

# Government Withholding Relief Coalition

April 28, 2008

Mr. Stephen Coleman  
Office of the Associate Chief Counsel  
CCPA:LPD:PR (Notice2008-38), Room 5203  
Internal Revenue Service  
P.O. Box 7604, Ben Franklin Station  
Washington, D.C. 20044

RE: Notice 2008-38 (Government entities required to withhold 3% on payments for services and property)

Dear Mr. Coleman:

The undersigned members of the *Government Withholding Relief Coalition* (the Coalition) appreciate the opportunity to comment on Treasury Notice 2008-38. The Coalition was formed to seek repeal of Section 511 of Public Law No. 109-222, which mandates the sweeping new requirement that federal, state, and local governments withhold 3% of their payments for goods and services (the “government withholding regime”). We continue to advocate vigorously for repeal of this misguided and far-reaching law.

While a 3% government withholding tax may appear to be a simple solution to stories of tax non-compliance, we do not believe there is any equitable, practical, or cost-effective way to implement this new requirement. It would impose significant financial and resource burdens on federal, state, and local entities, including the Internal Revenue Service (IRS). Ultimately, the Coalition believes the government withholding regime will significantly increase costs to governments and will directly impact the ability of governments to maintain competition and receive best value for the taxpayer’s dollar.

The Department of Defense (DoD) released a report on April 14, 2008 which explicitly illustrates the extraordinary costs of the government withholding regime. DoD estimated that the costs to comply with the 3% withholding requirement will be in excess of \$17 billion over the first five years, which is far more than any estimated revenue gains. While \$17 billion is substantial, it is only a portion of the additional costs with which governments will be burdened. The rest of the federal government and state and local governments will face massive additional outlays to comply with this mandate as well.

The Coalition continues to advance efforts to repeal this requirement and emphasize the costly and harmful consequences if it is not repealed. The following comments highlight a number of our key concerns with the government withholding regime and the significant impediments to its implementation.

- **Timing of Refunds and Credits Against Tax Liability**

Section 511 does not state what type of taxes can be offset by the 3% withholding, nor does it state how affected entities will receive refunds in the event the withheld amount exceeds tax

liability. If a contractor's corporate tax liability is significantly lower than the withheld amount (e.g., in the case where the contractor has net operating loss carry forwards), will there be opportunities throughout the year to receive refunds, or will the contractor have to wait until after an annual tax return is filed? For taxpayers generating operating losses, the ability to receive a refund at the earliest possible date may be essential to the viability of their business.

Similar concerns exist in connection with the obligation to make estimated tax payments throughout the year. Many businesses will experience serious liquidity issues if they are subjected to a government withholding regime while also being required to make estimated tax payments without any offset for amounts withheld by government customers. Assuming the unfortunate situation where the government withholding regime becomes effective, it is critical that the regulations permit law-abiding taxpayers to reduce the amounts of estimated income and/or payroll taxes submitted by amounts previously taken under the withholding regime.

If taxpayers are not permitted to reduce their estimated tax payments, they will incur significantly higher costs due to annual financing expenses to compensate for illiquidity resulting from the withholding. It is essential that the Congress and procurement officials at the federal, state, and local levels understand that over time the price of goods and services sold to governments will increase to cover these additional financing expenses. Those price increases will place undue pressure on budgets that are already stressed and will either lead to increased taxes or degradation in services provided by the government.

In order to minimize the burden on taxpayers and future price increases, regulations should permit offsets to be taken against income and payroll tax submissions. To achieve this goal all government payment offices imposing withholding should be required to submit the amounts withheld to the IRS along with a file providing transaction-level detail of the withholdings taken on a weekly or every-other-week basis.

The information provided by government agencies making payment should be hosted on a secure IRS system that taxpayers can access to determine the aggregate withholding that can be used to reduce payroll or estimated income tax submissions. An alternate approach would permit the recovery of amounts withheld by good-standing taxpayers based on their own records and controls. Under the alternate approach the IRS system would simply serve as an audit tool to test the reasonableness of the withholding credits claimed. Under either approach controls would need to be developed to ensure that credits for withholdings taken are used only once by a taxpayer.

Any process or system developed must also permit taxpayers to quickly identify and resolve situations when withholdings reported to the IRS are inaccurate. To ensure systems and processes developed by the IRS do not create undue burden, we would urge the IRS to form a joint requirements committee that includes representation from law-abiding taxpayers that currently provide goods and services to government agencies.

