



Issue Brief: New Government Withholding Provision Could Involve Costs to States

National Association of State Budget Officers

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The government withholding provision, under the *Tax Increase Prevention and Reconciliation Act of 2005*, is set to go into effect on January 1, 2011, and will require state and local governments to withhold three percent of nearly all payments to contractors or vendors. The three percent is then remitted to the federal government for federal income tax purposes. The federal government projects that the withholding provision will generate \$7 billion between 2011 and 2015. The goal of the provision is to reduce the amount of underpayment of federal taxes by government vendors not currently subject to withholding. Numerous concerns regarding withholding have been raised by various state and local groups. These concerns include added costs involving administrative changes, that the withholding provision is an unfunded mandate, and a lack of clear regulations and guidelines.

BACKGROUND

On May 17, 2006, the *Tax Increase Prevention and Reconciliation Act of 2005* was signed into law. Major elements of this law include extending the fifteen percent tax rate on capital gains and dividends, and preventing an increase in the number of taxpayers subject to the Alternative Minimum Tax. Another important component of the law that received far less publicity, but could impact state and local governments, requires governments to withhold three percent on certain payments to persons providing property or services. The provision will not go into effect until 2011.

Specifics of Withholding Provision

The withholding provision extends the act of withholding to new areas. Under the withholding provision, all levels of government are required to withhold three percent on most payments for products and services. According to the summary provided by the Senate Finance Committee, the provision “requires withholding on certain payments to any person providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the state.” Governments would then be required to remit three percent of most payments to the federal government for federal income tax purposes. The withholding provision will go into effect on January 1, 2011.

Prior law states that employers are required to withhold income tax on wages paid to employees, including wages paid to employees of federal, state, and local government. This law has not previously included withholding payments to workers who are not classified as employees, such as independent contractors. Instead, independent contractors and other taxpayers who receive income that is not subject to withholding are required to make estimated tax payments.

There are some exemptions to the withholding provision. First, localities and other political subdivisions of states with less than \$100 million of annual expenditures for goods or services are exempt from the withholding requirement. Second, the provision exempts payments made through a federal, state, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. Finally, the provision exempts payments of interest, payments for real property, payments to tax-exempt entities or foreign governments, intergovernmental payments, payments based on a classified or confidential contract, and payments made to a government employee not otherwise excludable with respect to their service as an employee.

Reasons for Withholding Provision

The main stated justification for the withholding provision is to attempt to undermine the misreporting of taxes by certain government vendors not currently subject to withholding. It is one of a series of steps designed to help minimize the tax gap. According to the IRS, in 2001 taxpayers paid \$345 billion less than what they should have paid. This caused the Joint Committee on Taxation (JCT) to produce a report in 2005 entitled *Options to Improve Tax Compliance and Reform Tax Expenditures*. The first recommendation of the report was to impose withholding on certain payments made by government entities. The JCT contended that a lack of a withholding requirement on non-wage payments leads to substantial underpayment of taxes each year. Additionally, the JCT argued that requiring withholding on government entities for non-wage payments would improve taxpayer compliance, promote fairness, and reduce the tax gap. According to government estimates, the withholding provision will raise \$7 billion for the federal government between 2011 and 2015.

ISSUES RAISED REGARDING WITHHOLDING PROVISION

State and local groups have begun to raise numerous concerns about the withholding provision. The law is vague in many areas, and specific regulations have yet to be established. Further details regarding the implementation of the withholding provision will be determined by the Department of Treasury. Currently, many state and local government associations are monitoring developments regarding the withholding provision. In addition to NASBO, these associations include the National Governors Association (NGA), the National Association of Counties (NACo), the National Association of State Auditors, Comptrollers, and Treasurers (NASACT), the National Conference of State Legislatures (NCSL), the National League of Cities (NLC), the United States Conference of Mayors, the Federation of Tax Administrators (FTA), the National Association of State Retirement Administrators (NASRA), and the Government Finance Officers Association (GFOA). Some of the primary issues that have been raised concern:

- Unfunded mandate – As reported by the Congressional Budget Office (CBO), the Joint Committee on Taxation (JCT) has determined that the cost of the withholding provision exceeds the threshold specified in the *Unfunded Mandates Reform Act*.
- Costs to States – state and local governments will receive no funding from the federal government in exchange for providing this service. Additionally, states will likely have to make programming changes to financial and accounting systems, purchase new software, register vendors, possibly hire additional staff, and keep massive new data files and paper reports.

- Applies only to public sector – state and local governments would be required to withhold three percent on payments, but private companies would not. This could place state and local governments at a disadvantage.
- Lack of consultation – neither the original House nor Senate version of the *Tax Increase and Prevention Act of 2005* contained the withholding requirement. Instead, the provision was added in the conference committee. This prevented state and local governments from expressing their views on the measure.
- Perceived need for withholding arose regarding federal contracts – one of the main justifications for the withholding provision is that the Government Accountability Office (GAO) issued a report showing that 3,800 General Services Administration (GSA) federal contractors had tax debts. Instead of creating a withholding provision that applies to all levels of government, Congress could have passed a law that only applies to federal contractors.
- Inflating bids – vendors and contractors could increase their bids by three percent in order to compensate for withholding. This would cause state and local governments to spend additional funds.
- Purchasing cards – the provision also requires withholding on purchases made by purchasing cards. Many questions have been raised regarding how withholding can be accomplished using purchasing cards.
- Many unanswered questions – in addition to the other issues, many additional unanswered questions remain regarding withholding, including how to report withheld amounts to the IRS or payees, how payments must be sent, and who is exempt and who is not.

CURRENT STATUS OF WITHHOLDING PROVISION

Shortly after the *Tax Increase Prevention and Reconciliation Act of 2005* was signed into law this past May, Senator Larry Craig (R-Idaho) introduced legislation calling for the repeal of the withholding provision. Sen. Craig stated that, “Proponents of the withholding provision describe it as closing a loophole. That is nonsense. Reporting requirements are already in place for government contractors. All this does is buck the IRS’s collection responsibilities to the taxpayers.” In addition to Sen. Craig’s legislation, Congressman Wally Herger (R-California) has also introduced legislation calling for repeal.

Furthermore, the National Association of Counties (NACo) has called for the repeal of the withholding requirement on the grounds that it is an unfunded mandate. Other state and local associations are continuing to monitor the issue and are hopeful that if the provision is not fully repealed, the Department of Treasury will take their concerns into consideration when establishing rules and guidelines.

If you would like additional information regarding the government withholding provision, please contact Brian Sigritz at (202) 624-8439 (bsigritz@nasbo.org) or Scott Pattison at (202) 624-8804 (spattison@nasbo.org) in NASBO’s Washington D.C. office.