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FULL COMMITTEE HEARING ON THE NEW HIDDEN TAX ON SMALL BUSINESS

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UNITED STATES HOUSE OF REPRESENTATIVES

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FULL COMITTEE HEARING ON THE NEW HIDDEN TAX ON SMALL BUSINESS

THURSDAY, MARCH 22, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. Nydia Velázquez [Chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Shuler, Cuellar, Altmire, Braley, Ellsworth, Chabot, Musgrave, Westmoreland, Fallin, Buchanan and Jordan.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

Chairwoman VELÁZQUEZ. Good morning. I now call to order this hearing to examine the impact of a three percent withholding requirement on all government payments.

Today's hearing focuses on what might seem to be a minor change in tax law, but will have a huge effect on small businesses across this country. We will discuss the potential problems of a provision passed last year that will require the government to withhold three percent on many government payments.

While the withholding requirement is not scheduled to become effective until 2011, it is important to understand the problems now. This change goes far beyond those who do business with the federal government. Farmers receiving payments from the USDA, health care providers who receive Medicare reimbursement, as well as the thousands of small businesses who perform contract work for the federal government will all be hit. This money will be withheld regardless of what you actually owe in taxes.

This could be an enormous burden for small businesses. Taking away three percent of revenues can mean the difference between meeting payroll, expanding a company or buying needed equipment. It will reduce their ability to compete against their corporate counterparts.

For small government contractors, the results could be severe. When you consider that small firms are continuing to be squeezed out of the federal marketplace, the last thing Congress should be doing is creating another obstacle to success. Small firms, which often have fewer resources, may be unable to afford to stay in the market. If businesses leave the federal marketplace, there will be less competition, which could lead to higher prices, costing valuable taxpayers' dollars.

The change will also have a negative impact on the health care industry. The sheer volume of transactions affected by this change creates a huge administrative burden. Hospitals and small business health care providers conduct millions of transactions that will be subject to withholding.

I believe the intent of this provision was a good one. Right now there is a $350 billion tax debt. However, I question whether this change will really get at that problem. Most of the revenues generated by this provision do not come from collecting taxes, but from a budget gimmick. It simply moves up the collection of money that will have come in the next year.

We must consider the hidden costs of this legislation. We should not increase the cost of running a business by requiring an interest free loan to the government. It seems to me that the most logical step is to repeal the provision. There are better ways to crack down on those who are not paying their taxes without creating a hardship on small businesses.

I appreciate the witnesses coming here today to talk about their concerns, and I look forward to today's discussion.

And now I will recognize the Ranking Member, Mr. Chabot.

OPENING STATEMENT OF MR. CHABOT

Mr. CHABOT. Thank you very much, Madam Chairwoman, and thank you for holding this important hearing to discuss, as you mentioned, Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, known as TIPRA.

I find it truly ironic that legislation that was called the Tax Increase Prevention and Reconciliation Act, which provides for lower taxes on capital gains and dividends and that generally helps small business owners, also contains a provision added at the 11th hour during a House-Senate conference committee that will raise taxes on those same small businesses if Congress fails to take action.

Of course, we hope that Congress will take action.

Section 511 of the Act, scheduled to take effect in 2011, will require federal, state, and local governments with an annual procurement budget of at least $100 million to withhold three percent from all payments for goods and services as a guard against possible business tax evasion, justification that I find particularly offensive.

Section 511 will affect goods and services under government contracts, as well as payments to any person for services or products provided to a government entity, such as Medicare payments or certain grants. This provision is based on revenue from government payments and is unrelated to a company's taxable income or tax liability.

As I mentioned earlier, it is particularly troubling to me that Section 511 was inserted in the Tax Increase Prevention and Reconciliation Act of 2005 during the House-Senate conference without open debate on the merits. A provision that will likely have this type of impact on small businesses, as well as state and local governments and the private sector, should have been fully considered in both Houses of Congress with inputs from all sides.

At a time when we are trying to encourage the federal government to do more business with small businesses, Section 511 is exactly the wrong message to send. Small businesses typically work

with very small margins, and three percent withheld from any payment affects its operating capital and could make the different between its ability to submit a bid or not.

Furthermore, companies of all sizes that do business with government will likely have to increase prices to account for this additional burden. The impact of Section 511 will likely be enormous and far reaching. From the cost of construction projects to taxpayers, which would likely increase, to the already low Medicare reimbursement payments to physicians that will likely decrease, which could cause physicians to stop accepting new Medicare patients.

Some companies may be forced to pass some of the withholding amount down to subcontractors. This can be especially harmful to small businesses down the supply chain. According to the Congressional Budget Office and the Joint Committee on Taxation, Section 511 amounts to an intergovernmental unfunded mandate and would be extremely expensive to implement.

In many cases, governments and the private sector would have to adopt new accounting and financial control measures and perhaps additional personnel to track these payments. In short, Section 511 hurts honest taxpaying small businesses without providing any additional enforcement provisions to improve tax compliance.

Section 511 of TIPRA is bad law and bad tax policy. I want to again thank the Chairwoman for holding this hearing to expose the damaging effects this provision will have on small businesses should Congress fail to take action in the next several years to prevent it, or should there be an attempt to expedite Section 511's implementation, as happened last year. We need to be looking at ways to foster growth and productivity in the small business sector, not penalize everybody for the actions of a few.

Madam Chairwoman, thank you again for holding this hearing. I look forward to hearing from our distinguished panel and working with you to address this important issue, and I look forward to introduction, if possible, Mr. Coleman who is from the great State of Ohio. He does not have the good fortune to be from Cincinnati. He is from Cleveland, but close enough. [Laughter.]

Mr. CHABOT. I yield back.

Chairwoman VELÁZQUEZ. Thank you. Thank you.

Our first witness is a constituent from New York, the great State of New York, Vincent Iannelli. He is the President of Iannelli Construction Company, Inc., and a member of the General Building Contractors of New York State, Associated General Contractors Chapter. Associated General Contractors of America represents over 32,000 firms throughout the country.

Mr. Iannelli, you will have five minutes to make your presentation, and I want to excuse myself. I have to go before Natural Resources Committee to testify on a bill that I am the lead sponsor. So I will ask for you to excuse me, but Mr. Shuler will be on the Chair, and I will be coming back as soon as I finish.

Mr. SHULER. [presiding] Thank you, and you may start.

STATEMENT OF VINCENT IANNELLI, PRESIDENT, IANNELLI CONSTRUCTION COMPANY, INC. ON BEHALF OF ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. IANNELLI. Thank you, Chairwoman Velázquez and Ranking Member Chabot, for this opportunity to testify on the new three percent withholding law.

I am testifying on behalf of the Associated General Contractors of America, a national trade association representing more than 32,000 companies. I am Vincent Iannelli, President of Iannelli construction and a member of the General Building Contractors of New York State, an AGC chapter.

My father started our company in 1958, and now my brother Thomas and I are running it. My daughter Carla started working with us two years ago.

Iannelli Construction is a family business. We are also 99 percent public works.

Small business is big in construction. In 2005, 91 percent of construction establishments had fewer than 20 employees. Only one percent had 100 or more. According to the 2006 construction industry annual financial survey, earnings after taxes in the most recent fiscal year averaged 2.1 percent, up from 1.6 percent in 2005.

Today, Iannelli Construction works 99 percent on school construction. We employ six full-time employees in the office and ten to 20 in the field, depending on how much work we have. We are 100 percent union, working mostly with the locals from the Carpenters Union and the Mason Tenders Unions.

All of my public projects have retainage. The public owners hold back from five to ten percent on each progress payment until the project has been substantially complete.

In addition, some public owners hold out an additional five percent of the project for closeout and punch list. It has taken me years sometimes to receive final payment after the contract has been completed.

Because these are public projects, all of our jobs are bonded. Having bonds on projects insures 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 performance and payment bonds for government projects. The performance bond insures that payroll taxes will be paid on behalf of the employees working at the 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. Under the bond everyone is protected.

Now the federal government has added an additional layer by requiring three percent holding on payments for goods and services from every level of government, federal, state, and local. This new requirement plus the retainage and closeout costs could add up to 15 percent of every progress payment.

This kind of hit to my cash flow also makes it more costly for me to purchase the bonds necessary. Many companies who provide the bonds study my books in detail before offering coverage. Based on past performances, the ability to perform the work for which I bid and my cash flow assurity gives Iannelli Construction a bond rating which governs the price of the bonds and how much bonding coverage I can receive.

This is just one of the reasons why cash flow is so important. Another is my ability to pay 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.

What is frustrating is the government is penalizing good contractors for paying their taxes and paying their payroll taxes in a timely manner. There should be a better way to do this.

Every couple of years we have to prequalify for certain government agencies that we do work for, and one of the questions during the process is if we pay our taxes. The agency looks into this and someone's tax returns from the previous two or three years. If you cannot come up with that, you are not qualified to bid on these jobs. This shuts people down if after a while they aren't paying their taxes.

The majority of AGC contractors work on some kind of government contract every year, and this three percent withholding will have a large impact on the construction industry.

Again, thank you for this opportunity to testify today on behalf of the AGC, and I look forward to your questions.

Mr. SHULER. Mr. Iannelli, thank you so much for your testimony and comments.

[The prepared statement of Mr. Iannelli may be found in the Appendix on page 35.]

At this time I'd like to introduce Mr. Daryl Deel, the president of three small business trucking companies and comes on behalf of the American Trucking Association, ATA. Mr. Dill is the Vice Chairman of the ATA Tax Policy Committee.

ATA represents carriers of government agencies, and I thank you for your testimony.

STATEMENT OF DARYL DEEL, VICE CHAIRMAN, TAX POLICY COMMITTEE, AMERICAN TRUCKING ASSOCIATION

Mr. DEEL. Thank you.

And good morning. Again, my name is Daryl Deel. I am a certified public accountant by training and now I am in the trucking industry, and I do own three small trucking companies.

I am here today representing the American Trucking Association, or better known as ATA, and we certainly appreciate the opportunity to be here today.

My trucking company specializes in transporting highly specialized security sensitive cargo for the Department of Defense and the Department of Energy. As a member of ATA, I am currently the Vice Chairman of the ATA Tax Policy Committee, and for three years prior to that I chaired the Government Traffic Policy Committee, which is comprised of motor carriers and brokers which provide contract services to haul government freight.

ATA represents the motor carriers who serve government agencies with the best freight logistics support in the world, and it takes a lot of money and expertise to provide that level of service. We take immense pride in the fact that we support public missions. We are particularly proud to be an indispensable link in the defense supply chain that sustains America's war fighters domestically and throughout the world.

Like most businesses and Mr. Iannelli's business, we expect customers to pay with 30 days or net 30. When a customer has a good track record of payment, we give them the best rates. When the government begins withholding the three percent, we are not going to see that money returned to us for much longer than 30 days.

Depending on the state of the economy, the motor carrier industry's net profit margins range from one half of one percent to five percent of revenues, for an average net profit of about three percent. Therefore, when the government customers start withholding the three percent of the freight bill that they owe the carriers, trucking companies may be compelled to raise rates just to stay whole.

Otherwise, all of that profit margin, that three percent profit margin becomes unavailable until we file our tax returns and then maybe get our refund a year later.

And then when the economy is down and suppresses profit margins for our industry, the three percent withholding will more than devour all of the net profit for our industry. This is like a loan to the government. Most small business will not be able to withstand the negative cash flow impact and could eventually go bankrupt.

A large company with mostly commercial customers and does business with governmental agencies, they are likely to be able to absorb that three percent by just reducing their quarterly estimated tax payments. So they are paying it one way or the other way.

But a small company, on the other hand, that does a lot of business with government customers could suffer that 100 percent withholding of their profit margin and, again, would have to wait until they file their tax returns and get a refund the following year.

Worse yet, that three percent withholding could bite into the cash needed to provide the direct services to the customer. They have to pay their contractors or their employees, and their fuel bill, and all of those operating expenses. So the negative cash flow impact might force a small company, small business, to either raise its rates, but it may be difficult to do that in a competitive environment where a larger company can withstand the cash flow impact of the three percent, and it may make small business not competitive in vying for government business.

So it could force the small company to consider leaving government service and increasing their business with commercial shippers, those shippers that pay within 30 days, the full 100 percent of the freight bill.

I do have a simple chart that demonstrates the tax and cash flow impact of a large business versus a small business for a motor carrier. With your pleasure, I will submit that for additional testimony.

For these reasons, I am convinced that if the three percent withholding is actually implemented that my three small companies may be compelled to raise rates or to exit providing service to government agencies. And I believe this is the opposite to what Congress intended when this new withholding tax or the bill was enacted.

For these reasons, the motor carriers of the American Trucking Association urge the members of this honored panel to support H.R. 1023.

And thank you for the opportunity to be here today. I look forward to your questions.

Mr. CHABOT. Mr. Chairman, I would just move that the chart that Mr. Deel referred to be admitted to the record, without objection.

Mr. SHULER. Without objection.

Mr. CHABOT. Thank you very much.

[The prepared statement of Mr. Deel and chart may be found in the Appendix on page 43.]

Mr. CHABOT. Mr. Deel, thank you so much for your testimony.

At this time I would like to introduce Lamar Whitman, who is a public policy manager for Computing Technology Industry Association, CompTIA. CompTIA has more than 2,000 members in the information technology industry. This organization is driven by helping individuals obtain skills necessary to succeed in the IT industry.

Mr. Whitman, thank you so much for your testimony.

STATEMENT OF LAMAR WHITMAN, PUBLIC POLICY MANAGER, COMPUTING TECHNOLOGY INDUSTRY ASSOCIATION

Mr. WHITMAN. Thank you very much for the invitation.

Good morning, Mr. Shuler and Ranking Member Chabot and also distinguished members of the Committee. My name is Lamar Whitman. I am appearing today on behalf of the Computing Technology Industry Association, CompTIA, representing 20,000 member companies.

I want to thank Chairwoman Velázquez and members of the Committee for holding this important meeting concerning the effects of this impending three percent withholding. While this requirement does not distinguish between government payments made to either large corporations or small businesses, our comments today will concentrate on the effects of this provision on our small business members.

The typical small business does not have an IT department, but relies upon the services of an important segment of the computer industry referred to as value added resellers, or VARs. VARs are small system integrators that design, install, and maintain computer systems and networks for other small businesses. There are an estimated 32,000 VARs, most of which are small businesses themselves, sell approximately $43 billion worth of computer hardware, software, and services annually. This means that about one third of the computer hardware sold in the United States is sold by a VAR.

A 2006 government VAR survey found that about half of the VAR's gross revenue derived from the public sector, which would

put this somewhere in the magnitude of $20 billion annually; of this, about 37 percent is from sales to federal government; 35 percent sales to state and local governments; and 28 percent goes to educational institutions.

This three percent withholding requirement is unnecessary to promote tax compliance and will unfairly penalize compliant small businesses. First, we must note the unprecedented nature of this new withholding requirement. Historically, prepayments of tax had borne some direct relationship to a taxpayer's estimated tax liability. However, this new three percent withholding departs from the traditional scheme of federal tax payments because it bears no relation to the tax liability.

Indeed, a VAR working under a government contract with a slim profit margin could experience a net loss for the year, but it would still be subject to the three percent withholding.

With keen competition, VARs operate on a very small profit margin, often three to six percent and sometimes much less. I provided two examples in the written testimony. In both situations, assume the business receives $5 million in government payments with $150,000 being withheld for this three percent payment. With a six percent net profit margin, as shown in the first example, the federal tax liability is about $100,000. However, $150,000 has been withheld from payments to that person. So, therefore, they have lost the benefit of $50,000 in operating capital.

The three percent withholding becomes even more absurd when applied to a company with a four percent net profit margin, as shown in the second example. In that scenario, the business would be deprived of about $90,000 of working capital.

This three percent withhold provision has a regressive effect, reserving its greatest penalty for those businesses with the lowest net income, typically small businesses.

In addition to our cash flow concerns, we see a number of other adverse issues. In subcontracting situations, this three percent withholding will inevitably be passed down from the prime to the subcontractor. Without this operating income, subcontractors will be forced to use credit, incurring interest costs, and this will, in turn, increase the cost of goods and services to government purchasers.

We also believe this new requirement will make it much more difficult for government agencies to meet their small business contracting goals, something that I know that this committee is very concerned with.

Further, the three percent withholding on pass-through entities, such as Subchapter S corporations, partnerships, joint ventures, whatever, will need to be allocated out to the shareholders for an S corporation or to the partners in the case of a partnership. This will further increase the complexity of return preparation far beyond that of the contracting entities alone.

The purported justification for instituting this three percent withholding was that some recipients of government payments were not reporting and paying their federal income tax. If, in fact, this is the problem, we believe the proper and least harmful course of action is to require government payers to report such payments.

The goal here should be to promulgate effective tax compliance measures, not punish all government contractors indiscriminately.

CompTIA and CompTIA's members were fully supportive of efforts to promote tax compliance. However, we object to unnecessary and harmful tactics, such as this three percent withholding. This new requirement is unfair to small businesses, especially of ours, and will force more and more small businesses out of the competition for federal government procurement opportunities.

Thank you very much, and I will be pleased to answer questions later on.

[The prepared statement of Mr. Whitman may be found in the Appendix on page 46.]

Mr. SHULER. Mr. Whitman, thank you for your testimony.

At this time I will introduce Charles Kahn, who is the President of the Federation of American Hospitals. FAH is the national representative of investor owned or managed community hospitals and health care systems throughout the United States.

Mr. Kahn, thank you for being here today, and we are looking forward to hearing your testimony.

STATEMENT OF CHARLES KAHN, PRESIDENT, FEDERATION OF AMERICAN HOSPITALS

Mr. KAHN. Thank you, Mr. Chairman.

And I appreciate the committee holding this hearing today. It is a pleasure to appear before the committee on behalf of the Federation of American Hospitals.

We represent approximately 20 percent of the hospitals across the country that serve our communities. Our members also pay their fair share of federal, state, and local taxes.

I would like to make four points today. One, the three percent withhold is unfair because it penalizes all because of the misdeeds of a few.

Two, the federal health care agency who will implement the three percent withhold for Medicare, as well as the Medicare claims payment system itself are ill-suited to adapt to this kind of requirement.

Three, the health care providers will be harmed by the three percent withhold and are likely to suffer unanticipated problems that the framers of the law could not have anticipated.

And finally, that the GAO report that defines the problems points to a solution other than the three percent withhold, the federal payment levy program. We need to give this program a chance to work before we penalize everyone doing business with the federal government.

First, let me start off by talking about the providers themselves. Most health care providers are paid by Medicare program on a per claim basis, a per service basis. Under Part A and Part B, hundreds of millions of claims are processed each year, and a new process will need to be implemented to capture the three percent withhold for tax paying health care businesses.

The tax revenue to be generated from three percent withhold is smaller than most people think after the first year. Yet the implementation costs to the entire federal government, particularly to

the Medicare program will be enormous and continue into the future.

The Medicare program currently uses some 40 private contractors to process Medicare claims. This means the federal government will provide significant oversight of its contractors which have different from processing systems to insure that the three percent withhold is correctly collected.

