

April 24, 2008

**VIA ELECTRONIC MAIL AND FACSIMILE**

CC:PA:LPD:PR (Notice 2008-38)  
Room 5203  
Internal Revenue Service  
POB 7604  
Ben Franklin Station  
Washington, DC 20044

Re: Government Entities Required to Withhold Three Percent on Payments for Services and Property, Notice 2008-38 (March 11, 2008)

The Office of Advocacy (Advocacy) offers the following comment in response to the above-referenced notice entitled Government Entities Required to Withhold three percent on Payments for Services and Property (the “three percent withholding requirement”), published by the Department of Treasury (Treasury) and the Internal Revenue Service (IRS). Advocacy understands that Treasury and the IRS issued the above-referenced notice to invite public comments regarding guidance that Treasury and the IRS will issue on the three percent withholding requirement. Advocacy commends Treasury and the IRS for seeking public comments, and offers the following suggestions. To the extent that Treasury and the IRS use the language of this guidance as the basis for a future notice of proposed rulemaking (NPRM), Advocacy’s suggestions should be treated as recommendations for compliance with the Regulatory Flexibility Act (RFA).

The three percent withholding requirement will adversely impact all small businesses that provide services to Government entities. Most small businesses that provide services to Government entities will have to increase their debt level in order to ensure sufficient cash flows and will be forced to pass these additional expenses on to their Government customers. The three percent withholding requirement will force many other small firms that are unable to secure additional debt out of the Federal contracting business.

**Office of Advocacy**

Congress established the Office of Advocacy under Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. The RFA as amended by the Small Business Regulatory Enforcement Fairness Act<sup>1</sup> enhances small business participation in the Federal rulemaking process. Advocacy is an independent entity within the United States Small Business Administration (SBA), so the views expressed herein by Advocacy do not necessarily reflect the views of the SBA or the Administration. Section 612 of the RFA requires Advocacy to monitor agency compliance with the RFA. On August 13, 2002, President Bush underscored the importance of agency compliance with the RFA and Advocacy's role in giving a voice to

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<sup>1</sup> Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq).

small businesses in the rulemaking process when he signed Executive Order 13272, titled "Proper Consideration of Small Entities in Agency Rulemaking."

### **Background of the three percent withholding requirement**

Under section 3402(t) of the Internal Revenue Code, which was added by section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, all Government entities (except for certain small State entities) will be required to withhold three percent of all payments for services or property made after December 31, 2010. IRS Notice 2008-38 invites public comments regarding guidance to be provided to Government entities required to withhold on payments made by the Government entities or their paying agents for services and property.

Advocacy observes that Notice 2008-38 does not request comments concerning the implementation of the three percent withholding requirement from the perspective of contractors that will be subject to the new requirement. Specifically, Advocacy notes the following areas that the statute and Notice 2008-38 do not address:

1. Section 3402(t) does not specify whether contractors may use the three percent amount that will be withheld to offset other taxes, or how contractors should be reimbursed if the three percent amount is withheld.
2. Section 3402(t) is silent as to whether it applies to subcontractors.
3. Section 3402(t) does not address how it should be applied with respect to contractors already subject to the similar bonding requirements of the Miller Act, 40 U.S.C. §3131.

Advocacy provides recommendations below regarding how Treasury and the IRS could treat these issues in the guidance and when developing proposed regulations to implement the three percent withholding requirement.

### **Recommendations**

1. Small businesses could be permitted to offset payroll tax submissions by the three percent amount withheld, and small businesses could be reimbursed quarterly for any amounts withheld in excess of their payroll tax liabilities.

Section 3402(t) does not specify whether small firms that are contractors may use the three percent amount that will be withheld to offset other tax liabilities, or how contractors will be reimbursed for the three percent amount withheld. In general, Treasury and the IRS require contractors to submit quarterly estimated payments of their taxes. To minimize the burden of the three percent withholding requirement on small businesses, Advocacy recommends that Treasury and the IRS develop guidance to permit small businesses affected by the three percent requirement to offset payroll tax submissions by the three percent amount withheld.

