

Statement of

Mr. Mike Murphy of Turner Murphy Company, Inc.

on behalf of

The Associated General Contractors of America

to the

Subcommittee on Contracting and Workforce

Committee on Small Business

U.S. House of Representatives

For a hearing on

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

May 26, 2011

AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

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The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7,000 of America's leading general contractors, and over 12,000 specialty-contracting firms. Over 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation/utilities installation for housing development, and more.

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Statement of Mr. Mike Murphy
Turner Murphy Company, Inc., Rock Hill, South Carolina
Subcommittee on Contracting and Workforce
Committee on Small Business
United States House of Representatives
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Thank you Chairman Mulvaney and Ranking Member Chu for this opportunity to testify on the three percent withholding law. I am testifying on behalf of the Associated General Contractors of America (AGC), a national trade association representing more than 32,000 companies, including 7,000 of America's leading general contractors and 11,000 specialty contractors. AGC is the voice of the construction industry.

My name is Mike Murphy, President of Turner Murphy Company Inc, and a member of the Carolinas AGC, an AGC chapter covering North and South Carolina. My dad, Turner, started our company in 1950, with assets of \$127.42. We are a third generation construction company based in Rock Hill, SC. Today, Turner Murphy Construction works primarily on wastewater construction. We have successfully completed over 125 major treatment plants and upgrades. We self perform an average of 80% of all work in place. Our project range is from \$100,000 to \$25,000,000. We employ seven full time employees in the office, and 20-40 in the field, depending on how much work we have.

However, I believe Congress is making it tougher and tougher for my company to stay in business by not repealing a requirement that will make federal, state, and local governments withhold 3% from each and every payment to contractors for goods and services. This withholding applies to the total contract, not to the taxable net revenue generated from a project. This provision has nothing to do with my company's tax liability, it is just an accounting gimmick that whitewashes over the real cost of government while leaving small companies like mine holding the bag.

This 3% withholding is more than the profit margin on most public construction contracts for companies like mine. The 2010 Construction Industry Annual Financial Survey, conducted by the Construction Financial Management Association, included responses from 623 companies. Earnings after taxes in the most recent fiscal year averaged 3.2%, up from 3.0% in 2009. For smaller construction firms, \$25 million and under, the margin is closer to 1.6%. So the 3% withholding is almost 200% of the total profit for small companies.

So if my company is lucky enough to win a public contract to build a wastewater facility and my total bid price is \$1,000,000 here is simplified example of how the money would break down if I applied this 1.6% average profit. I would spend \$984,000 for materials, labor, and subcontractors. My company's profit would be \$16,000 on the project. If my company paid a 35% federal tax rate, my company's tax liability would be \$5,600. The 3% withholding law would force the government to withhold \$30,000 from payments to my company for the work performed. That is more than 5 times the tax

liability my company could owe on the project. It is also almost two times my total profit on the project. Can you imagine how you would feel if you got your pay stub and instead of a withholding that closely matched your tax owed they withheld five times your tax liability or they figured out a way to withhold two times what you actually made. This withholding provision is an interest free loan of \$24,400 from my company to the federal government. Imagine what that would do to your ability to pay your bills, take out loans or take care of long term commitments. It has the same impact on my company.

Local, State, and Federal governments already hold 5-10% retainage on our payments until project completion. Another 3% is unduly burdensome. Retainage is different than this withholding requirement in that it is directly related to the performance of the contract: meeting certain milestones, paying subcontractors and suppliers and finishing with high quality. In short, making sure the government gets a good product in the end. According to Businessdictionary.com, Retainage is the "Portion of a contract's final payment withheld by a principal (client or owner) until the project is complete in all respects, functioning satisfactorily according to the contract terms, and all mechanic's liens have either been released or have expired." It is tied directly to the project and released when the project is completed. The 3% withholding is not tied to the project nor based on any project performance criteria. It is not released when the project is completed, it is held for as much as a year. It is just an interest-free loan to the federal government.

