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WRITTEN STATEMENT OF

**MR. BRIAN GEORGE
DEPUTY DIRECTOR, OFFICE OF COST, PRICING AND FINANCE
DEFENSE PROCUREMENT AND ACQUISITION POLICY**

BEFORE

**SUBCOMMITTEE ON CONTRACTING AND WORKFORCE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES**

ON

**IMPACT OF COMPLIANCE AT
THE DEPARTMENT OF DEFENSE WITH
SECTION 511 OF THE TAX INCREASE AND RECONCILIATION ACT OF 2005**

MAY 26, 2011

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Chairman Mulvaney, Congresswoman Chu and distinguished members of the Subcommittee on Contracting and Workforce, I welcome the opportunity to appear before you to discuss questions regarding the Department of Defense's (DoD's) report to Congress. Our 2008 report addressed the impacts of compliance with Section 511 of the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005. Section 511 generally requires the Government to withhold and remit to the Internal Revenue Service (IRS) three percent of payments made to its contractors.

My name is Brian George and I serve as the Deputy Director, in the Office of Contract Cost, Pricing, and Finance. My Office's mission is to help ensure that the taxpayer and Warfighter obtain contracted goods and services at fair and reasonable prices. We are the focal point for the Department's pricing and finance policies on our contracts with industry.

I report to the Director of Defense Procurement and Acquisition Policy (DPAP), Mr. Shay Assad. DPAP is responsible for all acquisition and procurement policy matters in DoD. The DPAP office also serves as the principal advisor to the Under Secretary of Defense for Acquisition, Technology and Logistics (AT&L), Dr. Ashton Carter, on procurement strategies for the acquisition of all major weapon systems and services.

With me today is Mr. David McDermott, the Director for Standards and Compliance at the Defense Finance and Accounting Service, an organization reporting directly to the Under Secretary of Defense (Comptroller). He is responsible for developing finance and accounting goals and standards and analyzing operational results

for the Department. He also is responsible for overseeing the Comptroller's implementation of Section 511 and will be answering any questions related to how the Comptroller is implementing this rule.

Department of Defense's Report – Background

Our March 2008 report was submitted in response to the House of Representatives' Report of the Committee on Armed Services that accompanied the National Defense Authorization Act for Fiscal Year 2008 (H.R. 110-146). The Committee's report requested the Department to assess the impacts of compliance with Section 511 of TIPRA (Public Law 109-222). Section 511 generally requires federal, state, and local governments to withhold and remit to the IRS three percent of payments made to contractors or other entities for goods and services. The law was to be effective January 1, 2012 though the final IRS implementing regulation delays the start of withholding until January 1, 2013.

The Department's March 2008 report was prepared by my organization with significant inputs from an industry association and from staff in the Under Secretary for Defense, Comptroller's office. It addressed the cost of modifications to our financial accounting systems, additional personnel costs, and anticipated financial impacts for defense contractors.

At the time the 2008 report was submitted to Congress, the IRS was developing implementing regulations to establish the process for the Section 511 withholds. Accordingly, our report was based on a number of assumptions regarding how the IRS

would implement Section 511 and included a caveat that the estimated impact would be more accurately known when the IRS published its final implementing regulations.

About eight months after we issued our report, the IRS published its December 2008 proposed regulation for the three percent withholding under section 3402(t) of the Internal Revenue Code. And early this month, on May 9, 2011, the IRS published its final regulation in the Federal Register. Since some provisions in the final IRS regulation differ from a few key assumptions we used to estimate the impact of the three percent withhold, I will address the changes that would have to be made as I next discuss the details of our 2008 estimate.

