confidential contract described in section 6050M(e)(3),

“(G) made by a political subdivision of a State (or any instrumentality thereof) which makes less than \$100,000,000 of such payments annually,

“(H) which is in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test, and

“(I) to any government employee not otherwise excludable with respect to their services as an employee.

“(3) Coordination with other sections.--For purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to this chapter, payments to any person for property or services which are subject to withholding shall be treated as if such payments were wages paid by an employer to an employee.”.

(b) Effective Date.--The <<NOTE: 26 USC 3402 note.>> amendment made by this section shall apply to payments made after December 31, 2010.

Government Finance Officers Association (GFOA)
International City/County Management Association (ICMA)
International Municipal Lawyers Association (IMLA)
International Public Management Association for Human Resources (IPMA-HR)
Miami-Dade County
National Council on Teacher Retirement (NCTR)
National League of Cities (NLC)
National Association of Counties (NACo)
National Association of State Auditors, Comptrollers and Treasurers (NASACT)
National Association of State Budget Officers (NASBO)
National Association of State Retirement Administrators (NASRA)
National Conference of State Social Security Administrators (NCSSSA)
United States Conference of Mayors (USCM)

April 25, 2008

Mr. Stephen J. Coleman
Office of the Associate Chief Counsel
CCPA:LPD:PR (Notice 2008-38), Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, D.C. 20044

RE: Notice 2008-38

Dear Mr. Coleman:

On behalf of the above listed organizations representing state and local governments nationwide we appreciate the opportunity to provide our comments on Section 3402(t) of the Internal Revenue Code (the Code) which requires governments to withhold 3% on most payments for services and property procured after December 31, 2010.

As you are aware, Section 511 was added to the Tax Increase Prevention and Reconciliation Act of 2005, PL 109-22, during conference negotiations without input from the entities responsible for implementing this onerous requirement. In addition to being an unfunded mandate, the law is wrought with unanticipated complexities making its implementation nearly impossible to achieve, particularly without specific guidance by 2011. Furthermore, sophistication levels of systems to capture and report the required data vary greatly between governments and some entities do not have the capacity or staff to undertake the additional reporting, let alone withholding and remittance.

The significant implementation and ongoing costs associated with this requirement are among the foremost concerns of state and local governments. Original system modification and maintenance, on-going operations and administration, impact on prompt-pay options, and contract competitiveness are just a few of those concerns. Our sentiments mirror those found in the conclusions of the recent Department of Defense report sent to the Senate Armed Services Chairman Carl Levin and House Armed Services Committee Chairman Ike Skelton on April 14,

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2008. The report is in response to the House of Representatives Report of the Committee on Armed Services accompanying the National Defense Authorization Act for Fiscal Year 2008, H.R. 110-146, which requested the Department of Defense (DoD) to assess the impacts of compliance with Section 511. Similar to the costs that will be borne by state and local governments, the report finds that:

“DoD anticipates the costs for DoD to comply with section 511 will be significant – over \$17 billion for the first five years. The estimated cost impact includes the costs for DoD to implement and manage section 511 within DoD and the additional costs escalation DoD will pay its contractors as a result of section 511. Further, DoD is concerned that section 511 may limit the number of companies willing to enter into the government market, thereby reducing competition and access to new technologies, and may cause other unintended consequences that are addressed in the report.”

We firmly believe that legislation to repeal Section 511 is the only equitable solution. However, until Congress takes up such legislation, the Treasury will need to issue very specific guidance on the business rules immediately in order to accommodate an impending implementation date of 2011. At least two years are needed to allocate resources for purchase, design, testing and modification of system components, in addition to sufficient time to issue vendor notices and undertake staff training. Two years however is a best case scenario as the majority of governments would be pressed to meet even a two year implementation time line. New duties include, but are not limited to, reconciliation of withholdings and subsequent payment to the federal government, preparation of tax deposits, monitoring of agency payments, and increased compliance monitoring (i.e., excessive training). Additional staff time (FTEs) will also be required to track down payment errors, monitor changes in the law, and field telephone calls from vendors.

