

REPEAL OF IMPOSITION OF 3 PERCENT WITHHOLDING
ON CERTAIN PAYMENTS MADE TO VENDORS BY GOV-
ERNMENT ENTITIES

OCTOBER 18, 2011.—Committed to the Committee of the Whole House on the State
of the Union and ordered to be printed

Mr. CAMP, from the Committee on Ways and Means,
submitted the following

R E P O R T

[To accompany H.R. 674]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 674) to amend the Internal Revenue Code of 1986 to repeal the imposition of 3 percent withholding on certain payments made to vendors by government entities, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

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I. SUMMARY AND BACKGROUND

A. Purpose and Summary

The bill, H.R. 674, reported by the Committee on Ways and Means, provides for the repeal of the imposition of three-percent withholding on certain payments made to vendors by government entities, enacted in section 511(a) of the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”)¹, and amended in section 1511 of the American Recovery and Reinvestment Act of 2009 (“ARRA”).² The amendment in ARRA changed the TIPRA effective date for this provision from payments made after December 31, 2010 to payments made after December 31, 2011.

B. Background and Need for Legislation

Originally enacted in 2006 under TIPRA, the three-percent withholding requirement has generated considerable concern among taxpayers and Federal, State and local government agencies. While this current-law provision was purportedly intended to improve tax compliance, it is now widely acknowledged that, if allowed to take effect, this requirement would reduce the cash flow of many cash-strapped employers and require significant outlays to modify payment systems by governmental entities, which would outweigh any potential improvement in tax compliance. Indeed, as of the date of the Committee’s markup, two hundred sixty-nine Members of the House of Representatives from across the political and ideological spectrum had cosponsored H.R. 674, reflecting a growing consensus that this requirement should be repealed. 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.

C. Legislative History

Background

H.R. 674 was introduced on February 11, 2011, and was referred to the Committee on Ways and Means.

Committee action

The Committee on Ways and Means marked up the bill on October 13, 2011, and ordered the bill favorably reported.

Committee hearings

On February 16, 2011, the Committee on Ways and Means held a full Committee hearing with Office of Management and Budget Director Jacob Lew on the President’s Fiscal Year 2012 Budget, at which the three-percent withholding rule was discussed.

Additionally, in connection with its series of tax reform hearings held throughout 2011, the Committee has received several submis-

¹Pub. L. No. 109–222 (May 17, 2006).

²Pub. L. No. 111–5 (February 17, 2009).

sions for the record advocating for the repeal of the three-percent withholding requirement.

II. EXPLANATION OF THE BILL

A. Repeal of Imposition of Three-Percent Withholding on Certain Payments Made to Vendors by Government Entities (sec. 1 of the bill and sec. 3402(t) of the Code)

Present Law

In general

Wages paid to employees, including wages and salaries of employees or elected officials of Federal, State, and local government units, are subject to withholding of income tax, which employers are required to collect and remit to the government. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee. The withholding amount is allowed as a credit against the individual taxpayer's income tax liability. It may be refunded if it is determined, when a tax return is filed, that the taxpayer's liability is less than the tax withheld, or additional tax may be due if it is determined that the taxpayer's liability is more than the tax withheld.

Certain nonwage payments also may be subject to withholding. Such payments include pensions,³ gambling proceeds,⁴ Social Security and other specified Federal payments,⁵ unemployment compensation benefits,⁶ and reportable payments such as dividends and interest.⁷

Nonbusiness income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent (14 percent for certain items of income), which is collected by withholding at the source of the payment.⁸ The categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, such that determination of the withholding tax liability determines the substantive liability.

³Payors of pensions are required to withhold from payments made to payees, unless the payee elects no withholding. Withholding from periodic payments is at variable rates, parallel to income tax withholding from wages, whereas withholding from nonperiodic payments is at a flat 10-percent rate. Sec. 3405(a), (b). Withholding at a rate of 20 percent is required in the case of an eligible rollover distribution that is not directly rolled over. Sec. 3405(c).

⁴Certain gambling proceeds are subject to withholding obligations which vary depending on the form of wager or game. Sec. 3402(q)(3). Withholding is at a flat rate based on the third lowest rate of tax applicable to single taxpayers. As a general rule, every person making payment of gambling winnings from a wagering transaction subject to withholding must withhold 25 percent of such payment. Sec. 3402(q)(1). If the winnings are payable to a nonresident alien individual or a foreign corporation, the extent to which the payment is subject to withholding is determined under the withholding regime generally applicable to foreigners. Sec. 3402(q)(2).

⁵Voluntary withholding applies to specified Federal payments which include Social Security payments, certain payments received as a result of destruction or damage to crops, certain amounts received as loans from the Commodity Credit Corporation, and other payments.

⁶Withholding is at a flat 10-percent rate. Sec. 3402(p)(2).

⁷A variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN"). Withholding is at a flat rate based on the fourth lowest rate of tax applicable to single taxpayers. Sec. 3406.

⁸Secs. 1441 and 1442.

