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3% Withholding on Payments by the U.S. Government

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Background on 3% Withholding

- In 2005, Congress passed the Tax Increase Prevention and Reconciliation Act (P.L. 109-222)
 - Primary intent to was stem **income tax delinquency** among recipients
 - Section 511 of TIPRA (codified at 26 U.S.C. § 3402(t))
 - Generally mandates that federal, state, and local governments withhold 3% from **any** payment to **any** person providing **any** goods or services
 - Numerous exceptions
 - Payments already subject to withholding (such as wages)
 - Retirement benefits
 - Unemployment compensation
 - Social security
 - Public assistance payments made on the basis of needs or income
 - Payments for real property
 - Interest payments
 - Payments to other government entities and tax-exempt organizations
 - Payments under classified contracts

Background on 3% Withholding

- “Phased in” withholding set to begin in **January 2013 / January 2014**
 - [Nearly 19 months away](#)
 - Originally scheduled to begin in 2010
 - Pushed out to 2011, then 2012, then 2013
- Congress is currently considering legislation to eliminate withholding
 - Thus far, nothing has gained traction
 - At this point, only a legislative fix will solve the problem
 - S.89 and S.164/H.R. 674 (112th Congress)
- Final regulations published by the IRS on May 9, 2011 (76 FR 26583 and 76 FR 26678)
 - Very similar to rules proposed in December 2008



IRS Withholding Regulations

- New May 2011 Regulations
 - Withholding will not apply to **payments < \$10,000**
 - But will apply to bulk payments of > \$10,000 paying on multiple invoices
 - **Credit card payments** generally exempt
 - But the IRS reserves this issue for potential future change
 - Onus to implement withholding rests on Government agency paying the money
 - But, be careful... Potential contract remedies; overpayments; etc.
 - Withheld amounts can be claimed as a **credit on paid income tax**
 - No reductions on other income tax withholding to compensate for increased withholding
 - 3% withholding to offset income tax does not act as a credit for other taxes
 - But the withholding will likely affect most companies' quarterly tax payments

IRS Withholding Regulations (cont'd)

- Withholding will be phased in:
 - Initially, only **new** contracts awarded on or after **January 1, 2013** will be subject to withholding
 - However, beginning **January 1, 2014**, withholding will likely apply to **ALL** contracts (including those entered into prior to 2014)
 - Will likely be implemented via a bilateral contract modification
- Be aware that the IRS withholding relates only to payments by government entities, not to payments by prime contractors
 - Prime vendors may be caught in the middle on payments to subs
 - For example...
 - Required to pay subcontractors/vendors 100% of value
 - But only paid 97% by the Government
 - Issue was repeatedly raised, but IRS declined to address it in the final rule

Cost to the Government of Withholding Requirement

- 2008 DOD Report – DOD will incur more than \$17 billion complying
 - Managing withholding
 - Modifying accounting systems
 - Personnel/training costs
 - Contractor/subcontractor management
 - Contractor cost escalation
 - Risks to contractor performance



Cost to the Government of Withholding Requirement (cont'd)

Government Withholding Relief Coalition**

Cost Estimate for the 3% Tax Withholding Law (for contractors)**

Total Federal, State, and Local Implementation Costs (1):	Total 5 Year Cost (\$M)	Total 5 Year Cost Excluding Impact on Credit Cards (\$M) (2)	Total 5 Year Cost with Credit Card and \$10k Exemption (\$M) (2)
Total States/Local Costs	\$48,391	\$13,368	\$10,026
Total Federal Level Costs	\$26,796	\$6,866	\$5,150
Combined Total Cost	\$75.2B	\$20.2 B	\$15.2B
Selected States (\$M)			
California	\$5,214	\$1,808	\$1,356
Texas	\$2,839	\$978	\$734
Florida	\$1,903	\$655	\$491
Massachusetts	\$1,062	\$358	\$268
Michigan (Est)	\$1,000	\$347	\$260
Ohio	\$988	\$329	\$247
Arizona	\$821	\$288	\$216
Utah (Est)	\$500	\$173	\$130
Iowa	\$442	\$180	\$135
Montana	\$147	\$56	\$42



