



# Tax Gap: Should the 3% Withholding Requirement on Payments to Contractors by Government Be Repealed?

**James M. Bickley**  
Specialist in Public Finance

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## Summary

The Internal Revenue Service (IRS) defines the *gross* tax gap as the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay *voluntarily* and timely for that year. It defines the *net* tax gap as the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year.

On January 27, 2005, the Joint Committee on Taxation (JCT) published a report titled *Options to Improve Tax Compliance and Reform Tax Expenditures*. The JCT report identified many options, including several to increase withholding. The first option was titled “Impose Withholding on Certain Payments Made by Government Entities.” The JCT argued that the IRS had extensively and successfully used withholding and information reporting to improve tax compliance. Furthermore, much empirical data supported the use of withholding and information reporting to reduce the tax gap. On May 17, 2006, President George W. Bush signed the *Tax Increase Prevention and Reconciliation Act of 2005* (P.L. 109-222), which included Section 511: “Imposition of Withholding on Certain Payments Made by Government Entities” (the JCT option). This section required 3% withholding on payments for goods and services to contractors made by all branches of the federal government and its agencies and all units of state and local governments, including counties and parishes. Local governments with less than \$100 million of annual expenditures were excluded from the withholding requirement. The section also imposed information reporting requirements on payments that are subject to withholding. This section was a revenue offset and was scheduled to take effect on January 1, 2011.

Substantial opposition developed to this withholding provision. Critics argued that the public and private compliance costs were unacceptable, existing IRS enforcement tools were adequate, and privacy would be reduced. The *American Recovery and Reinvestment Act of 2009* (P.L. 111-5) delayed the implementation of the withholding provision until January 1, 2012. On May 5, 2011, the IRS issued regulations that further delayed the implementation of the withholding provision until January 1, 2013.

In the 112<sup>th</sup> Congress, four bills to repeal the Section 511 withholding provision were introduced: S. 89, S. 164, S. 1726, and H.R. 674. In addition, S.Amdt. 405 to S. 782, *Economic Development Revitalization Act of 2011*, would have repealed the withholding provision.

The IRS attempted to address concerns about compliance costs by proposing a \$10,000 threshold on government purchases from contractors and increasing the number of exemptions.

On September 12, 2011, President Obama proposed the *American Jobs Act of 2011*, which included a section that would delay implementation of the withholding provision until after December 31, 2013. On September 13, 2011, at the request of President Obama, Senate Majority Leader Harry Reid introduced S. 1549, *American Jobs Act of 2011*.

On November 21, President Obama signed H.R. 674 (P.L. 112-56), *3% Withholding Repeal and Job Creation Act of 2011*, which repealed the 3% withholding provisions and provided tax credits for businesses hiring unemployed veterans. The \$11 billion cost of the repeal was paid for by \$13 billion from a change in the definition of income for determining eligibility for exchange subsidies, Medicaid, and the Children’s Health Insurance Program.

This report will not be updated.

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## Introduction

The Internal Revenue Service (IRS) defines the *gross tax gap* as the difference between the aggregate tax liability imposed by law for a given tax year and the amount of tax that taxpayers pay *voluntarily* and timely for that year.<sup>1</sup> It defines the *net tax gap* as the amount of the gross tax gap that remains unpaid after all enforced and other late payments are made for the tax year.<sup>2</sup> For tax (calendar) year 2001 (the most recent year available), the IRS estimated a gross tax gap of \$345 billion, equal to a noncompliance rate of 16.3%.<sup>3</sup> For the same tax year, IRS enforcement activities, coupled with other late payments, recovered about \$55 billion of the gross tax gap, resulting in an estimated net tax gap of \$290 billion.<sup>4</sup> The estimated gross tax gap of \$345 billion consisted of underreporting of tax liability (\$285 billion), nonfiling of tax returns (\$27 billion), and underpayment of taxes (\$33 billion).<sup>5</sup> For 2001, the \$285 billion of underreporting of tax liability had the following components: \$197 billion in individual income tax, \$54 billion in employment tax, \$30 billion in corporate income tax, and \$4 billion in estate taxes.<sup>6</sup>

On January 27, 2005, the Joint Committee on Taxation (JCT) published a report titled *Options to Improve Tax Compliance and Reform Tax Expenditures*.<sup>7</sup> The JCT report identified many options, including several to increase withholding. The first option was titled “Impose Withholding on Certain Payments Made by Government Entities.” This option would require 3% withholding on payments for goods and services to contractors made by all branches of the federal government and its agencies and all units of state and local governments, including counties and parishes. Local governments with less than \$100 million of annual expenditures would be excluded from the withholding requirement. The withholding proposal would also impose information reporting requirements on payments that are subject to withholding. The JCT argued that the IRS had extensively and successfully used withholding and information reporting to improve tax compliance. Furthermore, much empirical data supported the use of withholding and information reporting to reduce the tax gap.<sup>8</sup>

On May 17, 2006, President George W. Bush signed the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA; P.L. 109-222), which included Section 511: “Imposition of Withholding on Certain Payments Made by Government Entities” (the JCT option). Furthermore, the explanation of Section 511 by the Joint Committee on Taxation (“JTC Section 511 Explanation”),<sup>9</sup> was essentially a summary of the JCT revenue proposal published in the JCT report about options. This section was a revenue offset and was scheduled to take effect on

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<sup>1</sup> Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2, 2007, p. 6. Pages 9-16 of this reference are the source of the data about the tax gap shown in **Appendix A**.

<sup>2</sup> *Ibid.*, pp. 9-10.

