American Public Power Association
Government Finance Officers Association
International City/County Management Association
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National Association of State Budget Officers
National Association of State Retirement Administrators
National Council on Teacher Retirement
National Institute of Governmental Purchasing
National League of Cities
U.S. Conference of Mayors

March 10, 2009

Mr. Douglas Shulman
Commissioner
CC:PA:LPD:PR (REG -158747-06), Room 5205
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, D.C. 20044

RE: REG-158747-06 - Proposed Regulations on Withholding Under Internal Revenue Code Section 3402(t)

Dear Mr. Shulman:

The organizations listed above appreciate the opportunity to provide comments on the proposed regulations for implementing Section 3402(t) of the Internal Revenue Code (the Code) which requires governments to withhold 3 percent from most payments for services and property. We commend the Internal Revenue Service for reaching out to state and local governments in developing this guidance. However, we believe that full repeal is the only workable solution, and therefore we will continue to vigorously advocate for the provision's repeal.

We would like to provide you with an overview of the concerns that state and local governments have with the law and the proposed regulations and offer recommendations to reconcile the needs of local and state governments with the proposed regulations and law. Our organizations are more than willing to provide additional information and examples on any subject that would be helpful to the IRS as you continue your work on these regulations. In addition, we applaud those state and local governments who have submitted comments to the IRS and discussed their specific concerns with the proposed regulations and law.

Background

As you are aware, Section 511 was added to the *Tax Increase Prevention and Reconciliation Act of 2005*, PL 109-22, during conference negotiations without input from the entities responsible

for implementing this burdensome requirement. While the recent passage of the *American Recovery and Reinvestment Act of 2009* includes a one-year delay in implementation, pushing the date from January 1, 2011 to January 1, 2012, the delay does not alleviate the numerous implementation hurdles surrounding compliance. These challenges must be addressed.

For state and local governments, the costs associated with complying with the law, in addition to the likely increase in costs for purchases and services, would be immense and bear no direct tangible benefit for these entities. While we agree with the law's goal of ensuring that taxpayers pay all of their applicable taxes, placing the burden on state and local governments to ensure compliance with federal tax law is an unfunded mandate that places undue responsibilities on state and local governments. These governments already struggle to ensure that their own taxes and revenues are being properly received, and this unfunded mandate will divert funds from services that address the needs of the citizens – including public safety and education programs. We understand that the IRS cannot change the law; however we ask that it considers the significant burdens that state and local governments will endure in order to comply with the law when finalizing the regulations.

The proposed rules provide clarification in a number of areas including which payments are subject to withholding, when the withholding is required and how government entities will pay and report the withheld amount to the IRS. We sincerely appreciate having this proposed guidance and request that final guidance is provided in an expedited manner so that governmental entities can begin to make the necessary changes to their payment systems, which, as you are aware, will take considerable time.

General Observations

In addition to being an unfunded mandate, the law is fraught with unanticipated complexities. Several states and localities have explained that their current systems are already unable to handle the increase in the volume of 1099s required for vendor reporting, let alone the new withholding requirement. Even state and local governments with robust payment and enterprise resource planning (ERP) systems have noted that the current payment component is not designed to withhold and would need to be customized to enable a state or locality to deduct, submit, reconcile and report. State and local governments do not have the additional resources, particularly during these trying economic times, to make modifications to existing systems and to hire the necessary additional support to comply with the 3 percent withholding requirement.

While we are aware that the IRS is tasked with complying with the statute, costs such as original system modification and maintenance, on-going operations and administration, impact on prompt-pay options, and contract competitiveness are alarming and must be considered. The reality is that funding for the purchase or modification of existing systems simply does not readily exist.

Government Entities Subject to 3402(t)

We request clarification regarding the definition of a governmental entity. For example, one issue arises when a county and a county hospital individually are below the $100 million threshold but together they surpass it. This would thus force each of them to comply with the law. We would ask that that regulations specifically state whether or not they are considered joint or individual entities with regard to meeting the $100 million threshold.

The proposed regulations state that a government should determine the applicability of the law to their jurisdiction based on the preceding accounting year's payments. This could impose additional administrative burdens, as some governments may fall both under and above the threshold in various years, and the need to adjust their systems to accommodate this will be costly. The IRS should work with

local governments to determine if they fall under or above the threshold, how to disengage from the law if in subsequent years they fall under the threshold, and what documentation may be necessary if they traditionally fall under the threshold, but then in a future year meet the threshold and have to comply. (For instance, if a government is under the threshold in 2011 and 2012, but in 2013 is over the threshold, does the exclusion of "existing contracts" apply to the government based on those that were intact as of January 1, 2013?).

