

Senate Finance and Revenue Committee

SB 59

Executive Summary:

Authorizes the Department of Revenue to adopt rules that require withholding of Oregon income tax from certain payments.

Beginning January 1, 2012, businesses and individuals who receive contract payments of at least \$10,000 from the federal government will have 3% of the payment withheld and credited against their federal tax liabilities. The purpose of the federal requirement is to help ensure that those doing business with the government meet their tax filing and payment obligations. (See, e.g., GAO07-742T, Thousands of Federal Contractors Abuse the Federal Tax System at www.gao.gov).

Currently, Oregon law does not require that state taxes be withheld from contract payments made to those who do business with the state. In some cases, those individuals and businesses fail to file income tax returns and pay taxes that are owed.

SB 59 authorizes the Department of Revenue to adopt rules that require up to one percent of a payment to be withheld and credited to Oregon tax liability if the payment is subject to federal requirements that federal taxes be withheld from the payment.



Highlights of GAO-07-742T, a testimony before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

Since 1990, GAO has periodically reported on high-risk federal programs that are vulnerable to fraud, waste, and abuse. Two such high-risk areas are managing federal contracts more effectively and assessing the efficiency and effectiveness of federal tax administration. Weaknesses in the tax area continue to expose the federal government to significant losses of tax revenue and increase the burden on compliant taxpayers to fund government activities. Over the last several years, the Senate Permanent Subcommittee on Investigations requested GAO to investigate Department of Defense (DOD), civilian agency, and General Services Administration (GSA) contractors that abused the federal tax system. Based on that work GAO made recommendations to executive agencies including to improve the controls over levying payments to contractors with tax debt—many of which have been implemented—and referred 122 contractors to IRS for further investigation and prosecution.

As requested, this testimony will highlight the key findings from prior testimonies and related reports. This testimony will (1) describe the magnitude of tax debt owed by federal contractors, (2) provide examples of federal contractors involved in abusive and potentially criminal activity related to the federal tax system, and (3) describe current law and proposed federal regulations for screening contractors with tax debts prior to the award of a contract.

www.gao.gov/cgi-bin/getrpt?GAO-07-742T

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gregory Kutz at (202) 512-7455 or kutzg@gao.gov.

TAX COMPLIANCE

Thousands of Federal Contractors Abuse the Federal Tax System

What GAO Found

In our previous audits and related investigations, we reported that thousands of federal contractors had substantial amounts of unpaid federal taxes. Specifically, about 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. 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.

As part of this work, we conducted more in-depth investigations of 122 federal contractors and in all cases found abusive and potentially criminal activity related to the federal tax system. Many of these 122 contractors were small, closely held companies that provided a variety of goods and services, including landscaping, consulting, catering, and parts or support for weapons and other sensitive programs for many federal agencies including the departments of Defense, Justice, and Homeland Security. These contractors had not forwarded payroll taxes withheld from their employees and other taxes to IRS. Willful failure to remit payroll taxes is a felony under U.S. law. Furthermore, some company owners diverted payroll taxes for personal gain or to fund their businesses. A number of owners or officers of the 122 federal contractors owned significant personal assets, including a sports team, multimillion dollar houses, a high-performance airplane, and luxury vehicles. Several owners gambled hundreds of thousands of dollars at the same time they were not paying the taxes that their businesses owed.

Examples of Abusive and Potentially Criminal Activity

Type of business	Unpaid tax debt	Payments to contractor	Contractor activity
Custodial services for DOD	Over \$1 million	Over \$1 million	Owner bought a boat, several cars, and a home outside the country.
Temporary help for civilian agency	Nearly \$900,000	Over \$1 million	Owner followed pattern of over 20 years of closing businesses with tax debts, opening new ones, and incurring more tax debts.
Security under GSA contract	Over \$9 million	Over \$1 million	Owner made cash withdrawals to fund an unrelated business and purchase a men's gold bracelet worth over \$25,000.

Source: Previous GAO testimonies.

Federal law, as implemented by the Federal Acquisition Regulation (FAR), does not now require contractors to disclose tax debts or contracting officers consider tax debts in making contracting decisions. Federal contractors that do not pay tax debts could have an unfair competitive advantage in costs because they have lower costs than tax compliant contractors on government contracts. GAO's investigation identified instances in which contractors with tax debts won awards based on price differential over tax compliant contractors.