<sup>3</sup> The noncompliance rate is the percentage of the aggregate tax liability that taxpayers do not pay voluntarily and in a timely manner for a given year.

<sup>4</sup> Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, p. 10.

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*

<sup>7</sup> Joint Tax Committee, *Options to Improve Tax Compliance and Reform Tax Expenditures*, Report no. JCS-02-05, January 27, 2005, 430 p.

<sup>8</sup> For a more detailed description of the JCT 2005 option, see **Appendix B**.

<sup>9</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109<sup>th</sup> Congress*, committee print no. JCS-1-07, January 7, 2007, pp. 309-311.

January 1, 2011. This new withholding provision would raise revenue by improving tax compliance and thus reducing the tax gap. The JCT estimated that the provision would yield \$6.977 billion over FY2011-FY2015.<sup>10</sup>

On October 11, 2011, the JCT estimated that enacting 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*, would lose \$7.786 billion over FY2012-FY2016 and \$11.194 billion over FY2012-FY2021.<sup>11</sup> The first revenue loss would be \$6.065 billion in FY2013.<sup>12</sup> In FY2014, the revenue loss would be as estimated \$546 million.<sup>13</sup> On October 17, 2011, the Congressional Budget Office (CBO) published its cost estimate for repealing H.R. 674 and used the estimates from the JCT.<sup>14</sup>

On October 25, 2011, CBO issued a new report that estimated that the repeal of the withholding provision would reduce discretionary costs by \$7 billion over the 2012-2021 period.<sup>15</sup> This decline in discretionary costs would consist of two parts: (1) a reduction in direct costs to federal agencies that would be required to implement the withholding requirement, and (2) lower costs for goods and services purchased from contractors who would otherwise raise their prices to recover part of their higher costs from complying with the withholding requirement.<sup>16</sup> CBO also estimated the administrative and financing costs that would be incurred by vendors if the 3% withholding provision is implemented.<sup>17</sup>

In the Joint Tax Committee's report titled *Options to Improve Tax Compliance and Reform Tax Expenditures*, the JCT explained "the significant revenue effect" in the first year as "largely attributable to accelerating tax receipts as a result of the withholding requirement."<sup>18</sup> In other words, approximately \$5.5 billion of the estimated revenue loss in FY2013 from repeal would be due to a timing change; taxes would be withheld before they were actually due. The 3% withholding requirement would shift collections from future years (particularly FY2014) to FY2013. For FY2014 and subsequent fiscal years, contractors would have credited the amount withheld against their tax liabilities. Thus, in future years the amount withheld in a given year due to the 3% withholding would be largely offset by a decline in future tax collections. Thus, the most significant revenue effect from tax shifting is a one-time increase in revenues in the first year that the 3% withholding is implemented. The estimated revenue amounts beginning in FY2014 are due to changes in compliance.

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<sup>10</sup> Joint Committee on Taxation, *Estimated Revenue Effects of the Conference Agreement for the "Tax Increase Prevention and Reconciliation Act of 2005,"* Report number JCX-18-06, May 9, 2006, p. 2.

<sup>11</sup> Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 674, Fiscal Years 2012-2021,* Report number JCX-52-11, October 11, 2011, p. 1.

<sup>12</sup> Ibid.

<sup>13</sup> Ibid.

<sup>14</sup> Congressional Budget Office, *Cost Estimate for H.R. 674,* October 17, 2011, p. 1.

<sup>15</sup> Congressional Budget Office, *Cost Estimate of 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,* October 25, 2011, p. 4.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures,* p. 9.

This report discusses arguments for and against the withholding provision, legislation in the 110<sup>th</sup> and 111<sup>th</sup> Congresses, implementation delay by IRS, proposed repeal legislation in the 112<sup>th</sup> Congress, the repeal of the withholding provision, and conclusions.

## **Arguments for the Withholding Requirement**

Both the JCT Options Report and the JCT Section 511 Explanation maintain that mandatory withholding and information reporting substantially improve tax compliance and reduce the tax gap. These JCT publications present arguments for this position. Models of tax compliance assume that the tax gap will be reduced when potential tax evaders perceive that their probability of being caught is increasing. Many individuals compare the expected benefits of tax evasion against the expected costs in theory.<sup>19</sup>

### **Widespread IRS Withholding and Information Reporting Reduce the Tax Gap**

Both JCT publications emphasize the extensive use of withholding and information reporting by the IRS under current law in order to reduce the tax gap. Employers are required to withhold employment and income taxes from wages and salaries. Certain non-wage payments are subject to mandatory or voluntary withholding. For examples, payers of pensions are required to withhold from payments made to payees, unless the payee elects no withholding, and a variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number.<sup>20</sup> Thus, withholding and information reporting are widely and successfully used by the IRS to reduce the tax gap. A detailed presentation is included in **Appendix A**.

## **Empirical Support**

### **IRS Data**

IRS empirical research has consistently shown that withholding and information reporting substantially improve tax compliance and thus reduce the tax gap. The most recent IRS calculation of the tax gap was for tax year 2001, which was based on 46,000 randomly selected returns.<sup>21</sup> High-income returns were deliberately oversampled in order to draw conclusions about this important sub-category of taxpayers concerning the use of withholding to decrease the tax gap.<sup>22</sup> The results indicate that the individual income tax underreporting gap increased as information reporting declined and the withholding requirement ended. A detailed presentation is included in **Appendix A**.

