

The Three Percent Solution? Withholding Tax Repealed

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A three percent withholding tax provision was inserted and enacted in section 511(a) of the Tax Increase Prevention and Reconciliation Act of 2005[1] at the last minute. With some exceptions (e.g., payments of interest, payments for real property, and payments of wages or any other payment with respect to which mandatory or voluntary withholding applied under the present law), the provision mandated that federal, state, and local governments with an annual procurement budget of at least $100 million, in "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) ...deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment." The object was, apparently, to improve tax compliance by making it more difficult for government contractors to avoid paying their income taxes.[2] The measure was initially to take effect in 2011, but was later deferred until January 1, 2013.

Since enactment, the measure was opposed by IMLA and other local government organizations (as well as business and industry groups such as The U.S. Chamber of Commerce, the National Council for Public Procurement and Contracting, the Associated General Contractors, the Associated Builders and Contractors, the National Electrical Contractors Association, and others).

Why? The law provided the federal government with an "interest-free loan," it created an accounting or paperwork burden for governments and the companies that provide goods or services to them, it would force such vendors to increase their costs (including to offset the impact of any delayed payments), and, for smaller businesses (with a profit margin of less than three percent), the tax obligation would likely cause cash-flow problems and reduce the capital such businesses had that could be used for job-creation purposes. One article noted that, with respect to construction, "[o]n many projects, a new 3% withholding, in addition to retainage, will deplete not only the contractor's profit, but reduce sorely needed operating capital. Undoubtedly, this will impact risk analysis by insurance underwriters, sureties, and financiers. Eventually, contractors and suppliers will be forced to raise their proposal price to account for this shifting burden of financing and the taxpayer's cost of construction will increase."[3] The Government Withholding Relief Coalition (GWRC), a group formed to fight the tax, stated that the federal Department of Defense (DoD) cost to comply with the withholding requirement was estimated to be "over $17 billion over the first five years. DoD's estimated costs are already substantially more than any savings, and the rest of the federal government and state and local governments will have enormous costs as well."[4]

On October 27, 2011, the House of Representatives passed H.R. 674, a bill to repeal the withholding tax, on a vote of 405-16. The bipartisan bill was sponsored by Rep. Wally Herger (R-Calif.) and Rep. Earl Blumenauer (D-Ore.) (and co-sponsored by over 260 members of the House of Representatives from across the political spectrum). Moreover, according to House Report 112-253:

> The Obama Administration has acknowledged the need to address this issue as well, calling these rules "burdensome withholding requirements that keep capital out of the hands of job creators." Repeal of the three-percent withholding requirement is an immediate step that Congress and the President can take to remove a significant barrier to job creation.[5]

On November 10, the bill was passed in the U.S. Senate by a vote of 95 to 0 but, because an amendment to H.R. 674 was approved, the bill went back to the House for approval. The Senate-amended version of H.R. 674 passed on November 17 in the House of Representatives by a vote of 422 to 0. The bill now goes to the White House for the President's signature.

Notes

1. Pub. L. No. 109-222 (May 17, 2006).
2. One source states that the measure had its genesis in a 2004 Government Accountability Office report that found, on a review of Defense Department and IRS records, that in 2002, over 27,000 defense contractors owed $3 billion or more in unpaid taxes. *See* Jill R. Aitoro, *Contractor tax provision forces agencies to change financial systems*, Government Executive, Oct. 02, 2007.
3. *The Tax Increase Prevention and Reconciliation Act of 2005, Section 511: A Time-Bomb for the Construction Industry*, Gregory T. Spalj & Ryan G. Miner, Dec. 01, 2006 at http://www.fwhtlaw.com/articles/the_tax_increase_prevention.cfm.
4. GWRC, *Talking Points*, 2010, at http://www.withholdingrelief.com/files/2010/12/2GWRCTalkingPoints32709.pdf.
5. House Report 112-253, *Repeal of Imposition of 3 Percent Withholding on Certain Payments Made to Vendors by Government Entities*, 112th Congress (2011-2012), at http://thomas.loc.gov/cgi-bin/cpquery/R?cp112:FLD010:@1%28hr253%29. ML