Furthermore, a government may have a year in which there is a significant increase in spending due to a one-time occurrence, such as rebuilding after a natural disaster or another special capital project, which would cause that government to be over the $100 million threshold amount for only one year. Applying the withholding law only to that year (or the following year) – due to a specific and unique reason – would be especially burdensome and costly for the government. Accordingly, we recommend a process that would allow the Director to exempt a government that would normally be exempt but due to extraordinary events or circumstances exceeds the threshold in one year.

We also recommend that in relation to the exemption for political subdivisions and instrumentalities with total payments under $100 million, that the IRS consider allowing an averaging of multiple accounting years to ensure consistency.

Payments Subject to Withholding

We appreciate that the withholding only applies to payments greater than $10,000. However, we note that the provision will penalize governments that consolidate payments to vendors to achieve cost savings. Nonetheless, we believe that providing a transaction threshold is a very positive and welcome addition to the proposed regulations.

Further, regarding the anti-abuse rules designed to prevent the deliberate splitting of payments to avoid the 3402(t) withholding, we find that the proposed rule improperly places the full responsibility on the government entity. We believe there could be instances where a payee intentionally adjusts their billings to avoid withholding.

Payment/Credit Card Transactions

We have serious concerns with having the law apply to government credit or payment card transactions, and request that the IRS exempt payment and credit card transactions from the law. Specifically, the proposal states that the government entity is liable for the withholding and reporting associated with payments made by a credit or purchase card. A contracting bank is under no obligation to provide assistance to the government entity to withhold 3 percent from a payment at the point of sale. It would be especially problematic for a governmental entity to authorize 97 percent of the invoice to be placed on the payment card (which would have to be done through a special arrangement with the contractor), and then have to send the remaining 3 percent in another form to the federal government.

Furthermore, as full payment is required by contract on many transactions when credit cards are used, complying with the law would cause governments to revise all contracts, which no doubt would be costly, or would cause vendors to not accept credit/purchase card transactions with a government.

In effect, requiring governments to withhold 3 percent on purchases made by credit and purchase cards will force governments to prohibit the use of credit or payment cards for payment transactions over $10,000. Governments have been expanding the use of payment and credit cards to capitalize on the processing efficiencies and streamlined payment processes associated with this method. Negotiated

discounts offered for early payment and rebates offered by credit card companies would be severely diminished as a result of limited use of these cards.

Specific Item Exceptions

In general, every exception to Section 3402(t) increases the complexity and risk of failure within the governmental entity's payment system. Most systems are not able to recognize and automate certain types of exemptions during processing. Therefore, those payments would be subject to manual intervention, further complicating the already burdensome process.

Interest payments: We believe that a definition of interest would be helpful. Specifically, we request clarity on whether imputed interest for leased equipment (not real estate) is exempt. Interest is a function of financial reporting and is typically not recognized at the time payments are made. The exemption of imputed interest on leases would cause more complicated payment processes. Further, it would be helpful to know if interest includes, but is not limited to, all payments connected with a debt service.

Emergency Payments: When a disaster occurs, government entities often suspend rules and regulations concerning purchasing so that new codes and appropriation categories can be established to help track payments. Because of the rapid nature of this coding and usage, governments will have to develop a more complex procedure to ensure that emergency payments are exempted from the 3 percent withholding requirement. We request that the IRS provide more detail on how this exemption will be implemented. As this is an area mired in complexity and governments need to react with urgency to an emergency, clearly understanding the rules in play is essential. We would recommend that these rules should be suspended for any federally designated disaster area.

Exemptions for Existing Contracts: We request clarification of the rule on whether a modification, allowed by state or other governing law that does not require a new contract, is a "material modification to an existing contract" that takes the contract out of the existing contract exemption.

Further, we do not believe that exercising a renewal option to extend the period of a contract should constitute a material modification taking the contract out of the existing contract exemption. We recommend that the "material modification to an existing contract" be defined as a written binding change to an existing contract not specifically included in, contemplated by or within the scope of the existing contract or that is otherwise not allowable under applicable state or other governing law for the existing contract. In many instances, governments have the right to renew contracts based on terms considered favorable to the government (otherwise they would not exercise the right to renew). If those contracts must be renegotiated to include provisions for withholding, the governments may lose the opportunity to extend these favorable terms to the renewed contract, thus imposing significant unintended costs and lost opportunity costs to these governments. To protect against this issue the regulations should include a rule extending the law to contracts in existence within six months following the date of the final adoption of the regulations or their renewal.