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<sup>19</sup> For a comprehensive review of the literature on tax compliance, see James Adreoni, Brian Erard, and Jonathan Feinstein, "Tax Compliance," *Journal of Economic Literature*, vol. 36, no. 2, June 1998, pp. 818-860. For an overview of the economics of tax evasion, see Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion," *Journal of Economic Perspectives*, vol. 21, no. 1, winter 2007, pp. 25-48.

<sup>20</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109<sup>th</sup> Congress*, pp. 309-310.

<sup>21</sup> Internal Revenue Service, "Understanding the Tax Gap," FS-2005-14, March 2005, p. 1.

<sup>22</sup> *Ibid.*

## **GAO Studies**

The Government Accountability Office has found widespread tax evasion by federal contractors. These GAO studies used IRS records, agency data, and results from their own investigations.<sup>23</sup> It can be argued that tax evasion by federal contractors would be reduced by the contractor withholding provision.

## **Arguments for Repeal of Withholding Requirement**

After the passage of the 3% contractor withholding provision in TIPRA, significant opposition arose against its implementation. On March 22, 2007, the House Small Business Committee held a hearing on the “Potential Effects on Small Businesses of 3 Percent Withholding Provisions on Government Contracts.” On May 26, 2011, the Subcommittee on Contracting and Workforce of the House Small Business Committee held a hearing titled “Defer No More: The Need to Repeal the 3% Withholding Provision.”

At these hearings and in other public statements by trade associations and public entities, several arguments have been expressed against the 3% contractor withholding provision.

## **Compliance Costs**

Opponents argue that the 3% contractor withholding provision would impose unacceptable costs on businesses and government entities. Overwithholding will occur if a business has a low profit margin or no income tax liability. Thus, some businesses would provide the federal government with an interest-free loan. Some critics argue that the 3% withholding requirement will adversely affect some businesses and government entities more than others. These critics maintain that small businesses and small government entities will have to pay relatively more to comply with the withholding requirement. But the relative compliance costs of business and government entities of different sizes is unknown.

On May 26, 2011, at a House Small Business Committee hearing, the representative for the American Institute of Certified Public Accountants (AICPA) testified that

Our CPA members who provide services to state and local governments are hearing that these governmental entities consider the 3 percent withholding law to be an unfunded mandate, causing significant challenges for governmental accounting and procurement systems. Similarly, state and local governments are also informing our members that this need to reprogram systems (to comply with the law) will likely prove a costly task, particularly during a period of budgetary imbalances and difficult economic times.<sup>24</sup>

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<sup>23</sup> The results of three of these GAO studies are shown in **Appendix C**.

<sup>24</sup> Patricia A. Thompson, *Statement on Behalf of the American Institute of Certified Public Accountants*, House Committee on Small Business, Hearing on “Defer No More: The Need to Repeal the 3 Percent Withholding Provision,” May 26, 2011, pp. 2-3.

A statement for the record of the hearing from the U.S. Chamber maintained that

In order to comply with the mandate, companies of all sizes that do business with the government will need to develop new internal accounting systems to track, handle and reconcile these payments. The cost to develop these systems will be passed on to the government, with the ultimate cost being borne by individual taxpayers. The 3% withholding tax is particularly problematic because it reduces capital needed for day-to-day operations.<sup>25</sup>

The statements and testimony before the House Small Business Committee lack verifiable data. No data-based estimate is available concerning the compliance costs that the proposed 3% withholding provision would impose on federal, state, and local governmental entities and businesses.

## **Existing IRS Tools**

Some repeal proponents argue that the existing tools of the IRS are sufficient to enforce tax laws for government contractors. Thus, the IRS does not need the additional tool of the proposed 3% withholding. For example, the representative for AICPA testified that the

IRS already has a number of tools in place to address taxpayers with federal tax liabilities without the need for governments to resort to 3 percent withholding on payments. Some of these tools included (among others): (1) the Federal Awardee Performance and Integrity Information System, involving a federal (legal and tax compliance) data base that the government employees and grant officials are required to review before awarding a federal prime contract; and (2) tax compliance certifications, requiring government contractors to certify that the offeror and its principals have no delinquent federal taxes with a delinquency grounds for suspension and disbarment.<sup>26</sup>

In addition, the IRS, in conjunction with the Financial Management Service (FMS) of the Department of Treasury, operate the Federal Payment Levy Program, which collects overdue taxes through a continuous levy on certain federal payments disbursed by FMS.<sup>27</sup>

## **Privacy**

Some critics are concerned about the possible reduction in privacy if the IRS collects and cross-checks more data. They argue that as the authority of the tax collector increases, the possibility of the misuse of tax information rises.<sup>28</sup> But many federal laws and regulations are in place to safeguard taxpayer data.<sup>29</sup> Criminal and monetary penalties may be levied on parties for unauthorized disclosures or uses of taxpayer data.<sup>30</sup>

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<sup>25</sup> U.S. Chamber of Commerce, *Statement for the Record*, submitted to House Committee on Small Business, Hearing on "Defer No More: The Need to Repeal the 3% Withholding Provision," May 26, 2011, p. 3.

<sup>26</sup> Patricia A. Thompson, p. 2.

<sup>27</sup> Internal Revenue Service, *Federal Payment Levy Program*, p. 1. Available at <http://www.irs.gov>.

<sup>28</sup> Linda J.B. McKee and Thomas E. McKee, "Proposed Tax Gap Legislation Erodes Individual Privacy and Protections," *The CPA Journal*, April 1, 2010, pp. 6, 8-9.

<sup>29</sup> Internal Revenue Service, *Safeguarding Taxpayer Data*, Publication 4557, October 2008, p. 9.