Another problem involves Medicare claims themselves that are filed, but frequently need to be amended or refiled. This common practice usually results in a payment adjustment which will mean some type of reconciliation on the tax withholding side will be necessary. It is unclear how this will be accomplished.

Third, the health care provider community will be unduly burdened by the three percent withholding and are likely to suffer unanticipated problems. Medicare providers already experience slim operating margins, in large part due to the insufficient levels of government insurance payments. In 2007, hospitals are expected to experience a negative operating margin of 5.4 percent on their Medicare business alone. Withholding three percent of Medicare payments off the top, regardless of the taxpayer's situation, will exacerbate this problem and create additional cash flow concerns, especially for start-up or small businesses that need to maximize cash flow to survive.

The administrative burden on the health care industry will be similar to burdens the federal government faces and will create an expense for businesses that will be unfunded, of course, by the government itself.

The GAO reports focus on the federal payment levy program as a solution, which targets delinquent taxpayers by collecting what they owe from current government payments. The reports make clear that the implementation challenges remain for the levy program, and that increased participation by federal agencies is essential for the program to reach its full potential.

HHS does not participate in the levy program, but clearly should be able to capture much of the money that is not being paid in taxes by this program. Congress should consider the GAO recommendations on this program and how to improve it and take steps to insure greater participation by the federal agencies as a solution to this problem.

So let me reiterate. The Medicare program has millions of claims that are processed for those who are serving Medicare beneficiaries every day. To take three percent from those claims obviously will be extremely complicated and difficult to implement, and will have effects on those who are providing those services.

There has got to be a better way, and we believe in the GAO report their recommendations for a better way to solve this real problem that our taxing system faces.

Thank you.

[The prepared statement of Mr. Kahn may be found in the Appendix on page 55.]

Mr. SHULER. Mr. Kahn, thank you.

I will yield to Ranking Member Chabot for the introduction of Mr. Coleman.

Mr. CHABOT. I thank the gentleman very much for yielding.

It is my pleasure to introduce, as I mentioned before, a fellow Ohioan, Lonnie Coleman who is President and CEO of Coleman-Spohn in Cleveland, Ohio.

Founded in 1994, Coleman-Spohn Corporation formed as a result of a merger between a residential heating firm and a state-of-the-art mechanical engineering company. Today Coleman-Spohn is a full service mechanical contractor whose clients are some of Cleveland's most noted public and private institutions.

Lonnie Coleman has received the Small Business Administration's Award of Excellence and was recognized as its prime contractor of the year. Coleman- Spohn has been honored as the Ohio Governor's Minority Business of the Year, the Environmental Protection Agency's National Minority Contractor of the Year, and the City of Cleveland's Construction Firm of the Year.

I am pleased to welcome to the hearing, as I said, Mr. Lonnie Coleman, and we thank you very much for your testimony here this morning, Mr. Coleman.

STATEMENT OF LONNIE COLEMAN, PRESIDENT AND CEO, COLEMAN-SPOHN, ON BEHALF OF THE MECHANICAL CONTRACTORS ASSOCIATION OF AMERICA

Mr. COLEMAN. Thank you, Representative Shuler.

You have taken the first part of my speech away.

[Laughter.]

Mr. COLEMAN. Thank you very much.

Good morning to Ms. Velázquez, who has left, and Mr. Shuler and the Ranking Member Chabot and the members of the Committee. Thank you for inviting me here today.

My company performs general mechanical and facilities management contracts as both a prime contractor and a specialty contractor on federal, state, and local projects throughout Ohio and in several markets nationwide. And as you have heard in my introduction from Representative Shuler, we have had some success on the small business level thanks to many of the things that the Small Business Committee and Congress have done in aiding and assisting small and minority businesses throughout our country.

I am here today representing the Mechanical Contractors Association of America, a nationwide specialty construction employer trade association. I am also an officer of the MTA, serving this year as the Senior Vice President and Treasurer.

A little bit about MCAA. MCAA's 2,300 member companies install, maintain and service all types of mechanical systems. The systems range from residential plumbing and heating and air conditioning systems to more sophisticated piping systems found in the commercial industrial markets, such as nuclear power facilities, clean rooms, data centers, and refineries of all types.

Today I am also privileged to represent five other of our sister associations, allied in an ongoing legislative campaign for quality construction. These groups are the Sheet Metal and Air Conditioning Contractors National Association, the National Electrical Contractors Association, the International Council of Employers of Bricklayers and Allied Crafts, the Finishing Contractors Association, the Association of Union Constructors.

Of these groups, according to the Bureau of Labor Statistics figures, our group of specialty construction employers represents the vast majority of industry employment in our industry and well over 64 percent. In addition, many of our groups participate in two wider coalitions: the Construction Organizations for a Sensible Taxation, the Government Withholding Relief Coalition, both of which are adamantly opposed to the three percent withholding provisions of the Tax Reconciliation Act.

Now, what distinguishes our campaign for quality construction specialty groups is that we employ highly skilled technicians for field construction under local, multi-employer collective bargaining agreements with local building trades unions. Our bargaining agreements come with high value wages, health and welfare, and pension trust fund obligations for our employees that require ready cash flow and prompt and reliable payments.

Moreover, the discipline of operating under collective bargaining agreements prevents misclassification of the workers as independent contractors rather than employees. As we all know, in the construction industry, misclassification is an area of high abuse and tax avoidance.

Now, we realize that there is a problem here that needs fixing, but at the same time, we feel the three percent withholding slated for public contract payments is a bad idea and is entirely contrary to the small and minority business development goals of your Committee. This Committee is about helping, not hindering.

So we ask that you support the repeal bill H.R. 1023 co-sponsored by Ways and Means Committee members, Representatives Herger and me.

We also ask that the repeal is done quickly to avoid any further efforts taken to accelerate the effective date of the measure for misjudged budget gains and offsets.

Put plainly, fiscal enforcement policy and sound procurement policies do not and should not be mixed. To be sure, small and minority owned business enterprises, as well as all other responsible firms should not 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 we feel is just not fair.

And I will tell you our campaign for quality construction 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 businesses. So if stopping tax avoidance by public agencies, goods and services providers is the target, then there are more specific tools to achieve that goal, such as the contract eligibility process can 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 id eliminated. The agency gets quality work by qualified firms, and the added financing and administrative costs of the three percent withholding is avoided.

The U.S. Congress has passed two prompt payment laws recognizing that prompt and fair payment terms are the best way to administer public contracts and to avoid all the extra costs and delays

that result from less sufficient contract administrated practices. It really does matter how well firms are paid and how fairly contracts are administered. Time and again, it proves out that the best projects are the ones that are the most competently administered. And all of that matters even more for small and minority business enterprises whose margins are thinner and cannot carry the cost of public contract misadministration the way larger firms can.

And I should point out what makes this issue even more problematic is the outdated and unfair practice of withholding five to ten percent retainage from the monthly invoice of public and private construction contracts without any regard to performance, as my colleagues have stated.

As a second tier or lower contractor, which many of my group are, the wait for delays of invoice processing and payment for only 90 percent of what you put out the previous month can be very difficult for small, small disadvantaged, and small minority businesses.

Now, on top of that, the Tax Reconciliation Act would add an additional three percent deduction even though we have always paid our taxes on time and our performances have been entirely up to par.

Members of the Committee, it is a fact that construction projects are very complex and risky business propositions. Profit margins are thin. Risks are high, and the competition is very competitive, and the industry, even with this complexity, is relatively easy to enter, which makes it an ideal market for small business.

So the question becomes: who pays for the cost of this added three percent? Is it the taxpayer? Is it the small or minority owned business that has to close up shop because it can't afford the three percent delay in payment?

Ultimately, as taxpayers, we all pay. We will pay with higher bids to cover increased financing costs, and we will pay with diminished competition within our industry, and the worst part is that all of this is completely unnecessary.

Let me be perfectly clear. I am opposed to companies receiving contracts when they don't pay their taxes. However, the government already has the information it needs to address this problem without putting the burden on small businesses and driving some small businesses out of business.

When I registered in CCR like every other federal contractor, the government validated my taxpayer identification number with the IRS. This means that the government had all of the information it needed for debt collection and could check at that time to see if I had any outstanding tax liabilities.

When I renew my CCR registry each year, which I'm inclined to do, the government could again determine whether or not I had outstanding tax liabilities. I also must supply representations and certifications whenever I submit a proposal that includes a statement that I haven't been convicted of tax evasion. At that time I would be happy to certify that I am current with my taxes. If done, it would insure that tax evaders were caught or risk suspension and debarment of false claims at penalties.

Finally, CCR already shares information with agency payment systems. If someone does get a contract—excuse me. I am trying

to roll it—and owes tax liability, the government should be able to withdraw the funds at that time. It is my understanding that some agencies already do so. The important thing to remember here is that the government can do all of these things without it costing law abiding small businesses a single penny.

Member of the Committee, I ask that you help small businesses. I ask that you help minority businesses by supporting the repeal bill H.R. 1023.

Thank you, and I am sorry it took a little longer.

[The prepared statement of Mr. Coleman may be found in the Appendix on page 61.]

Mr. SHULER. Mr. Coleman recognized when there was a rookie in the chair.

Mr. COLEMAN. Absolutely, a rookie at the table. [Laughter.]

Mr. SHULER. Well, I want to thank the entire panel for their testimony today. I, too, can relate to so many of you having a small business myself, being in the construction industry, being the health care industry. I, too, can relate to the added burden that so often is place upon our small businesses.

And at this time we will move to questions from the Committee, and I would like to start off by asking Mr. Kahn a question concerning the health care industry. Can you talk more about the impact that this rule will have on small health care providers, especially in the rural areas which I come from?

We have one major hospital and 15 small hospitals, and most of which are community managed hospitals. Through the paper work and administrative resources to handle the extensive paper work, can you tell me, you know, more of the problem and truly expand on what your testimony has already given us today?

Mr. KAHN. I think if we look at all of the array of providers, particularly in the rural areas, whether it's the physicians that generally have small group practices, whether it's the suppliers, the durable medical equipment, whether it's the small hospitals in the rural areas, many of whom are for profit, half of my members have rural hospitals across the country. We know that the Medicare payments are already sort of very close to the margin so that these payments, if you deduct three percent is really like a three percent cut on a payment that already hardly meets your cost. That's the first issue.

The second issue is just the complexity. The number of claims particularly for smaller providers who may be seeing a lot of patients and have a lot of small claims means that there's a lot of paper work that could be added because of this, and the question of whether or not the agency can even handle the administration of this three percent in a fair way, considering the way that claims are frequently refiled and re-adjudicated and payments are made and then payments sort of go back and forth between the providers and the CMS, the agency that administers this program, is mind boggling.

So I guess the first question here is did those who wrote this particular law even understand the implications for Medicare and for the Medicare beneficiaries, as well as those providing services, and did they—and I do not think they did—even talk to the agency that would have had to administer this program?

So one of the reasons that we are so fervent in our support for repeal is that we're not sure this is the kind of law that can even be administered fairly. In the contracting area, my fellow witnesses brought up all kinds of issues that arise, but here there's a basic contract, but this is a fee for service environment. It's an environment in which a provider is providing a service and then expects to be paid, and it's even different than the contracting environment where you can anticipate some of the effects, albeit the problems it raises.

Mr. SHULER. Thank you.

Mr. Whitman, I was wondering if you know of anything preventing the IRS from determining what amount has been paid to the government contractors or which businesses are receiving these Medicare or AG and contracting payments.

Mr. WHITMAN. Is anything preventing the IRS?

Mr. SHULER. Yes.

Mr. WHITMAN. Well, currently there is no reporting is my understanding. There is no reporting that these payments made by the federal government or by the state governments. Some of my members have told me that when they're dealing with counties that some counties do provide a 1099; some don't. Some just decide to err on the side of safety and provide this, but there is no reason that governments couldn't simply report these payments that are being made. Therefore, the IRS could determine whether the income is reported, and that's the complaint. Is the income reported?

Mr. SHULER. If you could give just one outside of just repealing the rule altogether, you know, that I can go back to my district and when I talk to my hospitals or my contractors or the people, this could be open for any of the members on the panel. If there was one thing that I could say because most of it is not being able to understand the rules, first of all, from so many of our people that say this is an added tax on and continuation of taxes and taxes and taxes pushed down; is there one thing that could help me when I am talking to my small businesses and groups, whether it be a trucking industry or whether it be a construction industry, that can also help us be more clear about how this tax is implemented and the reason and the major impacts that it causes in your small businesses?

Mr. WHITMAN. I am sorry. To explain it more thoroughly?

Mr. SHULER. Yes, yes, absolutely.

Mr. WHITMAN. Well, I do not really look upon it as a tax. I look upon it as a penalty for doing business with the government, so to speak, that you lose your cash flow. It is considered to be a prepayment of tax because it is being withheld for federal tax payment.

But we already have systems for doing it now. We have the estimated tax system where corporations estimate their tax liability possibly on a quarterly basis, go back and revisit, and make quarterly tax payments. This is just something on top of that that's unnecessary.

Mr. SHULER. Right. Thank you.

I yield back.

Chairwoman VELÁZQUEZ. [presiding] I now recognize the Ranking Member, Mr. Chabot.

Mr. CHABOT. Thank you very much, Madam Chair.

I'll begin asking Mr. Coleman, if I can.

You had requested the consideration of co-sponsoring H.R. 1023, which would do away with this completely and as a result of your request and having studied this pretty closely, it is our intention to do that. So thank you for bringing that up.

Secondly, you referred in your testimony to the fact that the construction industry is really keenly competitive and that construction projects are extremely complex. Again, how would the three percent withholding affect your ability to, for example, submit competitive bids?

Mr. COLEMAN. What happens in our industry, Congressman, as Mr. Iannelli probably on the panel has stated earlier, we are already dealing with a ten percent retention, which is deducted from our monthly invoices on an ongoing basis, and we find that in the construction industry retentions are just commonplace, and to put on top of the ten percent a three percent retention, what it does is it creates a situation that we are taking three percent out of our pocket to fund this, and so that puts an added burden on construction companies.

Now, we are already in a fight over this ten percent retention. We would like to see that eliminated because it was originally intended to make sure that the workers in the work place were being paid. Now there is all other types of protection against that. You have performance bonds. You have labor material and payment bonds that cover that cost.

So you are taking ten percent, which our margins are tight already. So if a contractor is bidding a project and he has ten percent in there for fees, so what you are doing is you are trading dollars until you get to the very end of a project where you can realize the ten percent.

But on top of that you take three percent. So I as a contractor have to go in my pocket and say, "Okay, Mr. Federal Government. I will let you hold my three percent until some time in the future when you are assured that the taxes have been paid and everything is in compliance. Then you will release my money."

That puts an added burden on the contractor, large and small. It is a burden that we have to deal with, and generally we are financing retentions anyway. So we have to go out and find additional financing. If we cannot find the additional financing to be able to cover the cost of the additional three percent, you will see many businesses go by the wayside, and I do not think that is what the Small Business Committee is about.

I think you guys are here to help, not hinder.

Mr. CHABOT. Thank you very much.

Mr. Kahn, let me go to you next. One of the chief complaints that we hear from physicians and hospitals is the red tape and the reporting requirements and record keeping, and you have already touched on this to some extent already. This three percent withholding provision would be yet another layer of complexity, and I think perhaps a threat to physicians participating in Medicare, which is already a problem because of the reimbursements, etcetera.

Could you comment on that very briefly?

Mr. KAHN. Yes. Well, if we look at the physicians, and basically all physicians are for profit except a few that may work in universities, and so they would have three percent more withdrawn from their fees, and unless Congress acts, and I assume Congress will, but if it does not, there is a ten percent real reduction in fees coming January 1 of next year for physicians.

So this causes a real problem for physician fees that were already low. It is a bookkeeping issue because Medicare claims are not simply a claim and then a payment is made. There are frequently, as I said, all kinds of contentions about the claims. So getting back your three percent when you file your taxes and the bookkeeping on that is going to be extremely complicated.

Finally, Medicare knows physicians, the suppliers, the hospitals that they do business with. I mean, there are Medicare numbers each of these people have to have. There are papers constantly being filed with Medicare. So if IRS can narrow down these individuals, which they ultimately have to do, the bad actors, the GAO report shows they can be found. All you have got to do is have communication between IRS and Medicare, and Medicare can locate the bad actors and action can be taken on the bills that they have filed, and those claims can be held by Medicare, you know, until adjudication.

So this issue of affecting everybody will have administrative effects. It will have cash flow effects, and it is a big problem. And, frankly, on the hospital side, 35 to 40 percent of your business is Medicare. You can't walk away from Medicare.

On the physician side, many communities, depending on the practice, many physicians today look at Medicare and say, "Can I really afford to provide services to Medicare beneficiaries?" And this adds sort of another piece to that.

And when it goes into effect in a few years, if the program continues on the path that it is, it could cause real access problems for Medicare beneficiaries because more physicians could say, "Gee, I am just not going to put up with the hassle. I cannot afford the cash flow issues or the paper work issues."

Mr. CHABOT. Thank you very much.

Madam Chair, if I have time for one more question, I'll just put it to the other three witnesses, if you could all comment on this briefly.

Part of the SBA mission, as we all know, is to help small businesses to receive a fair share of government contracts, and it is not easy oftentimes for small businesses, given the challenges in contracting with the federal government. Do you think that small business is likely to increase or even retain its percentage of government contracts given this new, complex constraint, and is it possible that small businesses could even lose some of its current share if this is enacted?

I will start with you, Mr. Whitman and Mr. Deel and Mr. Iannelli.

Mr. WHITMAN. Yes, my members tell me this. The situation is that by taking out the three percent, especially for the smaller businesses that you mention poses a huge problem with the cash flow situation for these companies, and so they're going to have to

take a hard look at whether they can do business with the government with all of the other hoops that they have to jump through.

So a few people have told me, and we have discussed this in our small business committee, that they definitely would shy away from doing business with this provision.

Mr. CHABOT. Thank you very much.

Mr. Deel.

Mr. DEEL. My companies compete in the motor carrier industry, and one of my largest competitors in the segment that we serve, which is the Department of Defense is a large, publicly traded company, very well capitalized with a lot of capacity, thousands of trucks compared to my company of a few hundred trucks.

They can withstand this three percent more easily than my company can, and so I would have a difficult time raising rates if they do not raise rates as well because of this, and so I would lose competition because we compete. Price is very important. The lowest price carrier get the bid from the government, and so I would either have to operate at a lower margin or lower cash flow or exit the market. It would probably be difficult to raise rates if our larger competitors do not because they can withstand the cash flow impact of this.

And I have a lot of competitors that are small like me as well, who will have the same problem. So, yes, I think the answer is probably fewer motor carriers vying for the government business.

Mr. CHABOT. Thank you.

Mr. Iannelli.

Chairwoman VELÁZQUEZ. Would the gentleman yield for a moment?

Mr. CHABOT. Yes.

Chairwoman VELÁZQUEZ. Mr. Deel, you know, this three percent withholding applies to prime contractors. So do you think that a prime contractor will withhold if they are doing business with a subcontractor? It will push down to the subcontractor?