We are very concerned that the questions posed by Treasury in Notice 2008-38 do not consider the costs that will be incurred by governments, or the business process rules that will be necessary to carry out the new law. For many governments, investment in an expensive complex system modification is questionable considering the age of some systems and modification to meet compliance with the Act could render many of those systems inoperable. Furthermore, system replacement of this complexity would take years to implement even if funding were currently available.

As there is no specified guidance or further interpretation of the withholding law, responses to the specific questions posed by Treasury rely on anecdotal information, not inclusive of all governments across the country, and on the capacity of existing systems.

How to Apply the Withholding Requirements to Purchases Made with Credit Cards or Other Forms of Payment Cards

There is currently no ability for governments to comply with the 3% withholding requirement for purchases made through credit or other forms of payment cards as the cards are administered through an intermediary that requires payment in full for every purchase made on the card. Payments represent an aggregate of goods and services and

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the actual payment being made by a government is for a financial debt, not goods and services.

Based on the current business process, it would make far more sense for the intermediary to undertake the withholding. Nonetheless, withholding on payment card transactions will be extremely difficult to administer because a merchant receives payment from the payment card organization within a few days after the transaction, but the cardholder does not pay the payment card organization until after it receives a payment card monthly billing statement.

Furthermore, we are very concerned regarding the cost impact should governments be forced to eliminate the use of payment cards. Currently the vast majority of governments make use of payment cards and the current trend shows that payment card use will only continue to grow. Eliminating payment card use because of new withholding requirements will cause only governments to lose ground in achieving administrative efficiencies and cost savings.

How to Apply the Withholding if the Payee is Not Subject to US Tax

Section 3402(t) of the Internal Revenue Code, added by Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, exempts payments from withholding if the payee is not subject to U.S. tax. However, the burdensome effect of this on state and local governments would necessitate that, regardless of the status, state and local governments would need to withhold on all payments. It would be too time consuming and costly to verify the status of an entity before making a payment. The vendor should ultimately have the responsibility to file the appropriate forms and to request a refund from the IRS. Such a process however may discourage foreign vendors from dealing with state and local governments in the United States.

Furthermore, conducting business with foreign entities presents unique challenges as vendors may be located in countries with international treaties that exempt such entities from U.S. Tax. Applying the 3% withholding to non-U.S. companies could potentially conflict with these current income tax treaties.

How to Apply the Withholding Requirements to Partnerships and Other Pass-through Entities in Which a Government Entity is a Partner or Owner

The business rules necessary to accommodate the withholding requirement and the fact that an entity may receive both excluded and non-excluded payments will require extensive modifications to current accounting and payment systems. Existing capacity to undertake the withholding and reporting requirements required by the new law are questionable and current payment systems are unable to distinguish between partnerships or other pass through entities in which a government entity is a partner or owner.

How to Apply the Withholding Requirements to Government Contractors and Subcontractors

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It will be important to advise and educate contractors on the aspects of the new law far in advance of implementation. Vendor accounts receivable practices must be capable of identifying payments from governmental agencies and crediting the three percent portion withheld. Education is vitally important so that vendors do not re-bill governments for the 3% withheld assuming that the government has not paid a bill in full.

Current systems are not programmed to allow for withholding for sub-contractors nor does the law address pass through payments to subcontractors. Many governments operating on legacy systems could not accommodate such vendor withholding.

Lastly, it should be noted that since the new law will subject all 1099 payments (excluding selected payment categories) to the 3% offset, a larger volume of potential TIN errors will require the implementation of a quick pay/withholding correction system for state and federal errors.

The Application of the Withholding Requirements to So-Called Government Sponsored Entities

Further definition of so-called government sponsored entities is warranted however from a vendor file prospective these entities are treated as regular vendors as there is currently no way to differentiate a government sponsored entity from other types of vendors.