Report - Cost Impact, Key Assumptions and Concerns:

As detailed in our 2008 report, we estimated that the cost would be significant for the Department and its contractors to comply with Section 511. Specifically, to comply with TIPRA, we estimated \$17.6 billion for implementation and management for the first five years¹, comprised roughly as follows:

- \$4.2 billion related to the cost to DoD to implement withholding related to the (loss of use of the) commercial purchase card;
- \$50 million for DoD implementation and recurring costs other than the purchase card impact;
- \$6.3 billion related to contractor implementation costs; and finally,

¹ The report included the (nonrecurring) cost to implement Section 511 (years 2009 to 2011), which totaled \$6.3 billion. It also included the annual recurring cost to manage it for the first five years (2011 to 2015) which totaled \$11.3 billion (assuming an effective implementation date of January 2011).

- \$7.1 billion for contractor recurring costs.

The Department still expects the impact to comply with TIPRA to be in the billions of dollars, albeit lower than the \$17 billion we originally estimated. It will be lower since a few of our key assumptions in 2008 differ from the IRS final regulations published in 2011. Following are some of the assumptions we made to develop our 2008 estimate:

First, we assumed the IRS would establish a process for the Section 511 withholds similar to the process the IRS established for backup withholding (under 26 U.S.C. 3406(b)). Consistent with our assumption, the final regulation requires the Department to withhold three percent of the affected payments, remit the withheld money to the IRS, and report the amount of payments and associated withholds to both the IRS and the payees. Additionally, payees are required to recover excess withholds through the normal federal income tax process, not DoD.

Second, we assumed the IRS would not allow payees to offset the amounts withheld under Section 511 immediately against estimated quarterly income or payroll tax obligations, which is consistent with the final IRS regulation.² The Department's 2008 report expressed our concern that companies properly paying their tax obligations will experience cash shortages equal to the amounts withheld until the amounts are recovered through the normal federal income tax process. That concern remains unchanged, particularly for small businesses.

² The final IRS regulation does not permit a credit against estimated income taxes for the specific quarter in which the amount is withheld, but allows for such a credit in the taxable year for which the taxpayer would receive credit for the withholding.

Third, we assumed the IRS would not apply the withholding requirements to prime contractors' payments to their subcontractors, which is also consistent with the final rule.

Fourth, we incorrectly assumed that the IRS would not exclude third party payments, such as the commercial purchase card, from the three percent withhold. Our 2008 report stated that, if third party payments were not excluded, DoD would lose its ability to use the commercial purchase card and other third party payment mechanisms. Thus would occur because the Department would not be able to execute the Section 511 withholds against those payments. Almost \$8 billion of our 2008 estimate related to this impact; \$4.2 billion for DoD and about \$3.6 billion for our contractors.

Although the final regulation excludes purchase card payments from the withholding requirements and related reporting requirements, the IRS indicated in its final rule that it may require withholding on payment card transactions (including payments by credit, debit, and other payment cards) in the future. If the IRS elects to impose the withholding and reporting requirements on purchase card payments at a later date, the Department will incur significant additional costs as stated in our 2008 report.

Fifth and finally, the final regulation states that withholding will not apply to any payment less than \$10,000 (although this limit is subject to an "abuse" rule). By contrast, our 2008 report assumed the three percent withhold would apply to *all* payments, regardless of amount. Although we have not revised our 2008 cost estimate to reflect this change, the \$10,000 threshold will help reduce the impact, especially on the small business

community.

The Department continues to be concerned that the three percent withhold will limit the number of companies willing to enter into the government market, thereby reducing competition and access to new technologies. In addition, we believe that the final IRS rule will be difficult to implement and administer, especially since Agencies are liable for any amount they fail to withhold.³

Conclusion

Although the cost for the Department and our contractors to implement TIPRA will likely be less than originally estimated in 2008, we still expect the impact to be in the billions of dollars. I am particularly concerned that it will restrict the available cash of tax-compliant companies, especially for small businesses, which would otherwise be used to develop new technologies and provide working capital. I appreciate the work the Subcommittee is doing to assess the impact of TIPRA and thank you for the opportunity today, to discuss the Department's 2008 report.

³ However, the liability will be abated if the Agency can demonstrate that the contractor has included the amount of the payment in income and paid the appropriate taxes, typically through a signed statement of the contractor.