Mr. DEEL. I think that is certainly possible, and even in my company I use subcontractors, independent owner-operators that work for my company, and I would be faced with the decision: do I carry that three percent burden or do I pass it on down to that real small business person?

That would be the decision that would have to be made, but likely I think it is going to go downhill to the lowest common denominator.

Mr. CHABOT. Thank you. I will reclaim my time.

Mr. Iannelli.

Mr. IANNELLI. I would love to pass along a three percent on my future bids, but I know that is never going to happen because the contracting climate in New York City, there is always somebody out there who is going to come along and basically work for less than that.

I think I might move to Ohio though.

[Laughter.]

Mr. IANNELLI. Working on ten percent, and I think I would love to do it. So give me your address and I will be there tomorrow.

[Laughter.]

Mr. IANNELLI. Here I come.

As far as passing the costs down to the subcontractor, and you also know, too, it could never happen because there's no legitimate reason for me to tell my subcontractors I am withholding three percent of your money because they are worried I am not paying my taxes. It is not going to work.

So it is just a bad situation that I think should not be in place.

Mr. CHABOT. Thank you very much.

Madam Chair, this has really been an excellent panel. So thank you.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Ellsworth.

Mr. ELLSWORTH. Madam Chairwoman, thank you for calling this hearing. I cannot think of anything that we do in the federal government, anything that needed a light shown on it, it is this subject, and I appreciate that.

Mr. Deel, do you pay your taxes on time, your federal taxes on time?

Mr. DEEL. Yes, I do.

Mr. ELLSWORTH. Mr. Coleman, do you pay your federal taxes on time?

Mr. COLEMAN. Yes.

Mr. ELLSWORTH. Have either of you—sorry.

[Cell phone interruption.]

Mr. ELLSWORTH. I pay mine on time, too.

[Laughter.]

Mr. ELLSWORTH. Totally forgot my line of questioning.

Have either of you ever changed the name of your company, opened a new company and applied for a new TIN in order to secure a new federal contract or avoid because you had not paid one, know you cannot get a contract under your old TIN and so you open a new company or change it in order to get a federal contract?

Mr. DEEL. No, sir.

Mr. COLEMAN. No, sir.

Mr. ELLSWORTH. Have you ever heard of that or know of that to occur, that somebody opens a new company, changes the name, applies for a new TIN? I think Mr. Coleman alluded to this, that it occurs.

Does that occur?

Mr. COLEMAN. Yes, it does.

Mr. DEEL. Yes, sir.

Mr. ELLSWORTH. Would one or both of you touch on what that is like, how that puts you at a disadvantage? Law abiding, tax paying companies to compete against a person or a company that does that and how that puts you at a disadvantage on a federal contract.

Mr. COLEMAN. Well, one of the things that it does when it happens, it basically takes work away from you. You will find instances where a contractor will do something like that, and I know an example where it has happened, where you feel that, you know, you have put together a very responsible organization. You are paying your taxes. You are employing people. You are paying good wages, and to have a contractor come by to try and beat the system like that, all of the good things that you have done, you know, trying to build and participate and be a part of the American dream, to just go fall off the table, so to speak.

And one of the things that in our organization and our campaign for quality construction that we are trying to do is lobby Congress to tighten up the contractor responsibility laws, and if we could get something like that, we could eliminate this problem. Then you can have capable, qualified, good contractors performing the services to our government, and that is what it should be about.

We do not need the competition. We do not mind competition, but let the competition play on the same field. Let the playing field be level, so to speak, and that we are all competing under the same guidelines, the same rules, and we are okay with that.

I do not mind losing the contract to Mr. Iannelli when he is out doing the same thing, paying his taxes, you know, doing the same things that I am doing as an organization. What we do mind is when you allow someone to not play by the rules, beat the system and drive legitimate taxpaying contractors out of business.

Mr. DEEL. I agree with all of those comments. It is certainly troubling to know that businesses or individuals avoiding the tax that they would otherwise owe by changing their corporate name or their federal ID number. Those same kind of individuals are not just avoiding federal taxes. They are also maybe not paying their contractors or suppliers, and the list goes on.

Those kinds of people that are unscrupulous are just disheartening for us that are quality business people. We pay our taxes and we vie for the business and would like to see it on a fair, competitive playing field.

Mr. ELLSWORTH. Certainly they know that if they are not going to pay their taxes, they can bid that at a lower rate.

Mr. DEEL. Absolutely.

Mr. ELLSWORTH. Well, again, Chairwoman, I appreciate this. This goes right to the heart, and, Mr. Coleman, you could add me to co-sponsors on the bill you have mentioned. This goes right to the heart of what the people in Indiana and, I am sure, across the country drives them crazy. They do not mind paying taxes. They mind getting ripped off. You are being ripped off, and I will do my part.

Thank you very much.

Chairwoman VELÁZQUEZ. Thank you.

And now I will recognize Ms. Musgrave from Colorado.

Ms. MUSGRAVE. Thank you, Madam Chairman.

And I would like to compliment you on the fact that you are holding hearings that really get to the heart of what is affecting small businesses, and I really applaud you for your efforts.

You know, when we are talking about this mandatory three percent withholding, it just really illustrates what happens when you have something done in a conference where there has not been open debate and then later everybody raises their hand and says, "Wait a minute. You know, this is really going to hit small businesses hard."

And we are seeing that today, and I certainly will be a co-sponsor of the repeal. You know, Mr. Chabot spoke with you, Mr. Kahn, about Medicare providers, the impact on physicians with paper work, and you know, I am very concerned as the elderly population increases that we need docs who are going to accept Medicare pa-

tients, and here is one more thing now to put on top of it that is going to be a disincentive for them, and that concerns me greatly.

Could someone elaborate for me on the federal payment levy program and see how this differs from this mandatory three percent withholding?

Mr. KAHN. Well, in the levy program, they identify the bad players and in a sense go after them and their payments. It is a very direct one-two, and at least in terms of our experience in sort of observing that, we deal with the Department of Health and Human Services, and they have been very reticent to get into it, and we think that either the Congress needs to tell or the administration needs to decide that the HHS is going to play because clearly in terms of provider numbers and other information, Medicare has the information to locate providers and physicians who are not paying their taxes if the IRS has the information.

So you cannot change a provider number very simply. It is even more difficult than in the other areas that have been discussed. So we think it is a question of the government getting its act together and CMS, the agency that oversees Medicare being told to do it.

Ms. MUSGRAVE. Thank you for that response.

You know, as I looked at the big picture on this, can any of you address how this will affect your ability to reinvest in your business, grow your business and create jobs if this is not repealed?

Mr. DEEL. Well, I will start with my particular companies. We do a lot for the U.S. government, and that three percent would amount to for us about a million dollars a year, and that is one million dollars less that I would have available to buy tractors or trailers or grow my business, and that's a million dollars of working capital that I wouldn't otherwise have available to me.

So, yes, that is a huge amount of money for my particular group of companies.

Ms. MUSGRAVE. Very dramatic.

Mr. DEEL. Yes.

Ms. MUSGRAVE. Does anyone else want to respond to that?

Mr. COLEMAN. I would. In my company, in the construction industry three percent could be ten jobs, and we should be at the point of developing jobs and work for our society.

It also takes away cash flow, and in our business we need cash flow. We are already dealing, as I said before, with a ten percent retention which takes away cash flow. So we struggle with cash flow, and for those businesses that cannot go to a bank or cannot go to some type of financial organization to get that finance, they are going to struggle.

They will not be able to grow their businesses. Three percent to some major corporations may not sound like a lot of money, but to a small, emerging business, it is a lot of money, and in my organization ten jobs is a lot of jobs. So it is going to have a dire effect on cash flow in our organization.

Mr. KAHN. You know, I would like to add that if I understand the GAO reports, a good bit of the problem is with payroll taxes. So, one, this does not go to the heart of payroll taxes, and frankly, in the hospital business, as I said, we are around 20 percent of hospitals. We are competing with tax exempt hospitals that do not pay

income taxes. So they will get their full Medicare payment and we will not when the issue is an issue primarily of payroll taxes.

And anybody who is not paying their payroll taxes is not just cheating the government. They are cheating their employees and probably should be hung, particularly if they go out and spend the money on luxury items and things, which is what the GAO report concluded.

So I think we need to find solutions to this problem, and I understand in the GAO report that they just came out with the other day that five percent of physicians and suppliers being paid by Part B of Medicare have some kind of problem here, and that is a big number. It is shocking.

But they should be dealt with. They can be identified, and taking money away from everyone will put everyone at a disadvantage.

Ms. MUSGRAVE. Thank you, and I yield back, Madam Chairman.

Chairwoman VELÁZQUEZ. Thank you.

And now I recognize the gentleman from Pennsylvania, Mr. Altmire.

Mr. ALTMIRE. Thank you, Madam Chair.

And I want to thank the panel for being here today and for full disclosure, say that I used to work at the Federation of American Hospitals before Mr. Kahn was there, but I am glad to see you here today as well.

My first question is for Mr. Deel, and I just wanted to ask for my own benefit if you could give me an example of how withholding three percent of payment is different from withholding three percent of taxable income from your business perspective.

Mr. DEEL. Well, three percent of the top line, my revenues, three percent of the gross revenue is entirely different than three percent of the net. In our industry, take just five percent is the pre-tax number of the top line. So if the company has a million dollars a year of gross revenues that the three percent would come out of, that would be $30,000. If that company only makes five percent of that million, that is $50,000 of taxable income and times the tax rate, you can see there that taking a three percent of the gross top line has no correlation to what your bottom line may be. It is just a wrong way of trying to get at the taxes that are not being paid by companies.

Mr. ALTMIRE. And if we repeal the requirement to withhold the three percent, how will we be able to offset the cost to the tax breaks from the original legislation? What would you suggest?

Mr. DEEL. My recommendation would be do what Mr. Kahn has been talking about and additionally implement a 1099 reporting kind of mechanism for any government payments to any company, whether they're large business, small business, sole proprietary; that there is a mechanism to report to the Internal Revenue Service. This is a tried and true method of 1099 reporting.

They would know what your federal ID number is. A company would have to sign a W-9 form certifying what your tax withholding number is your federal ID number, and at least the IRS would have the ability to follow and see is this company either filing a tax return, and if they are, are they reporting their revenues correctly?

I think the combination of following up and withholding money from companies that do not pay their taxes that the IRS knows about is great, and I think additionally there needs to be reporting similar to when you receive an interest statement from your bank, a 1099. The IRS checks to make sure you put that on your tax return.

That would be one relatively simple way of doing it, and it would only be a burden to the government agency once a year. They have to keep track of it during the year, but it is just one piece of paper that has to get sent out, one to the business owner and one to the Treasury department.

Mr. ALTMIRE. Okay, and for Mr. Iannelli and Mr. Coleman, you both talked about some of the bonds that are required in your industry to perform certain types of work, and it seems that surety bonding would require that they look at your books to make sure that you are financially solvent.

Can you each discuss with the committee the type of records that you think they will look at in determining your eligibility for those bonds?

Mr. COLEMAN. Well, number one is the financial statement. They're going to look at the financial statement. They're going to require audited financial statements. When you reach a certain level of bonds, they're going to require an audited statement and you're going to go through a full blown audit to make sure that you are capable of being able to perform at whatever level that you're performing at. That's number one, first and foremost, with those organizations.

And if you don't meet their requirements, chances are you are not going to get a performance bond, and without performance bonds, you don't compete in the public environment, and not only public environment from a federal standpoint, but you're not going to compete with the local and state municipalities as well.

Mr. IANNELLI. The bonding community in New York City has dried up considerably. So there are not a lot of places where your contractor can go for bonds, and they have regulations and requirements that are about, you know, they basically want to come over to your house and see how you live.

And my bonding company every year, the financial statement, wants to check my tax returns and make sure the bottom line or whatever I said that I grossed on my tax returns is what I'm saying is the bottom line on my financial statement. So they check. There are checks and double checks and triple checks. So there is no way out of it, no way I could not pay my taxes.

Mr. ALTMIRE. Great. Thank you.

I yield back my time.

Chairwoman VELÁZQUEZ. Mr. Jordan from Ohio, you are recognized.

Mr. JORDAN. Thank you very much.

That is a rookie for you right there.

[Laughter.]

Mr. JORDAN. But I do appreciate the panel, and Mr. Deel's testimony as well. You know, there is nothing like mathematics to show what is going on. Sometimes politicians are not too good in that

subject, but it is good to have that in front of us. So I appreciate what you are doing.

This is just, in my judgment, one more example of government saying we are smarter than the business owner. We are smarter than the family out there. We want to use your money for the year instead of letting you use it and invest it in jobs and business and in our community.

So I think it is a good piece of legislation that we should pass, and I appreciate the panel's testimony today, and I yield back.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Whitman, it seems that the three percent withholding could have a particularly harsh impact on the tech industry where start-up costs are high and financing is critical. Do you believe that this change could have a negative effect on innovation in technologies because of the unique financing challenges facing your industry?

Mr. WHITMAN. Well, when we were talking about research and development, typically research and development is done by larger organizations. Our members are typically smaller tech companies that are the providers of services. So I would not really speak to whether or not this three percent would affect innovation.

Chairwoman VELÁZQUEZ. Mr. Deel and Mr. Coleman and Mr. Iannelli, maybe the three of you can address my question.

As the tax code has become more complex, so have the organizational set- ups of small businesses. The structure of a company can be based on a number of factors, including estate planning, liability concerns, and partnership sharing. Do you think this three percent withholding could be particularly burdensome for certain types of organizations, whether that be an S corporation, a partnership or some other structures?

Mr. DEEL. I had not thought earlier until one of the other testimonies about the complexities of an S corporation or a partnership. This money is going to be withheld and sent over to the Treasury Department, and they are going to have to match that against the federal ID number, but if the real taxpayer is a member of an S corporation or a partnership, be the one paying the tax on the income, how will that match up that they will be able to get credit on their 1040 tax return when they file it or the money that was paid in under the corporation's tax ID number or the partnership's ID number?

That is going to be a nightmare I would just imagine.

Chairwoman VELÁZQUEZ. Yes. Any other witness who would like to answer?

Mr. KAHN. Well, I think in the health care situation, particularly in group practices for physicians or in the hospital situation there may be subsidiaries that actually could create a similar kind of situation where some kind of holding entity is actually paying the taxes and you have got other entities that now are going to lose money on their Medicare payment, and the bookkeeping issues, assuming that you can even locate all of the dollars are going to be a big problem.

Chairwoman VELÁZQUEZ. Thank you.

The federal government and I have been particularly on this issue for the many years that I have been serving in this committee making sure that small businesses have an opportunity to

do business in the federal marketplace, and in fact, the contracting goal of the federal government has not been reached for several years now of 23 percent.

I would like to hear from the witnesses on how they think this change will affect small business' abilities to get contracts over large competitors, and do you believe that the cash flow issue will limit the ability of small contractors to perform these contracts?

Mr. Coleman.

Mr. COLEMAN. I think it will limit the ability. We're talking cash flow in many cases, and any amount of cash flow is important to a small business. My biggest fear is this three percent will drive some of your small emerging businesses out of the marketplace, and I do not think that we really want to do that.

In our group we feel that this three percent is just a bad idea, and there has got to be other ways to be able to reach the goal that you want to see accomplished and closing that tax gap and not penalize small emerging businesses in the process. I just think it is a bad idea.

Chairwoman VELÁZQUEZ. Could the government end up paying more for contracts because of this change?

Mr. COLEMAN. They will pay more. They will pay more in increased costs because those that can finance it are going to try and pass that cost on to the federal government. You will pay more with reduced competition because if you drive businesses out of business, that means you're going to have less competition in the marketplace for the work that you're putting out there for bid or for offerors.

Chairwoman VELÁZQUEZ. Okay. Any other witness? Yes, Mr. Whitman.

Mr. WHITMAN. Yes. And for those businesses that are in the smaller end of the spectrum, as they lose this operating capital because of the withholdings, they will have to go into the market to borrow, if in fact they can borrow, and this is another cost that they will have to pass on to the government. So, I mean, no matter how you cut it, it's going to be more expensive for the government, and it's going to be bad for small business.

Mr. DEEL. I can give a recent example how the motor carrier industry that serves the Department of Defense transportation needs. Several years ago they made the decision that the way they would pay the carriers is through a system called Powertrack. It's through U.S. Bank, and they withhold approximately two percent from your payment to receive the funds by electronic wire.

Well, that two percent charge is a very expensive charge for the cash for that faster payment, and what the industry did was raise rates by approximately the two percent. That was the general reaction.

So to answer your question about will the costs go up, it is likely that they will through reduced competition if some of the small business goes out and the bigger guys that are left say, "Well, we can raise rates now."

And one further thing I'd like to say is that when I started my company ten years ago, had this been in place, it would have been very, very difficult for me to be where I am today. In those early years cash was very, very tight. Cash flow was I refer to "cash is

king." I could not have grown my company with this three percent and served the government market.

Chairwoman VELÁZQUEZ. Thank you.

I will recognize the gentleman from Georgia, Mr. Westmoreland.

Mr. WESTMORELAND. Thank you, Madam Chairwoman.

And I want to say that I look forward to working with you and the rest of the Committee on repealing this crazy thing, and I also want to apologize to the people. I am embarrassed that this was passed during a Republican control of Congress, and I think this is an example of what happens when we hurriedly pass some of these big pieces of legislation, two and three and 400 pages of very technical stuff, and we have a very short time in which to look at it. Madam Chair, I think this is one of those things that got past all of us, and especially the people that are familiar with small business.

So forgive us, and hopefully this year if we can right this wrong, I think it will be the highlight of my congressional career in a short three years just to right any wrong, but especially this one.

[Laughter.]

Mr. WESTMORELAND. Mr. Coleman, I am a small business guy, too, and I was in the construction business all my life, a Mom and Pop guy, and when I was in the state legislature I fought very hard to make sure that procurement of government contracts was available to all business, small, large, minority, whatever the case is. Everybody had an opportunity to do this, and you know, we passed—I say "we," but I did not have any responsibility for this—but back in the late 1980s, we passed a tax called the AMT tax, the alternative minimum tax, and it was designed to get 150 millionaires who did not pay any taxes.

This year I think it is going to affect 20 million people. So something that they did to catch 150 has developed into a bunch of us.

In contract, I think it is the same thing. While their goal was good and what they wanted to do—well, I do not know that it was good in what they wanted to do, but it is not small business' job to enforce the tax codes. Now they are wanting us to enforce immigration laws, tax code. I mean, I do not know what else we are going to be responsible for.

But in your testimony, and I read your testimony. I am sorry I was not here for you to give it, but in reading your testimony, you said it is anywhere from five to ten percent of your payment. In a small business cash flow kind of crunch, that is a lot, isn't it?

Mr. COLEMAN. Exactly.

Mr. WESTMORELAND. And I know from my experience in small business a lot of these large government contracts, I never got any of them, but—

[Laughter.]

Mr. DEEL. You were lucky.

Mr. WESTMORELAND. Yes, I know I was lucky, yes. I did not have an opportunity to lose money.

