U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

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Background on the Government Withholding Provision in the *Tax Increase Prevention and Reconciliation Act of 2005* Prepared by Chairman Grassley's Finance Committee Staff

The Internal Revenue Service (IRS) developed the concept of the tax gap as a way to gauge taxpayers' compliance with their federal tax obligations. For tax year 2001 alone, the IRS estimates a tax gap – the difference between what taxpayers should have paid and what they actually paid – of $345 billion. Every tax year, the Treasury loses billions of dollars attributable to the tax gap.

The Senate Finance Committee has worked and continues to work to close the tax gap. Previously, the committee asked the nonpartisan, bicameral Joint Committee on Taxation (JCT) to recommend ways to improve tax compliance and close the tax gap. The JCT released a series of recommendations in its report *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005. The very first recommendation presented in that report was to impose withholding on certain payments made by government entities. The basis for this recommendation was due to the fact that the lack of a withholding mechanism on nonwage payments leads to substantial underpayments of tax each year and has long been identified as contributing to the tax gap. Government payments represent a significant amount of annual payments that are not subject to withholding. The JCT concluded that imposing withholding on nonwage payments made by government entities would improve taxpayer compliance, reduce the tax gap, and promote fairness. Requiring withholding on government payments also addresses concerns regarding the poor compliance records of Federal contractors.

Widespread abuse of the Federal tax system among government contractors has been documented over a three-year period by the Government Accountability Office (GAO). In testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs on March 14, 2006, the GAO confirmed that thousands of GSA contractors flagrantly abused the federal tax system, significantly contributing to the yearly Federal tax gap. Specifically, over 3,800 GSA contractors, or about 10% of all GSA contractors, had tax debts totaling about $1.4 billion as of June 30, 2005. This follows on top of testimony to the same Subcommittee, provided less than one year before, that found that about 33,000 civilian agency contractors owed over $3 billion in unpaid federal taxes as of September 30, 2004. Also, GAO noted in a February 2004 report that over 27,000 Department of Defense contractors owed about $3 billion in unpaid taxes as of September 30, 2002.

Contractors that do not pay tax debts have an unfair competitive advantage because they may have lower costs than tax compliant contractors on government contracts. GAO's investigation of GSA contractors identified specific instances in which contractors with tax debts won awards based on price differential over tax-compliant competing contractors.

Everybody has a duty to pay their fair share of taxes owed. Those who are paid by the government should be held to a high degree of responsibility to pay taxes that are legally due. Failure to effectively enforce the tax laws against government contractors encourages noncompliance among other contractors. Over time, the failure by government contractors to pay their tax debts could erode taxpayers' confidence in the fairness of the nation's tax system, leading to increased rates of noncompliance with the nation's tax laws.

In the 2004 Annual Report to Congress, the National Taxpayer Advocate stated that Federal contractor noncompliance is among the most serious problems facing taxpayers because it contributes to the growing federal tax gap and thus forces law-abiding taxpayers to subsidize these contract awards by making up for the resulting revenue shortfall. This noncompliance also places law-abiding contractors at an unfair competitive disadvantage because nonpaying contractors can use their "tax savings" to underbid compliant ones. The report notes that there is an inherent unfairness when those who "reap the benefits of Federal contracts" refuse to fulfill their federal tax obligations.

The National Taxpayer Advocate has repeatedly reported that systematic withholding is the most effective means of supporting and contributing to a taxpayer's ability to comply with income tax reporting requirements. The Taxpayer Advocate notes that employees who are subject to wage withholding have little opportunity to underreport income. Taxpayers subject to withholding are less likely to face a large tax liability at the end of the tax year and have less motivation for underreporting income. In contrast, the absence of withholding on many types of payments has been cited as contributing to the growing compliance problem. Studies have consistently shown that rates of noncompliance are considerably higher for taxpayers with income not subject to withholding than for those taxpayers whose income is subject to withholding. Because the payments by Federal, state and local governments and their agencies represent a significant part of the economy, the new withholding regime that begins in 2011 is expected to appreciably improve compliance, while not burdening private sector payors.

The following is a review of the current law reporting and withholding requirements and a discussion of the new government contract minimum withholding requirements recently enacted into law. The new withholding requirements aim to alleviate the serious systematic abuse and contribution every year to the Federal tax gap by government contractors.

