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Defer No More: The Need to Repeal the 3% Withholding Provision

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The Quality Construction Alliance represents five specialty construction associations. These groups are: the International Council of Employers of Bricklayers and Allied Craftworkers (ICE), the Mechanical Contractors Association of America (MCAA), the Finishing Contractors Association (FCA), the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA), and The Association of Union Constructors (TAUC). According to Bureau of Labor Statistics figures, specialty construction employers represent more than 64% of overall employment in the construction industry.

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Introduction

Good morning Chairman Mulvaney and members of the House Small Business Committee's Subcommittee on Contracting and Workforce. Thank you, Chairman Mulvaney, for holding this important hearing today, and for inviting me and my association to participate.

My name is Jim Gaffney, and I am a principal owner of a small business mechanical construction firm, Goshen Mechanical Contractors, located in Malvern, Pennsylvania. My firm operates in the public-sector construction market throughout the greater Philadelphia area, in the Delaware Valley, and throughout Southeastern Pennsylvania. Our firm performs many public sector construction projects, such as public school new construction and retrofits and other municipal facilities. We operate both as prime contractor and subcontractor with a variety of public sector entities that will be covered by the 3 % withholding tax unfunded mandate if it is not repealed before it takes effect on January 1, 2013.

I am here today representing the Mechanical Contractors Association of America (MCAA). MCAA is a nationwide specialty construction employer trade association based in Rockville, Maryland. MCAA's member companies perform all types of mechanical, plumbing, heating and ventilating new construction and maintenance and service work for public and private project owners nationwide. The vast majority of MCAA member companies are small businesses, and many of them perform projects of the type that will be covered by the 3% withholding unfunded mandate.

I am also President of the Mechanical Contractors Association of Eastern Pennsylvania, based in the Philadelphia area. The majority of its 100 members are small business contractors. Many of these firms also perform projects with government entities that will be covered by the 3% withholding mandate.

I am also privileged today to represent four sister specialty associations allied in an ongoing legislative initiative known as the Quality Construction Alliance (QCA). These groups are: the International Council of Employers of Bricklayers and Allied Craftworkers (ICE), the National Finishing Contractors Association (FCA), the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA), and The Association of Union Constructors (TAUC). According to Bureau of Labor Statistics figures, specialty construction employers represent more than 64% of overall employment in the construction industry. The majority of QCA association member companies are also small businesses, and perform a great deal of public works projects with governmental entities that will be covered by the 3% withholding mandate if it should go into effect in 2013.

I should add that many of the QCA groups also actively participate in the wider Government Withholding Relief Coalition (GWRC), which adamantly espouses rapid repeal of the 3% withholding provisions in Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005. QCA fully supports that coalition's written remarks filed for the record for this hearing.

Action Requested

Our request is simple: we would ask the subcommittee members to take the lead in vigorously pursuing the rapid repeal of the 3% withholding unfunded mandate as laid out in H.R. 674, and to take the lead in finding a legislative vehicle in this Session of Congress to finally dispatch this ill-conceived bit of public contract administration that had been added hastily in conference committee simply to score a widely overstated amount of revenue gain as a pay-for back in the 2005 Tax Reconciliation Act.

Congressmen Herger and Blumenauer and 116 co-sponsors are to be commended for their persistence in pressing for repeal again this Session. Eventually sound public policy must recognize that a well-intentioned mistake was made in Section 511 back in 2006, and that responsible policy making should own up to that reality and avoid compounding the problem by failing to take timely and effective remedial action.

The QCA couldn't agree more with the title of today's hearing – Defer No More. We are hopeful that will continue to be your motto on this important public policy issue. Once this onerous provision has been successfully repealed, you can proudly say that mistakes were confronted, adverse small business effects were avoided, further harm and fiscal waste was averted, precious public agency procurement and program dollars were saved in this time of fiscal austerity, burgeoning compliance costs were avoided, and better ways to encourage tax compliance by public contractors were instituted and encouraged. The repeal of the 3% withholding tax will be a great legacy for this subcommittee.

Background

Section 511 of The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) requires all government entities—Federal, state and local—to deduct and withhold from all payments made to any individual or business providing any goods or services an amount equal to 3% of the total payment. Implementation has been delayed until 2013, when government entities will be required to remit the 3% of payments to the federal government for federal income tax purposes. Government entities with less than $100 million in annual expenditures for goods and services are exempted.

The goal of the 3% withholding provision is to stem tax avoidance by firms performing public contracts. In 2009 it was estimated that the 3% withholding tax will raise $11 billion dollars over 10 years. According to the Internal Revenue Service (IRS), the federal government receives approximately $345 billion less in tax revenues annually than it should receive.