[Laughter.]

Mr. WESTMORELAND. But three percent was in some cases all of the profit you were going to make, and I think going back to what Mr. Deel said, it is going to drive the small guys out of business, and the guys that had some fat in it that can afford the three per-

cent will be the only ones left, and then once small business is driven out of it, then the prices are just going to escalate at a rapid rate, and I think we are going to see an outcome that is not going to be good for us all.

But can you speak to what you were talking about as far as your association of contractors and how you kind of police yourself, I guess, on this?

Mr. COLEMAN. Yes, yes. Our association of contractors have campaigned for quality construction. We like to think of ourselves as a group that want fair legislation, legislation that all can abide by, have that level playing field, so to speak. We want to do the right things.

We pay very good wages. Just about all of our members are associated with collective bargaining agreements where we negotiate with the local building trades unions to put forth some very good packages with health and welfare benefits, multi-employer pension plans that are portable. The gentlemen or women in our association are in building trades unions. They can move from state to state, city to city and work and have everything travel and go along with them.

And we think that it is a very good situation for all parties concerned, and we all want to do the right thing. We all want to pay our taxes. We all want to be good citizens. It is that when situations are created where that playing field gets tilted, we're running up here on the Hill trying to meet with you and your constituents to help get this thing back to level so that we can all go down the road and do the right thing for our businesses and for our country by paying our taxes so that you guys can have the funds to do what you need to do on the other side back in our district.

Mr. WESTMORELAND. If you find that level playing field, take a picture of it because I've been looking for it for years, and it is always tilted one way or the other.

[Laughter.]

Mr. WESTMORELAND. I do not know what it is, and I am sure all of your associations are the same, that you try to police yourselves. You want to be the blue chip association of organization where when your members come in they feel like they have been accredited in some way to be part of it and you are responsible for people.

Government does not need to be policing it for you. I think you will do a great job of it yourselves.

Madam Chairman, with that I will yield back and just tell you that I am looking forward to working with you and see if we cannot right this wrong.

Thank you.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Coleman.

Mr. COLEMAN. Yes, I wanted to make one more point that the Congressman raised about the five to ten percent retention. I think to get a clear understanding of what the retention is about, if we had a million dollar contract, and I billed a million dollars a month, they are going to take $100,000 of that million dollars a month away from me, and they are going to hold that until the completion of the project.

Now, when I buy equipment, materials, and provide labor on my project, I am not going to pay the labor that I have working 90 percent of what he is due in the week. He will be up here and you will come and shut me down.

When I buy equipment, if I have to buy a piece of air conditioning equipment and it costs me $100,000, I have got to pay that $100,000 right then and there. I cannot pay the guy $90,000 and expect him not to put a hold or come after me for the balance of his money.

So that money that we are being withheld, that money is the type of dollars that we have to go and finance or take out of our business to be able to make sure that everyone is whole while we wait in the public environment to the end of the project to be able to get those dollars back.

And then when you put three percent on top of that, now we are talking 13 percent. We are not talking ten percent, and that is what I mean by the effect of cash flow in our businesses. It is devastating. And if you want to put some small businesses out of business, then pass this legislation. That is how devastating it will be to our constituents across the country.,

Mr. WESTMORELAND. Can I make one comment to that?

That is a great point about the ten percent retainage because what we probably need to do is pass some type of legislation that says the government has to give you back that ten percent retainage in a timely fashion. Because I know that sometimes that retainage is tough to get in a timely way, and you may have to wait 90, 120, six months.

Mr. DEEL. Year.

Mr. COLEMAN. In some cases.

Mr. WESTMORELAND. Years, and a lot of time that ten percent is more than your profit; is that not true?

Mr. COLEMAN. That is true.

Mr. WESTMORELAND. Thank you, sir.

Chairwoman VELÁZQUEZ. The time has expired.

I have another question, my last questions, and I want to address it to Mr. Kahn or Mr. Whitman.

In your testimony you talk about how the budget score of the three percent withholding requirement was not an accurate reflection of the effect on the federal budget. So I was hoping that you could shed some light on why the $7 billion is not an accurate figure. How much of this is attributable to taxes that will have not been paid otherwise?

In other words, how much it will actually close the tax gap?

Mr. KAHN. I think what we were referring to, and this is something, joint tax, whatever, would reveal. I am not sure they looked at the Medicare program as one of the sources of revenue here that would be affected by the three percent, and there is some evidence to that.

So, one, we think that the estimate understates what would be collected because you're talking about, you know, three percent on the Medicare program, which is hundreds of billions of dollars, and of course, there are tax exempt organizations that would get the three percent, but they only make up probably about 35, 40 percent of Medicare spending.

So we think the effect is going to be much greater on revenues than was anticipated.

Mr. WHITMAN. Yes. Are you speaking to the fact as to whether or not this three percent will close the tax gap? Oh, okay. Fine.

The three percent withholding does not do anything. It is the reporting of the income that does something. So the IRS can determine if a contractor, if a person has reported that income on the return. So if we have that, we do not need the withholding. Withholding does not close this tax gap in any fashion. It simply is money that would have been paid at the end of the year had it been owed.

Chairwoman VELÁZQUEZ. Thank you.

Well, I want to thank you all for taking time to come here and talk to us about this important issue, and you know, this Committee, I want to use it as a vehicle to be able to raise the profile of the impact of this issue on small businesses. So I want to thank all of you for your participation, and without objection members will have five days to submit a statement for the record.

With that, this hearing is adjourned.

[Whereupon, at 11:36 a.m., the Committee meeting was adjourned.]

STATEMENT
of the
Honorable Nydia M. Velázquez, Chairwoman
House Committee on Small Business
Hearing on "The Hidden Tax on Small Businesses"
March 22, 2007, 10am

I now call to order a hearing to examine the impact of a three percent withholding requirement on all government payments.

Today's hearing focuses on what might seem to be a minor change in tax law, but will have a huge affect on small businesses across this country. We will discuss the potential problems of a provision included in a tax bill passed last year that would require the government to withhold 3% on many government payments.

While the withholding requirement is not scheduled to become effective until 2011, it is important understand the problems now. This change goes far beyond those who do business with the federal government.

Farmers who receive payments from the USDA, health care providers who receive Medicare reimbursements, as well as the thousands of small businesses who perform contracts for the federal government will all be hit with this 3% withholding. The way it works, this money will be withheld regardless of what you actually owe in taxes.

This could be an enormous burden across the board, but especially for small businesses. While 3% may not seem to be a significant amount, it can mean the difference between meeting payroll, expanding your company or buying needed equipment. Cash flow is a major issue for small companies. If they have money withheld on every payment they receive, it will reduce their ability to compete against their corporate counterparts.

For small government contractors, the results could be severe. When you consider that small firms are continuing to be squeezed out of the federal marketplace, the last thing Congress should be doing is creating another obstacle to success.

Small firms, which often have limited resources, may be unable to afford to stay in the market. Furthermore, if businesses leave the federal marketplace, there will be less competition. Limiting competition will lead to higher prices – costing valuable taxpayer dollars.

The change will also have a negative impact on the health care industry. Putting aside the cash flow issue, the shear volume of transactions affected by this change creates a huge administrative burden. Hospitals and small business health care providers will have millions of transactions that will be subject to the three percent withholding.

That means the health care industry will be responsible for accounting for every transaction has met the requirements of this tax provision.

I believe the intent of this provision was a good one. Right now, there is a $350 billion tax gap because many are not reporting income and paying taxes on that income. However, I question whether this change will really get at that problem. Most of the revenue costs of this provision do not come from collecting taxes, but due to a budget gimmick. It simply moves up the collection of money that would have happened the next year.

We must consider the hidden costs of this legislation. Small businesses already face enough problems and we should not make the costs of running a business more by requiring an interest free loan to the government.

It seems to me that the most logical step is to repeal the provision. There are better ways to get at those who are not paying their taxes without creating a hardship on small businesses. I appreciate the witnesses coming here today to talk about their concerns.

I look forward to today's discussion.

Opening Statement	
Hearing Name	Hearing on 3% Withholding on Government Contracts
Committee	Full Committee
Date	3/22/2007

Opening Statement of Ranking Member Chabot

"Thank you, Madam Chairwoman, and thank you for holding this important hearing to discuss Section 511 of the '*Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)*.'

"I find it truly ironic that legislation called the '*Tax Increase Prevention and Reconciliation Act*' -- which provides for lower taxes on capital gains and dividends and that, generally, helps small business owners -- also contains a provision (added at the eleventh hour during a House-Senate conference committee) that will *raise* taxes on those same small businesses, if Congress fails to take action.

"Section 511 of the Act, scheduled to take effect in 2011, will require federal, state and local governments with an annual procurement budget of at least $100 million, to withhold 3% from all payments for goods and services as a guard against possible business tax evasion – justification that I find particularly offensive.

"Section 511 will affect goods and services under government contracts, as well as payments to any person for service or products provided to a government entity, such as Medicare payments or certain grants. This provision is based on revenue from government payments, and is unrelated to a company's taxable income or tax liability.

"As I mentioned earlier, it's particularly troubling to me that Section 511 was inserted in the *Tax Increase Prevention and Reconciliation Act of 2005* during the House-Senate conference, without any open debate on the merits. A provision that will likely have this type of impact on small businesses, as well as state and local governments and the private sector, should have been fully considered in both houses of Congress, with input from all sides.

"At a time when we are trying to encourage the federal government to do *more* business with small businesses, Section 511 is exactly the wrong message to send. Small businesses typically work with very small margins, and 3% withheld from any payment affects its operating capital, and could make the difference between its ability to submit a bid or not. Furthermore, companies of all sizes that do business with government will likely have to increase prices to account for this burden.

"The impact of Section 511 will likely be enormous and far-reaching – from the cost of construction projects to taxpayers (which would likely increase) to the already low Medicare reimbursement payments to physicians that will likely

decrease (which could cause physicians to stop accepting new Medicare patients). Some companies may be forced to pass some of the withholding amount down to subcontractors. This can be especially harmful to small businesses down the supply chain.

"According to the Congressional Budget Office and the Joint Committee on Taxation, Section 511 amounts to an intergovernmental unfunded mandate, and would be extremely expensive to implement. In many cases, governments and the private sector would have to adopt new accounting and financial control measures, and perhaps additional personnel, to track these payments. In short, Section 511 hurts honest, taxpaying small businesses without providing any additional enforcement provisions to improve tax compliance.

"Section 511 of TIPRA is bad law and bad tax policy. I want to again thank the Chairwoman for holding this hearing to expose the damaging affects this provision will have on small businesses should Congress fail to take action in the next few years to prevent it – or should there be an attempt to expedite Section 511's implementation as happened last year.

"We need to be looking at ways to foster growth and productivity in the small business sector, not penalize everybody for the actions of a few.

"Madam Chairwoman, thank you again for holding this hearing. I look forward to hearing from our distinguished panel, and to working with you to address this important issue."

Statement of Rep. Jason Altmire
Committee on Small Business Hearing: "The New Hidden Tax on Small Business"
March 22, 2007

Thank you, Madam Chair, for holding this hearing today on the deleterious effects for small businesses of a three percent withholding tax on government payments. This measure was originally included in the Tax Increase Prevention and Reconciliation Act of 2005 as a means of reducing the tax gap, the ever widening distance between what is owed the government and what the government is actually able to collect. While there is no question that the tax gap is a serious problem, I have strong doubts that this withholding tax is the best means of addressing it and am concerned that it will negatively impact America's small businesses.

I fear that the negative effects of the tax on small businesses may outweigh any positive impact on closing the tax gap. First, it will present an administrative nightmare, particularly when assessing Medicare reimbursements for hospitals and physicians. Worse, it will present small businesses that rely on government contracts with a debilitating cash crunch. Small businesses have a hard enough time competing for government contracts as it is; this provision will be a boon for the large companies that already dominate federal contracting by leading to an erosion of their small business competitors.

Madam Chair, it seems the full effects of this provision were not fully considered before being inserted into the final TIPRA conference report. The majority of small businesses pay their taxes in full and on time, and this provision will punish all those businesses for the sake of catching the few that do not. I thank you for holding this hearing today and shining a light on the impact this will have on small businesses.

Thank you, Madam Chair. I yield back the balance of my time.

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Testimony of

Vincent Iannelli

on behalf of

The Associated General Contractors of America

Presented to the

U.S. House of Representatives
Committee on Small Business

For a hearing on

The New Hidden Tax on Small Business

March 22, 2007

Building Your Quality of Life

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 32,000 firms, including 7,000 of America's leading general contractors, and over 11,000 specialty-contracting firms. More than 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. Visit the AGC Web site at www.agc.org. AGC members are "Building Your Quality of Life."

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
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March 22, 2007
U.S. House of Representatives
Committee on Small Business

Thank you Chairwoman Velázquez and Ranking Member Chabot for this opportunity to testify on the new 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.

I am Vincent Iannelli, President of Iannelli Construction Company Inc, and a member of the General Building Contractors of New York State, an AGC chapter. My dad started our company in 1958, and now my brother Thomas and I run it. My daughter Carla started working with us two years ago. Iannelli Construction is a family business.

We are also 99% public works. My dad at one time bid on more private jobs, but he eventually decided to focus 100% on public jobs, and we still follow that tradition. Periodically we have built hospitals, stadiums, university buildings, and nursing homes, but right now we mostly focus on school buildings.

As the construction industry representative today, I am also here speaking for many of the concerns shared by the Construction Organizations for Sensible Taxation (COST) Coalition. Members include the Air Conditioning Contractors of America, the American Council of Engineering Companies, the American Subcontractors Association, the Associated Builders and Contractors, the Construction Management Association of America, the Finishing Contractors Association, the Independent Electrical Contractors, Inc., the Mason Contractors Association of America, the Mechanical Contractors Association of America, the National Association of Surety Bond Producers, the National Electrical Contractors Association, the National Roofing Contractors Association, the National Utility Contractors Association, the Plumbing-Heating-Cooling Contractors-National Association, the Sheet Metal and Air Conditioning Contractors' National Association.

The construction industry is a significant source of jobs. We provide jobs for 7.7 million employees—more than 5% of the total nonfarm workforce. Even as homebuilding has declined recently, nonresidential construction has added 185,000 jobs in the past year—nearly 9% of all net new jobs.

We also provide good-paying jobs. In January 2007, seasonally adjusted hourly earnings in construction averaged $20.51, 20% higher than the average for all private industry nonsupervisory workers, according to BLS.

Construction makes a disproportionately large contribution to GDP. The value of construction put in place in 2006 totaled $1.2 trillion, 9% of gross domestic product (GDP). Residential spending totaled $639 billion; nonresidential, $559 billion.

The typical construction firm size is very small. In 2005, there were 831,000 construction establishments with 6.8 million paid employees, plus more than two million firms without paid employees—mainly self-employed individuals but also partnerships and holding companies. Thus, average employment was only eight per establishment. Small business is big in construction. In 2005, 91% of construction establishments had fewer than 20 employees. Only 1% had 100 or more.

The 2006 Construction Industry Annual Financial Survey, conducted by the Construction Financial Management Assn. (www.cfma.org), included responses from 495 companies. Earnings after taxes in the most recent fiscal year averaged 2.1%, up from 1.6% in 2005.

Today, Iannelli Construction works 99% of the time on school construction. We employ six full time employees in the office, and 10-20 in the field, depending on how much work we have. We are 100% union, working mostly with the local carpenters and masonry unions.

We work at all hours, both day and night. Interior and exterior school renovations are all at night, when kids aren't in school. New school construction is during the day. Contracts take from a year to three years to complete and we work in all five Burroughs.

All of my public projects have retainage. The public owner holds back from five to ten percent of each progress payment until the project has been substantially completed, in order to keep a monetary incentive over the contractor to ensure the project is finished. Normally, after a project has been certified 95% complete, the retainage will drop to 2.5%. It has sometimes taken me years to receive that final 2.5% when the contract has been completed.

In addition, some public owners hold out 5% of the project for closeout. In addition to the retainage which held on until the project is entirely complete, public owners also hold onto an additional 5% to ensure the final punch list is complete. They slowly release this money in increments as we close out and work through the punch list. If the contract has phases, then this money is returned at the end of each phase.

Because these are 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 one specific bond – performance bonds – guarantees 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 can not get the bond, they are not qualified to bid on government contracts, or will lose their contract.

As you can see, there are several protections in current law for the taxpayer on public projects. Five to ten percent retainage, five percent close out costs, and several layers of bonds, all paid for by the constructor during the construction process.

Now the federal government has added an additional layer by requiring three percent withholding on payments for good and services from every level of government, federal, state, and local. This new requirement plus the retainage and close out costs could add up to 15% of every progress payment. All to ensure that the contractor makes tax payments that are required to be paid by the bond that is required just to be qualified to bid on the project.

This kind of a hit to my cash flow also makes it more costly for me to purchase the bonds necessary. Surety companies, who provide the bonds, study my books in detail before offering coverage. Based on past performances, the ability to perform the work for which I bid, and my cash flow, a surety gives Iannelli Construction 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 retainage, closeout costs and 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 my cash flow, directly impacts how much work my company can take on.

That is just one of the reasons why cash flow is so important. Another is my ability to pay my suppliers, sub contractors 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, or cause them to pay them short. Subcontractors, often small businesses, also have a tight cash flow and need to be paid on time; this could hurt many and send them right out of business.

I've been asked if I will bid up projects, tacking on an additional one or two percent. I can't, because there is always someone willing to do the job without doing that. The climate for projects I bid on is very tight. Someone will suffer through the situation instead, and that person will get the project if I out-price them. Right after Sept 11, insurance costs skyrocketed, and we could not control it. Even then, contractors didn't increase costs overall, because there was always someone who wouldn't raise their prices. The competitive bid process really helps keep costs down for the public owner.

I've also been asked if I think people will get out of the public works business. I know that I won't, and I don't think others will either. People who bid on public projects have already encountered layers of bureaucracy and paper work, and this will be one more. For some, it may be the final straw, but for most, I imagine they continue the work.

What is frustrating is the government is penalizing the good contractors for paying their taxes and paying their payroll taxes in a timely manner. The government requires that construction contractors obtain a bond to insure our taxes are paid. There should be a better way to do this. The agencies and construction managers that we do work for, we have to pre-qualify every couple of years, and one of the questions during the process is if we pay your taxes. The agency looks into this, and some want tax returns for two or three years. If you can't come up with that, then you aren't qualified to bid on the jobs. You have to pay taxes on time. Just shut people down if after awhile they aren't paying their taxes. I don't get it. I just want to pay my bills, do my work.

Finally, we are concerned about implementation. In general, we know this will affect cash flow. But there will also be real trouble in the implementation regulations.

TIMING OF WITHHOLDING
The assumed timing of the withholding for constructors is at the time of each progress payment. Nevertheless, it appears the IRS could regulate that timing. Two obvious choices would be withholding 3% of the contract from the first progress payments, and holding on to it until the contract has been completed, or withholding at the end of the contract from the final progress payments.

We believe withholding the necessary 3% from the first progress payments would be intolerable, and damage cash flow to the extent even more contractors would be forced from the government sector. In addition, as change orders and contracts often change during the building process, it would be impossible to know what 3% of the entire contract cost would actually equate.