If an offset approach is adopted by the IRS, both payroll and quarterly income tax regulations, forms, and processes would all need to be updated. If on the other hand the IRS does not permit offsets prior to annual income tax return filings, the government will need to start budgeting for substantial price increases and the impact of claims for equitable adjustment and damages for breach of contract.

- **Subcontractors**

One of the specific questions asked in the solicitation was how to apply the withholding to government contractors and subcontractors. However, Section 511 mandates the withholding only on prime contractors, and we do not see where it grants the authority for a company to withhold taxes on behalf of another company. The law on its face pertains to prime contracts only since the government's contract is with the prime contractor. Flowing down the additional costs may very well be prohibited under terms of Federal Prompt Payment laws, the Federal Acquisition Regulation (FAR) clauses, and other federal statutes.

The compliance burden for many companies would be extremely high if it were required by law to withhold these payments on all its payments to subcontractors. In fact, it would be like creating a payroll department for non-employees. Currently companies do not need to withhold on payments to non-employees and are required to issue a Form 1099 to only a limited number of vendors. For those companies with commercial and government business, would they need to withhold from some suppliers and not others? The cost to put in place a system to cover this would be very high.

However, due to the diversity of industries dealing with the government, the highly competitive environment, and cash flow situations, some companies may wish to have flexibility in dealing with their subcontractors. The withholding will be a severe problem to prime contractors wishing to flow down the costs because no simple mechanism would make the flow-down of costs to subcontractors work under the parameters of Section 511, federal Prompt Pay laws, or FAR clauses.

- **Applying Withholding to Government Contractors and Subcontractors - “Management and Operations” Contracts**

Prime contractors who manage and operate large government facilities under management and operation (M&O) contracts for agencies like the Department of Energy are paid a management fee. A significant part of the M&O prime contractor’s duties include managing the procurement of services and equipment on the federal government’s behalf from other commercial vendors and subcontractors. As part of this management service, these M&O government contracts generally have been structured to pay for the procured services and equipment by wire transfer directly into the M&O prime contractor’s advance payment account for the project, which is essentially a zero-balance account.

The funds received in a zero-balance account are then virtually simultaneously wire transferred out by the primary contractor to the ultimate vendor of services or equipment to the government. Using such a zero-balance advance payment account is a standard practice for these federal government M&O contracts, and is consistent with government contracting standards and FAR rules.

As a nongovernmental entity managing a government site, the M&O prime contractor has the obligation to pay the vendors and subcontractors 100% of vendor invoices. However, this zero-balance account system would be severely disrupted and would not be able to function properly if, under the new withholding rules, the government can only wire transfer 97% of amounts due into the zero-balance advance payment account held in the name of the prime contractor. The

M&O prime contractor would be out of pocket for the withholding amounts imposed on transfers to the advance payment account.

Withholdings on such transfers could well exceed the M&O contractor's entire management fee. The contractor would have to include such time value costs in its bids for government M&O contracts, increasing the government contracting costs on account of this withholding rule. The end result would be a funds transfer, wherein higher contracting costs at the contracting government agency would in effect finance the time value benefit that Treasury is expected to receive from these withholdings.

- **Transmitting and Crediting Withholding for Pass-Through Entities**

In countless instances, government payments for goods and services are made to nontaxable entities such as partnerships and S corporations. In those situations, the equity holders of the nontaxable entities generally will be responsible for paying income taxes and, accordingly, will need a mechanism for crediting the withheld amounts against their tax liability. In the context of a pass-through entity with numerous partners—many of whom may acquire or sell their equity during a given tax year—the process associated with tracking and appropriately allocating withholding taxes to each equity holder will be complex to administer, and will be complex to audit for the IRS. Given that most of the equity holders likely were tax compliant to begin with, the expense and complexity of the government withholding regime is excessive and unwarranted.

Implementing regulations would need to address acceptable methodologies for pass-through entities to apply when allocating and reporting tax credits to equity holders. Regulations also must address the information, if any, government payors will be required to collect from pass-through entities concerning equity holders. In many cases, pass-throughs will have owners, such as governmental entities, tax-exempt entities, and foreign governments, that are exempt from the government withholding regime under Internal Revenue Code section 3402(t)(2)(E). It would be inappropriate to impose withholding at the pass-through level without regard to potential withholding exemptions that may apply to equity holders.

