

# "Bah! Humbug!" - 3% Withholding and the Ghost of Christmas Future

*January 11, 2012 by: David S. Gallacher*

Just in time for the end-of-year push to fund the Government and to "create more jobs," members of Congress and President Obama had a rare moment of consensus when they unanimously(!) repealed an extremely unpopular withholding requirement that has been haunting recipients of federal funds since 2005. The "3% Withholding Repeal and Job Creation Act" was signed into law on November 21, 2011 (Pub. L. No. 112-56, Title I), eliminating a requirement to withhold 3% on most payments to contractors and grant recipients. While there are many in Government and industry alike who are ecstatic at the passage of the Act, the Ghost of Christmas Future warns that this specter of "withholding" may not have yet fled the scene. Like poor, chained Jacob Marley from Dickens' *A Christmas Carol*, industry may yet find itself captive, bound, and double-ironed by future Congressional plots to confiscate funds from government contractors. Miserly grasping for every penny, one can almost hear the federal Government grumbling, "Bah! Humbug!"

### **The Ghost of Christmas Past – Background on the 3% Withholding**

The 3% withholding requirement dates back to 2005 and the Tax Increase Prevention and Reconciliation Act (Pub. L. No. 109-222), which, among other things, extended the "Bush Tax Cuts" on capital gains and dividends, while simultaneously attempting to identify additional sources of revenue. Recognizing that some companies receiving federal contracts or grants were also delinquent in paying their income taxes, Congress decided that withholding 3% from payments to most contractors and grant recipients would help to improve the recovery of delinquent taxes. See Pub. L. No. 109-222, § 511. Committed to avoiding the day of reckoning, however, Congress delayed the start of the withholding requirement for another 5 years – until December 31, 2010. Notably, there was little discussion as to the wisdom or feasibility of implementing the withholding requirement; instead, Congress simply passed the 3% withholding as one of several "revenue offset provisions."

Almost from the beginning, everyone recognized that the withholding requirement would, at best, generate only modest revenues and that the withholding requirement also presented significant drawbacks. DOD estimated that the \$17 Billion cost of implementing the requirement over five years would exceed any anticipated revenue gains from the same period. Industry argued that the withholding did little more than restrict a company's cash flow while simultaneously imposing pointless administrative burdens. While the withholding would be used to supplement annual income tax payments, fully-compliant contractors would be entitled to full repayment of the 3% at the end of the year with little net benefit for the government. In fact, the very day that the Act was signed into law, legislation was introduced to repeal the withholding requirement. See S. 2821, 109th Congress (May 17, 2006). Later, as part of the Stimulus Act in 2009 (Pub. L. No. 111-5, Division B, Section 1511), the withholding requirement was delayed until December 31, 2011, and the Internal Revenue Service' final regulations implementing the law further delayed the full implementation until December 31, 2013. See 76 Fed. Reg. 26,583, 26,678.

Needless to say, the haunting presence of this withholding requirement generated a fair bit of anxiety among recipients of federal funds. In fact, we have frequently been asked to speak on this topic, and slides from one of our recent seminars in the Summer of 2011 can be viewed by clicking [here](#).

### **The Ghost of Christmas Present – The Recent Repeal**

Driven in part by the efforts of industry groups like the [Government Withholding Relief Coalition](#), the push to repeal the withholding requirement gained significant steam in 2011. With virtually everyone in Government and industry alike opposing it, the key factor that prevented its repeal was indentifying spending cuts to offset the loss of revenue that would come from eliminating the withholding. Not surprisingly, since the biggest news stories of 2011 have revolved around "government spending" and "budget cuts," the repeal effort struggled to gain any real momentum. However, when the 3% withholding repeal was paired with another bill to provide tax incentives and employment benefits for U.S. veterans (which was part of President Obama's original jobs bill that failed in the Senate), the opponents of the withholding finally achieved victory.

### **The Ghost of Christmas Future – Congressional Demands to Investigate Future Revenue Streams**

Eclipsed by the celebration accompanying the repeal of the 3% withholding requirement, Public Law No. 112-56 also directed the Department of the Treasury to investigate additional ways by which the government can reduce the amount of delinquent taxes owed by federal contractors. See Title III, Section 302. Notably, this provision does not attempt to investigate recovery against

"grant recipients," which receive approximately *half* of all federal discretionary spending. Instead, Congress has focused on the Government's favorite stalking horse – the nefarious and treacherous "government contractor," which many in Congress and the media would have us believe are responsible for all of the government's ills.

Essentially, the purposes of the Section 302 report are to identify: (1) ways by which the government can better identify government contractors and subcontractors that owe delinquent taxes; and (2) recommendations, including legislative changes, on how the government can better recover those delinquent taxes from the contractor. Faced with such scrutiny, and finding itself in dire need for funding, it seems likely that Congress will come up with other ways by which it can extract additional revenue from the government contractors.

While the 3% withholding requirement proved to be a blunt tool that would not have effectively resolved the delinquent tax issue, the Government has repeatedly demonstrated its preference for using blunt – as opposed to precise – solutions. Blunt tools require less consensus; they are easier to draft; they are (ostensibly) easier to implement. Congress has demanded a report from the Department of the Treasury by November 2012 to identify ways in which contractor tax delinquency can be addressed. Do not be surprised if Treasury identifies a number of solutions that are as overly broad and dysfunctional as the 3% withhold. Congress' change of heart on the withholding issue in 2011, should give industry absolutely no assurances that Congress cannot (or will not) again be persuaded by equally bad ideas based on unrealistically rosy revenue projections similar to those made back in 2005 when withholding was originally adopted. "Bah! Humbug!"

Authored by:

[David S. Gallacher](#)

(202) 218-0033

[dgallacher@sheppardmullin.com](mailto:dgallacher@sheppardmullin.com)