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MANDATORY 3% WITHHOLDING *on Government Contracts*

While we were sleeping, the IRS figured out a way to close the tax gap – the government's measure of the difference between what taxpayers should pay and what they actually remit.

However, the solution could create more problems than it solves, especially for contractors who perform public work.

According to a September 2006 study by the Treasury's Office of Tax Policy, the gross tax gap was $345 billion in tax year 2001.[1]

In response to this problem, the congressional Joint Committee on Taxation (JCT) released a series of recommendations in its September 2006 report, *Options to Improve Tax Compliance and Reform Tax Expenditures.*

Its keystone recommendation was to withhold 3% of certain payments made by government entities, including payments for construction services. The JCT estimated that, if the measure had been implemented in 2006, the withholding provision would have raised approximately $6.4 billion during fiscal years 2006-2014.[2]

There is a hardship provision that excludes political subdivisions of states with less than $100 million in annual expenditures for property or services. But, even with the hardship exclusion, *many governments will be required to hold back 3% of a contract's total payments made after December 31, 2010* and remit that amount to the IRS on behalf of the contractor.

How did this proposal become a federal mandate? While contractors focused on material price increases and price escalations, Congress passed the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA).

Section 511 of TIPRA includes the 3% withholding provision. Interestingly, §511 was not part of either the House or Senate bills, but was developed during the final reconciliation process. (See "The Tax Policy Process and the Democratic Congress" in this issue.) Read on to learn what this provision means to contractors, and how the construction industry has responded so far.

The Impact on Contractors

Cash Flow

Unless the provision is repealed, contractors who perform work on schools or other buildings owned by government entities will receive less in direct payments. Consider a payment by the General Services Administration (GSA) to a GC. The GSA would withhold 3% of the total payments and remit that amount to the IRS. The GC would take the remaining 97% to pay the job's various subs and material suppliers.

As CFMs are well aware, 3% can have a substantial impact on a contractor's success. Participants in *CFMA's 2006 Annual Financial Survey* reported an average operating margin of 2.2%.[3] The 2.2% is a composite, with some types of contractors generating a larger operating profit than others. But, the point is clear–at 3%, governments could easily withhold most, and perhaps all, of a contractor's operating profit.

Retainage of 5% and government withholding of 3% equals an 8% automatic cash deficit throughout the contract. This cash deficit might doom many government contractors.

Overwithholding is also an issue. For example, if a contract has a 15% gross profit and overhead of 10%, then the GC would net 5% of the total contract value. The tax on the net profit of 5% would equal approximately 1.75% at a 35% tax rate.

Yet, the IRS is withholding 3% of the GC's money as a prepayment of tax. If the GC has multiple government jobs and the margins are not adequate, the GC may experience a critical cash flow shortage while waiting for its tax refund.

Exhibit 1 illustrates the potentially devastating effect of this provision on cash flow. Since generating adequate cash flow is a challenging task for even the most successful contractors, a significant decrease in cash flow could increase contractor default rates.

Payment Issues

There are several other scenarios to consider. Will the 3% come entirely from the GC's gross payment or will the government also hold back payments to subs? If not, will GCs be permitted to withhold payments from subs to reduce the impact of this provision?

What if a contract lasted several years, and government payments were uneven? This would influence the timing of the contractor's tax liability or refund, and create significant cash flow swings. And, how would the contractor gauge its total estimated tax payments when the withholding amounts varied depending on these periodic payments?

Exhibit 1: The Effects of 3% Withholding on Cash Flow

In this scenario, the total contract amount is $10 million with an estimated gross profit of $1 million. The A/P schedule approximates the A/R schedule and the billing schedule approximates the cost schedule (e.g., no front-end loadings or unbalanced bid items).

% Complete	Billings To Date	Contract Receivables & Retainage	3% Government Withholding	10% Retainage on Billings & 3% Govt W/H	Cash Collected	Cost To Date	Accounts Payable	Cash Paid	Net Cash Flow	Cash Flow Decrease
25%	$2,500,000	$1,000,000	$45,000	$295,000	$1,455,000	$2,250,000	$900,000	$1,350,000	$105,000	-30%
50%	$5,000,000	$1,000,000	$120,000	$620,000	$3,880,000	$4,500,000	$900,000	$3,600,000	$280,000	-30%
75%	$7,500,000	$1,000,000	$195,000	$945,000	$6,305,000	$6,750,000	$900,000	$5,850,000	$455,000	-30%
100%	$10,000,000	$1,000,000	$270,000	$1,270,000	$8,730,000	$9,000,000	$900,000	$8,100,000	$630,000	-30%
Retainage Paid	$10,000,000	$ –	$300,000	$300,000	$9,700,000	$9,000,000	$ –	$9,000,000	$700,000	-30%

Project completion, before retainage collection (which can be as long as one year after project completion):

Total Profit	$ 1,000,000
Total Withheld	(1,270,000)
Cash Flow Deficit	$ (270,000)

For a more detailed analysis, see www.wordcpa.com/3%GovernmentWithholding

Administrative Burden

Tax reporting compliance can be a mammoth job. Even the most insignificant tax notices can require immediate action and a significant outlay of administrative time. The following are common tax areas that must be dealt with in a timely manner:

Federal Payroll Taxes

- *Payment Frequency:* weekly
- *Payment Amount:* 15.3% of gross payroll (7.65% expense to employer), plus employee income tax withholdings
- *Reporting Frequency:* Quarterly and annual summaries
- Garnishments and employee benefit plan contributions also require frequent payment and reporting.

