Statement of Associated Builders and Contractors

House Small Business Committee

Chairwoman Nydia Velazquez and Ranking Member Steve Chabot

Hearing on "The New Hidden Tax on Small Business"

March 22, 2007

The Voice of the Merit Shop

4250 North Fairfax Drive
Arlington, Virginia 22203
(703) 812-2000

Associated Builders and Contractors (ABC) appreciates the opportunity to submit the following statement for the official record. We would like to thank Chairwoman Nydia Velazquez, Ranking Member Steve Chabot and members of the Committee on Small Business for holding today's hearing on "The New Hidden Tax on Small Business," which will examine Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

ABC is a national trade association representing more than 24,000 merit shop contractors, subcontractors, materials suppliers and construction-related firms within a network of 80 chapters throughout the United States and Guam. Our diverse membership is bound by a shared commitment to the merit shop philosophy in the construction industry. This philosophy is based on the principles of full and open competition unfettered by the government, nondiscrimination based on labor affiliation, and the award of construction contracts to the lowest responsible bidder through open and competitive bidding. This process assures that taxpayers and consumers will receive the most for their construction dollar.

Today's hearing will focus on the withholdings on payments remitted by governmental entities as proposed in Section 511 of TIPRA and now included in Internal Revenue Code (IRC) 3402(t) for payments remitted after December 31, 2010. Should IRC 3402(t) be implemented, there will be a dramatic negative effect on the economic viability of the construction industry in the United States. Consider:

- These withholdings on payments will dramatically impact the cash flow of the Construction Industry and increase the cost of construction for governmental projects;
- Secondly, costly over-regulation will be the result of this new law – and these increases in the end will be borne by taxpayers; and
- Thirdly, there are alternatives to the required withholding that can be implemented in lieu of the withholding requirements under IRC 3402(t).

We now consider these three points in order.

1. **<u>Cash Flow Impact to the Construction Industry</u>**

According to statistics accumulated in the *2006 Construction Industry Annual Financial Survey* published by Construction Financial Management Association, the construction industry operates with a very low net margin. The survey reports the average construction company's operating margin is 2.2%. The 2.2% is a composite so some companies participating in the survey may generate a larger profit and others less profit.

The industry has been historically known for low net income margins and the implementation of IRC 3402(t) will negatively impact this already cash-tight industry. Construction is an industry in which businesses unfortunately fail and in many such cases it is because of inadequate capitalization. A reduction of cash flow will further stymie the economic viability of contractors performing work for the governmental entities who do not always have adequate cash flow and equity. While we certainly do not believe it is the intent of Congress to cause small businesses to go out of business that may be an unintended effect of IRC 1302(t).

Contractors utilize Surety credit to secure certain contracts, as is the case with many governmental jobs. Typically, only financially qualified contractors can secure surety bonds. Significantly, a prerequisite considered by sureties in extending surety capacity to contractors is adequate working capital. Adequate working capital reflects adequate cash flow. This provision under IRC 3402(t), if implemented, will have a negative impact on cash flow and hence, could reduce the number of contractors that can qualify for adequate surety capacity to work on jobs for governmental entities. The result would, in turn, mean less competition for governmental jobs, and therefore more cost to taxpayers. While we certainly do not believe it is the intent of Congress to reduce competition on governmental construction projects that may be an unintended effect of IRC 3402(t).

Exhibit A reflects a typical example of a contractor who has a $10 million contract and faces 10% retainage (cash hold-backs) on that job. As a result, there will be roughly 13% withheld from the cash flow of the job when the 3% federal withholdings under IRC 3402(t) is added to standard retainage. The chart in Exhibit A has been produced to reflect how payments are remitted on a typical construction contract. The net result for this sample contract is a 30% reduction of actual cash flow to the contractor. At certain points, the contractor will actually be at a deficit until the final payment is received on the job. Restated: the contractor will experience no profit but a cash loss on the job until he receives final payment on the job.