<sup>30</sup> *Ibid.*

## Revenue Yield Due to Timing Change

As indicated at the end of the introduction, much of the revenue yield from the 3% withholding is due to a timing change. In the first year, taxes withheld are collected before they are actually due. This revenue yield due to the timing change does not affect tax compliance.

## Legislation in the 110<sup>th</sup> and 111<sup>th</sup> Congresses

### Repeal Legislation in the 110<sup>th</sup> and 111<sup>th</sup> Congresses

In the 110<sup>th</sup> and 111<sup>th</sup> Congresses, several bills to repeal the contractor withholding requirement were introduced. Three bills to repeal were introduced in the 110<sup>th</sup> Congress: H.R. 1023, *To Repeal the Imposition of Withholding on Certain Payments Made to Vendors by Government Entities*; S. 777, *Withholding Tax Relief Act of 2007*; and S. 2394, *Good Government Contractor Act of 2007*. Further, two repeal bills were introduced in the 111<sup>th</sup> Congress: H.R. 275, *To Repeal the Imposition of 3 Percent Withholding on Certain Payments Made to Vendors by Government Entities*; and S. 292, *Withholding Tax Relief Act of 2009*.

### Implementation Delay Included in ARRA

On February 17, 2009, the *American Recovery and Reinvestment Tax Act of 2009* (ARRA; H.R. 1) was signed as P.L. 111-5. ARRA delayed by one year the implementation of the 3% withholding tax on government contractors (Section 1511 of ARRA and Section 3402(t) of the Internal Revenue Code) so that it would apply to payments made after December 31, 2011.<sup>31</sup> The Joint Committee on Taxation stated that the reason for the change was that

The Congress believes that the three-percent withholding requirement was not appropriately targeted to the noncompliant taxpayers for whom it was originally intended and may impose significant and costly administrative burdens on state and local governments.<sup>32</sup>

The IRS proposed regulations included a payment threshold of \$10,000; thus payments less than \$10,000 would not be subject to withholding.<sup>33</sup>

### Implementation Delay by IRS

On May 5, 2011, the IRS issued final regulations (T.D. 9524) that delayed the implementation of the 3% withholding tax on government contractors until January 1, 2013.<sup>34</sup> These regulations

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<sup>31</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 111<sup>th</sup> Congress*, JCS-2-11, March 2001, p. 94.

<sup>32</sup> *Ibid.*, p. 95.

<sup>33</sup> Internal Revenue Service, *Implementation of Contractor Withholding Delayed One Year*, p. 1, available at <http://www.irs.gov>.

<sup>34</sup> Internal Revenue Service, IRS Final Regulations (T.D. 9524), "Extension of Withholding to Payments by Government Entities," *Internal Revenue Bulletin*: 2011-23, June 6, 2011, 20 p.

included a \$10,000 threshold on payments from government entities to contractors and numerous exemptions.<sup>35</sup> In response to comments on initially proposed regulations, the IRS stated that

The Treasury Department and the IRS received numerous comments in response to the proposed regulations, all of which were considered in formulating the final regulations. Commenters generally expressed concerns about the administrative burdens of compliance and the revenue effect on persons subject to section 3402(t) withholding. The final regulations are intended to balance the legislative intent to construct a withholding and reporting regime for payments by government entities for property and services . . . with the goal of alleviating administrative burdens on both government entities required to withhold and persons receiving payments subject to withholding where appropriate.<sup>36</sup>

The IRS is receiving public comments on its new proposed regulations.

On September 12, 2011, the IRS held a public hearing on proposed regulations (REG-151687-10) on section 3402(t) of the code, which “provide guidance on whether Section 3401(t) withholding would apply to certain payments by government entities made on or after January 1, 2014, under existing contracts that are not materially modified.”<sup>37</sup> Representatives of five testifying government contractors urged that the 3% withholding requirement be repealed.<sup>38</sup> Mr. Tom Wilder, Senior Counsel for America’s Health Insurance Plans, expressed the view that there should be a single implementation date. Mr. Wilder stated that “it doesn’t make a lot of sense to base when the implementation date on whether or not it’s a so-called existing contract or a new contract or a materially modified existing contract.”<sup>39</sup>

## **Proposed Repeal Legislation in 112<sup>th</sup> Congress**

In the 112<sup>th</sup> Congress, four bills, without revenue offsets, were introduced that include a provision to repeal the contractor withholding provision. On January 25, 2011, Senator David Vitter introduced S. 89, *Withholding Tax Relief Act of 2011*, which currently has 12 cosponsors. Also on January 25, 2011, Senator Scott P. Brown introduced S. 164, *Withholding Tax Relief Act of 2011*, which currently has 30 cosponsors. On February 11, 2011, Representative Wally Herger introduced 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*, which currently has 269 cosponsors. On October 17, 2011, Senator Mitch McConnell introduced S. 1726, *Withholding Tax Relief Act of 2011*, which currently has 20 cosponsors. In addition, on June 9, 2011, Senator Scott P. Brown proposed S.Amdt. 405 to S. 782, *Economic Development Revitalization Act of 2011*. This amendment would repeal the withholding provision.

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<sup>35</sup> Ibid., p. 2.

<sup>36</sup> Ibid.

<sup>37</sup> Internal Revenue Service, *REG-151687-10, Notice of Proposed Rulemaking Withholding on Payments by Government Entities to Persons Providing Property or Services*, June 6, 2011, p. 1.

