

Chairman, ABC National Tax Advisory Group  
Shavell & Company, P.A.,



## Tax Withholding on Government Contracts - Big Brother Trying to Reach Further into Contractors' Pockets

The 2006 Tax Act signed by President

Bush this past Spring temporarily addresses the Alternative Minimum Tax (AMT), Capital Gains, Section 179 expensing and many other provisions. But one extra twist that will affect contractors in the not too distant future is a new withholdings provision.

A few years from now, the new law will require 3% (three percent) withholding on certain payments made by the federal government and every state government (including political subdivisions and instrumentalities) to

vendors and persons providing property or services. This is regardless of whether the government entity making the payment is the recipient of the property or services. There is an exception for state political subdivisions (or instrumentalities) with less than \$100 million of annual expenditures for property or services.

The provision also requires information reporting on the payments that are subject to withholding. It generally does not apply to any payments that are subject to withholding under present law, payments of interest, and certain other types of payments. The provision applies to payments made after December 31, 2010.

Consider the impact of this provision from the perspective of a construction contractor. If you are a contractor performing work on schools or other buildings owned by governmental entities, you will be receiving less in direct payments in the future. The reason for this is that retainage and any other holdbacks will be increased by an additional 3%, which will be paid to the IRS on your behalf by the governmental entity.

The issue is how the IRS will handle this. Consider a payment by General Services Administration (GSA) to a general contractor (GC). The GSA would be required to withhold 3% of the total payments and remit that amount to the IRS. The GC would take the remain-

ing 97% received and use those funds to make payments to the various subcontractors on the job. If the GSA withholds 3% from the GC they may be withholding too much of the GC's profit.

For example, the contract at issue may only have a 15% gross profit and an application of overhead at 10%. The GC would then net 5% of the total contract value. At a 35% tax rate, the tax on the profit of 5% would equate to approximately 1.75% (.05 x .35) in taxes on this sample job. Yet the IRS is holding 3% of the GC's money as a prepayment of tax. If the GC has multiple governmental jobs and margins are not adequate, the GC may be in for a big tax refund. Also, potentially, a steep cash flow shortage.

There are several other scenarios to consider. One issue is whether there will be rules requiring tax withholdings from the subcontractors by the governmental agency rather than the 3% coming entirely from the GC's gross payment. Further confusion could occur if the GC will be permitted to withhold payments from the subcontractors in an effort to alleviate the impact to the GC.

Once the reporting infrastructure is put in place for this 3% withholding requirement (and it will require significant computer changes for the governmental entities), the possibility of that 3% rate changing may further impact contractors in the future. It certainly appears that it would be very easy for Congress to accelerate tax payments by later increasing the percent of withholding.

What if the GC's contract extended over several years, yet payments were not even? The impact could cause the timing of the contractor's tax liability or refunds to result in

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significant cash flow swings. Lastly, how will the GC know what his total estimated tax payments should be when the withholding amounts are constantly in flux depending on these periodic payments?

Carin Nersesian, Director of ABC's National Government Affairs Department in Arlington, VA states, "ABC very early joined a coalition of business and industry leaders to pursue this. It is becoming one of the hottest tax issues in Washington D.C. because it

affects just about every industry including the Construction Industry."

Nersesian also indicated, "ABC participated in the coalition's initial meeting in June 2006 and we are hopeful that something will be done to head off the implementation of these new withholding rules."

Rich Shavell, CPA, CCIFP is President of Shavell & Company, P.A. CPAs and Consultants in Boca Raton and Stuart, FL. Rich has been an advocate for contractors

over the last twenty years presenting comments before the IRS on proposed regulations and testifying before the House and Senate on behalf of ABC. Currently, Rich serves as Chair of ABC's National Tax Advisory Group. Locally he serves on our Chapter's Legislative Committee and Rich is the 2005 winner of the South FL Business Journal's Excellence in Accounting Award in Construction. For more information visit [www.shavell.net](http://www.shavell.net) or call (561) 997-7242.



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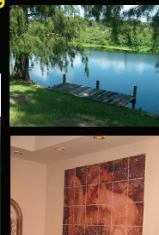
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