BONDING
AGC believes that the IRS should more proactively use the protection of performance bonds to ensure proper payroll withholding by constructors in order to close the tax gap. Furthermore, due to this third party guarantee already provided under current law, AGC requests the IRS consider an industry-specific waiver be created for construction. Under this scenario, a constructor who has a performance bond and has won a section 511 government contract would not have 3% or any extra withholding applied to contracts as the bond guarantees the payment. Those constructors working on projects which did not require the performance bond could proactively provide that bonding as a way to ensure compliance and avoid the 3% withholding.

PAYROLL WITHHOLDING
It has been suggested that the 3% withholding could also be used to offset payroll withholding. Not only is it illegal, we believe it is highly problematic. Employers are

required to file and remit the withholding from their employee's paycheck the day after they pay the employee. Not doing so can get an owner thrown in jail, and for good reason. Indeed, remitting payroll withholding is a personal, not company, liability for some employers, because of the set-up of their company. This is not company money, this is money that actually belongs to the employee, and the employer is acting as a third party to ensure payment is made. To use these funds to offset taxes owed by the company denies the nature of this relationship, and the reason for the criminal and civil liability.

Further, by allowing this process, the federal government actually weakens the laws designed to protect both the taxpayer and the IRS. The IRS would be relying on an outside party (the section 511 government agency) to accurately and timely withhold the 3% of the payment on behalf of the company, who would then immediately claim this withholding (regardless of when the 511 government agency actually remit the withholding to the IRS) as payment legally required by them on their employee's behalf. The employer would then pocket the money they withhold from the employee. This opens the system to more fraud and abuse by those who are currently the trouble-makers. It also creates a system where employers are claiming withholding funds that may not yet have arrived at the IRS, impacting the cash flow of the federal government.

AGC taxpaying members don't believe this solution helps close the loophole or narrow the tax gap, as desired by members of Congress. Indeed, we believe it opens up the system to more problems.

ESOPs

As you may know, many construction companies have and continue to become Employee Stock Ownership Plans (or ESOPs). Due to their nature, these companies do not owe federal income tax; nevertheless, if the company performs work, they owe payroll withholding for their employees.

For these companies, this 3% withholding is a direct loan to the government, as there is no income tax to offset against. If the federal government includes payroll withholding as an item to be offset against, this may mitigate the cash flow burden, but would still create further loopholes for fraudulent companies to cheat the system.

S CORPS

Sixty percent of businesses in the construction industry are S corporations, which means the corporate income tax is paid at the shareholder level. Just last year, Congress increased the number of shareholders in an S corp to 99. While 99 shareholders is uncommon, 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. The IRS will be counted on for having increased capacity in its record keeping

system as well. This has the promise of resulting in a lot of extra records, files, and paperwork, and could easily lead to more fraud and abuse in the system.

Congress should act in this area, before the regulators get started, to not penalize pass-through corporations that pay their taxes at the shareholder level.

JOINT VENTURES (JVs)
As government construction contracts have grown, expanded, and become more complicated, construction companies have had to increasingly work together to tackle large projects. Especially in federal highway work, often two companies will join together, one with paving capabilities and the other specializing in bridge work for example, and form a joint venture to bid on the work. JVs are normally set up in two different ways: integrated and non-integrated. Regardless of the method used, JVs are also commonly used in order to spread contract risk and increase bonding capacity.

Non-integrated JVs are typically bound by a contract, where each party takes on a specific scope of work (i.e. bridge building) and is responsible for the profits and losses from that specific work.

AGC has specific concerns with section 511 withholding and non-integrated JVs. Non-integrated JVs by nature do not carry an income tax liability at the entity level; all taxes are incurred by the venture partners. The partners themselves are then responsible for their own quarterly filings and payroll withholding requirements. Withholding 3% of the contract at the JV level creates unintended consequences and complications as the JV doesn't actually owe taxes.

Integrated joint ventures are often legal partnerships, LLC, or S Corps that are formed and each partner receives a percentage of the profit or loss depending on their interest in it. Again, the integrated JV does not remit any payroll withholding, as it subcontracts out 100% of the work to the venture parties. The integrated JV may have an income tax liability depending on its legal form of business. Nevertheless, the burden created by the over withholding on cash flow is then passed on to parties of the JV, which are in many cases S corps. This dividing up of the section 511 withholding becomes increasingly burdensome.

Regardless of the method of integration, the contract or partnership stipulates the amount of working capital each partner contributes to the JV. The JV doesn't have any other finances. Cash flow, which is important to every construction company, is magnified with a JV as there is no savings or any other income for the entity to use to prepay and prepare for the construction project. In this case, the over withholding by the government has to come from the working capital, which then must be increased by each of the partners. This increases the cost of doing business, decreases bonding capacity, increases the cost of the bonds, and over-burdens constructors trying to complete a project.

AGC believes that Joint-Ventures must be given special consideration as the IRS is writing regulations.

A majority of AGC contractors work on some kind of government contract every year, and this 3% withholding will have a large impact on the construction industry. The provision is unnecessary because the performance bonds required for federal work ensure tax compliance. The 3% withholding exceeds the average net revenue on construction projects. We ask for your help to repeal this unfair, burdensome, and overly-complicated law.

Again, thank you for the opportunity to testify today on behalf of AGC. I look forward to your questions.

Oral Testimony
By Mr. Daryl Deel
President and CEO of three small-business trucking companies
on behalf of the American Trucking Associations
before the House Small Business Committee

Good morning. My name is Daryl Deel. I am a Certified Public Accountant by training, and the president and principal owner of three small trucking companies. I am here today representing the American Trucking Associations, or ATA. We appreciate the opportunity to be represented before this distinguished panel. My trucking companies specialize in high security shipments for the Departments of Defense and Energy. As a member of ATA, I currently am Vice-Chairman of the ATA Tax Policy Committee. For three years prior to that, I chaired the Government Traffic Policy Committee which is comprised of motor carriers and brokers who provide contract services to haul government freight.

ATA represents the motor carriers who serve government agencies with the best freight logistics support in the world. It takes a lot of money and expertise to provide that level of service. The trucking industry takes immense pride in the fact they support public missions. We are particularly proud to be an indispensable link in the Defense supply chain that sustains America's warfighters domestically, and throughout the world.

Like most businesses, we expect customers to pay within 30 days, or "net 30." When a customer has a good track record of payment, we give them the best rates. When government agencies begin withholding 3%, we will not see that money for much longer than the customary 30 days allowed.

Depending on the state of the economy, our profit margins range from about ½ of 1 percent to 5 percent of the amount charged for service. This represents an average net profit margin of under 3%. Therefore, when government customers start withholding 3 percent of the freight bill they owe, trucking companies may be compelled to increase their rates. Otherwise:

- All or most of the profit margin would be unavailable until after tax returns are filed and refunds are received.

- And when the economy is down and suppresses profit margins, the 3 percent will more than devour all of the profit margin. This is like floating a loan to the government. Most small businesses will not be able to withstand the negative cash flow impact and could eventually go bankrupt.

A large company with mostly commercial customers can absorb the 3% withholding by merely reducing the amount it pays in quarterly tax payments. But a small company with mostly government customers could suffer withholding of 100% of their profit margin until after tax returns are filed and the refund received. Worse yet, withholding the 3% could bite into cash needed to pay for direct costs incurred to provide the service. This

negative cash flow would force the smaller company to raise its rates, but that may make it less competitive against a larger company. It also forces the smaller company to consider leaving government service in favor of commercial shippers that pay in full within 30 days. I have a simple chart demonstrating the numbers. With your permission, I can offer it for the record.

For these reasons, I am convinced, that if the 3 percent withholding is implemented, that my companies will be compelled to increase rates. This is the exact opposite of what Congress intended when the new withholding tax was established.

For these reasons, the motor carriers of the American Trucking Associations urge the members of this honored panel to support H.R. 1023. Thank you again for the opportunity to be here today.

~ * * * ~

Impact of 3% Withholding		Large Motor Carrier		Small Motor Carrier
Revenues:				
US Government		3,000,000		2,000,000
Commercial		37,000,000		500,000
Total		40,000,000		2,500,000
Operating Expenses		38,000,000		2,450,000
Taxable Income	5.0%	2,000,000	2.0%	50,000
Federal Income Tax Rate	34.0%	680,000	15.0%	7,500
Net Income		1,320,000		42,500
Federal Income Taxes as a % of Revenue		1.7%		0.3%
Withholding rate on Government Revenues		3.0%		3.0%
Withholding on Government Revenues		90,000		60,000
Additional taxes (due) or refundable		(590,000)		52,500

The large motor carrier is impacted only slightly by the new law requiring 3% federal tax withholding on revenue earned on govermental contracts. The 3% withholding would simply reduce the amount of quarterly estimate payments that are otherwise due and payable.

The small motor carrier is negatively impacted since they only owe federal income tax for the year of $7,500 and must wait until the end of the taxable year to file its federal tax return and request a refund of $52,500.

Submitted by Daryl Deel, witness for the American Trucking Associations, March 22, 2007
For more information, please contact Michael Robinson at the American Trucking Associations at: (202) 544-6245.

The Computing Technology Industry Association

Testimony Before the

House Committee on Small Business

"The New Hidden Tax on Small Business"

by

Lamar Whitman,

CompTIA, Public Policy Manager

Thursday, March 22, 2007

Introduction.

Good afternoon, Chairwoman Velázquez, Ranking Member Chabot, and distinguished members of the Committee. My name is Lamar Whitman. I am appearing today on behalf of the Computing Technology Industry Association (CompTIA) representing our 20,000 member companies.

I want to thank Chairwoman Velázquez and Members of the Committee for holding this important hearing concerning the effects of the impending 3% withholding requirement on certain government payments. While this requirement does not distinguish between government payments made to either large corporation or small unincorporated businesses, our comments today will concentrate on the effect of this provision on our small business members. We believe your efforts to focus public attention on this issue will lead to actions that will preserve tax compliance, without unfairly penalizing compliant small businesses.

As this Committee certainly appreciates, small businesses are the backbone of the American economy. Some 23 million small businesses employ over half of the private sector workforce. Small businesses are a vital source of the entrepreneurship, creativity, and innovation that keeps our economy globally competitive. As a nation, we are dependent upon the health of the small business sector, and this is why we are so concerned with this unfair 3% withholding requirement.

CompTIA Overview.

The typical small business does not have an IT department but relies upon the services of an important segment of the computer industry referred to as "Value Added Resellers" or VARs. VARs are small system integrators that design, install and maintain computer systems and networks for other small businesses. An estimated 32,000 VARs, most of which are small businesses themselves, sell approximately $43 billion dollars worth of

computer hardware, software, and services annually. This means that over one third of the computer hardware sold in the U.S. today is sold by VARs. A 2006 Government VAR survey found that about half of VAR gross revenue was derived from the public sector, which would put these sales in the order of $20 billion annually. Of this, approximately 37% was generated from the federal government, 35% from state and local government, and 28% from sales to educational institutions.

Ms. Chairwoman, the Computing Technology Industry Association represents the business interests of these VARs. For 25 years, CompTIA has provided research, networking, and partnering opportunities to its 20,000 mostly American member companies. And while we represent nearly every major computer hardware manufacturer and software publisher, nearly 75% of our membership is comprised of American VARs – the small business component of the tech industry. So, we particularly appreciate the opportunity to testify before this Subcommittee.

As further background, in addition to representing the interests of VARs, CompTIA also works to provide global policy leadership for the IT industry through our headquarters in Chicago and our public policy offices in Washington, Brussels, Hong Kong, and Sao Paulo. For most people in the computer industry, however, CompTIA is well known for the non-policy-related services that it provides to advance industry growth: Standards, professional certifications, industry education, and business solutions.

The Issue.

We come here today to discuss the effects of a 3% federal withholding requirement on payments made by government entities. We believe this withholding requirement is unnecessary to promote tax compliance and will unfairly penalize compliant small businesses.

Enacted into law on May 17, 2006, section 511 of the "Tax Increase Prevention and Reconciliation Act of 2005" (Public Law No. 109-222) requires all federal, state and local government entities and instrumentalities to withhold 3% of payments made for goods and services for federal income tax liabilities. This withholding requirement will become effective for payments made after calendar year 2010.

First, we must note the unprecedented nature of this new withholding requirement. As a general rule, prepayments of tax (either withholding tax or estimated tax payments) historically have born some direct relationship to a taxpayer's estimated income tax liability for a specific tax period. For individual taxpayers, a wage earner prepares a Form W-9, which determines the federal income tax that will be withheld from payments of wages and salary. Individuals with non-wage income and most businesses generally prepare an estimated income tax return calculating the estimated tax due according to the anticipated taxable income for the year. In both situations, the amount of tax required to be withheld or paid as an estimated tax is based on the expected tax liability for that particular taxable year. However, this new 3% withholding requirement departs from the traditional scheme of federal tax payments, because the static 3% withholding rate bears no relation to anticipated taxable income. Indeed, a VAR working under a government contract with a slim profit margin could actually experience a net loss for the tax year; even so, that VAR would still be subject to the 3% withholding.

Cash Flow Examples.

With keen competition, VARs operate on very small profit margins, often three percent to six percent – and it is not unusual for margins to be as low as one to two percent. To illustrate the practical effects of this 3% withholding requirement, consider the following example of a company operating on a six percent net income margin:

Gross Sales	$5,000,000
LESS: Cost of Sales	$4,000,000
Gross Profit	$1,000,000
LESS: Operating Expenses	$ 700,000
Net Income	$ 300,000
FIT – 2006 Rates	$ 100,250
Income After Tax	$ 199,750

Based on this example, the government would withhold $150,000 from the $5,000,000 (3% x $5,000,000 = $150,000) contract payment. However, the federal income tax liability is only $100,250. Accordingly, this small business would be deprived of about $50,000 of operating capital – that cannot be recouped until after the income tax return is filed for the year during which the withholding is made (generally due on March 15 following the close of the calendar tax year). This 3% withholding requirement becomes even more absurd when applied to a company with a four percent net income margin:

Gross Sales	$5,000,000
LESS: Cost of Sales	$4,000,000
Gross Profit	$1,000,000
LESS: Operating Expenses	$ 800,000
Net Income	$ 200,000
FIT – 2006 Rates	$ 61,250
Income After Tax	$ 138,750

When the taxable income margin is reduced to four percent, the federal income tax drops to $61,250, however the withholding remains unchanged at $150,000. Thus, this small business would be deprived of almost $90,000 in operating capital.

This 3% withholding provision has a regressive effect, reserving its greatest penalty for those businesses with the lowest net income – typically, small businesses. As such, this 3% withholding requirement is particularly burdensome for small businesses – and even more burdensome to small technology businesses, which already operate on thin net income margins.

Adverse Effects on Small Businesses.

Federal procurement opportunities will be reduced. As you know, the federal government has a small business contracting goal of 23% agency-wide. The subject 3% withholding requirement will certainly make this 23% goal more elusive for most government agencies, and within a few years we will see a decrease in economically do-able government procurement opportunities for small businesses. As a result, this 3% withholding requirement will widen the procurement gap between small and large contractors, and out of necessity, the federal government will proceed to purchase an increasing proportion of goods and services from larger concerns, which have larger cash flows that can accommodate the 3% withholding.

Cash flow concerns for both prime and subcontractors. Even if a small business acts as a subcontractor to a large prime, the cash flow decrease resulting from the 3% tax withholding will inevitably be passed down from the prime to the small business subcontractor. Therefore, we believe that the resulting cash flow for a small business contractor will be negatively affected, whether the small business itself acts as a prime or as a subcontractor to a larger prime.

Unfair result for more successful contractors. Those businesses earning a greater percentage of revenues from government sales will be more adversely affected. Another way of saying this is: Those businesses which have worked to partner with and supply government purchasers with quality goods and services will be the group most penalized. We believe this is an unfair and unreasonable outcome

Increased interest costs. Clearly, this 3% withholding will widen the competition gap between large and small businesses. It will become more difficult for small businesses to run their day-to-day operations as the amounts withheld cannot be recouped until after the tax return is filed. In order to compete, smaller contractors will have to add interest costs (for operating funds needed to cover the 3% withholding amount) into their contract costs, and this will clearly affect their competitiveness. As such, we expect this 3% withholding will cause a shift in the composition of government suppliers away from small business (both in prime and subcontracting roles).

Higher contract costs for government. The increased interest costs for small businesses will force contractors to either renegotiate their pricing with the government or remove products from contracts with minimal profits margins. Cleary, this will decrease the availability of goods and services for government agencies. Also, the increased administration costs to the government and prime contractors (e.g., information collection, compilation, reconciling and reporting) will most certainly be passed down to the small business contractor.

Allocation issues. Many small businesses file either a subchapter S corporation or a partnership return. Accordingly, we must note the added complexity the 3% withholding requirement brings to return preparation. For withholdings on payments to these pass-through entities, the withheld amounts would need to be allocated out to shareholders for the S corporation or to the partners, in the case of a partnership. This will increase the complexity of return preparation beyond the contacting entities, extending the allocation issues to the individual returns of the S corporation shareholders or the partners.

Factors could worsen the situation. As we call your attention to this issue, we must note that talk of increasing this withholding percentage or advancing the effective date will compound the clear disadvantages for small businesses. As it stands now, the 3% withholding requirement will not become effective until after 2010. We caution here that advancing this date or increasing the percentage withholding (i.e., from the 3% amount) will cause severe negative ramifications for small businesses seeking to do business with government entities.

General business processes will be slowed. We also can predict that the decreased cash flow will lead to postponement of basic business advances such as hiring, business improvement, and for many concerns, activities such as research/product development. This is clearly not in the best interests of maintaining a healthy business environment for the small business community.

Tax Compliance? Reporting, Not Withholding.

The purported justification for instituting this 3% withholding tax was the conclusion by Treasury that some recipients of government payments were not reporting and paying federal income taxes. If, in fact, this is true, we believe the proper – and least harmful – course of action is to require government payors to report such payments. Many payors of non-wage payments are required to file a Form 1099 which allows the Internal Revenue Service to match payments with amounts reported on a recipient's return. If this requirement is simply extended to governments, tax administrators would be able to match reported payments with amounts included in revenues by the recipient contractors. The Internal Revenue Service would then be able to cross-reference payments made to a government contractor with revenue reported on that contractor's tax return, and this would address any tax compliance concerns. The goal here should be to promulgate effective tax compliance measures; not to punish all government contractors for the perceived non-compliance by an unidentified and unquantified segment of the business community.

Conclusion.

CompTIA members are fully supportive of efforts to encourage and promote tax compliance. We believe that all individuals and businesses must be responsible for reporting and paying their fair share of taxes. However, we object to unnecessary and harmful tactics, such as this 3% withholding requirement. This 3% withholding requirement is unfair to small businesses – especially VARs – and will force more and more small business out of the competition for federal government procurement opportunities. It is already very complicated for small businesses to do business with the government. The addition of this 3% withholding will add further complexity, making it economically impossible for many small businesses to seek government contracts.

