

**DESCRIPTION OF H.R. 674  
TO AMEND THE INTERNAL REVENUE CODE OF 1986  
TO REPEAL THE IMPOSITION OF THREE-PERCENT  
WITHHOLDING ON CERTAIN PAYMENTS MADE  
TO VENDORS BY GOVERNMENT ENTITIES**

Scheduled for Markup  
By the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on October 13, 2011

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 674 on October 13, 2011. H.R. 674 amends the Internal Revenue Code of 1986<sup>1</sup> to repeal the imposition of three-percent withholding on certain payments made to vendors by government entities. This document,<sup>2</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

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<sup>1</sup> Unless otherwise noted, all references to Code sections refer to the Internal Revenue Code of 1986.

<sup>2</sup> This document may be cited as follows: Joint Committee on Taxation, “*Description of H.R. 674, to Amend the Internal Revenue Code of 1986 to Repeal the Imposition of Three-Percent Withholding on Certain Payments Made to Vendors by Government Entities*” (JCX-51-11), October 11, 2011. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

## **A. Repeal of Imposition of Three-Percent Withholding on Certain Payments Made to Vendors by Government Entities**

### **Present Law**

#### **In general**

Wages paid to employees, including wages and salaries of employees or elected officials of Federal, State, and local government units, are subject to withholding of income tax, which employers are required to collect and remit to the government. 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. The withholding amount is allowed as a credit against the individual taxpayer's income tax liability. It may be refunded if it is determined, when a tax return is filed, that the taxpayer's liability is less than the tax withheld, or additional tax may be due if it is determined that the taxpayer's liability is more than the withholding tax.

Certain nonwage payments also may be subject to withholding. Such payments include pensions,<sup>3</sup> gambling proceeds,<sup>4</sup> Social Security and other specified Federal payments,<sup>5</sup> unemployment compensation benefits,<sup>6</sup> and reportable payments such as dividends and interest.<sup>7</sup>

Nonbusiness income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent (14 percent for certain items of income), which is collected by withholding at the source of the payment.<sup>8</sup> The categories of income subject to the

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<sup>3</sup> Payors of pensions are required to withhold from payments made to payees, unless the payee elects no withholding. Withholding from periodic payments is at variable rates, parallel to income tax withholding from wages, whereas withholding from nonperiodic payments is at a flat 10-percent rate. Sec. 3405(a), (b). Withholding at a rate of 20 percent is required in the case of an eligible rollover distribution that is not directly rolled over. Sec. 3405(c).

<sup>4</sup> Certain gambling proceeds are subject to withholding obligations which vary depending on the form of wager or game. Sec. 3402(q)(3). Withholding is at a flat rate based on the third lowest rate of tax applicable to single taxpayers. As a general rule, every person making payment of gambling winnings from a wagering transaction subject to withholding must withhold 25 percent of such payment. Sec. 3402(q)(1). If the winnings are payable to a nonresident alien individual or a foreign corporation, the extent to which the payment is subject to withholding is determined under the withholding regime generally applicable to foreigners. Sec. 3402(q)(2).

<sup>5</sup> Voluntary withholding applies to specified Federal payments which include Social Security payments, certain payments received as a result of destruction or damage to crops, certain amounts received as loans from the Commodity Credit Corporation, and other payments.

<sup>6</sup> Withholding is at a flat 10-percent rate. Sec. 3402(p)(2).

<sup>7</sup> A variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number (TIN). Withholding is at a flat rate based on the fourth lowest rate of tax applicable to single taxpayers. Sec. 3406.

<sup>8</sup> Secs. 1441 and 1442.

30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

#### Nonwage payments by governmental entities

Other than as described above, tax is not currently required to be withheld from payments made by government entities. Effective for payments made after December 31, 2011,<sup>9</sup> new withholding requirements apply to certain government payments for goods and services. Specifically, government entities must withhold three percent of certain payments to persons providing property or services.<sup>10</sup> Government entities include the government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multistate agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. 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.

Payments subject to three-percent withholding 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 are subject to the withholding requirement.

Withholding is not required with respect to government 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. For example, payments under government programs providing food vouchers or medical assistance to low-income individuals are not subject to withholding under the provision. However, payments under government programs to provide health care or other services that are not based on the needs or income of the recipients are subject to withholding, including programs where eligibility is based on the age of the beneficiary.

Withholding is not required with respect to payments of wages or any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g.,

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<sup>9</sup> Sec. 3402(t), which was added by section 511 of “The Tax Increase Prevention and Reconciliation Act of 2005.” Pub. L. No. 109-222. As originally enacted, its provisions were to be effective for payments made after December 31, 2010. Section 1511 of the “American Recovery and Reinvestment Act of 2009” delayed the effective date until payments made after December 31, 2011. Pub. L. No. 111-5. The regulations, as discussed *infra*, deferred the effective date an additional year.

<sup>10</sup> Amounts withheld from any payment under section 3402(t) are creditable against the income taxes of the payee. Treas. Reg. sec. 31.3402(t)-6(a). Thus, for calendar year taxpayers, taxes due on March 15 (for corporations) and April 15 (for individuals) will be reduced by amounts withheld under section 3402. For taxpayers making estimated tax payments, tax withheld under section 3402(t) and allowed as a credit may be taken into account in determining estimated tax liability. For calendar year taxpayers, section 3402(t) withholding generally would be treated as a payment of estimated tax for the same calendar year and liability for other payments of estimated tax for that year would be reduced. Treas. Reg. sec. 31.3402(t)-6(c).

unemployment benefits) withholding applies under present law. In addition, if taxes are actually withheld from payments under the backup withholding rules, the three-percent withholding provision is not applicable.

Three-percent withholding also does not apply to the following: 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)); and payments to government employees that are not otherwise excludable from the new withholding provision with respect to the employees' services as employees.

Under final regulations issued by the Secretary of Treasury, the withholding (and accompanying reporting) requirements apply to payments by government entities to any person providing property or services made after December 31, 2012.<sup>11</sup> Under these rules, a payment is subject to withholding if it is \$10,000 or more on a payment-by-payment basis. Multiple payments by a government entity generally will not be aggregated in applying this \$10,000 limit.

### **Description of Proposal**

Under the proposal, section 3402(t) enacted under section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, is repealed.

### **Effective Date**

The proposal is effective for payments made after December 31, 2011.

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<sup>11</sup> Treas. Reg. sec. 31.3402(t)-1(d)(1). The final regulations provide an exception to the section 3402(t) withholding rules for payments made under a written binding contract (as defined) that was in effect on December 31, 2012, and was not materially modified. However, if an existing contract is materially modified (i.e., the contract is changed such that it materially affects either the payment terms of the contract or the services or property to be provided under the contract) after December 31, 2012, payments under the contract become subject to section 3402(t) withholding. Treas. Reg. sec. 31.3402(t)-1(d)(2).