<sup>38</sup> Michael Beller, “Contracting Organizations Urge Repeal of 3 Percent Withholding Tax,” *Tax Notes Today*, September 13, 2011, pp. 1-2.

<sup>39</sup> Testimony of Mr. Tom Wilder before the IRS Public Hearing on “Withholding on Payments by Government Entities to Persons Providing Property or Services,” [REG-151687-10], Washington, DC, September 12, 2011.

On August 23, 2011, House Majority Leader Eric Cantor issued a press release, which stated that in September 2011, the House “will repeal the ‘3 percent withholding rule,’ which serves as an unnecessary tax increase on those who do business with the government.”<sup>40</sup>

On September 12, 2011, President Obama proposed the *American Jobs Act of 2011*. Section 113 of this act

would delay the effective date of the requirement that governmental entities withhold at a 3 percent rate from payments to persons providing certain property or services. Under this section, this withholding requirement would apply to payments made after December 31, 2013.<sup>41</sup>

On September 13, 2011, at the request of President Obama, Senate Majority Leader Harry Reid introduced S. 1549, *American Jobs Act of 2011*.

On October 20, 2011, the Obama Administration said that it supported the intent of S. 1726 to repeal the 3% withholding requirement but strongly objected to the bill’s rescission of appropriated discretionary funds to pay for the repeal.<sup>42</sup> Subsequently, on October 20, 2011, S. 1726 fell three votes (57-43) shy of the 60 needed to invoke cloture.<sup>43</sup>

On October 13, 2011, H.R. 674 was marked up by the House Committee on Ways and Means and ordered to be reported by a voice vote.<sup>44</sup> On October 25, 2011, the Obama Administration endorsed H.R. 674 and H.R. 2576, which would modify the definition of income for determining eligibility for exchange subsidies, Medicaid, and the Children’s Health Insurance Program.<sup>45</sup> H.R. 2576 would raise an estimated \$13 billion over 10 years, which would more than offset the estimated \$11.2 billion cost of H.R. 674. On October 25, 2011, CBO issued a cost estimate for H.R. 674, which included estimates of the reduction in federal discretionary costs and vendors’ costs from the repeal of the withholding requirement.<sup>46</sup> On October 26, 2011, the House voted to adopt a rule (H.Res. 448) that combined H.R. 674 and H.R. 2576.<sup>47</sup> On October 27, 2011, the House passed both H.R. 674 with a vote of 405 to 16 and H.R. 2576 with a vote of 262 to 157.<sup>48</sup>

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<sup>40</sup> House Majority Leader Eric Cantor, “Congressman Cantor Statement on Middle-Class Jobs and the Obama Administration’s Underwhelming Regulatory Review,” Press Release, August 23, 2011, p. 1.

<sup>41</sup> The White House, Office of the Press Secretary, “Section-by-Section Analysis and Explanation of the *American Jobs Act of 2011*,” September 12, 2011, p. 2.

<sup>42</sup> White House, *Statement of Administration Policy, S. 1726—Withholding Tax Relief Act of 2011*, October 20, 2011, p. 1.

<sup>43</sup> Brett Ferguson, “Senate Rejects Bills to Impose Millionaire Surtax, Repeal Withholding Tax,” *Daily Tax Report*, October 21, 2011, p. 1.

<sup>44</sup> For a description of H.R. 674, see Joint Committee on Taxation, *Description 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*, Report number JCS-51-11, October 11, 2011, 4 p.

<sup>45</sup> Executive Office of the President, “Statement of Administrative Policy on H.R. 674—Repeal of the Three Percent Withholding on Government Vendors,” October 25, 2011, p. 1.

<sup>46</sup> Congressional Budget Office, “Cost Estimate for H.R. 674,” October 25, 2011, 6 p.

<sup>47</sup> Liz White, “House Adopts Rule sending Government Contractor Withholding Repeal to Vote,” *Daily Report for Executives*, October 27, 2011, p. G5.

<sup>48</sup> Michael Beller, “House Passes Repeal of 3 Percent Withholding,” *Tax Notes Today*, October 28, 2011, p. 1.

On November 1, 2011, at a press conference, Senate Majority Leader Harry Reid stated the he will not block consideration of legislation to repeal the 3% withholding requirement on contractor payments.<sup>49</sup> But he said that he would attempt to amend the legislation in order that only those contractors in compliance with the tax laws would be exempt from the 3% withholding requirement.<sup>50</sup> On October 27, 2011, the House passed H.R. 674. On November 10, 2011, the Senate passed H.R. 674 with an amendment. On November 16, 2011, the House voted to accept the Senate amendment.

## Repeal of Withholding Provision

On November 21, President Obama signed H.R. 674 (P.L. 112-56), *3% Withholding Repeal and Job Creation Act of 2011*, which repealed the 3% withholding provisions and provided tax credits for businesses hiring unemployed veterans.<sup>51</sup> The \$11 billion cost of the repeal was paid for by \$13 billion from a change in the definition of income for determining eligibility for exchange subsidies, Medicaid, and the Children's Health Insurance Program.<sup>52</sup> This law also included a provision that expanded IRS authority to continuously levy specified payments made to delinquent taxpayers.<sup>53</sup>

## Conclusions

The 3% withholding requirement on payments to contractors by government entities was passed as a revenue offset, and its implementation has been delayed until January 1, 2013. This requirement is intended to improve tax compliance. Widespread support exists for the repeal of this 3% withholding requirement primarily because of concerns about its compliance costs. Some members of both parties, public officials, business people, and representatives of trade associations have advocated its repeal.

