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REPEAL OF CONTRACTOR WITHHOLDING PROVISION WOULD ENCOURAGE TAX ABUSE

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The House will vote tomorrow on whether to repeal a 2006 law designed to fight tax abuse by private contractors for federal, state, or local governments. Congress and President George W. Bush enacted the 2006 law after the Government Accountability Office (GAO) uncovered widespread tax abuse by government contractors. Repealing the law would reduce revenues by around \$600 to \$700 million a year because of increased tax abuse, based on estimates from the Joint Committee on Taxation (JCT).¹

GAO investigations have found that tax abuse by government contractors costs the federal government billions of dollars each year, which increases deficits and places an unfair burden on individuals and businesses that obey the nation's tax laws. In response, the JCT recommended in 2005 that Congress impose a withholding requirement — one of the most common and effective methods of improving tax compliance — on government contractors.² The 2006 law, scheduled to take effect in 2013, imposes a 3 percent withholding requirement on contractors in order to allow the federal government to collect taxes that contractors would *already owe*. To avoid burdening small contracts, the IRS has exempted contract payments worth less than \$10,000.

Supporters of repeal have relied on dubious arguments, such as labeling the withholding requirement a tax increase (as noted, it merely ensures payment of taxes that would already be owed under the tax code) and claiming that compliance measures taken since 2006 have eliminated the problem of widespread tax abuse among government contractors (the JCT's revenue estimate already takes account of those compliance measures).

Repeal would continue Congress's recent poor record concerning tax-compliance issues. Earlier this year, Congress repealed a provision of the Affordable Care Act designed to address significant under-reporting by vendors of their income to the IRS. The recent Budget Control Act failed to

¹ Repeal would cause a higher revenue loss in the first year (in fiscal year 2013) than in subsequent years, primarily because the government receives taxes that are withheld sooner than taxes that are *not* withheld (i.e., the initial increase reflects a change in *when* taxes are received, rather than their level). Over the ten-year period, JCT estimates that the repeal proposal would reduce revenues by \$11.2 billion, reflecting both this initial timing shift and increased tax abuse. JCT, "Estimated Revenue Effects of H.R. 674", Oct. 11, 2011, <http://www.jct.gov/publications.html?func=startdown&id=4368>.

² Joint Committee on Taxation, "Options To Improve Tax Compliance And Reform Tax Expenditures," January 29, 2005, <http://www.jct.gov/publications.html?func=startdown&id=1524>.

provide for increased IRS funding to improve tax compliance — funding that CBO estimates would more than pay for itself in increased tax payments. House and Senate appropriations bills propose cutting the IRS tax enforcement budget for 2012, even though doing so would *add to deficits* by reducing tax collections.

A recent *Bloomberg* story reported that Senator Charles Grassley (R-IA), who sponsored the 2006 law to require withholding from government contractors, “said in an interview that he didn’t want to end the [withholding] requirement without addressing the issue of tax cheating by contractors. ‘There’s still a lot of revenue lost,’ said Grassley.”³ Senator Grassley is exactly right. Repeal would encourage tax abuse, while sending a signal to honest taxpayers that they will have to pick up more than their fair share for the cost of government.

Withholding Requirements Are Common and Effective Way to Curb Tax Abuse

Withholding requirements are among the most common and effective tax compliance methods. Most households are familiar with tax withholding, since employers withhold income and payroll taxes on employees’ wages — a requirement that GAO has described as “the cornerstone of our tax compliance system for employees.”⁴

In its 2005 report to Congress recommending a withholding rule for government contractors, the JCT summarized the compliance benefits of withholding requirements:

Employees who are subject to withholding have little opportunity to underreport income. Withholding also provides taxpayers with a gradual and systematic method to pay their taxes. Thus, taxpayers subject to withholding are less likely to face a large liability at the end of the tax year and have less motivation for underreporting their income.⁵

The IRS and independent studies have shown that withholding requirements significantly reduce the “tax gap” — that is, the gap between what is owed and what is paid — in large part because income that is subject to withholding is less likely to be underreported.⁶ Tax compliance for wage earners whose income is subject to withholding is approximately 99 percent. In sharp contrast, self-employed individuals, whose income is subject to neither withholding nor information reporting, were estimated to be only 41 percent compliant in 2003.⁷

³ Richard Rubin, “House Considers Health Tax Credit to Ease Contractor Tax Compliance Burden,” *Bloomberg*, October 13, 2011.