This simple example shows the dramatic impact of removing what appears to be a small percentage of the <u>gross</u> revenue on a job. The important point is that the 3% withholding required under IRC 3402(t) is based on <u>gross</u> payments, not net. It is conceivable that a contractor, not fully understanding the implications of this 3% withholding could cause himself to <u>not</u> produce any profit in cash on the job whatsoever. All of the profit could be subjected to withholdings that the contractor will not receive the benefits of until the filing of an annual tax return. This could be, in many circumstances, as much as a year later.

Consider that the knowledgeable contractor facing this mandatory 3% withholding on government contract payments would include in their bid an estimated cost of capital to fund this additional burden to their working capital (cash flow). While we certainly do not believe it is the intent of Congress to cause higher prices to governmental entities for construction services this may be an unintended effect of IRC 3402(t). Restated: this would be a further tax on taxpayers in the sense that this withholding requirement will increase the cost of construction of public facilities and services.

2. <u>Hidden Costs of Regulation</u>

There will be costs to implementing IRC 3402(t) for the jurisdictions that are required to withhold taxes. In addition to upfront information technology costs, there will be ongoing annual costs. In the aggregate, for all jurisdictions across the country as well as the federal government, this could be a significant amount of money that is impacting the entire economy and all governmental entities. As a result, these additional costs will need to come from somewhere and this will only mean additional budget constraints and potentially additional taxes at state and local levels.

Additionally, each of the jurisdictions will have to effectively communicate the requirements of IRC 3402(t) to all of their payees and services providers. This will have an impact to bidding documents, which will likely require additional legal fees for review. Further, consider the changes to "advertisements to bid" and information displayed on governmental websites. In the aggregate, although we don't have any firm estimates today, it is fair to say that this will be a significant amount of money that puts into question the true annual aggregate impact for taxpayers and the federal government.

Billing practices will also have to change. This will affect documentation that has been traditionally utilized by governmental agencies and their service providers, such as construction contractors. As indicated previously, not only will it affect bidding documents, but also consider how it will affect standard contracts that are issued by jurisdictions across the country. This will entail additional legal fees and opportunity costs for internal review.

In the construction industry, another issue might be whether IRC 3402(t) will ever actually reach the multitude of intended taxpayers. The way that the law is written in IRC 3402(t), it would appear that only the direct payment to a general contractor is the source of funds from which taxes will be withheld. There are a myriad number of subcontractors, sub-subcontractors, and suppliers involved on each governmental construction project. Will regulations enable or require general contractors to withhold corresponding amounts from subcontractors, sub-subcontractors and suppliers? If so, then there is a further extension of the IRC 3402(t) requirements and additional administrative burdens to be considered by these taxpayers as well as governmental agencies.

Another complication that will impact contractors is how they will comfortably address their estimated taxes. Depending on the timing and amount of payments received on their governmental contracts, contractors may have significant cash withholdings that they cannot utilize or "get to" until they file a tax return. If, for example, a contractor is having a less profitable tax year, they may have a significant amount of withholdings and very little, or no corresponding tax.

Consider if a contractor has a net operating loss. In addition to a refund of all taxes for the current year, the contractor is in a position of also potentially filing for a carry-back claim refund. The result could be a significant amount of withholdings that would be far better served in the hands of the contractors. This common circumstance has little to do with the so-called "tax gap" and appears more to do with the federal government implementing what amounts to a hidden tax increase to the compliant taxpayer.

Another issue is, whether a contractor will be able to secure an exemption from withholdings if they can show that they are going to have little or no tax liability for the year. What if this IRC 3402(t) withholding requirement is extended to subcontractors, sub-subcontractors and suppliers? Will these taxpayers also have the opportunity to request an exemption and certify that they have no tax liability for the year and therefore withholdings would be wholly inappropriate for their circumstances?

In any event, if withholdings do occur, how are the internal and outside accountants to facilitate any certainty of what tax withholdings will, in fact, be available for estimated tax purposes? This would require specific advanced knowledge of when and how much the final payment would be from the governmental entity by the end of the calendar or fiscal year of the contractor. If the contractor has multiple governmental entity jobs, it will be unduly burdensome to estimate how much withholdings will be available for the tax return that will be filed, either two and a half or three and a half months later after the end of the fiscal year (i.e. March or April 15th for the calendar year taxpayer).