We realize that one of the primary goals of this Committee is to promote prosperity and growth for the small business community. With this goal in mind, we ask for your support in overcoming this onerous withholding provision – which will adversely affect the ability of small businesses to survive, compete and continue to supply governments with essential goods and services.

I thank you for your time, and I would be pleased to answer any questions you might have.

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

"THE NEW HIDDEN TAX ON SMALL BUSINESS"

TESTIMONY OF

THE FEDERATION OF AMERICAN HOSPITALS

MARCH 22, 2007

Presented by:

Charles N. Kahn III
President

On behalf of the Federation of American Hospitals (FAH), I am pleased to offer our views on a new federal tax withholding requirement for government payments and the impact that this requirement will have upon investor-owned hospitals and the health care industry as a whole. FAH is the national representative of investor-owned or managed community hospitals and health systems throughout the United States. Our members include general community hospitals and teaching hospitals in urban and rural America. As investor-owned hospitals, our members provide many significant benefits to the communities they serve and to the nation as a whole, which include multiple federal and state taxes that our members pay each year.

Background

The new withholding requirement emanates from section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), which requires federal, state, and local governments to withhold three percent from payments for goods and services beginning after December 31, 2010. As a member of the Government Withholding Relief Coalition, FAH is acutely aware of the concerns that this new tax withholding requirement is raising in virtually every sector of the business community. We are pleased to appear before the Committee today to address the very unique impact this requirement will have on the health care sector, particularly regarding payments made to investor-owned hospitals and other tax-paying health care companies and practitioners under the Medicare program.

Before addressing the specific impact on the health care sector, I offer a few general observations on section 511. Notably, this provision was inserted into the TIPRA conference report even though it was in neither the House nor Senate versions of the tax legislation.

The genesis of Congressional interest in the new tax policy is a Government Accountability Office (GAO) report[1] and related testimony[2] which reports that about 33,000 government contractors might owe $3 billion in unpaid federal taxes. This conclusion was reached based upon an extrapolation from a sample of 50 cases that GAO examined. The review of the 50 cases focused on unpaid payroll taxes that business owners had failed to remit and then diverted the money for personal uses, such as gambling activities, luxury vehicles, and other things.

It is noteworthy that the GAO made 18 recommendations to the Financial Management Service[3] and one recommendation to the Internal Revenue Service.[4] However, the solution of a mandatory tax withholding was not even suggested, let alone proposed. Because the new withholding was not considered, the GAO report did not focus on the unique nature of government payments under health insurance programs, such as Medicare. Moreover, a mandatory income tax withholding for everyone does not resolve the failures regarding payroll tax compliance reported by the GAO. Therefore, we believe section 511 goes well beyond the concerns that the GAO identified as needing to be remedied.

This week, the GAO issued another report on this topic finding that approximately five percent of physicians, health professionals, and suppliers who furnish Medicare Part B services have significant outstanding federal tax liabilities, including failure to pay payroll taxes and personal

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[1] GAO report, GAO-05-637, *Thousands of Civilian Agency Contractors Abuse the Federal Tax System with Little Consequence* (June 2005).

[2] GAO testimony on the above report delivered June 16, 2005, GAO-05-683T.

[3] Most deal with verifying taxpayer identification numbers and procedures to levy upon government payments.

[4] Pursue criminal cases against contractors who fail to pay taxes.

income taxes. When medical providers fail to pay their taxes, federal law authorizes the recovery of those delinquent funds through the Federal Payment Levy Program (FPLP). However, the Department of Health and Human Services is not participating in the levy program, thus the government has not collected unpaid taxes from Medicare payments.

Impact of the Withholding Provision on the Health Care Industry

1. **The costs associated with the new withholding requirement will greatly outweigh the benefits to the federal government.**

Section 511 is aimed at collecting underreported tax revenues and increasing tax compliance. While that is an admirable goal, the reality is that the bulk of this $7 billion revenue score results from the acceleration of tax receipts during the transition year (*i.e.,* 2011) and not an actual revenue increase from improved tax compliance. We believe the provision would generate only an estimated $215 million per year of increased revenue in 2012 and slight increases in each of the following years. The estimated $215 million per year of increased revenue will be less – we believe far less – than the additional costs to administer the program that will be incurred by the federal government, which likely also will see increases in government contract bid rates to assume these added costs.

This negative impact will be even more pronounced for the Medicare program. The Centers for Medicare & Medicaid Services (CMS), the agency which administers the Medicare program, contracts with some 40 different contractors to process claims under Medicare Part A and Part B. There is no set annual contract payment amount per se that a particular hospital or physician will receive from Medicare. Instead, the federal government's total Medicare payments to health care providers which pay federal income tax will depend on the volume of actual claims filed with the program, which cannot be determined with specificity before a tax year begins. This differs from many typical goods and services government contracts, where the scope of work and payments are known in advance and government payments are made in a smaller number of larger increments. In the Medicare world, section 511 would require that only 97 percent of each Medicare claim payment goes to the entity or practitioner who provided the service, while three percent of that payment goes into a Treasury account as the withholding amount.

The reach of Section 511 into the health care world is quite extensive. It would affect Medicare payments to all income tax-paying providers and suppliers as well as individual practitioners and the vast majority of medical group practices. As a result, section 511 will impact the processing of millions of Medicare claims each year and its implementation will place a significant financial and resource burden on CMS and its many contractors. Many, many small businesses will be affected substantially, including all solo practitioners and small medical group practices.

The health care-related burden actually will be even greater because Medicare allows providers and suppliers to submit corrected claims when circumstances require their original submission to be amended, and these amended claims commonly result in payment adjustments. It is not clear how procedures and software could be developed to account for situations where the service provider repays a portion of certain reimbursements but also may be due additional payments for services. One concern is that health care providers may have withholdings on amounts that are never included in taxable income. What is clear is that the mere presence of so many Medicare claims processing contractors significantly increases the possibility of errors and recordkeeping mistakes by the government, which will require CMS to bolster oversight of its contractors.

2. **Applying Section 511 to Medicare payments will place a significant burden on the health care industry.**

The federal government will not be the only party that will face a significant unfunded mandate to implement section 511. Income tax-paying health care entities and practitioners also will be forced to implement monitoring and recordkeeping functions to track the payments and to ensure that both the Medicare program and the Internal Revenue Service accurately account for and report their diverted revenue.

As stated above, other than the one-time timing acceleration in 2011, the new withholding provision generates very little revenue. However, for the health care system, the compliance costs could be large, especially given the gross payment amounts involved. For example, it is estimated that CMS will make Medicare payments of approximately $367 billion for items and services in 2007, which exceeds almost every other government agency in payments for services. Section 511 will apply to a large portion of this total Medicare outlay, and the sheer magnitude of this number implies a heavy administrative burden on the private sector to make sure the withholding is implemented and operated properly.

Investor-owned hospitals will be impacted significantly by section 511. Currently, hospitals receive approximately 30 percent of their revenues annually from Medicare payments alone. Because section 511 applies to Medicare payments[5] and potentially some state health care programs where eligibility is not based upon the recipient's income (Medicaid payments are exempted[6]), a substantial share of our members' revenue will be subject to the new withholding. The reporting and administrative complexities associated with claiming the withholding as a credit on income tax returns will be burdensome, especially for integrated delivery systems with multiple subsidiaries that file individual tax returns.

As a result, section 511 places an additional burden on investor-owned hospitals, which already are in a precarious financial situation. Currently, the Medicare Payment Advisory Commission (MedPAC), which advises Congress on Medicare spending issues, estimates hospitals will experience a negative operating margin of 5.4% in 2007 from serving Medicare beneficiaries. This means that investor-owned hospitals will not be able even to cover their costs if they received 100 percent of Medicare payments. If section 511 was effective for 2007, this problem would be exacerbated by the back up withholding, and it likely will have the same impact when it takes effect in 2011.

The withholding also will create a difficult cash flow problem for small health care businesses, including solo practitioners and small medical group practices, which rely on a steady stream of patient care revenues to meet payroll and maintain offices and supplies. This withholding will be particularly painful for entrepreneurial and start-up organizations which need to generate as much operating cash flow as possible and are likely to be generating tax losses in the early years such that the withholding does nothing more than deprive them of the use of those funds until they are refunded by the federal government.

For similar reasons, section 511 also presents a major cash flow problem for any tax-paying health care entity or practitioner which is carrying forward a net operating loss, because these entities

[5] The law specifically states it applies to all payments, unless exempted, including payments made for services provided to recipients other than the government. Also, the committee report specifically includes payments under government programs where eligibility is based upon the age of the beneficiary.

[6] The law exempts medical assistance programs to low-income individuals.

will not be subject to tax on the loss amount in the current year and instead will make, in essence, an interest free loan to the federal government. In both cases, entities may be forced to incur expenses related to short-term borrowing to offset the withholding.

For taxpayers who do not have a net operating loss for the year, the withholding essentially is a one to three month acceleration of tax payments to the government, as these taxpayers generally are required to file quarterly estimated tax payments (and thus will be able to take into account the three percent withholding to reduce their quarterly payment). More complicated are health care joint venture and partnership arrangements, under which there is an additional burden of having to account for, and report to each partner, the effects of the withholding, which affects those individual tax returns as well.

Given the magnitude of this tax law change, we anticipate that some in the health care industry will fail to properly account for and claim the new withholding on their tax filings. Our members have experienced this in the past, and a cottage industry of consultants subsequently emerged to help those entities obtain refunds for lost withholding amounts. Section 511 is likely to magnify this problem, and to keep these consultants gainfully employed in this lucrative work to the detriment of the patients our members serve.

Summary

In summary, section 511 of TIPRA will impose significant burdens on health care providers and practitioners who pay federal income taxes, and will be particularly onerous for small businesses. The three percent withholding provision appears to have been intended to ensure that a small subset of federal service providers identified by GAO pay their federal taxes. However, it has morphed into a provision that will require a total overhaul of the local, state, and federal government reimbursement systems in order to comply with its demands. Very few industries other than health care receive such a large portion of their revenues from government payments. As such, the health care industry will bear a major proportion of the burdens of this new requirement.

FAH believes that section 511 should be repealed because the increased revenue benefits over time likely will be dwarfed by the costs to the government and the business community of implementing and maintaining this policy. Accordingly, FAH fully supports HR. 1023 introduced in February by Representatives Kendrick Meek and Wally Herger and its companion bill, S. 777, introduced earlier this month by Senator Larry Craig.

At the very least, FAH submits that payments made under federal health care programs, such as Medicare, should be exempted from section 511 before the 2011 implementation date. Congress should exempt Medicare to protect seniors from the same type of negative impact that caused Congress to protect other needy populations when it exempted Medicaid payments from section 511.

We believe the Federal Payment Levy Program, which targets only delinquent tax payers, is a much better solution to the GAO's concerns than the "across the board" three percent income tax withholding imposed by section 511. Thus, we believe HHS should participate in the FPLP, and Congress should work to remove any additional legal or policy impediments to broad-based collection efforts under the FPLP. If the FPLP is able to operate at maximum effectiveness, there would be no need to maintain less directed policy alternatives like the new withholding imposed by section 511.

I hope our comments are helpful to you in your examination of this tax provision. Thank you for the opportunity to share our views. I am happy to answer any questions that you might have.

CAMPAIGN FOR QUALITY CONSTRUCTION

CONGRESSIONAL TESTIMONY
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

March 22, 2007

New Hidden Tax on Small Business
The Three Percent Withholding Provisions on Government Contracts

Testimony of Lonnie Coleman
Coleman-Spohn Corporation
Cleveland, OH

The Campaign for Quality Construction represents six construction associations allied in an ongoing legislative Campaign for Quality Construction. These groups are: the Mechanical Contractors Association of America (MCAA), the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA), the National Electrical Contractors Association (NECA), the International Council of Employers of Bricklayers and Allied Craftworkers (ICE), the Finishing Contractors Association (FCA), and The Association of Union Constructors (TAUC). According to Bureau of Labor Statistics figures, specialty construction employers represent the vast majority of industry employment at over 64% of employment overall in the industry.

Contact CQC: 1385 Piccard Drive, Rockville, MD 20850-4340
301-869-5800 * 301-990-9690 * www.constructionalliance.org

Introduction

Good morning Madam Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee. Thank you for inviting me here today.

My name is Lonnie Coleman. I am the principal owner of a small business, minority-owned construction firm, Coleman-Spohn Corp., based in Cleveland, Ohio. I came into the business as an apprentice pipefitter in the local pipefitter union in Cleveland 31years ago in 1976. Over the course of that time my company has grown from a small two-person operation to a company employing over 100 employees and one that is involved in most of the major construction in Cleveland, Ohio today.

Action Requested

I am here today to tell you why the 3% withholding provisions slated for public contract payments will hurt small businesses, drive small specialty construction companies out of the federal marketplace, and will end up costing the government more money. I also want to offer strong support for H.R. 1023, sponsored by Representatives Meek and Herger, which would immediately repeal the 3% withholding provision, and ask for your support of that bill.

Broad Coalitions Join In Support of Repeal of Withholding

My company performs general contracting, mechanical construction, and site facilities maintenance contracts as both a prime contractor and specialty subcontractor on Federal, state and local and private projects throughout Ohio and in several other markets nationwide.

I am here today representing the Mechanical Contractors Association of America (MCAA) where I serve as Senior Vice President and Treasurer. 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 in industrial, institutional, private commercial and residential projects nationwide.

I am also privileged to represent five other of our sister associations allied in an ongoing legislative Campaign for Quality Construction. These groups are: the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA), the National Electrical Contractors Association (NECA), the International Council of Employers of Bricklayers and Allied Craftworkers (ICE), the Finishing Contractors Association (FCA), and The Association of Union Constructors (TAUC). According to Bureau of Labor Statistics figures, specialty construction employers represent the vast majority of industry employment at over 64% of employment overall in the industry.

I should add that many in our group also participate in two wider coalitions, the Construction Organizations for Sensible Taxation, and the Government Withholding Relief Coalition, both of which also are adamantly opposed to the 3% withholding provisions in Section 511 of the Tax Reconciliation Act of 2005.

Unique Characteristics of Union-Signatory Construction Employers

What distinguishes our Campaign for Quality Construction specialty trades groups is that we employ highly skilled technicians for field construction work under local multiemployer collective bargaining agreements with local Building Trades unions.

That labor policy is a material consideration on this issue because our bargaining agreements come with high-value wage, health and welfare, workforce development/apprenticeship training, and pension fund trust payment obligations for our union-represented employees that require ready cash flow and prompt and reliable payments. Moreover, the discipline of operating under a collective bargaining agreement prevents misclassification of workers as independent contractors rather than employees, another recognized practice of high abuse and tax avoidance in the construction industry.

The Campaign for Quality Construction is united in its belief that the 3% withholding slated for public contract payments in the year 2011 in Section 511 of the Tax Reconciliation Act of 2005 is ill-conceived procurement and tax policy and is entirely contrary to the small and disadvantaged business development goals of the Committee and urge its immediate repeal.

Background

Section 511 of The Tax Increase 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 three percent of the total payment beginning in 2011. The governments will be required to remit the three percent 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.

At the end of the 109th Congress, an effort was made to accelerate the implementation of the withholding provision as a "revenue raiser."

The goal of the provision is to reduce the amount of underpayment of federal taxes. The law currently requires that employers withhold tax on wages paid to employees, including employees of federal, state and local governments. The law does not include withholding payments to workers who are not classified as employees, such as independent contractors. Independent contractors and other taxpayers who receive income that is not subject to withholding are required to make tax payments on their own.

The 3% withholding tax has been estimated to raise $7 billion dollars between 2011 and 2015. It is part of a series of steps to minimize the tax gap. According to the IRS, the federal government receives approximately $345 billion less in tax revenues annually than it should receive.

Important Issues For The Construction Industry

I suspect that all the distinguished Committee Members recognize that construction projects of any scope are very complex and risky business propositions. You may not be aware that profit margins historically are thin even as risks are high. 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 three percent 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. This affects small and disadvantaged business firms all the more as their cushion is thinner and they can't carry the costs of public contract misadministration the way larger firms can.

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

If anything, we should enact even broader and quicker payment terms for public contracts of all types – 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 point out here 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.

Holding Payments Impairs Successful Project Completion

Yes, in construction, the service providers help finance the government project – by having each monthly invoice discounted 10% even with satisfactory performance. When,

you are a second-tier or lower subcontractor the wait and 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 Reconciliation Act would add in 2011 the 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 the taxpayers will pay, in increased bids/price proposals with financing charges added to all contracts and/or diminished competition. Alternatively, small and disadvantaged businesses may be closed out further, as larger more well-capitalized firms absorb the added financing costs, whereas the smaller firms don't have those resources to absorb the added 3% float in their bids/price proposals.

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

The worst part of the 3% withholding provision is that it is completely unnecessary to penalize law-abiding businesses for non-compliant businesses. Let me make it perfectly clear that I am opposed to companies receiving contracts when they don't pay their taxes. However, the government already has the information it needs to address this problem without putting the burden on 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 could again determine whether or not I had outstanding tax liabilities. I also must supply representations and certifications whenever I submit a proposal – that includes a statement that I haven't been convicted of tax evasion. I would be happy to add a certification at that time that I am current with my taxes. This would ensure that tax evaders were caught or risked suspension and debarment or False Claims Act penalties.

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. It is my understanding that some agencies already do so. The important thing to remember here is that the government can do all of these without it 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.

Our Campaign for Quality Construction 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 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

To conclude, we ask you to support the repeal bill, H.R. 1023 cosponsored by Ways and Means Committee Members, Mr. Meek and Mr. Herger, and to pass that repeal quickly before any further efforts are taken to accelerate the effective date of the measure for fictitious budget gains and offsets.

For tax compliance efforts, we urge adoption of more stringent contractor responsibility determinations and certification of tax compliance as a condition of public contract eligibility. For greater industry tax compliance overall, we urge adoption of substantial reform of independent contractor classification criteria to shut down the high incidence of tax avoidance by firms that misclassify employees as independent contractors. And, for workers that are legitimately classified as independent contractors, we urge consideration of withholding on their IRS 1099 forms, at least on public contracts.

We ask your support for broader application of Prompt Payment laws to all public agencies on all Federal and Federally financed grant projects, and support for elimination of retainage as a relic of past inefficient contract administration practices.

Members of the Committee, thank you for the opportunity to state our position and for your support.

Statement of Associated Builders and Contractors

House Small Business Committee

Chairwoman Nydia Velazquez and Ranking Member Steve Chabot

Hearing on "The New Hidden Tax on Small Business"

March 22, 2007

The Voice of the Merit Shop

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Associated Builders and Contractors (ABC) appreciates the opportunity to submit the following statement for the official record. We would like to thank Chairwoman Nydia Velazquez, Ranking Member Steve Chabot and members of the Committee on Small Business for holding today's hearing on "The New Hidden Tax on Small Business," which will examine Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

ABC is a national trade association representing more than 24,000 merit shop contractors, subcontractors, materials suppliers and construction-related firms within a network of 80 chapters throughout the United States and Guam. Our diverse membership is bound by a shared commitment to the merit shop philosophy in the construction industry. This philosophy is based on the principles of full and open competition unfettered by the government, nondiscrimination based on labor affiliation, and the award of construction contracts to the lowest responsible bidder through open and competitive bidding. This process assures that taxpayers and consumers will receive the most for their construction dollar.