⁴ Testimony before the House of Representatives Committee on Small Business, “Tax Administration, Improving Independent Contractor Compliance with Tax Laws,” August 4, 1994.

⁵ JCT 2005 report, p. 7.

⁶ IRS, “Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance,” August 2, 2007, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

⁷ GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division (GGD)-96-165, August 1996, p. 12.

Whereas businesses are required to withhold income tax on wages paid to employees as well as certain other nonwage payments, many payments made by government entities are not subject to withholding. As a result, many government contractors have been able to simply not pay significant amounts of legally owed taxes.

GAO Has Uncovered Serious Tax Abuse by Government Contractors

GAO has found in multiple studies that thousands of federal contractors abuse the tax system each year. For example, in 2007 GAO summarized several of its previous reports, stating that 27,000 DOD contractors, 33,000 civilian agency contractors, and 3,800 GSA contractors owed about \$3 billion, \$3.3 billion, and \$1.4 billion in unpaid taxes, respectively.⁸ Earlier this year, GAO found that 3,700 contract and grant recipients of Recovery Act funds owed \$750 million in unpaid taxes.⁹

Tax abuse and non-payment of tax debts by federal contractors result in higher deficits, larger spending cuts, or an increased tax burden on taxpayers who meet their legal obligations. They also can hurt tax-compliant federal contractors, who may lose out on contracts because tax evaders and non-payers can undercut them on price as a result of illegal tax-evasion and abusive behavior.¹⁰ The GAO has identified instances in which contractors with tax debts won awards based on a price differential over tax-compliant contractors.¹¹

Ensuring that contractors do not inadvertently or deliberately abuse the tax law does not just save money; it also makes the system fairer to the vast majority of recipients, providers, taxpayers, and contractors who do play by the rules.

President Bush and Congress Acted in 2006 to Address Tax Abuse

In response to the GAO investigations and the Joint Tax Committee recommendation, Congress and President Bush enacted legislation in 2006 to crack down on this tax abuse. The law imposes a 3 percent flat withholding rate — which is simple, easy to verify, and applicable to all payees — on contracts that firms have with federal, state, or local governments; subsequent IRS regulations

⁸ The following GAO report summarized the findings of reports from 2004, 2005, and 2006: “Thousands of Federal Contractors Abuse the Federal Tax System,” April 19, 2007, <http://www.gao.gov/products/GAO-07-742T>. The earlier GAO reports are: “Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence,” February 12, 2004, <http://www.gao.gov/products/GAO-04-414T>; “Financial Management: Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence,” June 16, 2005, <http://www.gao.gov/products/GAO-05-683T>; and “Financial Management: Thousands of GSA Contractors Abuse the Federal Tax System,” March 14, 2006, <http://www.gao.gov/products/GAO-06-492T>. GAO notes, “These estimates were understated because they excluded federal contractors that understated their income or did not file their tax returns; however, some contractors may be counted in more than one of these groups.”

⁹ GAO, “Thousands of Recovery Act Contract and Grant Recipients Owe Hundreds of Millions in Federal Taxes,” April 28, 2011, <http://www.gao.gov/products/GAO-11-485>.

¹⁰ GAO 2004, 2005, and 2006 reports.

¹¹ GAO 2004, 2005, and 2006 reports.

limited the requirement to contract payments worth \$10,000 or more.¹² If, at the end of the tax year, the contractor's final federal tax liability turns out to be greater or smaller than the amount withheld, the contractor pays the difference or receives it in the form of a refund.