There was also considerable public opposition to the implementation of a requirement that payments of \$600 or more by corporations be reported to the IRS, which was similar in intent to the 3% contractor withholding requirement. On April 14, 2011, this 1099 reporting requirement was repealed with the passage of the *Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011* (P.L. 112-9; H.R. 4).<sup>54</sup>

The IRS has attempted to address concerns about compliance costs by proposing a \$10,000 threshold on government purchases from contractors and increasing the number of exemptions. Furthermore, there is the possible issue of finding a replacement source of revenue. In the 112<sup>th</sup>

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<sup>49</sup> Michael M. Gleeson, "Reid Proposes Applying 3 Percent Withholding Only to Delinquent Taxpayers," *Tax Notes Today*, November 2, 2011, p. 1.

<sup>50</sup> *Ibid.*

<sup>51</sup> Liz White, "Obama Signs Repeal of Contractor Withholding Law, Veterans Tax Credits," *Daily Tax Report*, November 22, 2011, p. G1.

<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid.*

<sup>54</sup> For an examination of this 1099 reporting requirement, see CRS Report R41400, *Economic Analysis of the Enhanced Form 1099 Information Reporting Requirements*, by Mark P. Keightley; and CRS Report R41782, *1099 Information Reporting Requirements and Penalties: Recent Legislative Activity*, by Carol A. Pettit and Edward C. Liu.

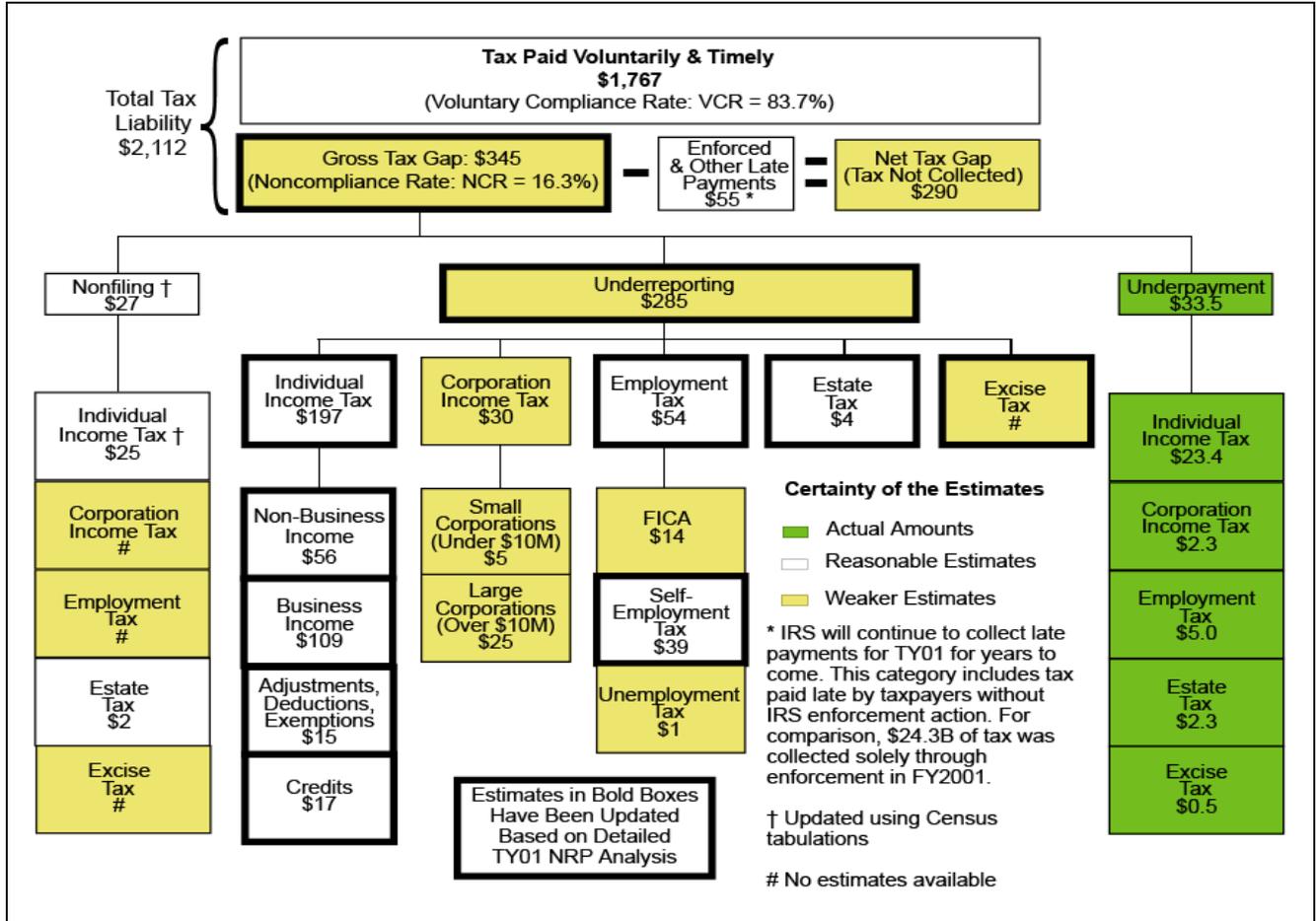
Congress, three bills, without a revenue offset, were introduced to repeal the 3% withholding provision, and a congressional hearing was held. On September 12, 2011, President Obama proposed the *American Jobs Act of 2011*, which included a section that would delay implementation of the withholding provision until after December 31, 2013. On September 13, 2011, at the request of President Obama, Senate Majority Leader Harry Reid introduced S. 1549, *American Jobs Act of 2011*.