Today's hearing will focus on the withholdings on payments remitted by governmental entities as proposed in Section 511 of TIPRA and now included in Internal Revenue Code (IRC) 3402(t) for payments remitted after December 31, 2010. Should IRC 3402(t) be implemented, there will be a dramatic negative effect on the economic viability of the construction industry in the United States. Consider:

- These withholdings on payments will dramatically impact the cash flow of the Construction Industry and increase the cost of construction for governmental projects;
- Secondly, costly over-regulation will be the result of this new law – and these increases in the end will be borne by taxpayers; and
- Thirdly, there are alternatives to the required withholding that can be implemented in lieu of the withholding requirements under IRC 3402(t).

We now consider these three points in order.

1. **Cash Flow Impact to the Construction Industry**

According to statistics accumulated in the *2006 Construction Industry Annual Financial Survey* published by Construction Financial Management Association, the construction industry operates with a very low net margin. The survey reports the average construction company's operating margin is 2.2%. The 2.2% is a composite so some companies participating in the survey may generate a larger profit and others less profit.

The industry has been historically known for low net income margins and the implementation of IRC 3402(t) will negatively impact this already cash-tight industry. Construction is an industry in which businesses unfortunately fail and in many such cases it is because of inadequate capitalization. A reduction of cash flow will further stymie the economic viability of contractors performing work for the governmental entities who do not always have adequate cash flow and equity. While we certainly do not believe it is the intent

of Congress to cause small businesses to go out of business that may be an unintended effect of IRC 1302(t).

Contractors utilize Surety credit to secure certain contracts, as is the case with many governmental jobs. Typically, only financially qualified contractors can secure surety bonds. Significantly, a prerequisite considered by sureties in extending surety capacity to contractors is adequate working capital. Adequate working capital reflects adequate cash flow. This provision under IRC 3402(t), if implemented, will have a negative impact on cash flow and hence, could reduce the number of contractors that can qualify for adequate surety capacity to work on jobs for governmental entities. The result would, in turn, mean less competition for governmental jobs, and therefore more cost to taxpayers. While we certainly do not believe it is the intent of Congress to reduce competition on governmental construction projects that may be an unintended effect of IRC 3402(t).

Exhibit A reflects a typical example of a contractor who has a $10 million contract and faces 10% retainage (cash hold-backs) on that job. As a result, there will be roughly 13% withheld from the cash flow of the job when the 3% federal withholdings under IRC 3402(t) is added to standard retainage. The chart in Exhibit A has been produced to reflect how payments are remitted on a typical construction contract. The net result for this sample contract is a 30% reduction of actual cash flow to the contractor. At certain points, the contractor will actually be at a deficit until the final payment is received on the job. Restated: the contractor will experience no profit but a cash loss on the job until he receives final payment on the job.

This simple example shows the dramatic impact of removing what appears to be a small percentage of the gross revenue on a job. The important point is that the 3% withholding required under IRC 3402(t) is based on gross payments, not net. It is conceivable that a contractor, not fully understanding the implications of this 3% withholding could cause himself to not produce any profit in cash on the job whatsoever. All of the profit could be subjected to withholdings that the contractor will not receive the benefits of until the filing of an annual tax return. This could be, in many circumstances, as much as a year later.

Consider that the knowledgeable contractor facing this mandatory 3% withholding on government contract payments would include in their bid an estimated cost of capital to fund this additional burden to their working capital (cash flow). While we certainly do not believe it is the intent of Congress to cause higher prices to governmental entities for construction services this may be an unintended effect of IRC 3402(t). Restated: this would be a further tax on taxpayers in the sense that this withholding requirement will increase the cost of construction of public facilities and services.

2. Hidden Costs of Regulation

There will be costs to implementing IRC 3402(t) for the jurisdictions that are required to withhold taxes. In addition to upfront information technology costs, there will be ongoing annual costs. In the aggregate, for all jurisdictions across the country as well as the federal government, this could be a significant amount of money that is impacting the entire economy and all governmental entities. As a result, these additional costs will need to come

from somewhere and this will only mean additional budget constraints and potentially additional taxes at state and local levels.

Additionally, each of the jurisdictions will have to effectively communicate the requirements of IRC 3402(t) to all of their payees and services providers. This will have an impact to bidding documents, which will likely require additional legal fees for review. Further, consider the changes to "advertisements to bid" and information displayed on governmental websites. In the aggregate, although we don't have any firm estimates today, it is fair to say that this will be a significant amount of money that puts into question the true annual aggregate impact for taxpayers and the federal government.

Billing practices will also have to change. This will affect documentation that has been traditionally utilized by governmental agencies and their service providers, such as construction contractors. As indicated previously, not only will it affect bidding documents, but also consider how it will affect standard contracts that are issued by jurisdictions across the country. This will entail additional legal fees and opportunity costs for internal review.

In the construction industry, another issue might be whether IRC 3402(t) will ever actually reach the multitude of intended taxpayers. The way that the law is written in IRC 3402(t), it would appear that only the direct payment to a general contractor is the source of funds from which taxes will be withheld. There are a myriad number of subcontractors, sub-subcontractors, and suppliers involved on each governmental construction project. Will regulations enable or require general contractors to withhold corresponding amounts from subcontractors, sub-subcontractors and suppliers? If so, then there is a further extension of the IRC 3402(t) requirements and additional administrative burdens to be considered by these taxpayers as well as governmental agencies.

Another complication that will impact contractors is how they will comfortably address their estimated taxes. Depending on the timing and amount of payments received on their governmental contracts, contractors may have significant cash withholdings that they cannot utilize or "get to" until they file a tax return. If, for example, a contractor is having a less profitable tax year, they may have a significant amount of withholdings and very little, or no corresponding tax.

Consider if a contractor has a net operating loss. In addition to a refund of all taxes for the current year, the contractor is in a position of also potentially filing for a carry-back claim refund. The result could be a significant amount of withholdings that would be far better served in the hands of the contractors. This common circumstance has little to do with the so-called "tax gap" and appears more to do with the federal government implementing what amounts to a hidden tax increase to the compliant taxpayer.

Another issue is, whether a contractor will be able to secure an exemption from withholdings if they can show that they are going to have little or no tax liability for the year. What if this IRC 3402(t) withholding requirement is extended to subcontractors, sub-subcontractors and suppliers? Will these taxpayers also have the opportunity to request an exemption and certify

that they have no tax liability for the year and therefore withholdings would be wholly inappropriate for their circumstances?

In any event, if withholdings do occur, how are the internal and outside accountants to facilitate any certainty of what tax withholdings will, in fact, be available for estimated tax purposes? This would require specific advanced knowledge of when and how much the final payment would be from the governmental entity by the end of the calendar or fiscal year of the contractor. If the contractor has multiple governmental entity jobs, it will be unduly burdensome to estimate how much withholdings will be available for the tax return that will be filed, either two and a half or three and a half months later after the end of the fiscal year (i.e. March or April 15th for the calendar year taxpayer).

Another issue for cash flow and estimated tax purposes is how will withholdings be handled for pass-through entities such as S Corporations and limited liability companies? Section 1402(t) indicates that the payments will be withheld from the person providing any property or services. However, the entity that is providing the property with services may not be a taxpaying entity. For a pass-through entity that has multiple pass-through beneficiaries (i.e. S Corporation shareholders or LLC members) this will add another layer of confusion and burden. Significant cash flow could be withheld and the corresponding benefit of those prepayments may be for an entity that doesn't even have a tax liability.

3. Alternatives to Withholdings

We recognize that this law was passed with good intent. The objective appears to be mitigation of the so called "tax gap". However, we believe this law has unintended effects that have not been fully considered, and as indicated above, the cost, uncertainty, and cash flow impact to the construction industry is untenable.

IRS statistics indicate that when reporting requirements such as Forms 1099 are required, compliance increases from approximately 57% to 96%.[1] IRS statistics also indicate that when reporting requirements are elevated to actual withholding requirements, which in the instant case are both withholding and reporting requirements simultaneously, the elevation in compliance is elevated from 96% to 99%.[2] As you can see from the Internal Revenue Service's statistics, taking the extra step of requiring withholdings rather than taking the simple step of moving from no reporting to requiring information reporting, there is only a three percent ***estimated*** increase in the compliance rates.

The implications of this is that if Congress were to simply implement reporting requirements on certain payments remitted by governmental entities, rather than extending withholdings to the payments remitted by governmental entities, a significant level of compliance will still be increased. While this would still entail significant, and in some cases untenable administrative and other costs, this would be a better step than removing cash flow from a cash-strapped construction industry. Most importantly, this would remove many of the cash flow concerns raised above. As indicated, the cash flow concerns of the construction industry are significant because:

a. It impacts the ability of a contractor to manage their operations work because they need adequate working capital (cash flow) to fund their operations;
b. It further impacts the ability of a contractor to secure work because they need adequate working capital (cash flow) to qualify for surety credit;
c. The contractor, like all small businesses, needs to ensure at the earliest opportunity, they actually receive the profit that they do earn on the contracts rather than waiting for an annual tax return to be filed at some date in the future.

4. Conclusion

ABC commends you for holding today's hearing to discuss the 3% withholding provision. We respectfully request that the preceding is carefully considered and should any other comments be necessary or desired, please contact us for additional information. We look forward to working with the Committee in reaching a feasible solution that is agreeable for all concerned constituencies including the construction industry.

Again, ABC thanks the Chairwoman, Ranking Member and members of the Committee for the opportunity to present the views of our membership on this important issue.

Respectfully Submitted,

Rich Shavell, CPA, CCIFP
President, Shavell & Company, P.A.
Chair, ABC National Tax Advisory Group

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[1] *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).
[2] *The Causes and Solutions to the Federal Tax Gap: Hearing Before the Senate Committee on the Budget, 109th Cong. (2006) (written statement of Nina E. Olson, National Taxpayer Advocate available at: http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf.*

***Impact of Governmental Withholding Under IRC 3402(t)**
Project Cash Flow Analysis
For the Year-Ended December 31, 2011
(See Notes on Next Page)

Project #	% Complete	Description	1 Contract Amount	2 Total Estimated Cost	3 (1-2) Estimated Gross Profit	4 (a), (c) Billings To Date	5 (a), (c) Contract Receivables	6 (4-5) (a), (c) Contract Billings Processed	7 (6*10%) 10% Retainage Withheld	8 (5+7) Contract Receivables & Retainage	9 (6-7) Cumulative Cash Remitted
2006-01	25%	Gov't Contract	10,000,000	9,000,000	1,000,000	2,500,000	825,000	1,675,000	167,500	992,500	1,507,500
2006-01	50%	Gov't Contract	10,000,000	9,000,000	1,000,000	5,000,000	825,000	4,175,000	417,500	1,242,500	3,757,500
2006-01	75%	Gov't Contract	10,000,000	9,000,000	1,000,000	7,500,000	825,000	6,675,000	667,500	1,492,500	6,007,500
2006-01	100%	Gov't Contract	10,000,000	9,000,000	1,000,000	10,000,000	-	10,000,000	1,000,000	1,000,000	9,000,000
2006-01	Retainage Paid	Gov't Contract	10,000,000	9,000,000	1,000,000	10,000,000	-	-	-	-	10,000,000

% Complete	Description	10 (9*3%) 3% Governmental Withholding	11 (7+10) Total Withholding (Retainage, plus 3% Gov't W/H)	12 (9-10) Actual Cash Collected	13 (a) Cost To Date	14 ((5+(13*10%)) (b) Accounts & Retainage Payable	15 (13-14) (b) Actual Cash Paid	16 (12-15) Net Cash Flow	17 (16+10) Net Cash Flow w/o Withholding	18 (1-(16/17)) % Cash flow Decrease
25%	Gov't Contract	***45,225***	**212,725**	1,462,275	(a) 2,250,000	1,050,000	1,200,000	262,275	307,500	**15%**
50%	Gov't Contract	***112,725***	**530,225**	3,644,775	4,500,000	1,275,000	3,225,000	419,775	532,500	**21%**
75%	Gov't Contract	***180,225***	**847,725**	5,827,275	6,750,000	1,500,000	5,250,000	577,275	757,500	**24%**
100%	Gov't Contract	***270,000***	**1,270,000**	8,730,000	9,000,000	900,000	8,100,000	630,000	900,000	**30%**
Retainage Paid	Gov't Contract	***300,000***	**300,000**	9,700,000	9,000,000	-	9,000,000	700,000	1,000,000	**30%**

* Robin Word, CPA, President of Word CPA Group originally developed this basic example. Additional details can be found at www.wordcpa.com/3%GovernmentWithholding

***Impact of Governmental withholding Under IRC 3402(t)**
Project Cash Flow Analysis
For the Year-Ended December 31, 2011
Notes

Note that the contractor in this basic example will not receive any of his true profit until retainage is paid after Project Completion.
Payment of retainage may be as long as one year after project completion:

Total Profit	1,000,000
Total Withheld	(1,270,000)
	(270,000)

Also, in this example on this one contract, there is $300,000 of withholdings for which the contractor may not experience any cash impact until a tax return is filed for the fiscal year (or years) that is applicable.

(a) Assume Billing Schedule approximates cost schedule. (i.e. no front-end loadings, or unbalanced bid items)
(b) Assume payment A/P payment schedule approximates A/R receivable schedule
(c) Assume architect/engineers approve contractor's applications of payment as submitted by contractor.

Typical Cash Flow Activities During a Construction Project Life Cycle

Week 1	1) Contractor incurs upfront marketing, estimating and bidding expense before being awarded project. These costs can be 5% of total project costs, even if bid is not awarded.
Week 4	2) Contractor is awarded project and begins to incur mobilization and possibly personnel recruitment costs, etc.
Week 5	3) Contractor commences work, coordinating big ticket subcontractor and material costs.
Week 9	4) Contractors submits first application for payment based on progress of completion based on the project's schedule of values
Week 10	5) Architect/engineer approves/disapproves application for payment and submits to owner for payment.
Week 13	6) Owner/governmental entity remits payment based on architect's/engineers revised/approved amounts, less 3% mandatory government withholding, less retainage percent of work completed (5%-10%).
Week 13	7) General contractor makes payment to subcontractors and suppliers based on approved schedule of values completed, less retainage.
Week 13	8) Subcontractors make payments to sub-subcontractors and suppliers based on approved schedule of values completed, less retainage.

Constant Cash Outlays

Weeks 1-13	Weekly payroll and related expenses
Week 13	Monthly sales tax based on collections.

* Robin Word, CPA, President of Word CPA Group originally developed this basic example. Additional details can be found at www.wordcpa.com/3%GovernmentWithholding

House of Representatives Committee on Small Business

Full Committee Hearing: The New Hidden Tax on Small Business
2360 Rayburn House Office Building
March 22, 2007

STATEMENT BY THE AMERICAN CONGRESS ON SURVEYING AND MAPPING

The American Congress on Surveying and Mapping (ACSM) is incorporated as a non-profit educational organization whose goal is to advance the sciences of surveying and mapping and related fields, in furtherance of the welfare of those who use and make maps. ACSM is comprised of four independently incorporated Member Organizations which include more than 5000 surveyors, cartographers, geodesist, and other spatial data information related professionals from private industry, government, and academia throughout the world. Many ACSM members are small business owners who do a good deal of government work on the local, state and federal levels.

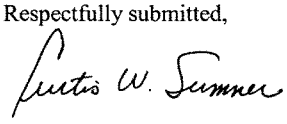
ACSM submits this statement in opposition to Section 511 of the Tax Increase Prevention and Reconciliation Act (PL 109-222). ACSM members, who reside in all 50 states, feel that Section 511 will have devastating effects on their businesses by severely decreasing or, in some cases, entirely wiping out the little profit margin that they now have.

Like many other small businesses, ACSM members believe that Section 511 will bring significant increases in private sector administrative costs because most small businesses are not set up to accurately track this type of withholding tax. Additionally, ACSM members feel Section 511 will severely hamper their day-to-day cash flow and will cause them to make choices regarding whether to pay business related expenses or personal expenses.

Additionally, ACSM members feel that Section 511 unfairly burdens honest taxpaying businesses in an effort to collect revenue lost by the failure of some businesses to pay their fair share of taxes. It is fundamentally wrong to punish those who comply with the law as well as those who intentionally break the law.

In conclusion, ACSM and its members feel that Section 511 is bad for small business in many ways. Any revenue gained by the federal government should not come as a result of decreased profits and lost cash flow by honest, tax paying businesses. ACSM and its members urge Committee members to work to repeal Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005.

Respectfully submitted,



Curtis W. Sumner, LS
Executive Director
American Congress on Surveying and Mapping (ACSM)

The Honorable John W. Douglass
President and Chief Executive Officer

March 28, 2007

The Honorable Nydia Velasquez
Chair, Committee on Small Business
United States House of Representatives
Washington, DC 20515

Dear Madam Chairman:

The Aerospace Industries Association of America (AIA) appreciates the opportunity to comment for the record of the March 22, 2007 hearing of the Small Business Committee on Section 511 of the Tax Increase Prevention and Reconciliation Act of 2006 (P.L. 109-222).

AIA operates as the largest aerospace trade association in the United States across three sectors: civil aviation, space systems, and national defense. Our nearly 300 member companies employ more than 635,000 high-skilled, high-wage workers.

Section 511 requires federal, state, and local governments with expenditures of $100 million or more to withhold three percent from all payments for products and services made after December 31, 2010. This provision applies to a broad category of payments, from Medicare to agricultural subsidies. Although there is no clear statement in the congressional record as to the objective of the provision, some supporters claim the objective is to improve compliance with the federal tax code. While Section 511 may improve compliance, the negative unintended consequences will far outweigh the benefits.

Unfortunately, most, if not all, of the revenue expected to be generated by Section 511 will come from companies and individuals who are complaint. As a result, the 3% withholding will serve as a penalty to the overwhelming number of taxpayers who have a long history of compliance with the tax code. It is a penalty that will be especially harmful to small business.

The financial impact on all contractors will be significant. They will have to substantially modify accounting and internal auditing systems to accommodate the change in quarterly tax liabilities. Furthermore, there will be significant adverse effects on their cash resources, forcing most to borrow money on a short-term basis and incur related interest costs to sustain routine operations and payrolls.

There will also be significant costs to the government to implement Section 511 that were not considered in the calculation of the expected new revenue. The costs will substantially negate the $6 billion in revenues estimated by the Joint Committee on Taxation.

Finally, the financial burdens of Section 511 will undermine the continuous efforts of the aerospace industry, in particular, to control government contract costs through manufacturing modernization and program management reforms.

Aerospace Industries Association of America, Inc.
1000 Wilson Boulevard, Suite 1700 Arlington, VA 22209-3901 (703) 358-1000 www.aia-aerospace.org

In summary, we respectfully urge Congress to repeal Section 511 of P.L. 109-222. If allowed to remain in effect, Section 511 will unfairly increase the compliance burden on law-abiding taxpayers, generate a significant adverse impact on the cash flow of thousands of tax-compliant companies across every sector of the U.S. economy, and dramatically inflate administrative costs to the federal government.