The law was originally scheduled to take effect in 2011, but Congress and President Obama delayed implementation to 2012 as part of the Recovery Act after contractors raised certain concerns. The final IRS regulations allow yet another year for implementation and include many provisions — including the \$10,000 threshold — designed to respond to those concerns. The requirement is now scheduled to take effect for new contracts signed in 2013 (existing contracts have an additional year to comply).

Arguments for Repeal Are Flawed

House Majority Leader Eric Cantor has mischaracterized the withholding law as a “tax increase on those who do business with the government.” This is flatly incorrect: a withholding requirement does not affect the amount of tax owed; it is merely a means of collecting taxes that taxpayers *already owe* under current law. Other arguments made in support of repeal are similarly flawed. The evidence shows that, contrary to claims by repeal proponents:

- **Recent compliance measures have *not* eliminated the problem of contractor tax evasion and abuse.** Repeal proponents argue that measures taken to improve tax compliance since the enactment of the 2006 law have made it redundant.¹³ But just this month, the Joint Committee on Taxation estimated that repeal would lose \$11.2 billion in revenues over the next ten years; this estimate takes into account all tax-compliance measures enacted since 2006.
- **The withholding provision will *not* harm economic growth.**¹⁴ Allowing tax evaders to keep their gains from illegal tax abuse activity would be an extremely poorly targeted, unfair, and ineffective form of “stimulus.” In any event, the economy is expected to be in recovery by the time the provision takes effect in 2013.
- **The provision does *not* impose overly onerous administrative requirements and is unlikely to create significant cash-flow problems for firms.** JCT described the 3 percent withholding requirement as “conservative,” noting that it “will limit instances of over-withholding.”¹⁵ The requirement applies only to government contracts, so no private companies would be required to withhold payments under contracts with other private firms. In the 2010 fiscal year, the top 100 contractors — each receiving on average \$2.8 billion in

¹² Internal Revenue Service, “Final Regulations on 3% Withholding Released,” May 6, 2011, <http://www.irs.gov/govt/fslg/article/0,,id=239542,00.html>.

¹³ American Institute of CPAs, “AICPA Urges Repeal of 3 Percent Withholding on Payments to Small Business Government Contractors,” May 26, 2011, <http://www.aicpa.org/press/pressreleases/2011/pages/aicpa urges repeal of 3 percent withholding.aspx>.

¹⁴ The U.S. Chamber of Commerce claims, “this mandate takes money from local economies and America’s small businesses... as well as drain[s] capital that could be used for job creation and business expansion”: <http://www.chamberpost.com/2011/10/repeal-of-3-withholding-tax-gaining-momentum/>.

¹⁵ JCT 2005 report, p. 9.

federal contracts — accounted for 54 percent of federal contract dollars.¹⁶ These businesses, like other large firms, are unlikely to be experiencing cash or credit constraints.¹⁷ And, as noted, the withholding rule is waived for contract payments of less than \$10,000 to avoid burdening small contracts. Taking additional measures to comply with existing tax law is a reasonable cost of making profits from contracts with the government.

Repeal Would Continue Congressional Pattern of Softness on Tax Compliance

Repealing the withholding provision would continue Congress's recent, troubling pattern of softness on improving tax compliance, despite concerns about budget deficits.

- In April, against the recommendations of the GAO, the IRS, and the Treasury Department, Congress repealed a provision of the Affordable Care Act (ACA) designed to raise revenue by improving tax compliance.