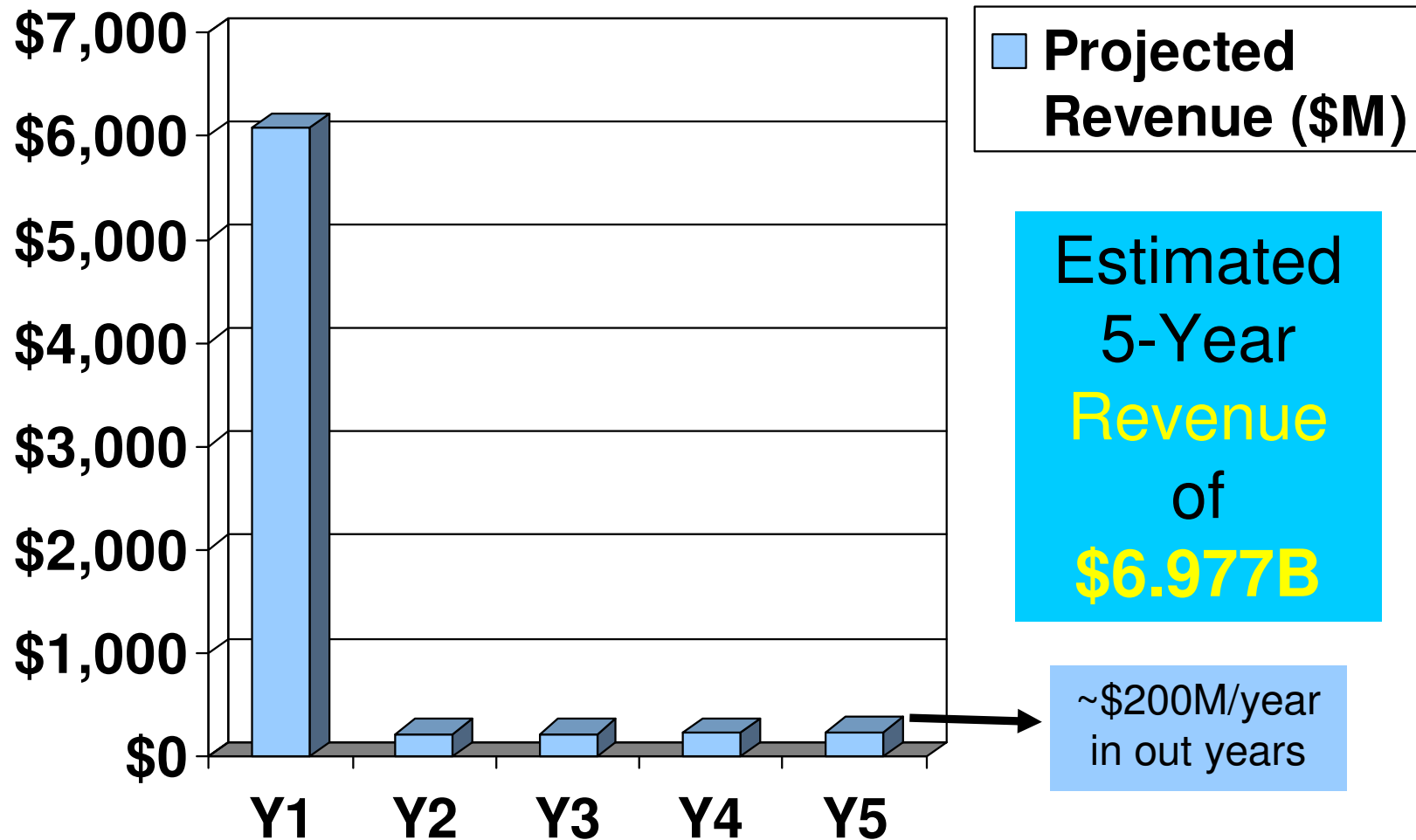
Versus an estimated 5-Year Revenue of only **\$7B**

Net Loss

(1) Includes systems and processing costs incurred by Federal, State and Local agencies to take, record, report, and reconcile withholds. Also includes systems and processing costs incurred by Federal, State, and Local contractors which will be recovered through price increases.

(2) IRS guidance and a proposed rule allows for a delay in implementing the 3% requirement for credit card transactions and allows for a \$10k threshold exemption.