Recently the IRS published its final regulations (76 *FR* 26583, 5/9/2011) implementing the 3% withholding, anticipating an attenuated preparation process in gearing up for implementation in 2013 – unless Congress remedies the problem before then. The regulations make the best of a bad situation – they raise the withholding threshold to invoices of $10,000 or more, defer application for credit card payments, and, importantly for QCA, clarify application of the law to construction prime contract and subcontract payment administration by example in the regulation.

Still, the IRS regulations highlight more regulatory, compliance issues and the questions and complications soon to come. For example, how and when will the Federal Acquisition Regulations (FAR) be amended in FAR payment contract clauses to enact and ensure the IRS's strictures against flow-down of payment withholding from prime contractors to subcontractors? Moreover, will the Office of Management and Budget (OMB) revamp its common rules for Federal grant administration to make sure that Federal grantees also respect the IRS restrictions against payment withholding flow-down from prime contractors to subcontractors? Furthermore, how will these restrictions be implemented by the many state and local government covered entities that have far less sophisticated contracting procedures as compared to FAR and OMB regulations? Simply put, Section 511 is a prime example of regulatory excess.

Important Issues for the Construction Industry

I suspect that all of the distinguished Committee Members recognize that construction projects of any scope are very complex and risky business propositions. Profit margins historically are thin, even as risks are high. When we are in a recession, as is currently the case, public works projects become all the more important, and competitive conditions can be quite tough – and margins even thinner.

The industry, even at a high level of complexity, is relatively easy to enter, which makes it an ideal market for small businesses. However, the 3% withholding could be larger than the entire profit margin on some jobs and would impede cash flow and viability for small companies doing government work.

In the construction industry, there are a great many competitors, and price competition is keen, even on best-value selections. Additionally, low bidding or reverse auctions can further increase the risk of poor contractor selection decisions.

It really does matter how well firms are paid and how fairly construction contracts are administered. Time and again it has been proven that the best projects are the ones that are the most competently administered. Small and disadvantaged business firms can't carry the costs of public contract misadministration the way larger firms can. The law would apply to the total contract and not the total revenue; therefore some prime contractors, even larger primes, could have a cash flow issue, further complicating payment to the small business subcontractor already operating on a very thin margin.

The taxpayer interest in successful project completion is seriously jeopardized by the 3% withholding. Payment processing complexity can impair performance and cause disputes, claims, delays-- even contractor defaults. The agency procurement program then suffers, the agency mission and project is impeded, and ultimately taxpayers get less value for their dollars. All of this is being done to ensnare those firms that avoid taxes and perform public contracts – even though much more effective and efficient methods are available and in use to achieve the same goal without these overbearing risks.

The 3% withholding is manifestly unfair to construction prime contractors and subcontractors, and to our businesses as consumers of government agency services and taxpayers.

For example, as prime contractor, under the current IRS regulations, the paying agency will hold 3% of a monthly invoice of $48,000 – $1,440 – even though $18,000 of that invoice is payable to two subcontractors in amounts of $16,000 and $2,000, all of which the IRS regulations say must be paid in full to the subcontractors without further flow-down of the withholding. In all fairness to the prime contractor, the amount of the withholding base should be only the $30,000 ($900) that is payable directly to the prime contractor for its work – and against its eventual tax liability for that amount.

That's a matter of simple equity for the prime contractor, and a matter of expedient protection for the subcontractor – because without very effective, explicit, and stringent subcontract payment clause protections, in many cases that prime contract withholding will be passed down to the subcontractors, despite the IRS regulations. As the payment stream becomes more complex and burdened with regulation, the risks of adverse consequences to the project recited above become ever greater.

Fair and Prompt Payment and Fair Contract Administration is Essential to Project Success

If anything, we should enact even broader and quicker payment terms for both direct Federal contracts and Federally assisted contracts as a way to improve project performance and enhance small and

disadvantaged business development at the same time. Recognizing that prompt and fair payment terms are the best way to administer public contracts and avoid all the extra costs and delays that result from less efficient contract administration practices, the U.S. Congress has passed two Prompt Payment laws.

I should also point out that payment on public construction contracts is even more problematic because of the outdated and unfair practice of withholding retainage of up to 10% on each monthly invoice. Retainage is a fairly typical practice in public construction contracts generally. While there is some discretion in direct Federal construction projects under the FAR with respect to retainage, in most public works projects across the country 10% retainage on monthly invoices is common.

Yes, in construction, the service providers help finance the government project – by having each monthly invoice discounted 10% even with satisfactory performance. With a second-tier or lower-tier subcontractor (often a small business) the delays of invoice processing and payment for only 90% of what you put out the previous month can be crushing. When the job is 50% complete, the contractor's contribution to project financing may be cut to just 5% of the monthly invoice, yet still there are the myriad risks of invoice processing and held payments by the prime contractor. Now on top of all that, the 2005 Tax Increase Prevention and Reconciliation Act would add in an additional 3% withholding – again, even when performance is entirely up to par.