The current system of wage withholding requires employers to withhold income tax on wages paid to employees, including wages and salaries of employees or elected officials of Federal, state, and local government units. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee. Certain nonwage payments also are subject to mandatory or voluntary withholding. Many payments, including payments made by government entities, are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors). Certain individuals can claim exemption from withholding, but generally only if that individual (1) received a refund of all federal income tax withheld for the previous year because he or she had no tax liability for the previous year and (2) expects a refund of all federal income tax withheld because he or she expects to have no tax liability for the current year. The exemption from withholding applies only to income tax, not to Social Security or Medicare tax.

Under current law, contractors and other taxpayers who receive income that is not subject to withholding must make estimated tax payments. Estimated tax is used to pay income tax and self-employment tax, as well as other taxes and amounts reported on the tax return. In general, corporations must make estimated tax payments if they expect their tax liability to be $500 or more. Individuals must generally pay estimated tax if they:

· Expect to owe at least $1,000 (after subtracting withholding and credits) on the current year return, and

· Expect their withholding and credits to be less than the smaller of

-- 90% of the tax to be shown on the current year return, or
--100% of the tax shown on the prior year return (110% if the taxpayer is not a farmer or fisherman and has adjusted gross income in the current year of more than $150,000 [$75,000 if married filing separately for the current year]).

Estimated tax payments are payable in four installments that are due, for calendar year taxpayers, on April 15, June 15, September 15, and December 15. If you are a farmer or fisherman and at least 2/3 of your gross income from the current or prior year is from farming or fishing, you can pay all your estimated tax in one installment that is due by January 15 of the following year or file your tax return and pay the tax due by March 1 of the following year.

If you do not pay enough through withholding or estimated tax payments, you may be charged a penalty.

The wage withholding rates for employees correspond to the tax rates and range from 0 to 35%. For wages paid in 2006, a taxpayer must earn wages of less than $52 per week ($155 per week if married) to be subject to the 0% withholding. For wages in excess of these amounts, the withholding rates are 10%, 15%, 25%, 28%, 33%, or 35%, depending on the amount of wages. The estimated tax rates work similarly, the goal being to withhold or make estimated tax payments to correspond to the tax bracket of the individual or corporation for the tax year.

The new withholding structure that was passed in the *Tax Increase Prevention and Reconciliation Act of 2005* applies to certain government payments made after December 31, 2010, and it basically imposes a flat rate of 3% withholding on all payments. This does not create a new tax; it merely creates a new mechanism for facilitating tax deposits. The 3% withholding rate enacted under this provision is significantly lower than withholding rates applied on income tax and will result in a lower estimated tax liability payment. Imposing a withholding requirement on taxpayers who would otherwise be required to make estimated tax payments will lower their estimated tax liability for the balance of the year, therefore lessening the burden of the withholding requirement.

Payments subject to withholding under the provision include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services (for example, payments to a commodity producer under a government commodity support program). The provision does not apply to any of the following payments:

· Payments made through a Federal, state, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test.

· Wages or to any other payment with respect to which mandatory or voluntary withholding applies under present law. (The provision does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, withholding under the new provision does not apply.)

· Payments of interest.

· Payments for real property.

· Payments to tax-exempt entities or foreign governments.

· Intra-governmental payments.

· Payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)).

· Payments to government employees that is not otherwise excludable from the new withholding provision with respect to the employees' services as employees.

To prevent undue hardship, political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement.

For more information on the recommendations to expand the current information reporting or withholding structure, see the following.

· GAO testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs (March 14, 2006), *Thousands of GSA Contractors Abuse the Federal Tax System,* available at http://www.gao.gov/new.items/d06492t.pdf.

· GAO testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs (June 16, 2005), *Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence,* available at http://www.gao.gov/new.items/d05683t.pdf.

· GAO, *Some DOD Contractors Abuse the Federal Tax System with Little Consequence* (February 2004), available at http://www.gao.gov/new.items/d0495.pdf.

· National Taxpayer Advocate, *FY 2004 Annual Report to Congress* 246-63, available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

· Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (Jan. 27, 2005), available at http://www.house.gov/jct/s-2-05.pdf.

· GAO testimony before the Committee on Finance (April 14, 2005), *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies,* available at http://www.gao.gov/new.items/d05527t.pdf.

· Joint Committee on Taxation testimony before the Committee on Finance (April 14, 2005), *The $350 Billion Question: How to Solve the Tax Gap,* available at http://www.house.gov/jct/x-18-05.pdf.

· GAO testimony before the Committee on Budget (Feb. 15, 2006), *Tax Gap: Making Significant*

Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions, available at http://www.gao.gov/new.items/d06453t.pdf.

· *The Description of Revenue Provisions Contained in the President's Fiscal Year 2007 Budget Proposal* 243-245, available at http://www.gpo.gov/congress/joint/jcs-1-06/26367.pdf.