Federal Unemployment Insurance

- *Payment Frequency:* Weekly
- *Payment Amount:* 0.8% of the first $7,000 of eligible wages
- *Reporting Frequency:* Annual

Sales Tax

- *Payment Frequency:* Monthly or lump-sum at contract award
- *Payment Amount:* 3.5-7% of gross contract amount (or 7% of purchased material cost)
- *Reporting Frequency:* Monthly
- Also, certain counties and cities charge sales tax, in addition to state sales tax.

Use Tax

- *Payment Frequency:* Monthly
- *Payment Amount:* Varies
- *Reporting Frequency:* Monthly
- Many states impose a use tax on items brought from other states.

State Income Tax

- Frequencies and amounts vary. However, most states charge an income tax similar to federal income tax.
- Contractors working in multiple states are required to pay income taxes to all states in which they work.
- An employee who works in more than one state during a pay period will have state income tax withholding requirements to each state.

State Unemployment Insurance

- *Payment Frequency:* Weekly, monthly, or quarterly
- *Payment Amount:* 2-5% of the first $7,000 of eligible wages
- *Reporting Frequency:* Quarterly
- Most states impose a state unemployment insurance premium based on gross payroll paid to each state.

All construction companies are subject to these reporting requirements; there is no *de minimis* exemption for small contractors. An additional 3% withholding requirement will only exacerbate an already significant administrative burden for accounting personnel.

Other Considerations

For the 3% withholding provision to address the tax gap in a meaningful way, the issues of cash flow, payment timing, and administrative burden must be considered. In addition, policymakers need to address several questions:

- What if a contractor has no current-year tax liability due to prior-year net operating loss carry forwards? Is there any provision, or waiver, for such companies? If so, who makes those determinations?
- How will impaired cash flow affect a contractor's bonding capacity?
- How will the Federal Acquisition Regulations (FAR) address the 3% withholding provision for cost-plus contracts? Will government contract costs increase due to the additional overhead and administrative burden?
- Will there be exemptions for compliant taxpayers, similar to the British Construction Industry Scheme, in which those with exemption certificates receive their gross pay?[4]
- What exposure to IRS imposed penalties and interest do contractors have if permitted to withhold 3% from subs or suppliers but those payments are remitted late?
- Are the government subdivisions potentially "responsible persons" for purposes of tax payments?
- Will mandatory withholding on payments from private companies be next?

Also, once the reporting infrastructure is in place, future withholding rate increases are certainly possible.

Industry Response

In response to this provision, a group of nearly 50 trade groups and associations have formed the Government Withholding Relief Coalition (GWRC), which is leading the effort to repeal the 3% withholding provision.

The GWRC argued the case of America's government contractors in a January 17, 2007 letter to U.S. Representative Peter DeFazio. The letter states, "This requirement will sap cash flows needed for day-to-day business operations and force some companies to alter their business models and pricing schemes when dealing with government customers."[5]

In addition, the GWRC has been instrumental in the development and support of H.R. 1023, a bill that calls for a complete repeal of the 3% governmental withholding provision. The GWRC has also drafted alternatives to a full repeal, including increased information reporting.

Other trade associations, such as CFMA, are monitoring this issue and disseminating information about its potential effect on the construction industry. (To learn more about CFMA's efforts, contact Lynn Mitchell, Co-Chair, Tax & Legislative Affairs Committee, at *lmitchell@cfma.org*.)

Conclusion

Cash flow can be as important to contractors as profits. Unless it is repealed, the 3% withholding provision will significantly impair the ability of many contractors to conduct business.

While this provision currently applies to contract payments made after December 31, 2010, Congress attempted to accelerate the implementation of this provision effective January 2007. This effort was unsuccessful due, in part, to lobbying by several construction industry trade associations. But, with the new congressional leadership, there could be additional attempts to accelerate this provision. BP

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Endnotes:

1. *www.treas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf*
2. *www.house.gov/jct/s-2-05.pdf*
3. *CFMA's 2006 Annual Financial Survey*, 18th Edition, page 35
4. *www.hmrc.gov.uk/pdfs/ir14-15cis.pdf*
5. *www.withholdingrelief.org*