With the added specter of another 3% withholding on monthly invoices, the question is, who pays for the cost of this delayed payment? Financing isn't free.

The answer is simple: the taxpayers will pay, in increased bids/price proposals with financing charges added to all contracts, and/or diminished competition. Small and disadvantaged businesses may be shut out further, since only larger and more well-capitalized firms will be able to absorb the added financing costs. Competition for work will be diminished, and costs will increase. Project administration costs will also increase thanks to the complex payment administration and regulation, and those resources will be taken from the procurement program and agency mission to collect IRS taxes. Again, all of this waste and overhead is meant to ensnare tax avoiders, even while more efficient methods are readily available.

Better Remedies to Stem Tax Avoidance by Public Agency Goods and Services Providers Are Already Available

The worst part of the 3% withholding provision is that it is completely unnecessary to penalize tax-compliant law-abiding businesses to ensnare or deter tax-avoiding, non-compliant businesses. QCA is as adamantly opposed to companies receiving public contracts when they don't pay their taxes as any other responsible contracting organization. We are competitors for the work, and taxpayers too. We support H.R. 829, just approved by the Oversight and Government Reform Committee. This bill would bar individuals and companies from receiving federal contracts or grants if they have seriously delinquent tax debt.

However, the government already has all the information it needs to address this problem without putting the burden on tax-compliant small businesses and driving some small businesses out of the market.

When I registered in Central Contractor Registration (CCR), like every other federal contractor, the government validated my taxpayer identification number with the IRS. This means that the government had all the information it needed for debt collection, and it could check at that time to see if I had any outstanding tax liabilities. When I renew my CCR registry each year, the government can again determine whether or not I have outstanding tax liabilities. I also must supply representations and certifications whenever I submit a proposal, including a statement verifying that I haven't been convicted of tax evasion.

Most importantly, since Section 511 was enacted in 2006, the Federal government instituted a Federal contractor legal compliance database - Federal Awardee Performance and Integrity Information System (FAPIIS) - which contracting officers must consult in their evaluation of prospective contractors in their contractor responsibility determinations. Moreover, in 2008 the Federal Acquisition Regulations were amended to require that prospective contract awardees present tax compliance certifications in the responsibility determinations process for all contracts above the simplified acquisition threshold of $100,000. At the Federal level, at least, these measures are effective deterrents to tax avoiders gaining public contracts in the first place, as the risks of Federal False Claims Act punishment are a powerful disincentive to falsified claims and certifications. These types of efficient and effective safeguards,

without penalizing tax compliant firms, could be required of Federal grantees through OMB's common rules for contracting by grantees. Covered state and local contracting entities could follow the same procedures and lead by example.

Finally, CCR shares information with agency payment systems. If someone does get a contract and owes tax liability, the government should be able to withhold the funds at that time. Some agencies already do so. The important thing to remember here is that the government can do all of these things without costing law-abiding small businesses a single penny.

Put plainly, fiscal enforcement policy and sound procurement policies should not be mixed. To be sure, small and disadvantaged businesses, as well as all other responsible firms, shouldn't have to compete against firms that have the unfair competitive advantage of undetected tax avoidance. Burdening tax compliant firms with added withholding to encourage tax payments by those otherwise inclined to cheat is truly robbing Peter to pay Paul. The GWRC estimates that compliance costs dwarf IRS revenue gains by a factor of nearly 10. For the $75 billion spent in administrative collection and contract financing costs, the IRS realizes a tax gain of just $11 billion.

Our Quality Construction Alliance is squarely in favor of closing the tax gap. The taxpayers, public agencies and our industry benefit by fair and robust competition among quality firms that are responsible in all aspects of their business. If stopping tax avoidance by public agency goods and service providers is the target, then there are more specific tools available to achieve that goal. The

contract eligibility process should be tightened up so that successful bidders or offerors are not awarded contracts unless they demonstrate, prove and certify tax compliance. In this way, any competitive advantage of tax cheaters is eliminated, the agency gets quality work by qualified firms, and the added financing and administrative cost of overbroad withholding is avoided.

Conclusion

Please support and pass H.R. 674 as rapidly as possible.

Respectfully submitted:

James P. Gaffney

For the Quality Construction Alliance:

International Council of Employers of Bricklayers and Allied Craftworkers (ICE)

Mechanical Contractors Association of America (MCAA)

National Finishing Contractors Association (FCA)

Sheet Metal and Air Conditioning Contractors' National Association (SMACNA)

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