In the 112<sup>th</sup> Congress, four bills were introduced to repeal the 3% withholding requirement: S. 89, S. 164, H.R. 674, and S. 1726. On November 21, President Obama signed H.R. 674 (P.L. 112-56), *3% Withholding Repeal and Job Creation Act of 2011*, which repealed the 3% withholding provisions and provided tax credits for businesses hiring unemployed veterans. The \$11 billion cost of the repeal was paid for by \$13 billion from a change in the definition of income for determining eligibility for exchange subsidies, Medicaid, and the Children's Health Insurance Program.

# Appendix A. Tax Gap Data for 2001

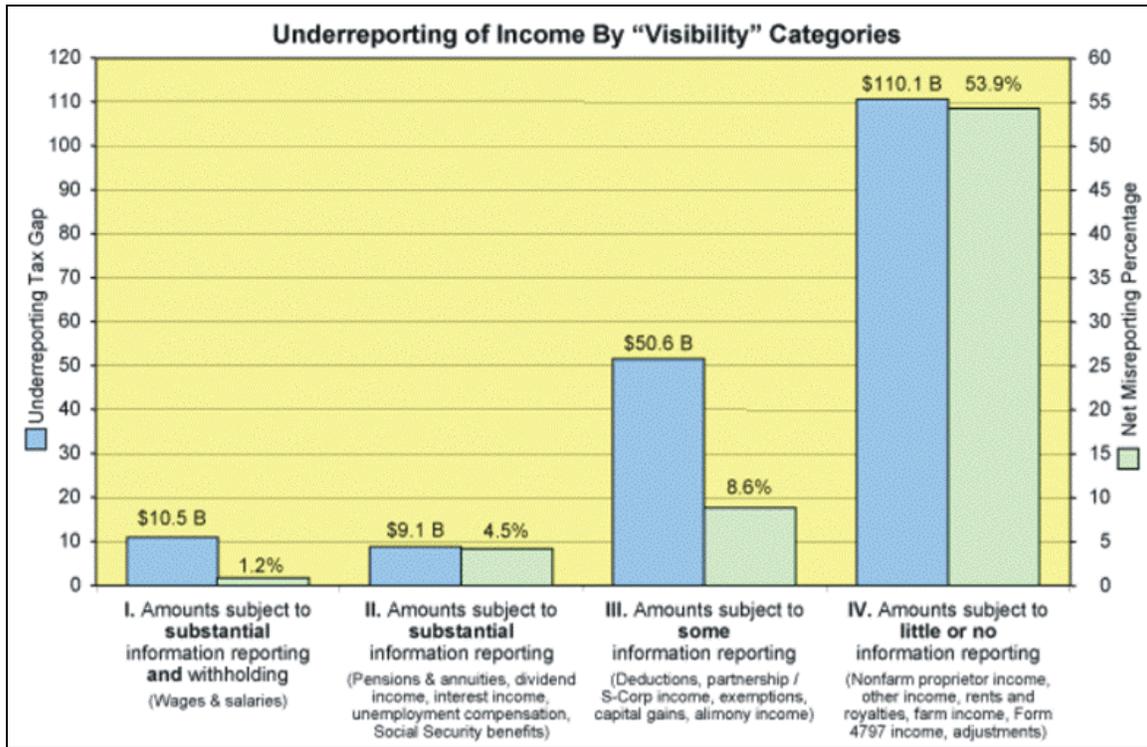
**Figure A-I. Tax Year 2001**

(billions of dollars)



Source: U.S. Treasury, Internal Revenue Service, February 2007.

Figure A-2. Individual Income Tax Underreporting Gap, 2001



Source: U.S. Treasury, Internal Revenue Service, February 2007.

Note: Based on updated estimates derived from the National Research Program underreporting compliance study.

**Table A-1. Individual Income Tax Underreporting Gap, 2001**

Category	Tax Gap (\$B)	NMP <sup>a</sup>
<b>Items Subject to Substantial Information Reporting and Withholding</b>	<b>10.5</b>	<b>1.2%</b>
Wages, salaries, tips	10.5	1.2%
<b>Items Subject to Substantial Information Reporting</b>	<b>9.1</b>	<b>4.5%</b>
Interest income	1.6	3.6%
Dividend income	1.1	3.7%
State income tax refunds	0.6	11.6%
Pensions & annuities	4.2	4.1%
Unemployment Compensation	b	11.1%
Social Security benefits	1.1	5.8%
<b>Items Subject to Some Information Reporting</b>	<b>50.6</b>	<b>8.6%</b>
Partnership, S-Corp, Estate & Trust, etc.	22.0	17.8%
Alimony income	b	7.2%
Capital gains	11.0	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
<b>Items Subject to Little or No Information Reporting</b>	<b>110.1</b>	<b>53.9%</b>
Form 4797 income	3.3	64.4%
Other income	22.6	63.5%
Nonfarm proprietor income	68.0	57.1%
Farm income	5.8	72.0%
Rents & royalties	13.4	51.3%
Total Statutory Adjustments	-3.0	-21.1%
<b>Not Shown on Visibility Chart</b>	<b>17.1</b>	<b>26.3%</b>
Credits	17.1	26.3%
<b>Total</b>	<b>197.4</b>	<b>18.0%</b>

**Source:** U.S. Treasury, Internal Revenue Service, February 2007.

- a. NMP = Net Misreporting Percentage, the net amount of income or offset misreported divided by the amount that should have been reported.
- b. Less than \$0.5 billion.