Potential Revenue to Government



Source: May 9, 2006 Report, Congressional Joint Committee on Taxation

Cost to Industry of 3% Withholding

- Groups like the Government Withholding Relief Coalition (www.WithholdingRelief.com), have repeatedly lobbied for repeal
 - Includes 100+ organizations
 - NDIA
 - NAW
 - NAM
 - CGP
 - PSC
 - U.S. Chamber of Commerce
- There is no “equitable, practical, or cost-effective way to implement this new requirement”

Cost to Industry of 3% Withholding (cont'd)

Government Withholding Relief Coalition

Estimated Impact by Company Size of the 3% Tax Withholding Law

3% Withhold Compliance Expense For Contractors	Company Size (Annual Govt Sales)			
	\$10B	\$1B	\$100M	\$10M (1)
Non-recurring (\$)				
Cost to modify systems, processes, and documentation per Contractor	1,000,000	500,000	200,000	5,000
Recurring (Annual) (\$)				
Administrative effort to record, reconcile, and recover withholds	1,550,000	155,000	19,100	2,390
Administrative expense if credit card contracting is eliminated	44,168,667	4,418,667	441,667	44,167
Interest expense (Withholds recovered quarterly)	3,087,934	308,793	41,172	5,147
Total Annual Expense per Contractor (\$)	48,804,601	4,880,460	501,939	51,704
Total Five Year Expense per Contractor Including Credit Card Impact (\$)		\$24.9M		
Total Five Year Expense per Contractor Excluding Credit Card Impact (\$)	\$24.1M	\$500K	\$42K	

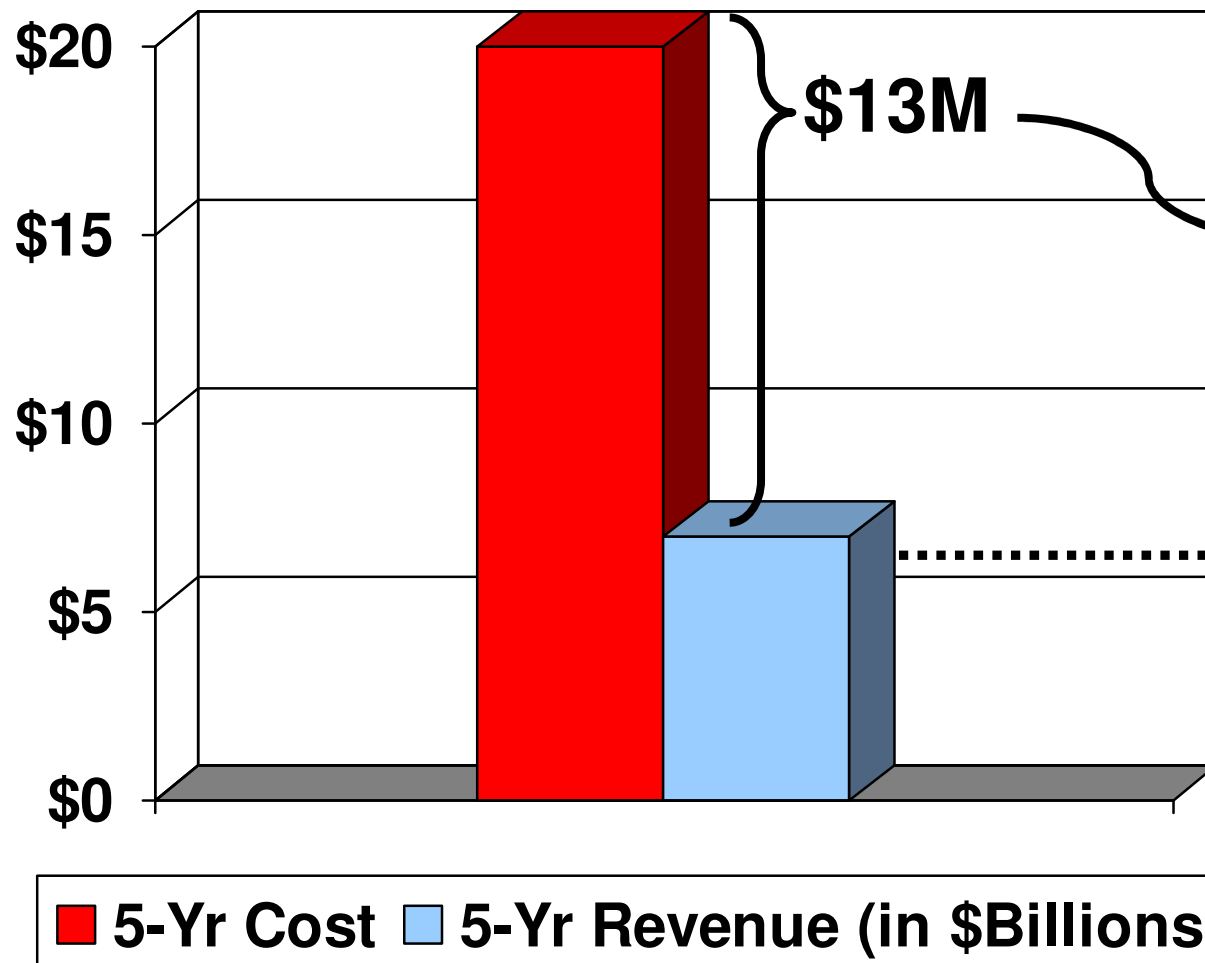
Estimated Number of Impacted Contractors