Prior to enactment of the ACA, businesses generally had to report to the IRS any payments of more than \$600 they made to vendors for services they received; this requirement was designed to help the IRS determine whether vendors were accurately reporting their income on their tax returns. Both the GAO and the IRS found, however, that the requirement was not sufficient to prevent a substantial number of vendors from significantly under-reporting their income in order to reduce their tax bills. Accordingly, the ACA's so-called "1099 provision" strengthened businesses' reporting requirements. CBO estimated that Congress' repeal of the provision would reduce tax revenues by \$21.9 billion over ten years.¹⁸

- When Congress enacted major deficit-reduction legislation this year (the Budget Control Act of 2011), it failed to include a proposal included in a version of the bill proposed by Senate Majority Leader Harry Reid that would have reduced deficits by increasing IRS funding to improve tax compliance. The proposal would cost \$13.6 billion but would result in \$43.6 billion in recovered taxes, according to CBO.¹⁹

CBO has estimated that increased investments to improve program integrity in four key areas would more than pay for themselves and thus reduce deficits: ensuring that people receiving disability benefits from Social Security or Supplemental Security Income (SSI) continue to qualify for them, fighting fraud and abuse in Medicare and Medicaid, identifying improper payments of unemployment insurance benefits, and strengthening IRS tax compliance efforts. The Budget Control Act proposal from Senator Reid permitted certain amounts of additional

¹⁶ Federal Procurement Data System, "Top 100 Contractors Report, Fiscal Year 2010," 2011, https://www.fpds.gov/fpdsng_cms/index.php/reports.

¹⁷ *Wall Street Journal*, "Companies Shun Investment, Hoard Cash," September 17, 2011, <http://online.wsj.com/article/SB10001424053111903927204576574720017009568.html>.

¹⁸ CBO, "H.R. 4: Small Business Paperwork Mandate Elimination Act of 2011," Feb. 18, 2011, <http://www.cbo.gov/ftpdocs/120xx/doc12071/hr4.pdf>.

¹⁹ CBO, "Analysis of the Impact on the Deficit of the Budget Control Act of 2011 as revised in the Senate," July 29, 2011, <http://cbo.gov/doc.cfm?index=12354>.

funding — above the caps it set on overall discretionary spending — in all four areas, in order to reduce the deficit.

Measures similar to the IRS enforcement provision had been proposed by both Presidents Obama and Bush and included in both Democratic and Republican congressional budget plans in recent years. However, the final version of the legislation lacked the IRS provision (as well as the unemployment insurance provision).

- The House and Senate Appropriations Committees have approved bills that would cut funding for core IRS functions in fiscal year 2012. Both the House and Senate bills include a \$300 million cut to the IRS enforcement budget relative to 2011 appropriations, about \$800 million less than the President's 2012 budget request. IRS Commissioner Douglas Schulman warns that cutting core IRS funding would require the IRS to reduce front-line staff and enforcement efforts:

leading to a measurable decrease of approximately \$4 billion in revenue annually, or seven times the reduction in [the] IRS budget. In other words, these budget cuts will result in a direct increase to the nation's deficit. We currently estimate that IRS examinations of individuals and businesses, and collection actions taken to recover known unpaid taxes would be down 5-8 percent.²⁰

Former IRS Commissioner Charles Rossotti was even more blunt. "It's hard to think of anything that's more stupid than cutting the IRS enforcement budget," he stated, noting, "If you were a business that had a cash problem where it was losing money, would the first thing to do be to cut the collections function?"²¹

This pattern would be troubling at any time; it is particularly disturbing at a time when the nation faces unsustainable long-term deficits. The IRS's most recent (2001) estimate of the tax gap is \$345 billion, and the IRS estimates that only about \$55 billion of that amount was later recovered.²² This massive, ongoing revenue loss swells deficits and debt and increases the deficit-reduction burden that Americans who comply with the nation's tax laws must bear.

²⁰ Douglas Shulman, October 17, 2011 letter to House Ways and Means Oversight Subcommittee ranking minority member John Lewis (D-GA).

²¹ Eric Kroh, "IRS Enforcement Cuts Would be First in More Than a Decade," *Tax Notes*, October 11, 2011.

²² IRS, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," August 2, 2007, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf. The tax gap is the yearly difference between taxes that are legally owed and those that are paid voluntarily and on time.