Another issue for cash flow and estimated tax purposes is how will withholdings be handled for pass-through entities such as S Corporations and limited liability companies? Section 1402(t) indicates that the payments will be withheld from the person providing any property or services. However, the entity that is providing the property with services may not be a taxpaying entity. For a pass-through entity that has multiple pass-through beneficiaries (i.e. S Corporation shareholders or LLC members) this will add another layer of confusion and burden. Significant cash flow could be withheld and the corresponding benefit of those prepayments may be for an entity that doesn't even have a tax liability.

3. Alternatives to Withholdings

We recognize that this law was passed with good intent. The objective appears to be mitigation of the so called "tax gap". However, we believe this law has unintended effects that have not been fully considered, and as indicated above, the cost, uncertainty, and cash flow impact to the construction industry is untenable.

IRS statistics indicate that when reporting requirements such as Forms 1099 are required, compliance increases from approximately 57% to 96%.[1] IRS statistics also indicate that when reporting requirements are elevated to actual withholding requirements, which in the instant case are both withholding and reporting requirements simultaneously, the elevation in compliance is elevated from 96% to 99%.[2] As you can see from the Internal Revenue Service's statistics, taking the extra step of requiring withholdings rather than taking the simple step of moving from no reporting to requiring information reporting, there is only a three percent ***estimated*** increase in the compliance rates.

The implications of this is that if Congress were to simply implement reporting requirements on certain payments remitted by governmental entities, rather than extending withholdings to the payments remitted by governmental entities, a significant level of compliance will still be increased. While this would still entail significant, and in some cases untenable administrative and other costs, this would be a better step than removing cash flow from a cash-strapped construction industry. Most importantly, this would remove many of the cash flow concerns raised above. As indicated, the cash flow concerns of the construction industry are significant because:

a. It impacts the ability of a contractor to manage their operations work because they need adequate working capital (cash flow) to fund their operations;
b. It further impacts the ability of a contractor to secure work because they need adequate working capital (cash flow) to qualify for surety credit;
c. The contractor, like all small businesses, needs to ensure at the earliest opportunity, they actually receive the profit that they do earn on the contracts rather than waiting for an annual tax return to be filed at some date in the future.

4. Conclusion

ABC commends you for holding today's hearing to discuss the 3% withholding provision. We respectfully request that the preceding is carefully considered and should any other comments be necessary or desired, please contact us for additional information. We look forward to working with the Committee in reaching a feasible solution that is agreeable for all concerned constituencies including the construction industry.

Again, ABC thanks the Chairwoman, Ranking Member and members of the Committee for the opportunity to present the views of our membership on this important issue.

Respectfully Submitted,

Rich Shavell, CPA, CCIFP
President, Shavell & Company, P.A.
Chair, ABC National Tax Advisory Group

[1] *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

[2] *The Causes and Solutions to the Federal Tax Gap: Hearing Before the Senate Committee on the Budgett, 109th Cong. (2006) (written statement of Nina E. Olson, National Taxpayer Advocate available at: http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf.*

***Impact of Governmental Withholding Under IRC 3402(t)**
Project Cash Flow Analysis
For the Year-Ended December 31, 2011
(See Notes on Next Page)

			1	2	3	4	5	6	7	8	9
					(1-2)			(4-5)	(6*10%)	(5+7)	(6-7)
						(a), (c)	(a), (c)	(a), (c)			
Project #	% Complete	Description	Contract Amount	Total Estimated Cost	Estimated Gross Profit	Billings To Date	Contract Receivables	Contract Billings Processed	10% Retainage Withheld	Contract Receivables & Retainage	Cumulative Cash Remitted
2006-01	25%	Gov't Contract	10,000,000	9,000,000	1,000,000	2,500,000	825,000	1,675,000	167,500	992,500	1,507,500
2006-01	50%	Gov't Contract	10,000,000	9,000,000	1,000,000	5,000,000	825,000	4,175,000	417,500	1,242,500	3,757,500
2006-01	75%	Gov't Contract	10,000,000	9,000,000	1,000,000	7,500,000	825,000	6,675,000	667,500	1,492,500	6,007,500
2006-01	100%	Gov't Contract	10,000,000	9,000,000	1,000,000	10,000,000	-	10,000,000	1,000,000	1,000,000	9,000,000
2006-01	Retainage Paid	Gov't Contract	10,000,000	9,000,000	1,000,000	10,000,000	-	-	-	-	10,000,000