The law will reduce my company's cash flow and reduce my company's ability to compete for business. When the public owner I'm working for withholds three percent from each and every payment, it causes my company to finance more of the work on the project without being paid for it. Under the regulations this money can be refunded when I file my annual tax return. That means I could be out this money for a year or more. This ripples down to my suppliers, subcontractors and service providers. Some suppliers ask for payment up front, which means I am paying for things before being reimbursed by the government. The additional 3% withholding will make this process even worse, which could possibly hamper the ability of some general contractors to pay their subcontractors in a timely manner. Subcontractors, often also small businesses, also have a tight cash flow and need to be paid on time; this could hurt many companies and make it difficult for them to stay in business.

This reduced cash flow would also restrict bonding capacity which is the key to my company being able to bid on projects. Federal law requires that construction contractors carry several types of bonds. Surety companies, who provide the bonds, study my books in detail before offering coverage. Based on past performance on contracts, the suitability of my company to perform the work for which I bid, my assets and my cash flow, a surety gives Turner Murphy Company a bond rating which governs the price of the bonds, and how much bonded coverage I can receive.

For example, a surety might offer coverage for \$10 million worth of work, at a cost of 1%. If a surety thought I was a risk because my cash flow had been restricted by this new 3% withholding, it may only cover \$5 million for 3%. That coverage governs the

size of contracts I can bid on, as the maximum amount I can have under contract at any one time would be either \$10 million, or \$5 million. My ability to get bonding, which again depends on a number of factors including my cash flow, directly impacts how much work my company can take on. This withholding law will reduce cash flow, leading to higher costs for bonds and borrowing for public contractors. It could also lead to the denial of coverage. The 3% withholding law imposes all of these negative constraints on businesses working for the public entities. It can't help but drive contractors out of public construction and drive up the cost of construction for the taxpayers.

And the implementation of this law couldn't come at a worse time for my company and my industry. The construction industry (residential plus nonresidential) went into recession a year and a half before the overall economy and still has not emerged from it. The total value of construction put in place was \$1.2 trillion in 2006. That number shrunk to about \$800 billion in 2010. That loss of \$400 billion in projects has led to loss of many good jobs and many good companies. The industry has lost 2.25 million jobs, nearly a third of its workers, from its employment peak in April 2006. The industry's unemployment rate in April 2011 was 17.8%, not seasonally adjusted, the highest of any industry and more than double the all-industry rate.

The tough economic conditions have made competition on public jobs fierce and profit margins tight. We are seeing more and more bidders on a dwindling number of projects. This causes many companies to shave more and more out of profit margins in hope of actually getting the job. A recent survey of AGC contractors found that in 2011, 29% of them planned to adjust their bids so that profits were smaller. And 3% planned to adjust bids so that they would be for a loss. Even when your company is losing money on a project, the 3% withholding law requires the withholding of 3% of every payment to a contractor.

This tough competition also means that any argument that contractors could cope with this law by simply increasing their bid prices is ludicrous. In this kind of market there is always someone willing to do the job. Someone will suffer through the situation instead just to keep money coming in the door, just to keep making payments on equipment and just to keep good people earning a paycheck. Recent history proves this. Right after September 11th, insurance costs skyrocketed, contractors didn't increase costs overall, because there was always someone who wouldn't raise their prices, in hopes of out-bidding the competition.

A tough economy magnifies the impact of preparation costs we are now having to factor into bids. Construction companies, as well as federal, state and local governments are expending funds preparing for implementation now. The Tax Withholding Relief Coalition estimates that the total costs to federal, state, and local governments, as well as to private industry, will exceed \$20 billion. That far exceeds the estimated increase in tax revenues generated by the provision. Much of these costs are needless preparation expenses, particularly during the current rough economic times. And, with companies facing narrower profit margins, due to stressed economic conditions leading to increased bidders for every contract, the prospect of additional tax withholding diverts

cash away from business expansion activities, including workforce investment and equipment purchases. This provision is a drag on many segments of the economy.