**IRS Information posted at www.irs.gov
Implementation of Contractor Withholding Delayed One Year**

The American Recovery and Reinvestment Act of 2009, signed into law February 17, delays the new withholding requirement for government payments under Internal Revenue Code subsection 3402(t) to contractors one year. The requirement now applies for payments made after December 31, 2011.

Proposed Regulations [REG-158747-06] were published in the Federal Register December 5, 2008, for new Internal Revenue Code subsection 3402(t). This subsection, created by the Tax Increase Prevention and Reconciliation Act of 2005, originally required that payments by governmental entities for goods or services after December 31, 2010, are subject to 3% income tax withholding, with some exceptions. The implementation date has now been changed by statute to payments after December 31, 2011. For more details, please see the Proposed Regulations, which can be accessed [here](#).

Major features of the law and the proposed regulations are discussed below.

Which Government Entities Are Required To Withhold

The following are subject to the new requirement:

- The entire U.S. government, including all federal agencies, the executive branch, the legislative branch and the judicial branch.
- All states including the District of Columbia (but not including Indian tribal governments).
- All political subdivisions of a state government or every instrumentality of such subdivisions unless the instrumentality makes annual payments for property or services of less than \$100 million.

Generally, withholding is required on all payments to all persons providing property or services to the government, including individuals, trusts, estates, partnerships, associations, and corporations. Withholding is required at the time of payment, and applies to payment in any form (cash, check, credit card or payment card). If the government entity fails to withhold the tax required under section 3402(t), it becomes liable for the payment of the tax.

Payment Threshold

The proposed regulations create a payment threshold of \$10,000 and provide that payments below the threshold are not subject to withholding. The regulations also include an anti-abuse rule that payments of \$10,000 or more may not be divided into payments of less than \$10,000 solely for the purpose of avoiding the withholding requirements.

Exceptions from the 3 Percent Withholding Requirement

The proposed regulations provide the following exceptions from the withholding requirements:

1. Payments otherwise subject to withholding, such as wages.
2. Payments for retirement benefits, unemployment compensation, or social security.

3. Payments subject to backup withholding, if the required backup withholding is actually performed.
4. Payments for real property.
5. Payment of interest.
6. Payments to other government entities, foreign governments, tax exempt organizations, or Indian tribes.
7. Payments made under confidential or classified contracts, as described in IRC 6050M(e)(3).
8. Payments made by a political subdivision of a state, or instrumentalities of a political subdivision of a state that make annual payments for property or services of less than \$100 million.
9. Public assistance payments made on the basis of need or income. However, assistance programs based solely on age, such as Medicare, are subject to the requirements.
10. Payments to employees in connection with service, such as retirement plan contributions, fringe benefits, and expense reimbursements under an accountable plan.
11. Payments received by nonresident aliens and foreign corporations.
12. Payments made by Indian tribal governments.
13. Payments in emergency or disaster situations.

Exception for Small Entities

Subdivisions of a state, or instrumentalities of a subdivision of a state, are exempt from the withholding requirement if its total annual payments for property and services (not including wages) are less than \$100 million. The proposed regulations provide a simple rule for determining whether an entity makes annual payments less than \$100 million. In general the entity looks to its accounting year ending with or within the second preceding calendar year. For example, if total payments for the entity's 2010 accounting year exceed \$100 million, the withholding requirement will apply in 2012.

How To Report Withheld Tax

Withholding is required at the time of payment. Payments subject to the withholding requirement must be shown on Form 945, Annual Return of Withheld Income Tax. These amounts are subject to the deposit rules for that form. The deposit rules are discussed in Publication 15, Circular E, Employer's Tax Guide. All amounts withheld must be reported by the government entity on Form 1099-MISC, Miscellaneous Income, at the end of the calendar year. Amounts withheld may not be applied as a credit against the employment tax liabilities of the payee. The payee will include withheld amounts in total withholding on the individual or business tax return. The proposed regulations provide an explanation of the timing of credit for the withholding to be taken when the recipient operates under a fiscal tax year.

More Information

The office of Federal, State and Local Governments (FSLG) will continue to provide information on these provisions, as it becomes available, on its website.

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<http://www.irs.gov/govt/fslg/article/0,,id=204409,00.html>