The Application of the Withholding Requirements to De Minimis Payments for Property or Services made by Affected Government Entities

From a reporting perspective, removal of the \$600 threshold will cause a huge increase in workload for a very small return in revenue. Payments for non contractual services will result in the collection of minimal withholding and later result in issuance of Form 1099 for reporting and earnings and for withholding of a single de minimis payment. As mentioned previously, most systems do not have the capacity to withstand a significant increase in reporting let alone to undertake a new withholding schema.

When and How the Withheld Amounts Should be Transmitted to the IRS

We are unable to respond to this question as we believe state and local governments will have to overcome significant hurdles and will most likely struggle to comply with the new law prior to its 2011 implementation date.

In closing we note that most governments cannot withstand a sizeable increase in the volume of work required to implement the new law, even if they have systems that can be modified to comply with this new requirement. Without significant increases in FTE's and in budgets, implementation will be virtually impossible. Proponents of the withholding law claim it assists in closing a tax loophole, however, we do not believe they fully understand the scope of problems Section 3402(t) actually creates. The law is extremely complex and implementation will place an undue administrative and financial burden on state and local governments. We believe

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companies will simply pass the 3% withholding along in increased prices when dealing with governments in order to maintain their cash flow. In turn, bids for government goods and services will be higher, which will put smaller businesses competing for government business at an unfair disadvantage due to their limited cash flow. We further fear that many of our vendors with whom we have strong working relationships will not understand these changes and stop selling goods and services to governments.

We appreciate the opportunity to comment on issues surrounding implementation of Section 3402(t) of the Code. The lack of regulations on the implementation of this mandate makes the effective date of January 1, 2011 extremely problematic and our organizations continue to advocate for repeal of this onerous requirement. As noted earlier, until Congress is able to address repeal legislation, it is incumbent on Treasury to provide clarity for governments to more fully understand the parameters for which they must consider in order to comply with the Code as currently written. Thus, specific guidance is needed immediately so that governments can more accurately ascertain the complexities and implementation hurdles that lie ahead. Should you have any questions or require additional information please feel free to contact our representatives.

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Florida Senate - 2010

SM 2254

By Senator Gelber

Bill Failed

35-01374-10

20102254__

1 Senate Memorial

2 A memorial to the Congress of the United States,

3 urging Congress to repeal Section 511 of the Tax

4 Increase Prevention and Reconciliation Act (TIPRA)

5 which requires governments that have annual budgets in

6 excess of \$100 million to withhold a 3 percent federal

7 tax on payments made for most goods and services.

8

9 WHEREAS, state purchasing officials serve the public

10 interest and are charged with maximizing the value of every tax

11 dollar expended, and

12 WHEREAS, the unfunded mandate in Section 511 of Public Law

13 No. 109-222 (26 U.S.C. 3402(t)) will result in additional

14 expenditures of human and budgetary capital to achieve agency

15 compliance, and

16 WHEREAS, an increase in operating costs would result in

17 significant reductions of support for critical services to the

18 citizens of the State of Florida, and

19 WHEREAS, implementation of the unfunded mandate in Section

20 511 of Public Law No. 109-222 (26 U.S.C. 3402(t)) will result in

21 the diluted value of the taxpayer dollar, and

22 WHEREAS, the requirement of a 3 percent withholding not

23 only places a substantial burden on state and local governments,

24 it is detrimental to the small businesses that are the backbone

25 of Florida's economy, NOW, THEREFORE,

26

27 Be It Resolved by the Legislature of the State of Florida:

28

29 That the Congress of the United States is urged to repeal

30 the unfunded mandate contained in Section 511 of Public Law No.

31 109-222 (26 U.S.C. 3402(t)) by enacting H.R. 275 or S. 292, or

32 similar legislation, which is pending before 111th Congress.

33 BE IT FURTHER RESOLVED that copies of this memorial be

34 dispatched to the President of the United States, to the

35 President of the United States Senate, to the Speaker of the

36 United States House of Representatives, and to each member of

37 the Florida delegation to the United States Congress.

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