Nonwage payments by governmental entities

Other than as described above, tax is not currently required to be withheld from payments made by government entities. Effective for payments made after December 31, 2011,⁹ new withholding requirements apply to certain government payments for goods and services. Specifically, government entities must withhold three percent of certain payments to persons providing property or services.¹⁰ Government entities include the government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multistate agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than \$100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement.

Payments subject to three-percent withholding include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services. For example, payments to a commodity producer under a government commodity support program are subject to the withholding requirement.

Withholding is not required with respect to government payments made through Federal, State, or local government public assistance or public welfare programs for which eligibility is determined by a needs or income test. For example, payments under government programs providing food vouchers or medical assistance to low-income individuals are not subject to withholding under the provision. However, payments under government programs to provide health care or other services that are not based on the needs or income of the recipients are subject to withholding, including programs where eligibility is based on the age of the beneficiary.

Three-percent withholding is not required with respect to payments of wages or any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. In addition, if taxes are actually withheld from payments under the backup withholding rules, the three-percent withholding provision is not applicable.

Three-percent withholding also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential con-

⁹Sec. 3402(t), which was added by section 511 of TIPRA, Pub. L. No. 109-222. As originally enacted, its provisions were to be effective for payments made after December 31, 2010. Section 1511 of ARRA delayed the effective date until payments made after December 31, 2011. Pub. L. No. 111-5. The regulations, as discussed *infra*, deferred the effective date an additional year.

¹⁰Amounts withheld from any payment under section 3402(t) are creditable against the income taxes of the payee. Treas. Reg. sec. 31.3402(t)-6(a). Thus, for calendar year taxpayers, taxes due on March 15 (for corporations) and April 15 (for individuals) will be reduced by amounts withheld under section 3402. For taxpayers making estimated tax payments, tax withheld under section 3402(t) and allowed as a credit may be taken into account in determining estimated tax liability. For calendar year taxpayers, section 3402(t) withholding generally would be treated as a payment of estimated tax for the same calendar year and liability for other payments of estimated tax for that year would be reduced. Treas. Reg. sec. 31.3402(t)-6(c).

tract (as defined in section 6050M(e)(3)); and payments to government employees that are not otherwise excludable from this withholding provision with respect to the employees' services as employees.

Under final regulations issued by the Secretary of Treasury, the withholding (and accompanying reporting) requirements apply to payments by government entities to any person providing property or services made after December 31, 2012.¹¹ Under these rules, a payment is subject to withholding if it is \$10,000 or more on a payment-by-payment basis. Multiple payments by a government entity generally will not be aggregated in applying this \$10,000 limit.

Reasons for Change

The Committee understands that poor tax compliance by some government contractors has been identified as a contributing factor to the tax gap, or difference between the amount of tax owed by taxpayers and the amount voluntarily paid to the IRS. The Committee recognizes that withholding and information reporting requirements can improve taxpayer compliance, but is concerned that the requirement of three-percent withholding on certain payments made to vendors by government entities is an overly broad remedy to this tax gap problem. The Committee believes that this withholding requirement would reduce the cash flow to many cash-strapped employers that contract with governmental entities, undermining job creation. The Committee further believes that the looming implementation of this requirement is contributing to the severe uncertainty facing employers during this challenging economic time. Moreover, the Committee believes that the withholding requirement imposes substantial costs on Federal, State, and local governmental agencies required to withhold payments, including costs to acquire new software or pay for additional accounting services. In addition to direct costs of implementation, the possibility that three-percent withholding will result in increased procurement costs at all levels of government, as small businesses contracting with governmental entities adjust their prices to address the changes in their cash flows, also concerns the Committee. The Committee believes these burdens are disproportionate when compared to the resulting improvement in tax compliance and therefore believes that the three-percent withholding requirement should be repealed.

Explanation of Provision

Under the proposal, section 3402(t) enacted under section 511 of TIPRA, is repealed.

Effective Date

The proposal is effective for payments made after December 31, 2011.

¹¹ Treas. Reg. sec. 31.3402(t)-1(d)(1). The final regulations provide an exception to the section 3402(t) withholding rules for payments made under a written binding contract (as defined) that was in effect on December 31, 2012, and is not materially modified. However, if an existing contract is materially modified (i.e., the contract is changed such that it materially affects either the payment terms of the contract or the services or property to be provided under the contract) after December 31, 2012, payments under the contract become subject to section 3402(t) withholding. Treas. Reg. sec. 31.3402(t)-1(d)(2).

III. VOTES OF THE COMMITTEE

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the votes of the Committee on Ways and Means in its consideration of H.R. 674, "To amend the Internal Revenue Code of 1986 to repeal the imposition of 3 percent withholding on certain payments made to vendors by government entities."

The bill, H.R. 674, was ordered favorably reported by voice vote (with a quorum being present).

IV. BUDGET EFFECTS OF THE BILL

A. Committee Estimate of Budgetary Effects

In compliance with clause 3(d) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effects on the budget of the revenue provisions of the bill, H.R. 674 as reported.