		10	11	12	13	14	15	16	17	18
		(9*3%)	(7+10)	(9-10)		((5+(13*10%))	(13-14)	(12-15)	(16+10)	(1-(16/17))
					(a)	(b)	(b)			
% Complete	Description	**3% Governmental Withholding**	**Total Withholding (Retainage, plus 3% Gov't W/H)**	Actual Cash Collected	Cost To Date	Accounts & Retainage Payable	Actual Cash Paid	Net Cash Flow	Net Cash Flow w/o Withholding	**% Cash flow Decrease**
					(a)					
25%	Gov't Contract	***45,225***	**212,725**	1,462,275	2,250,000	1,050,000	1,200,000	262,275	307,500	**15%**
50%	Gov't Contract	***112,725***	**530,225**	3,644,775	4,500,000	1,275,000	3,225,000	419,775	532,500	**21%**
75%	Gov't Contract	***180,225***	**847,725**	5,827,275	6,750,000	1,500,000	5,250,000	577,275	757,500	**24%**
100%	Gov't Contract	***270,000***	**1,270,000**	8,730,000	9,000,000	900,000	8,100,000	630,000	900,000	**30%**
Retainage Paid	Gov't Contract	***300,000***	**300,000**	9,700,000	9,000,000	-	9,000,000	700,000	1,000,000	**30%**

* Robin Word, CPA, President of Word CPA Group originally developed this basic example. Additional details can be found at www.wordcpa.com/3%GovernmentWithholding

***Impact of Governmental withholding Under IRC 3402(t)**
Project Cash Flow Analysis
For the Year-Ended December 31, 2011
Notes

Note that the contractor in this basic example will not receive any of his true profit until retainage is paid after Project Completion.
Payment of retainage may be as long as one year after project completion:

Total Profit	1,000,000
Total Withheld	(1,270,000)
	(270,000)

Also, in this example on this one contract, there is $300,000 of withholdings for which the contractor may not experience any cash impact until a tax return is filed for the fiscal year (or years) that is applicable.

(a) Assume Billing Schedule approximates cost schedule. (i.e. no front-end loadings, or unbalanced bid items)
(b) Assume payment A/P payment schedule approximates A/R receivable schedule
(c) Assume architect/engineers approve contractor's applications of payment as submitted by contractor.

Typical Cash Flow Activities During a Construction Project Life Cycle

Week 1	1) Contractor incurs upfront marketing, estimating and bidding expense before being awarded project. These costs can be 5% of total project costs, even if bid is not awarded.
Week 4	2) Contractor is awarded project and begins to incur mobilization and possibly personnel recruitment costs, etc.
Week 5	3) Contractor commences work, coordinating big ticket subcontractor and material costs.
Week 9	4) Contractors submits first application for payment based on progress of completion based on the project's schedule of values
Week 10	5) Architect/engineer approves/disapproves application for payment and submits to owner for payment.
Week 13	6) Owner/governmental entity remits payment based on architect's/engineers revised/approved amounts, less 3% mandatory government withholding, less retainage percent of work completed (5%-10%).
Week 13	7) General contractor makes payment to subcontractors and suppliers based on approved schedule of values completed, less retainage.
Week 13	8) Subcontractors make payments to sub-subcontractors and suppliers based on approved schedule of values completed, less retainage.

Constant Cash Outlays

Weeks 1-13	Weekly payroll and related expenses
Week 13	Monthly sales tax based on collections.

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