The IRS also will have to alter its computer systems and forms to allow withholdings to be treated as “allocated” tax payments that need to be attributed to and tracked under the multiple taxpayer identification numbers of the pass-through entity owners.

- **Applying Withholding Requirements to Pass-Through Entities with Governmental Equity Holders**

In many industries, taxable businesses act as partners with municipal and state authorities through joint ventures, cooperatives, partnerships and similar nontaxable pass-through entities. One example of this would be an electric cooperative or joint venture that includes both investor-owned utilities and also municipal electric companies. The government withholding regime will create significant uncertainty for partners, the pass-through entity itself, and those who do business with it.

Regulations would need to clarify whether, and in what precise circumstances, a pass-through entity will be considered a governmental entity. That determination would be relevant in determining whether the pass-through itself must withhold tax from payments to its vendors, and whether the pass-through qualifies, in whole or in part, for an exemption in connection with

payments it receives. Section 511 provides no guidance as to whether these issues should be resolved at the pass-through entity level or based on a look-through rule that analyzes the ownership of the pass-through.

For the partially-government-owned pass-through, the determination of which of its equity holders are governmental instrumentalities can be a difficult and ambiguous question, which is complicated by changes over time in ownership.

Also, those contracting with a partially-government-owned pass-through entity will possess even less information about ownership, but still must determine: first, in the case of a government payor, whether payments to the pass-through are subject to withholding; and second, how to price goods and services provided to the pass-through (i.e., whether there is a time value of money issue to be taken into account as a commercial matter).

Look-through rules would need to address how much to withhold in cases where some but not all the equity holders are governmental entities:

(a) If there is 51% governmental ownership, is there withholding on 100% of all payments to the pass-through, or 49%? Would payments by the pass-through be subject to withholding (In whole? In part?)?

(b) Is there a de minimis rule if 90% of an electricity cooperative is held by a municipal authority, such that there would be no withholding on payments to the pass-through?

(c) Can a government payor rely on representations from a pass-through concerning the exempt status of its owners, or does the payor have to examine ownership under look-through rules (keeping in mind that a wrong interpretation can have material economic consequences to contractors whose margins can be less than 3% of gross contract revenues).

- **Non-U.S. Businesses that Contract With the U.S. Government**

In many instances, non-U.S. businesses contract with the U.S. government. Pursuant to income tax treaties, these businesses generally are not subject to U.S. taxes when they provide their services from outside the United States or merely ship their goods into the United States. As drafted, the 3% withholding tax applies to non-U.S. companies. Any such withholding would override existing income tax treaties between the United States and its treaty partners. If taxes are withheld from non-U.S. operations, then each of these companies will suffer the cash flow and compliance burden of filing for a refund of the tax that was never owed. The U.S. government would incur the compliance cost of responding to all these foreign refund requests as well. Imposing withholding in contravention of existing treaties also may lead to the imposition of retaliatory taxes on U.S. businesses engaged in international commerce.

- **Impact on Existing Government Contracts**

Withholding imposed under the government withholding regime may breach contractual terms in contracts awarded prior to 2011. Based on a sample it is estimated that DoD alone has 2,000 contracts that currently extend beyond 2010. The number of impacted contracts for DoD is expected to grow to 3,000 by the end of FY'08 and 10,000 by year-end FY'09. The number of impacted contracts when all federal, state, and local agencies are taken into consideration will

obviously be significantly more. If withholding violates the terms of a government contract, the supplier/taxpayer likely will be eligible to receive an equitable price adjustment or terminate the contract. Contractors unable to negotiate equitable adjustments or those that are unable to absorb the impact of the withhold, especially those that have been irreparably harmed, may have legal standing to file suit for damages against the buying agency. Equitable adjustments and damages awarded to contractors as a result of the withholding will represent a substantial liability for federal, state, and local governments.

In addition to any Treasury guidance, the following regulations at a minimum will require updates: FAR Part 16 Allowable Cost and Payment, FAR Part 31 (Allowable Cost, Interest Expense, and Taxes), FAR Part 32 (Contract Financing and the Prompt Payment Act), FAR Part 52 Clauses, and all related supplemental clauses at both the federal and state levels.

