NCTR Federal e-News

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NCTR Files Joint Comments on Implementation of 3% Withholding Tax on State and Local Government Payments to Contractors

The Internal Revenue Service (IRS) has requested comments on issues with which government entities and their paying agents will need help in order to implement the requirement that governments withhold 3 per cent on most payments for services and property procured after December 31, 2010. NCTR has joined with the National Association of State Auditors, Comptrollers and Treasurers (NASACT) and others to request that very specific guidance on the business rules be issued immediately by the IRS in order to accommodate the impending implementation date. However, the joint comment letter reiterates that legislation to repeal the 3 per cent withholding mandate is the only equitable solution. Federal agencies that will be subject to the same mandate are also registering their concerns with potential costs, which could ultimately help in the effort to do away with this troublesome provision.

Despite the fact that neither the House nor the Senate included a similar provision in their original versions, the Tax Increase Prevention and Reconciliation Act (TIPRA, P.L. 109-222), signed by President Bush on March 17, 2006, (extending current capital gains and dividend treatment another two years) contained a new requirement (Section 511) that all states and many local governments, as well as certain instrumentalities thereof, withhold three percent on all payments to persons providing them with property or services. It was added as a revenue-raiser, and is expected to provide approximately $7 billion over the first 10 years for the Federal government.

Political subdivisions of states (and any instrumentalities thereof) with less than $100 million in annual expenditures for such properties or services would be exempt. In addition, other specific exemptions are made, such as for payments of interest; payments for real property; and intra-governmental payments. The provision would apply to payments made after December 31, 2010, and also imposes information-reporting requirements on such payments (the withheld amounts will be a credit against the tax liability of the recipient, and will be shown on an information return after the end of the tax year, similar to backup withholding or withholding on wages).

The Statement of Conferees specifically notes that payments under government programs to provide health care or other services that are not based on the needs or income of the recipients would be subject to such withholding, including programs where eligibility is based on the age of the beneficiary.

Although there is no specific discussion of where public pension plans would fit under this new law, it would certainly appear possible that, depending upon the specific circumstances of their establishment and governance, retirement systems could qualify as governmental entities subject to this new requirement. If so, the withholding requirements would appear to apply to a number of plan activities, such as consultant contracts, fees paid to money managers, and payments to healthcare providers where the plan administers health benefits.

This new requirement, if implemented, will impose a massive unfunded mandate on State and local governments and will cause significant administrative burdens. Furthermore, the costs for doing business with state and local governments and their instrumentalities will increase, and the private sector companies will pass those costs along. Accordingly, NCTR has consistently supported the repeal of Section 511. (See November 2006 NCTR Federal e-News) While the House of Representatives recently voted to delay the 3% withholding requirement until 2012, the bill (H.R. 5719) has been threatened with a White House veto for other unrelated resons (see story below on HSAs).

In developing their anticipated guidance, the Treasury and Service said they were particularly interested in:

- How to apply the withholding requirements to purchases made with credit cards or other forms of payment cards;
- How to apply the withholding requirements if the payee is not subject to U.S. tax;
- How to apply the withholding requirements to partnerships and other passthrough entities in which a Government entity is a partner or owner;
- How to apply the withholding requirements to Government contractors and Subcontractors;
- The application of the withholding requirements to so-called Government-Sponsored Entities;
- The application of the withholding requirements to de minimis payments for property or services made by affected Government entities; and
- When and how the withheld amounts should be transmitted to the IRS.

The NCTR joint comment letter points out that, 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 comment letter also underscores that at least two years will be needed to allocate resources for the 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," the letter argues. Finally, the letter stresses that 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.

Federal agencies will also be required to comply with Section 511, and they are beginning to register their dismay with the provision as well. For example, the Department of Defense (DoD) has prepared a report for Senate Armed Services Committee Chairman Carl Levin (D-MI) and House Armed Services Committee Chairman Ike Skelton (D-MO) which assess the impacts of compliance with Section 511. According to this report, the DoD anticipates their costs to comply will be significant

– over $17 billion for the first five years. This 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. Finally, the 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."

Nevertheless, the provision was added to the law as a revenue-raiser, and its repeal will require that the $7 billion in new revenues over 10 years that would be lost will have to be offset under the Congressional PAYGO rules. While it has been argued that $6 billion of this "increase" actually represents an acceleration of tax receipts and is not a real revenue increase, perhaps the additional costs to DoD and other Federal agencies that would be avoided by repeal will provide the real impetus for reconsideration. Such a cost-savings could significantly enhance the likelihood of relief from this onerous provision.