These implementation burdens are particularly acute on S Corporations and Joint Ventures. Sixty percent of businesses in the construction industry are S Corporations, including mine, meaning the corporate income tax is paid at the shareholder level. Family-owned businesses often have many shareholders, especially as families grow and expand. All shareholders pay the business' income tax on their personal taxes, and then would be required to keep track of this 3% withholding through the year for tax purposes. They and their accountants will be using their great record-keeping systems in order to ensure funds are not lost along the way or over-counted. So I thank this Committee for recognizing the particular burden this law will place on small businesses.

Withholding creates additional reporting burdens on other pass-through entities, as those withholdings will need to be accounted for and reported to each partner in the partnership, thereby impacting their tax returns and tax liability. As government construction contracts have grown, expanded, and become more complicated, construction companies have had to increasingly work together to tackle large projects. Joint ventures, which are created to complete only one large project, such as the Woodrow Wilson Bridge, do not have a backup of savings, as the entity did not exist before the contract was bid. There are no reserves available to reach for when withholding exceeds costs to complete the contract. The law could drive joint ventures out of the market, leaving large federal construction jobs with very few, if any, bidders.

What is truly frustrating for us is that there are already policies in place that prevent contractors from the kind of tax behavior this law is designed to stop. Instead of punishing all contractors, the federal government should enforce the laws already on the books. Existing laws require all corporations to make quarterly estimated tax payments to cover income tax liabilities. These laws should be vigorously enforced. While this provision requires withholding for the purported purpose of ensuring taxes are paid, the law does not require any additional enforcement or additional reporting in order to ensure "bad apples" are not under-reporting income or over-reporting deductions. This law also requires a withholding, for the first time, that has no relation to the potential tax owed by the government contractor.

Because the withholding is required on public projects, all of our jobs are bonded. Having bonds on projects ensures the taxpayers that the jobs will be completed at no additional cost to the public. The project must be completed for the price and in the time negotiated under the contract. The construction contractor is responsible for purchasing the bond, and if something happens to the company, the bonding company liquidates the contractor's assets to complete the project. The taxpayer is protected.

Contractors must purchase several kinds of bonds for a project, but performance bonds guarantee certain tax behavior by the constructor. The performance bond ensures that payroll taxes will be paid on behalf of the employees working at that site. If the government determines that payroll taxes have not been properly withheld and remitted,

then the government can ask the bond provider to fill in the gap. The bond provider then goes after the constructor for those funds, but the taxpayer – and the employee – is protected. If the company is not paying these taxes, it will not qualify for the bond. If the company cannot get the bond, they are not qualified to bid on government contracts, or will lose their contract.

In addition to the bond provider, in many cases the agencies and construction managers that we do work for require us to pre-qualify every couple of years, and one of the questions during the process is whether we pay our taxes. The agency looks into this, and some want tax returns for two or three years for the process of verification. So again, the taxpayers are protected.

As you can see, there are several protections in current law for the taxpayer on public projects: retainage, close out costs, pre-qualification, and several layers of bonds, all paid for by the contractor during the construction process.

This new 3% withholding law is just an interest free loan to the federal government, and Congress knew that when it was passed. The Joint Committee on Taxation scored this provision as bringing in billions but also recognized that almost 97% of those billions were over withholdings that would be refunded the next tax year. This law is complicated for contractors and for the government. When the regulations came out this month the IRS delayed implementation because of the complexity. It will cost billions to implement and cost billions to comply with and enforce. It is just another layer of red-tape that creates serious cash flow problems for government contractors, in perhaps the worst industry conditions in modern times. It does not help solve a problem by using the solutions that are already on the books. It is just bad public policy. 3% withholding on government contracts will seriously impact my business and the businesses of the construction industry at large. The vast majority of the members of the contracting community are responsible taxpayers. Don't punish the whole industry because of a few bad apples.

Again, thank you for the opportunity to testify today on behalf of AGC. I appreciate the fact that 3 members of this subcommittee and 6 members of the full committee have cosponsored this legislation and I look forward to any questions that will help get the rest of you to cosponsor H.R. 674.