- **Government Purchase Cards**

The use of government purchase cards has saved the federal government billions of dollars in transaction and manpower costs. As stated in DoD's April 14, 2008 report on the impacts of compliance with the government withholding regime, the "processing banks for purchase cards have advised DoD and GSA [General Services Administration] that they will not change their commercial processes to execute section 511 withholds on the behalf of DoD or any other agency." Therefore, if the 3% withholding requirement becomes effective, the federal government and state and local governments will no longer have the ability to use purchase cards, and they will have to forgo the billions of dollars in savings. This would create a situation where the buying activities would revert to issuing small dollar value contracts in lieu of simply using a government purchase card and will add significant administrative costs to both the contractor and the buying activity. Agencies would be forced to hire many GS-5s and GS-6s to process purchase orders that will be required because purchase cards are not available.

- **Exposure to Litigation for Financial Institutions**

Companies, such as banks, particularly face considerable expense and complexity in the implementation of this provision due to the need to reprogram homegrown computer software and hardware systems. Safe harbors for certain entities that face complex computer upgrades where mistakes may occur will be necessary. We are concerned about the possible exposure to litigation if a company is unable to meet the operational requirements demanded by the provision.

- **Prompt Pay Act**

The Prompt Pay Act requires federal agencies to pay their bills on a timely basis, to pay interest penalties when payments are made late, and to take discounts only when payments are made by the discount date. The Prompt Pay Act should be analyzed to determine the practical and legal impact the withholding law will have on it and attempt to reconcile the conflicts.

- **Impact on State and Local Governments**

The costs to state and local governments to implement this law will be substantial, and they will be forced to absorb these costs with no increase in revenue from the provision. The government withholding regime imposes significant administrative burdens upon the affected state and local government agencies. It requires each entity with a withholding obligation to develop and implement a collection, remittance, and record-keeping process. There would also be a significant workload impact upon the purchasing staff in all departments, as the withholding

regime would require renegotiation of current contracts to compensate for the withholding provision. In addition, similar to the federal level, state and local governments will no longer be able to utilize purchase cards, which will be a tremendous additional expense.

Regulations will need to lay out how state and local governments will be required to remit withheld funds to the federal government and what their record-keeping and dispute resolution procedures must be in order to resolve instances of erroneous withholding, among many others issues. State and local governments have many of the same implementation issues and costs as the federal government, but these will be frequently amplified for them. State and local governments will be establishing an entire system as collection agents for federal taxes for the first time, and will need detailed guidance on a multitude of issues.

Imposition of this federal 3% withholding tax will impact state and local governments' ability to obtain the lowest possible pricing for the goods and services purchased because companies will be forced to increase their bid prices to offset the additional expenses. This increase in operating costs to governments will ultimately result in a reduction of services to citizens, or passing through the higher costs in the form of increased taxes.

- **GSA Multiple Award Schedule Contracts and Other Contracting Vehicles**

It is unclear what will happen to existing GSA contracts. GSA currently has in place thousands of contracts with vendors of all sizes. Contract pricing has already been negotiated without the 3% withholding being taken into account. These are generally negotiated for five-year increments, and it would be nearly impossible to renegotiate them all at one time.

GSA Multiple Award Schedule (MAS) holders and GSA itself would face serious consequences if this law is implemented. Many schedule holders, especially small businesses, have gross margins currently in the 3%-8% range. Consequently, the withholding will jeopardize their businesses financially and ultimately result in the cancellation of many GSA contracts unless the regulations allow the withholding assessment to be added onto contract prices. This will severely hinder the attractiveness and mission of the GSA MAS program which guarantees best value.

- **Industry Funding Fees (IFF)**

In lieu of appropriations, Congress has authorized GSA to charge an IFF to vendors who supply commodities and services to federal, state and local agencies which use the GSA to procure goods and services. The IFF ranges from approximately ¾% to 4% on the volume of business the vendor conducts through the GSA. As an example, if a company provides a \$1,000 service to an agency it must remit a \$40 IFF back to GSA. It is essentially not true revenue, and therefore should not be subject to the 3% withholding.

- **De Minimis Payments**

While the law does not reference an exemption from the 3% withholding for small or de minimis payments, it would be virtually impossible to enforce it for certain types of small payments. For example, a taxi ride by a government official or an airline reservation would create a 3% withholding obligation. It essentially would be impossible, not to mention impractical, for a government official to pay 97% of the fare, obtain the tax identification number of the driver, and then submit the relevant information to the IRS.