Exemptions for "Needs Based" Services and Providers: One of the most challenging sections of the regulations are for "needs based" services, especially in the health care sector. Understanding how these types of payments are to be "sorted" for needs based purposes would greatly complicate an area where the sheer volume of transactions is enormous. In order for governments to correctly change and implement their payment systems to allow for exceptions is likely to add to the administration costs of complying with the law, we request that the IRS provide more detailed regulations in this area as soon as possible in order for governments to be able to comply with the law.

Application of Pass-through Entities

The proposed rules require withholding from payments to pass-through entities where 80 percent or more of the pass-through entity is owned by persons described in section 3402(t)(2)(E) (governmental entities required to withhold under section 3402(t)(1), tax exempt entities, and foreign governments). In many instances, a state or local government does not collect business designation information on owners of pass-through entities, as this is not required on the current Form W-9. Based on the proposed rules, it appears that the Form W-9 will need to be modified to include a breakdown of owner designations within any pass-through entity. The proposed rules do not speak to an intention to modify the Form W-9. If a new Form W-9 is created, it appears that the new form would need to be collected on all pass-through entities currently doing business with a state or local government, further complicating a government's tracking ability.

Effective Date and Transition Relief for Existing Contracts

While we appreciate the IRS's attempt to assist with issues related to current contracts, the solution proposed would be very difficult for state and local governments to implement. Payments under pre-existing contracts look like payments under new contracts to the accounting system. In some cases it would be a manual (and error prone) decision-making process to provide exemptions for contract payments based on the age of the contract. Even in state and local governments where contract systems are part of the state's accounting system, it will be difficult, if not impossible to determine whether a payment is being made against an existing or renewed contract during payment processing. Therefore, we suggest that the law should not apply to renewal contracts in addition to existing contracts.

Rate of Income Tax Withholding

The proposed rulemaking states that some taxpayers have requested that the Treasury Department and the IRS provide lower withholding rates for taxpayers with lower profit margins or lower marginal income tax rates. The statute provides for a uniform 3 percent rate of withholding. We believe that imposing variable rates under section 3402(t) would complicate withholding and lead to unavoidable mistakes. Therefore, we support the application of a 3 percent rate to all payments for services and property.

Liability for Section 3402(t) Withholding in the Event of Failure to Withhold

Under the proposed regulations, if a government entity fails to withhold the tax imposed by the law, the state or local government is liable for the payment of the tax to the IRS unless it can prove the payee has paid its proper income tax. Because the relationship between the local government and contractor is more complex than the employer-employee relationship, withholding monies becomes more complicated. Section 3402(t) and these regulations do not fully address how those complexities should be resolved.

Additional clarification is needed to be able to understand how to document "exempt" payments. Specifically, if a good/service is exempt from having the 3 percent withheld, is a government responsible for proving this or documenting it in some manner? Furthermore, the regulations do not provide a mechanism by which a vendor/payee may challenge the state or local government's decision to withhold. We believe that a procedure for these challenges should be established within the federal administrative process, since leaving resolution to the state or local governments 1) does nothing to resolve the underlying conflict of whether the state or local government will be held responsible for not imposing the withholding, 2) creates a piecemeal system and 3) does nothing to protect state and local governments from potential liabilities for wrongful withholding. Further discussion of this issue may be found in Appendix A.

Federal Grants

State and local governments receive federal grant funds for many different purposes. Under the law, even when receiving federal funds, state and local governments would have to withhold three percent of all payments made for goods and services needed to implement specific programs. Therefore, for governments over the $100 million threshold that must abide by the law the value of the grant will be less than grants for governments under the $100 million threshold. This will also diminish state and local governments' ability to execute grant funds in accordance with comprehensive procedures articulated in grant applications and acceptances. We request that the withholding law should not apply to goods and services associated with federal grant programs.

Good Faith Effort

We request that the IRS consider specific circumstances in determining what constitutes "good faith effort" for implementation. For example, some state and local governments may be in the process of procuring accounting and disbursement systems which are bound by legislative and statutory deadlines. While a state would be aware of the general requirements of 3402(t), there could be a delay in its ability to implement changes because of the switch to a new system.

We recommend that the IRS maintain the discretion to determine if an entity has made a good faith effort based on the specific circumstances to accommodate such instances.

Additional Comments

We find it important to note that withholding should be done at the time of disbursement. Unlike current 1099 reporting, where it is quite easy to provide a correction if an error is detected, withholding cannot be done retroactively. A state or local government regularly makes payments that are cancelled and reissued due to erroneous vendor selection, erroneous vendor addresses, erroneous payment amounts, etc. Because agencies may rely on a monthly or quarterly reconciliation process, most cancelled payments are processed within three months of the original payment being issued.