	Count of Impacted Contractors
Count of State/Local Contractors	794,000
Count of Federal Contractors	
Total Count of Impacted Contractors	~1.2M Impacted Contractors
Selected States	
California	133,536
Texas	75,267
Florida	51,461
Massachusetts	27,418
Michigan (Est)	27,871
Ohio	27,824
Arizona	24,271
Utah (Est)	13,056
Iowa	11,530
Montana	6,743

(1) The Coalition estimates that 1.2 million contractors will be impacted. Total five-year expense for small business is expected to exceed \$12B. 1.1M of the 1.2 million businesses are small (Under \$10M) and will incur between \$2000 and \$5000 of system/process upgrade expense.

- Types of increased industry costs
 - Modifying systems, processes, documentation
 - Recording, reconciling, and recovering withholds
 - Interest expenses (assuming quarterly recovery of withholds)
 - Increased bid prices/reduced competitiveness
 - Others/intangibles (e.g., cash flow)

Benefit of Withholding?



Doesn't seem to make much dollars and sense

- Of which, \$6B is actually *accelerated revenue*, and does not actually increase totals
- Actual revenues trail off dramatically...

Other Unintended Consequences

- Practical Impacts
 - Disproportionate impact on larger businesses
 - Disproportionate impact on businesses with more Government business
 - Strains on cash flow
 - Disruptions to industry
- Other unintended consequences...
 - Reduced competition?
 - Reduced R&D?
 - Strains on untrained Government procurement personnel?
 - Small businesses?
 - Jobs?
- All of this unnecessarily increases the risk/cost of doing business with the Government



3% Withholding Unnecessary?

- Industry has also argued that the withholding is no longer required thanks to other “**transparency**” initiatives implemented since 2005
 - FAPIIS
 - FAR 52.209-5, Certification Regarding Responsibility Matters/Tax Liability
 - New IRS Form 1099 reporting mandated by the Patient Protection and Affordable Care Act (P.L. 111-148)
 - FFATA and www.USAspending.gov
 - Updates to CCR
 - U.S. Treasury Offset program, which was expanded in 2009 to include State debts
 - Others...
- NDIA: “All these measures taken together pursue the laudable goal of tax compliance in a way that **puts the burden of the law and regulation more on the tax avoiders**, and provides a positive inducement to law-abiding firms and the public agencies with which they do business.”

3% Withholding Repeal?



- Most members of Congress support a repeal
 - S.89 and S. 164/H.R. 674
 - Congressional hearings on May 26, 2011
 - Senator Chuck Grassley (R-IA) appears to be the main hold-up
 - Acquisition Reform Working Group continues to lobby for repeal
- However, repeal will create a funding shortfall that Congress would need to address
 - Does Congress have the political will to cut costs and cut revenue simultaneously?
 - Will likely need to be tied to other legislation so that the Congressional Budget Office can score the “income” accordingly
- Repeal could also potentially be tied to a small business-boosting/jobs bill, similar to what was passed in November 2010

Tips on Mitigating Impacts of the 3% Withholding Tax



- Act now
 - Contact your Representative/Senator
 - Work with your trade associations (including the Government Withholding Relief Coalition)
- Prepare for the worst
 - Adjust revenue projections for 2013/2014 to accommodate for withholding impacts
 - Make sure that your future pricing is adjusted accordingly to account for the tax
 - Review your standard “Payments” clause in your subcontracts to ensure that payments to vendors will not compromise your cash flow
 - Adjust your quarterly income tax payments to address additional amounts withheld under this program
- And if all else fails...
 - Make sure that you coordinate with your Contracting Officer to make sure that payments are properly withheld
 - You do not want to be accused of keeping an “overpayment” from the Government, which could result in FCA liability