



Testimony of Ian Frost
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Before the House Committee on Small Business
Subcommittee on Contracting and Workforce
May 26, 2011

Chairman Mulvaney, Ranking Member Chu, and members of the committee, I appreciate the opportunity to testify today on the three percent withholding mandate, and particularly its impact on small firms that contract with federal, state, and local units of government.

My name is Ian Frost and I am the President of EEE Consulting, Inc. We are a small environmental engineering consulting firm based in Virginia. I am here today to ask for your assistance in repealing the three percent withholding rule. As you know, in 2006 Congress included a provision in the conference report for the Tax Increase Prevention and Reconciliation Act – without prior debate – that would require federal, state, and local governments that spend more than \$100 million a year on goods and services to withhold three percent from payments to engineering firms and other contractors.

I am also a member of the American Council of Engineering Companies (ACEC), the voice of America's engineering industry. ACEC members – numbering more than 5,100 firms representing hundreds of thousands of engineers and other specialists throughout the country – are engaged in a wide range of engineering works that propel the nation's economy, and enhance and safeguard America's quality of life. Over 70 percent of ACEC's members are small firms. Most have governmental clients and would be negatively affected by the three percent withholding mandate.

EEE Consulting has been in business since 1998, and during the last 12.5 years has grown to a 36-person firm based in three offices with revenue of about \$4.3 million in 2010. We are certified as a small business by the State of Virginia and meet the federal definition of a small business based on our annual revenue. About 95 percent of our work is for local, state, and federal agencies. Approximately 40 percent of our revenue comes from federal clients, primarily the Department of Energy, the Federal Highway Administration, and the Department of Defense.

During one of the most difficult economic periods since the Great Depression, we have experienced steady growth. Since the fall of 2009, we have added 13 new employees, five of whom were unemployed prior to joining our firm. Our revenue increased by about 40 percent over that period of time. We also signed an agreement to build a new office in July 2009, just before the recession struck. Despite a lot of trepidation over the economic forecasts, we stayed the course on the new building construction, secured a mortgage, and moved in during the spring of 2010.

Our success could not have occurred without a healthy cash flow because securing loans and managing cash flow for a small business is challenging at best. We have relied upon the personal finances of our owners and the company's cash reserves to buy new equipment, to pay the salaries of new employees until we get paid by our clients (which often takes many months), and to pay for the expansion of the company, including our new building. To a small business, cash flow is everything, especially during times of economic uncertainty. I am immensely proud of our past record, yet concerned about the future because the pending three percent withholding rule would negatively affect our operations.

If enacted, the rule would mean the withholding of approximately \$130,000 of revenue, using our projected 2011 revenue. This three percent withholding would essentially be a loan to the government for the year until our taxes are filed. Worse still, it might require our company to secure a loan to help us cover operating expenses at a time when cash in the bank is limited. The withholding could limit our ability to make payroll each month and limit our use of our profits to give bonuses to our employees, expand our business, and hire new employees. A \$130,000 withholding each year would deplete our cash reserves by about 30 percent. On some of our larger design build jobs for new infrastructure such as roads, we are a second or third tier consultant and it is often six to twelve months before we get paid. The three percent withholding mandate would exacerbate the

cash flow problem, especially in an industry that is transitioning to more design build contracts.

Our situation is not unique, as our trade association – ACEC – has raised serious concerns over how this mandate will impact engineering firms, including thousands of small firms like mine that work for government clients. It is important to emphasize that the withholding mandate will apply to the total cost of the contract, not to the net revenue generated or the size of the company. Many engineering companies realize a profit margin of less than three percent on a contract, and withholding three percent up front for tax purposes will force them to divert funds needed to complete the contract, creating cash flow problems such as those I outlined above.

Implementation of this mandate may also decrease business opportunities for small firms. The final regulations issued by the IRS state that the three percent withholding will apply to prime contracts but not to subcontracts. Prime contractors may be able to share the burden of the withholding under certain circumstances, but many states have “prompt pay” laws that require prime contractors to pay their subcontractors as soon as the work is completed. Bearing the full burden of the withholding may lead some prime contractors to do more work in-house, which will reduce opportunities for small firms that work as subcontractors.

Three percent withholding will also burden small firms with additional administrative and record-keeping costs. Firms will have to modify IT systems in order to keep track of the withholding from various contracts and ensure that it matches with their tax returns and tax refunds. Most small firms do not have the additional personnel required to devote to this task, and will have to divert personnel from other core responsibilities in order to be in compliance.

I am sure we agree that all taxpayers should pay the taxes they legally owe, as my firm does. I frequently hear in the news that small businesses are the economic engine for the country and are likely to be the main source of hiring that is needed to reduce our unemployment rate. Why then, would the federal government want to handcuff that economic engine by withholding a percentage of the contracts we have secured? I know that the withholding rule is intended help with tax collections, but it seems irrational to punish all firms that are involved in government contracting due to the actions of just a few.

The only solution to this problem is to repeal the three percent withholding mandate and replace it with measures that target firms and individuals that are not in compliance with the tax laws. I have attached to my testimony a list, compiled by the Government Withholding Relief Coalition, of tax compliance measures that have been enacted since the three percent withholding provision was passed in 2006. For example, in 2008 the Federal Acquisition Regulation was amended to require potential federal contractors to certify that they are in compliance with their federal tax obligations. This provision explicitly makes non-compliance with the tax code grounds for suspension and debarment. Measures such as these focus on the problem, instead of impacting firms that pay their taxes.

As an owner of a small business, I ask you to help give us relief from the burdensome and unfair withholding rule. Please find alternatives that ensure the government receives its share of our revenue through taxation but does so in a manner that does not endanger the ability of honest taxpayers to manage our cash flow, expand, add new jobs, and meet our payroll. Thank you for the opportunity to participate in today's hearing, and I would be happy to respond to any questions from committee members.