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New Government Withholding Provision Could Involve Costs to State and Local Governments and Vendors

Summary

The government withholding provision, under the *Tax Increase Prevention and Reconciliation Act of 2005*, is set to go into effect on January 1, 2012, 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. The provision will have a significant cost impact on vendors and on state and local governments.

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 nonwage 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.

Potential Cost Impact to Vendors and Contractors

The withholding is a flat percentage of revenues from government payments which bears no relationship to companies' taxable incomes and will also restrict cash needed for day-to-day operations and investments. In addition, the administrative and capital investment costs to businesses and governments will be substantial. With small businesses already lacking access to capital, the withholding mandate will further compound this problem by limiting their operating capital and cash-on-hand. Private sector companies are not required to withhold three percent on payments and this could place businesses with substantial government sales at a disadvantage.

Potential Cost Impact to State and Local Governments

For governments on all levels, the withholding mandate will create an administrative and record-keeping nightmare. State and local governments will receive no funding from the federal government in exchange for providing this service. States will likely have to

make programming changes to financial and accounting systems, purchase new software, register vendors, possibly hire additional staff, keep massive data files and paper reports, include additional terms and conditions in contracts and increase contract administration. The Department of Defense alone has estimated that it would cost over \$17 billion in the first five years to comply with the three percent withholding requirement, which far exceeds any estimated revenue gains. Vendors and contractors could increase their bids by three percent in order to compensate for mandatory withholding, further straining state and local procurement budgets.

Current Status of Withholding

In January 2009, Representative Meek (D-FL) and Senator Specter (D-PA) introduced legislation, H.R. 275 and S. 292, calling for the repeal of the withholding provision. Both bills are currently in Committee and have broad bipartisan cosponsors. However, neither bill has had any major action to date. Similar bills H.R.1023 and S.277 failed to leave Committee in 2008.

The House passed full repeal of the three percent withholding last year in the Stimulus bill. However, the Senate would only pass a one-year delay of the three percent withholding. So that is where we are at this point – a one-year delay. The provision goes into effect January 1, 2012.

NASPO and the membership of the Government Withholding Relief Coalition, U.S. Chamber of Commerce, support repeal of this onerous provision. The Coalition is open to membership from both government and contractor-vendor organizations.

The website is www.WithholdingRelief.org

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