- **Health Care Industry: Medicare Payments**

The government withholding regime will be very burdensome for the health care sector, particularly because of its impact on Medicare payments. Medicare payments are complex and take many forms, many of which will presumably be subject to withholding. Given the complexity of the Medicare payment system, it will be very challenging to the Centers for Medicare & Medicaid Services (CMS) to make appropriate withholdings and keep proper records of those amounts. In addition to the system programming that CMS will need to undertake, hospitals and health insurance companies will be required to add functionality to their systems to account for withheld amounts to be sure that appropriate credit is given for them when tax liabilities are calculated. The new withholding requirement will have a significant impact on all Medicare programs, including parts A (institutional providers), B (practitioners and suppliers), C (health insurance plans), and D (drug plans).

- **Reconciling with Other Laws and Regulations**

The IRS may have an insurmountable burden in drafting regulations that do not conflict with other types of federal laws and regulations, such as the FAR, OMB Circulars pertaining to federal grants and contracts, Prompt Pay laws, international agreements, and other regulations and statutes. The IRS regulations cannot supersede these contracting protocols without throwing the federal contracting process into chaos. The integration task to ensure regulations and laws across agencies and jurisdictions are not conflicting is a gargantuan task, which will require the Treasury Department and IRS to get the help of other agencies to facilitate the rewrite of scores of non-tax regulations.

## **Conclusion**

The *Government Withholding Relief Coalition* appreciates the opportunity to provide these comments, which demonstrate the numerous problems with attempting to implement this law. We will continue to advocate for repeal, and we urge the Treasury Department to highlight the significant difficulties and costs that will be associated with implementing this law.

Sincerely,

Government Withholding Relief Coalition

- Aeronautical Repair Station Association
- Aerospace Industries Association
- Air Conditioning Contractors of America
- Air Transport Association
- American Bankers Association
- American Concrete Pressure Pipe Association
- American Congress on Surveying and Mapping
- American Council of Engineering Companies
- American Farm Bureau Federation
- American Institute of Architects
- American Moving and Storage Association
- American Nursery and Landscape Association
- American Road & Transportation Builders Association
- American Shipbuilding Association
- American Society of Civil Engineers
- American Subcontractors Association
- American Supply Association
- American Trucking Associations
- Associated Builders and Contractors
- Associated Equipment Distributors
- Association of National Account Executives



- Business and Institutional Furniture Manufacturers Association
- Coalition for Government Procurement
- Colorado Motor Carriers Association
- Computing Technology Industry Association
- Construction Contractors Association
- Construction Industry Round Table
- Construction Management Association of America
- Contract Services Association
- Design Professionals Coalition
- Edison Electric Institute
- Engineering & Utility Contractors Association
- Federation of American Hospitals
- Financial Executives International's Committee on Government Business
- Financial Executives International's Committee on Taxation
- Finishing Contractors Association
- Gold Coast Hispanic Chamber of Commerce
- Independent Electrical Contractors, Inc
- Information Technology Association of America
- International Council of Employers of Bricklayers and Allied Craftworkers
- International Foodservice Distributors Association
- Management Association for Private Photogrammetric Surveyors
- Mason Contractors Association of America
- Mechanical Contractors Association of America
- Messenger Courier Association of the Americas
- Modular Building Institute
- National Association for Self-Employed
- National Association of Credit Management
- National Association of Manufacturers
- National Association of Minority Contractors
- National Burglar and Fire Alarm Association
- National Defense Industrial Association
- National Electrical Contractors Association
- National Federation of Independent Business
- National Italian-American Business Association
- National Precast Concrete Association
- National Office Products Alliance
- National Roofing Contractors Association
- National Small Business Association
- National Society of Professional Engineers
- National Society of Professional Surveyors
- National Utility Contractors Association
- National Wooden Pallet and Container Association
- North Coast Builders Exchange
- Office Furniture Dealers Alliance
- Oregon Trucking Association
- Plumbing-Heating-Cooling Contractors - National Association
- Printing Industries of America
- Professional Services Council
- Regional Legislative Alliance of Ventura and Santa Barbara Counties
- Santa Rosa Chamber of Commerce
- Security Industry Association
- Sheet Metal and Air Conditioning Contractors National Association, Inc.
- Small Business & Entrepreneurship Council
- Small Business Legislative Council
- Textile Rental Services Association of America
- The Associated General Contractors of America
- The Association of Union Constructors
- The Distilled Spirits Council of the U.S.
- The Financial Services Roundtable
- U.S. Chamber of Commerce
- United States Telecom Association
- Women Impacting Public Policy