## **Appendix B. JCT 2005 Option of Withholding on Payments to Government**

As stated in the introduction, the initial proposal to “Impose Withholding on Certain Payments Made by Government Entities” was included in the JCT Options Report. The JCT description of the proposal was as follows:

The proposal requires withholding on payments for goods and services made by all branches of the Federal government and its agencies and all units of State and local governments, including counties and parishes. Local governments with less than \$100 million of annual expenditures are excluded from the withholding requirement.

The rate of withholding is three percent on all payments, regardless of whether the payments are for goods or services.

The proposal imposes information reporting requirements on payments that are subject to withholding under the proposal but are not subject to information reporting under present law.

The proposal does not apply to payments of wages or to 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. The proposal also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intragovernmental payments; and payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)).<sup>55</sup>

The JCT states that the proposal would apply “to payments made after the first December 31<sup>st</sup> that is at least six months after the date of enactments.”<sup>56</sup>

In describing present law, the JCT indicated that “the Internal Revenue Code of 1986 (the Code) requires employers to withhold income tax on wages paid to employees.”<sup>57</sup> In addition, some “nonwage payments are subject to mandatory or voluntary withholding.”<sup>58</sup> The JCT also stated that “Present law imposes numerous information reporting requirements that enable the Internal Revenue Service (IRS) to verify the correctness of taxpayers’ returns.”<sup>59</sup>

In discussing its proposal, the JCT argued that withholding “provides taxpayers with a gradual and systematic method to pay their taxes,”<sup>60</sup> thus these taxpayers “are less likely to face a large liability at the end of the tax year and have less motivation for underreporting their income.”<sup>61</sup> The JCT also maintained that its proposal would reduce the number of collection points for regular tax payments and thus improve tax compliance, although there would be a burden on

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<sup>55</sup> Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, pp. 6-7.

<sup>56</sup> *Ibid.*, p. 7.

<sup>57</sup> *Ibid.*, p. 4.

<sup>58</sup> *Ibid.*

<sup>59</sup> *Ibid.*, p. 5.

<sup>60</sup> *Ibid.*, p. 7.

<sup>61</sup> *Ibid.*

payors.<sup>62</sup> The JCT stated that the flat 3% rate is “simple, easy to verify, and applicable to all payees,”<sup>63</sup> but “is likely to cause either overwithholding or underwithholding for some payees.”<sup>64</sup> The JCT estimated that this proposal would “raise approximately \$6.4 billion over fiscal years 2006 through 2014.”<sup>65</sup>

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<sup>62</sup> Ibid., p. 8.

<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

<sup>65</sup> Ibid., p. 9.

## **Appendix C. GAO Studies of Tax Evasion by Federal Contractors**

GAO has found widespread tax evasion by federal contractors. Three of these GAO studies are subsequently described.

### **2004 GAO Report on Department of Defense Contractors**

The JCT Options Report states that “a recent Government Accountability Office (GAO) study of Department of Defense (DOD) and IRS records showed that over 27,000 Federal contractors owed about \$3 billion in unpaid taxes as of September 30, 2002.”<sup>66</sup> This GAO report also states that “we estimate that DOD, which functions as its own disbursing agent, could have offset payments and collected at least \$100 million in unpaid taxes in fiscal year 2002 if it had fully assisted IRS in effectively levying contractor payments.”<sup>67</sup> In citing this report, the JCT was indicating unsatisfactory tax compliance of DOD contractors, but GAO did recommend the partial withholding of payments to contracts.

### **2007 GAO Reported Testimony on Federal Contractors**

After the passage of the contractor withholding provision, on April 19, 2007, GAO’s Managing Director, Forensic Audits and Special Investigations, testified at a hearing of a Subcommittee of the House Committee on Oversight and Government Reform.<sup>68</sup> GAO conducted an “in-depth investigation of 122 federal contractors and in all cases found abusive and potentially criminal activity related to the federal tax system.”<sup>69</sup> This GAO investigation was preceded by three GAO studies that “found thousands of federal contractors that owed billions of dollars of federal taxes.”<sup>70</sup>

### **2011 GAO Report on Recovery Act Recipients**

In April 2011, GAO reported that

At least 3,700 recipients of Recovery Act [*American Recovery and Reinvestment Tax Act of 2009*] contracts and grants—including prime recipients, subrecipients, and vendors—are estimated to owe more than \$750 million in known unpaid federal taxes as of September 30, 2009, and received over \$24 billion in Recovery Act funds.<sup>71</sup>

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<sup>66</sup> JCT Options Report, p. 6.

<sup>67</sup> U.S. Government Accountability Office, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95, February 2004, p. 3.

<sup>68</sup> United States Government Accountability Office, *Thousands of Federal Contractors Abuse the Federal Tax System*, Statement of Gregory D. Kutz, Managing Director Forensic Audits and Special Investigations, before the Subcommittee on Government Management, Organization, and Procurement; Committee on Oversight and Government Reform, GAO-07- 742T, April 19, 2007, 15 pp.

<sup>69</sup> *Ibid.*, p. 2.

<sup>70</sup> *Ibid.*, p. 4.

<sup>71</sup> United States Government Accountability Office, *Recovery Act: Thousands of Recovery Act Contract and Grant* (continued...)

## **Author Contact Information**

James M. Bickley  
Specialist in Public Finance  
jbickley@crs.loc.gov, 7-7794

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*Recipients Owe Hundreds of Millions in Federal Taxes*, GAO-11-485, April 2011, highlights page.