We believe there must be a procedure established which will allow a state to refund any amounts withheld in error without requiring the vendor to file a refund procedure through the IRS. A remittance schedule no more frequently than quarterly could alleviate some of these erroneous payment issues.

Request for Pilot Program and Public Hearing

Lastly, we suggest that the IRS hold a hearing to more fully understand the serious implementation issues facing state and local governments. We further recommend that a pilot project be considered to discover the intricacies and issues that will arise in implementing such a complicated provision. Only then can a true cost-benefit ratio be fully rationalized.

We sincerely appreciate the IRS's efforts at providing further clarification of Section 3402(t) of the Code and thank you for the opportunity to provide comment on issues related to implementation for state and local governments. Because of our We continue to have serious concerns, we fully intend to work with the IRS to explore all remedies available to minimize the impact should repeal of the provision not be achieved. Should you have any questions, please feel free to contact any of the organizations listed below.

Sincerely,

American Public Power Association, Amy H. Hille, 202-467-2929
Government Finance Officers Association, Susan Gaffney, 202-393-8468
International City/County Management Association, Alison Miller Richards, 202-962-3500
International Municipal Lawyers Association, Chuck Thompson, 202-466-5424
Large Public Power Council, Noreen Roche-Carter, 916-732-6509
National Association of Counties, Steve Traylor, 202-942-4254
National Association of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou, 202-624-5451
National Association of State Budget Officers, Brian Sigritz, 202-624-8439
National Association of State Retirement Administrators, Jeannine Markoe Raymond, 202-624-1417
National Council on Teacher Retirement, Leigh Snell, 703-684-5236
National Institute of Governmental Purchasing, Rick Grimm, 703-736-8900
National League of Cities, Lars Etzkorn, 202-626-3173
U.S. Conference of Mayors, Larry Jones, 202-861-6709

Appendix A: Liability Issues

Governments that are required to withhold under the Act and the proposed regulations face twp potentially conflicting areas of liability: 1) they can fail to withhold and be liable to the federal government for having done so to the extent of any taxes not paid; or 2) they can erroneously withhold from a person or entity and be subjected to various claims of liability.

The first of these areas of potential liability seems to have been addressed, albeit cavalierly, in the purpose of the Act; i.e., the federal government seems incapable of collecting taxes through its own resources so has commandeered state and local governments to help it. Whether this is the prohibited conduct of "conscript[ing] state governments as its agents" as described by Justice O'Connor in *New York v. United States*, 505 U.S. 144 (1992), may well be argued, but assuming its continued viability as now enacted, the more pressing problem for consideration rests in the accountability likely to arise in the latter issue of liability.

Should state or local government withhold monies (albeit, temporarily) from persons or entities, are they to be charged with violations of various constitutional provisions including those that protect against "takings" or "due process." Clearly, an entity that is deprived of this money will be able to claim lost interest; perhaps, lost opportunity; and in an emerging area of "takings" jurisprudence: lost profits (See: *Rose Acre Farm v. U.S. pending in the Federal Circuit).* In short, the regulations do not provide a mechanism for challenge by the taxpayer of a decision to withhold. Procedure for these challenges should be established within the federal administrative process, as resolution left to the state or local governments do nothing to resolve the underlying conflict of whether the state or local government will be held responsible for not imposing the withholding.

While states and local governments can devise mechanisms to address these issues that incorporate interpleading the funds into the federal court, doing so has the potential to unnecessarily overwhelm the federal court system. Nevertheless, absent a federally administered administrative process for resolving these disputes, the potential cost and liabilities of the program may require resort to the federal courts.

One can assume that at the rate of 3% few administrative appeals will develop, as the cost of challenging an improper withholding will likely exceed its benefit. Thus, the cost to the IRS of developing an administrative mechanism to deal with this issue should be slight. By comparison, those costs are considerably less than they will be to state and local governments faced with suits brought under Section 1983 of the Civil Rights Act for varying allegations of impropriety in the withholding and which lead upon loss to the payment of attorneys' fees. Cumulatively, these potential costs to state and local government extrapolated over a sphere of just one challenge in each of just a couple of hundred entities could be dramatic. Coming at a time, when many state and local governments are laying off employees, while the federal government continues to do business as usual seems especially indefensible. Thus, providing federal remedies within the regulations for taxpayers who dispute the decision to withhold cannot be ignored.