The bill, as reported, is estimated to have the following effects on budget receipts for fiscal years 2012–2021:

ESTIMATED REVENUE EFFECTS OF H.R. 674,
 TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO REPEAL THE IMPOSITION OF THREE-PERCENT
 WITHHOLDING ON CERTAIN PAYMENTS MADE TO VENDORS BY GOVERNMENT ENTITIES,
 AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS

Fiscal Years 2012 - 2021

(Millions of Dollars)

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
Repeal of Imposition of Three-Percent Withholding on Certain Payments Made to Vendors by Government Entities.....	pma 12/31/11	---	-6,065	-546	-576	-600	-627	-653	-681	-709	-738	-7,786	-11,194
NET TOTAL		---	-6,065	-546	-576	-600	-627	-653	-681	-709	-738	-7,786	-11,194

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be November 1, 2011.

Legend for "Effective" column: pma = payments made after

B. Statement Regarding New Budget Authority and Tax Expenditures Budget Authority

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee states that the bill involves no new or increased budget authority. The Committee states further that the bill involves no new or increased tax expenditures.

C. Cost Estimate Prepared by the Congressional Budget Office

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, requiring a cost estimate prepared by the CBO, the following statement by CBO is provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, October 17, 2011.

Hon. DAVE CAMP, *Chairman,*
Committee on Ways and Means,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 674, a bill to Amend the Internal Revenue Code of 1986 to Repeal the Imposition of 3 Percent Withholding on Certain Payments Made to Vendors by Government Entities.

If you wish further details on this estimate, we will be pleased to provide them. The staff contact is Kalyani Parthasarathy.

Sincerely,

DOUGLAS W. ELMENDORF,
Director.

Enclosure.

H.R. 674—A bill to Amend the Internal Revenue Code of 1986 to Repeal the Imposition of 3 Percent Withholding on Certain Payments Made to Vendors by Government Entities

H.R. 674 would repeal a requirement scheduled to take effect under current law that government entities withhold and deposit with the Internal Revenue Service 3 percent of certain payments made to vendors, as a credit against the vendor's income tax. The staff of the Joint Committee on Taxation (JCT) estimates that enacting the legislation would reduce revenues and thus increase federal deficits by \$11.2 billion over the 2012–2021 period.

Under current law, federal, state, and local government entities will be required to withhold 3 percent of payments to vendors made in exchange for properties or services, beginning on January 1, 2013. The requirement will apply only if a government entity spends \$100 million or more on all such payments to vendors annually. Payments made on contracts in effect on December 31, 2012, will not immediately be subject to the requirements. Repealing this requirement would reduce revenues by an estimated \$11.2 billion over the 2012–2021 period, as shown in the following table. Because enacting H.R. 674 would affect revenues, pay-as-you-go procedures apply. (All effects are on-budget.)

	By fiscal year, in millions of dollars—											
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012– 2016	2012–2021
Estimated Reve- nues	0	–6,065	–546	–576	–600	–627	–653	–681	–709	–738	–7,786	–11,194

Notes: Components may not sum to totals because of rounding.

Enacting H.R. 674 would not affect direct spending. Implementing the bill, however, would have an impact on spending subject to appropriation. That discretionary impact would be a reduction in estimated authorizations for future appropriations, but CBO has not yet completed the estimate of such discretionary savings.

Source: Staff of the Joint Committee on Taxation.

JCT has determined that the bill contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act.

The CBO staff contact for this estimate is Kalyani Parthasarathy. The estimate was approved by Frank Sammartino.

D. Macroeconomic Impact Analysis

In compliance with clause 3(h)(2) of rule XIII of the Rules of the House of Representatives, the following statement is made by the Joint Committee on Taxation with respect to the provisions of the bill amending the Internal Revenue Code of 1986: The effects of the bill on economic activity are so small as to be incalculable within the context of a model of the aggregate economy.

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. Committee Oversight Findings and Recommendations

With respect to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was a result of the Committee's oversight review concerning the tax compliance burden on taxpayers and on Federal, State, and local governmental agencies that the Committee concluded that it is appropriate to report the bill favorably to the House of Representatives with the recommendation that the bill do pass.

B. Statement of General Performance Goals and Objectives

With respect to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee advises that the bill contains no measure that authorizes funding, so no statement of general performance goals and objectives for which any measure authorizes funding is required.

C. Information Relating to Unfunded Mandates

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. No. 104–4).

The Committee has determined that the bill does not impose a private sector mandate or a Federal intergovernmental mandate on State, local, or tribal governments.

D. Applicability of House Rule XXI 5(b)

Rule XXI 5(b) of the Rules of the House of Representatives provides, in part, that “A bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase may not be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members voting, a quorum being present.” The Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not involve any Federal income tax rate increases within the meaning of the rule.

E. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the “IRS Reform Act”) requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Treasury Department) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses.

Pursuant to clause 3(h)(1) of rule XIII of the Rules of the House of Representatives, the staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Code and that have “widespread applicability” to individuals or small businesses, within the meaning of the rule.

F. Congressional Earmarks, Limited Tax Benefits, and Limited Tariff Benefits

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTION 3402 OF THE INTERNAL REVENUE CODE OF 1986

SEC. 3402. INCOME TAX COLLECTED AT SOURCE.

(a) * * *

* * * * *

[(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,

[(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.]