To the extent that the three percent amount withheld exceeds an affected small firm's tax liability, Treasury and the IRS must implement a process to reimburse or refund amounts not

used to offset tax liabilities in a timely manner. Because contractors are generally required to submit quarterly estimated payments, small firms that are contractors should not have to wait until the end of the year to receive the three percent amount withheld in excess of their quarterly tax liabilities. Accordingly, Advocacy recommends that Treasury and the IRS implement a process to reimburse any of the three percent amount withheld in excess of a small firm's quarterly tax liability on a quarterly basis.

2. Subcontractors could be excluded from the definition of "contract amount."

Section 3402(t) does not reference subcontractors, and therefore it could be assumed that Congress did not intend for the three percent withholding requirement to apply to subcontractors. Accordingly, Advocacy recommends that Treasury and the IRS develop the guidance to incorporate a definition of "contract amount" that excludes any subcontracting payments. Treasury and the IRS have an opportunity to develop the guidance to minimize the burdensome impact on certain small businesses by exempting subcontractors from the three percent withholding requirement.

3. Federal construction contracts that are already subject to the Miller Act could be exempt from the requirements of the three percent withholding requirement.

Section 3402(t) does not address how it would be applied with respect to contractors already subject to the similar bonding requirements of the Miller Act, 40 U.S.C. § 3131. Before any Federal construction contract over \$100,000 is awarded to a contractor, the Miller Act requires the contractor to provide a surety bond to the Federal Government. Thus, contracts to which the Miller Act applies are already subject to requirements similar to section 3402(t). Advocacy recommends that Treasury and the IRS exempt Federal contracts that are already subject to the similar provisions of the Miller Act from the three percent withholding requirement of section 3402(t).

### **RFA Considerations**

To the extent that Treasury and the IRS use the language of this guidance as the basis for an NPRM, Advocacy's suggestions should be treated as recommendations for compliance with the RFA. As a threshold matter, under the RFA, Treasury and the IRS will have to determine whether the rule as proposed will have a significant economic impact on a substantial number of small entities. Should Treasury and the IRS determine that the proposed rule will not have such an impact, the agencies may certify to that under section 605(b) of the RFA. Section 605(b) requires that the agencies provide a factual basis in support of the certification. At a minimum, Advocacy believes the factual basis should include: (1) identification of the regulated small entities based on the North American Industry Classification System; (2) the estimated number of regulated small entities; (3) a description of the economic impact of the rule on small entities; and (4) an explanation of why either the number of small entities is not substantial and/or the economic impact is not significant under the RFA.<sup>2</sup>

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<sup>2</sup> 5 USC § 605(b)

Alternatively, if the agencies cannot properly certify the proposed rule, then an initial regulatory flexibility analysis (IRFA) must be developed and published in the *Federal Register* with a period for notice and comment. An IRFA must contain: (1) a description of the reasons why the regulatory action is being taken; (2) the objectives and legal basis for the proposed regulation; (3) a description and estimated number of regulated small entities; (4) a description and estimate of compliance requirements, including any differential for different categories of small entities; (5) identification of duplication, overlap, and conflict with other rules and regulations; and (6) a description of significant alternatives to the rule.<sup>3</sup>

For purposes of complying with the RFA, Advocacy stands ready to assist Treasury and the IRS gather information regarding how the three percent withholding requirement will impact small businesses. Advocacy regularly disseminates information to, and solicits comments from, small businesses regarding proposed Federal rules affecting them. In order to understand the effect a particular proposal will have on small businesses within an industry, Advocacy holds roundtables as one means of gathering information and can provide the agencies with sources of information on the small business impacts of rules in general, and these requirements in particular.

Accordingly, Advocacy is committed to helping Treasury and the IRS comply with the RFA if Treasury and the IRS decide to develop the three percent withholding requirement as an NPRM.

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<sup>3</sup> 5 USC § 603.

## **Conclusion**

Advocacy looks forward to working with Treasury and the IRS on the three percent withholding requirement. If you have any questions or require additional information please contact Assistant Chief Counsel for Dillon Taylor at (202) 401-9787 or by email at Dillon.Taylor@sba.gov. Thank you for this opportunity to contribute to the record.

Sincerely,

/s/

Thomas M. Sullivan  
Chief Counsel for Advocacy

/s/

Dillon Taylor  
Assistant Chief Counsel for Tax

cc: The Honorable Eric Solomon, Assistant Secretary (Tax Policy), the Department of the Treasury  
The Honorable Donald Korb, Chief Counsel, Internal Revenue Service