Thank you for your consideration of our perspective.

Sincerely,
and very Respectfully

John

John W. Douglass
President and CEO

JWD:srs

AMERICAN FARM BUREAU FEDERATION®
600 Maryland Ave. SW | Suite 1000W | Washington, DC 20024

ph. 202.406.3600
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Statement to the
House of Representatives Small Business Committee
on the
Impact of Code Section 3402(t) Withholding on Farmers and Ranchers
March 22, 2007

Farm Bureau opposes the new 3 percent withholding tax on government payments for goods and services that was passed as part of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).

Section 511 of TIPRA added section 3402(t) to the Internal Revenue Code to impose a 3 percent withholding tax on payments for property and services made by the government, beginning in 2011. Taxes withheld are credited against the taxpayer's income tax liability for the year or are refunded if taxes are not owed.

The TIPRA conference report states that farm programs are explicitly intended to be covered by the new 3 percent withholding tax. This means, for example, that if a farmer or rancher would receive a $10,000 payment for protecting streams or rivers under the Conservation Reserve Program, $300 would be withheld from the payment.

USDA payments to farmers and ranchers that are subject to the withholding tax include:

- natural disaster and emergency assistance program payments
- conservation and environmental program payments
- fixed decoupled commodity payments
- counter-cyclical support payments
- special cotton marketing provision payments
- dairy support program payments
- peanut program payments

The withholding tax will hurt farmers and ranchers, and Farm Bureau supports its repeal for the following reasons:

- Farm profitability and tax liability fluctuate greatly from year to year due to weather and markets, but taxes are withheld regardless. For agricultural operations that end the year without owing taxes, the withholding amounts to an interest-free loan to the government.

- The tax is withheld on gross government payments while taxes are due on net income. This means that the amount of money withheld could be a substantial portion of the entire net income of a farm or ranch business, thereby creating significant cash flow problems.

- Farm and ranch inputs often are purchased months before a commodity is sold. Reducing farm revenue by 3 percent of government payments could create cash flow problems and make it harder for farmers to purchase the supplies they need.

- Withholding taxes on emergency and disaster programs reduces the amount of assistance provided to farms and ranches affected by floods, droughts, freezes and other natural disasters.

Finally, the conference report that accompanied TIPRA suggests that the new withholding requirement was imposed because current information reporting was not successful in closing the tax reporting gap for governmental payments. This argument cannot be used, however, to justify withholding on USDA payments to farmers and rancher because all such payments are accompanied by Form 1099 G.

Farm Bureau urges Congress to pass H.R. 1023, introduced by Representatives Meek (D-Fla.) and Herger (R-Calif.), to repeal the 3 percent withholding tax.

American Moving and Storage Association 1611 Duke Street <> Alexandria, VA 22314
www.moving.org <> www.promover.org <> 703-683-7410 <> Fax 703-683-7527

TESTIMONY OF THE

AMERICAN MOVING AND STORAGE ASSOCIATION

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

SMALL BUSINESS COMMITTEE HEARING ON

"THE NEW HIDDEN TAX ON SMALL BUSINESS"

Thursday, March 22, 2007

10:00 a.m.

2360 Rayburn House Office Building
Washington, D.C. 20515

On behalf of the 3,500 member companies of the American Moving and Storage Association (AMSA), the overwhelming majority of which are small business owned and operated, I thank Chairwoman Nydia Velazquez, Ranking Member Steve Chabot, and all members of the House Small Business Committee for holding these important hearings on the impact on small businesses of Section 511 of the Tax Increase Prevention and Reconciliation Act (PL 109-222).

For your information, AMSA is the national trade association representing the nation's moving and storage companies, which provide household goods moving services, specialized transportation for sensitive freight such as computers and trade show exhibits, and warehouse storage services, to the general public, corporations, and the government. AMSA is a member of the Small Business Legislative Council (SBLC) and the Government Withholding Relief Coalition (GWRC).

The majority of AMSA members are small business owners, many of them representing the 3rd, 4th, and in some instances, 5th generation of movers. As such, many of them rely heavily on the federal government procurement market through the U.S. General Services Administration (GSA) Centralized Household Goods Traffic Management Program and/or the U.S. Department of Defense (DoD) Personal Property Program, respectively. Specifically, some 275 AMSA members participate in the GSA program, and who handle approximately 12,000 household goods shipments annually for civilian government employees of non-DoD federal agencies. These AMSA members generate approximately $40 million per year in revenues from the GSA program.

Moreover, approximately 900 AMSA members participate in the DoD program, handling some 150,000 domestic DoD household goods shipments each year. AMSA members participating in the DoD program generate approximately $500 million each year in revenues from their DoD contracts.

In addition to the van lines and/or independent operators, many AMSA members "agents" sub-contract through their van lines and/or independent operators on these GSA and/or DoD contracts. As such, they, and the independent, owner-operator drivers they utilize, are subject to the 3% withholding as well, resulting in double and triple-taxation on the same service.

According to recent industry data, AMSA members performing household relocation services for our military service men and women through DoD's program, accounted for nearly 16% of their overall business. Other government relocations (i.e., GSA) accounted for approximately 1.5% of all of our members household relocation services.

Due to the economic burdens that will unduly harm our members who transport and store thousands of government shipments on an annual basis, AMSA supports bi-partisan, bi-cameral legislation (i.e., H.R. 1023 and S. 777) which proposes full repeal of Section 511. Again, thank you for this opportunity to provide comments on this important issue.

Sincerely,

AMERICAN MOVING AND STORAGE ASSOCIATION
Joe Harrison, President and CEO

"The New Hidden Tax on Small Business"

Testimony of
American Road and Transportation Builders Association

Before the
U.S. House of Representatives
Small Business Committee

Thursday, March 22, 2007

On behalf of the American Road & Transportation Builders Association (ARTBA) and its 5,000 member firms and member public agencies nationwide, the association would like to thank Chairwoman Velazquez and the members of the Small Business Committee for reviewing the recently enacted requirement mandating federal, state and many local governments to impose a three percent tax withholding on payments to all contractors for goods and services.

ARTBA member firms fulfill the public need for improved mobility through government contracts with state and local agencies for transportation improvement projects. ARTBA members belong to the association because they support strong federal investment in transportation improvement programs to meet the needs and demands of the American public and business community. The industry we represent generates more than $200 billion annually in U.S. economic activity and sustains 2.5 million American jobs.

The withholding requirement in Section 511 of the Tax Increase Prevention and Reconciliation Act (PL 109-222) was not included in the original House or Senate versions of the tax bill and was slipped into the conference report prior to its passing Congress last year. The quick insertion of this provision provided little time to openly debate its deleterious consequences and we again would like to thank you for this opportunity to do just that. In addition to the dubious manner in which this provision was enacted, we are concerned that its goal is to increase tax compliance from the transportation construction industry, and other sectors, yet no evidence has been presented that demonstrates our industry is failing to meeting its tax obligations. We believe it would be more appropriate for the federal government to focus its energy on individuals or sectors where tax evasion has been proven to be a problem.

As a significant amount of transportation infrastructure investment in the U.S. is made by the public sector through contracts with private firms, transportation construction and engineering firms would be directly impacted by this new mandate. Among the withholding provision's burdensome effects, would be diminished cash flow from government contracts, which would harm day-to-day business operations. On any given day, transportation construction firms must coordinate payments to a host of subcontractors for construction materials, rental of heavy equipment, and transportation costs. Resources that would be withheld by this new requirement could otherwise pay for immediate business expansion and investment, payroll requirements and business efficiency initiatives. Instead, firms will have to assume higher amounts of debt to finance the necessary liquidity levels for continued operations and new accounting requirements. This is particularly disturbing as profit margins on transportation construction projects are already difficult to predict and frequently fall within the two to four percent range.

The new withholding requirement is a one-size fits all approach that is unworkable in the real world. Transportation construction firms often only realize a profit at the end of a project and withholding payments throughout a contract's (often long) life makes this situation even more difficult. On the other hand, not all transportation improvement projects generate a profit. The new withholding requirement is particularly inappropriate in these instances as projects that result in a loss for a company have no corresponding tax obligation. It is counterintuitive that a policy would attempt to improve tax compliance on situations for which no tax is owed. Similarly, the withholding requirement would apply unfairly to S Corporations and Employee Stock Ownership Plans (ESOPs) that, because of their corporate structure, do not owe federal corporate income tax.

The combination of rising transportation construction material prices—which have increased 30 percent in the last three years and price increases are projected to continue—coupled with new administrative and debt financing costs will present an expensive one-two punch to contracting government entities. These governments, in many cases, would need to create new systems to withhold these payments and transfer the proceeds to the federal government. The business costs for transportation contractors and engineers will also increase and these firms may be forced to raise their proposal bids to recoup the new costs resulting from this new timing shift. Thus, the individual taxpayer will ultimately foot the bill for the new mandate's additional costs in the form of higher priced transportation improvement projects.

The new requirement would also create an unwarranted bias in the competitive marketplace towards firms that perform a high percentage of private sector work. Companies that contract mostly with the government will have significant revenues bottled up in withholding payments, leaving less available cash to grow and run their companies. By comparison, companies working primarily with the private sector will be largely unscathed by this withholding measure and able to invest in their business. This could result in more construction and engineering firms choosing to forego contracting opportunities with public sector entities, thereby potentially limiting competition.

Eliminating this provision will enable the transportation construction industry to continue to use innovation and flexibility to deliver needed transportation improvements at minimal cost to all levels of government. As such, we encourage members of the committee and Congress to support the repeal of this three percent government withholding measure and cosponsor legislation introduced by Representatives Kendrick Meek (D-Fla.) and Wally Herger's (R-Calf.), H.R. 1023, that would repeal this provision before it comes into effect. We also urge you to oppose any effort to accelerate the implementation of this unwarranted and inappropriate new burden.

Thank you for considering our views on this important matter.

WASHINGTON GOVERNMENT
AFFAIRS OFFICE

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The National Association
of Full-Service Plumbing,
Heating, Cooling and Piping
Products Wholesalers

American Supply Association
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Suite 1360
Chicago, Illinois 60654
312/464-0090
312/464-0091 (FAX)

Inge Calderon
Executive Vice President

Statement for the Record
of the
American Supply Association

Presented by
Joel Becker, President
American Supply Association

Before
United States House of Representatives
Committee on Small Business
On
The New Hidden Tax on Small Business

March 22, 2007

The American Supply Association (ASA) is the national organization serving wholesale distributors and their suppliers in the plumbing, heating, cooling and industrial pipe, valves, and fittings industries. Members of ASA are distributors, manufacturers, service vendors and independent manufacturer's representatives.

ASA urges all members of the Committee to support H.R. 1023, which would repeal section 511 of the Tax Increase Prevention and Reconciliation Act of 2005. Section 511 imposes a sweeping new requirement mandating that federal, state and local governments withhold 3 percent from payments for goods and services for federal income taxes. ASA is deeply concerned about the negative impact on all of our members receiving contract payments from all levels of government. A substantial segment of our industry does business with government agencies at all levels – federal, state and local.

The provision hurts honest taxpaying businesses while it attempts to find tax delinquents by forcing all companies to provide the federal government with an interest-free loan. The 3 percent withholding requirement significantly impacts our member's cash flow. Moreover, this new requirement is based on **total**

revenues from government payments which bear no relationship to a company's taxable income. Companies will lose vital funds needed to operate day-to-day activities and will be forced to pass along the added costs to customers or finance the additional amount themselves.

In addition, the costs to federal, state, and local governments to administer the program will be substantial and the process complicated to implement. The Congressional Budget Office reported that the withholding provision is an unfunded mandate on state and local governments because it exceeds the allowable $50 million annual threshold.

Section 511 was billed as a provision to close a "tax loophole" that allows taxpayers to avoid their tax obligations. Yet, there is no such "loophole" — the IRS has simply failed to do its job of collecting. Information reporting requirements are already in place to assist the IRS in its job of collecting taxes. Government entities are required to file an information return, reporting payments to corporations as well as individuals. Moreover, every head of every Federal executive agency that enters into contracts must file an information return reporting the contractor's name, address, date of contract action, amount to be paid to the contractor, and other information. At a minimum, reporting requirements should be strengthened before sweeping mandatory withholding requirements are imposed on small businesses and all government entities.

ASA applauds the Committee for holding today's hearing on this vital issue and urges all members to support legislation repealing Section 511 of P.L. 109-222 as soon possible.

Thank you for your consideration of these comments. The American Supply Association looks forward to working with the Small Business Committee on this important issue.

American Society of Civil Engineers

Washington Office
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Suite 375 East
Washington, DC 20001
(202) 789-7850
Fax: (202) 789-7859
Web: http://www.asce.org

Statement of the
American Society of Civil Engineers
Before the Committee on Small Business
U.S. House of Representatives
March 22, 2007

The American Society of Civil Engineers (ASCE) wishes to thank Chairwoman Nydia Velazquez and the members of the Small Business Committee for holding this hearing on the issues surround Section 511 of the Tax Increase Prevention and Reconciliation Act (P.L. 109-222).

> **ASCE supports the immediate repeal of Section 511 of the "Tax Increase Prevention and Reconciliation Act of 2005" (P.L. 109-222) which mandates a 3% withholding on payments to companies for any contract with a government entity.**

ASCE, founded in 1852, is the country's oldest national civil engineering organization representing 139,000 civil engineers in private practice, government, industry and academia dedicated to the advancement of the science and profession of civil engineering. ASCE is a 501(c) (3) non-profit educational and professional society.

As part of Section 511 of "Tax Increase Prevention and Reconciliation Act of 2005," the law mandates a 3% withholding on payments to companies for any contract with a government entity on any level. Specifically, the Section requires withholdings at a rate of 3% on all government payments for products and services made by the federal government, as well as state and local governments, with contracting expenditures of $100 million or more.

Additionally, the law imposes administrative costs and information reporting requirements. The new law applies to payments starting in 2011 and is estimated to "increase" revenue by $7 billion from 2011 to 2015. However, the $6 billion raised in 2011 would be solely due to accelerated tax receipts and does not actually represent an increase in revenues.

The provision will hurt many honest taxpaying businesses in an attempt to find tax delinquents by essentially forcing contractors, including engineering and construction firms, to provide the government with interest-free loans. The 3% withholding will hurt many firms' cash flow. This requirement is based on a company's revenue and has no relationship to its taxable income. Firms with tight profits margins will lose vital funds needed to operate day-to-day activities and will be forced to pass along the added costs.

In addition, the costs to Federal, State, and local governments to administer the program will be substantial and the process complicated to implement. The Congressional Budget Office (CBO) reported that the withholding provision is an unfunded mandate on state and local governments because it exceeds the allowable $50 million annual threshold.

Thank you for the opportunity to submit ASCE's views. If you have need additional information or have a question, please contact Martin Hight, ASCE Senior Manager, Government Relations at 202-789-7843 or mhight@asce.org.

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION
The Source and Resource for Construction Financial Professionals

House Committee on Small Business

Chairwoman Nydia Velázquez and Ranking Member Steve Chabot

March 26, 2007

"Mandatory 3% Withholding on Government Contracts"

The Construction Financial Management Association (CFMA)
The Source & Resource for Construction Financial Professionals

29 Emmons Drive, Suite F-50
Princeton, NJ 08540
Phone: (609) 452-8000
Fax: (609) 452-0474
www.cfma.org

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

The Source and Resource for Construction Financial Professionals

The Construction Financial Management Association (CFMA) would like to thank Chairwoman Velázquez, Ranking Member Chabot, and the members of the House Committee on Small Business for the opportunity to submit CFMA's views regarding the mandatory 3% withholding provision on governmental contracts, included in Section 511 of the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA).

CFMA is "The Source & Resource for Construction Financial Professionals" and the only nonprofit organization dedicated to serving the construction financial professional. Headquartered in Princeton, NJ, CFMA currently has more than 7,000 members in 90 chapters throughout the U.S.

Established in 1981, CFMA's General Members represent all types of contractors as well as developers, construction managers, architects, engineers, principals, and material and equipment suppliers. Associate Members include the accounting, insurance, surety, software, legal, and banking specialists who serve the construction industry.

The following comments outline why the mandatory 3% withholding provision creates a potentially grave situation for construction companies that perform public work. This provision will impair the cash flow of contractors that perform public work, reduce the number of contractors that perform public work, and raise prices on public projects.

IMPAIR CASH FLOW

Gross Profit

Unless the provision is repealed, contractors that perform work on schools or other buildings and structures owned by government entities will receive less in direct payments. Consider a payment by the General Services Administration (GSA) to a general contractor (GC). The GSA would withhold 3% of the total payments and remit that amount to the IRS. The GC would use the remaining 97% to pay the project's subcontractors and material suppliers.

Three percent can have a substantial impact on a contractor's bottom line. In the example below, the contractor experiences a cash flow decrease of 30% throughout the project and a total cash flow deficit of $270,000.

In this scenario, the total contract amount is $10 million with an estimated gross profit of $1 million. The A/P schedule approximates the A/R schedule and the billing schedule approximates the cost schedule (e.g., no front-end loadings or unbalanced bid items)

% Complete	Billings To Date	Contract Receivables & Retainage	3% Government Withholding	10% Retainage on Billings & 3% Govt W/H	Cash Collected	Cost To Date	Accounts Payable	Cash Paid	Net Cash Flow	Cash Flow Decrease
25%	$2,500,000	$1,000,000	$45,000	$295,000	$1,455,000	$2,250,000	$900,000	$1,350,000	$105,000	30%
50%	$5,000,000	$1,000,000	$120,000	$620,000	$3,880,000	$4,500,000	$900,000	$3,600,000	$280,000	30%
75%	$7,500,000	$1,000,000	$195,000	$945,000	$6,305,000	$6,750,000	$900,000	$5,850,000	$455,000	30%
100%	$10,000,000	$1,000,000	$270,000	$1,270,000	$8,730,000	$9,000,000	$900,000	$8,100,000	$630,000	30%
Retainage Paid	$10,000,000	$ -	$300,000	$300,000	$9,700,000	$9,000,000	$ -	$9,000,000	$700,000	30%

Project completion, before retainage collection (which can be as long as one year after project completion)

Total Profit	$1,000,000
Total Withheld	(1,270,000)
Cash Flow Deficit	$ (270,000)

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION
The Source and Resource for Construction Financial Professionals

Operating Profit

Unlike many industries, construction companies operate on a very thin margin. Participants in *CFMA's 2006 Annual Financial Survey* reported an average operating profit of 2.2%.[1] While this is a composite, with some types of contractors generating a larger profit, the point is clear. At 3%, governments could easily withhold most – and perhaps all – of a contractor's operating profit.

REDUCE PUBLIC CONTRACTORS

Overwithholding

Overwithholding is also an issue. The tax on the net profit of 5% (which would be an exceptionally profitable contract by construction standards) would equal approximately 1.75% at a 35% tax rate.

Yet, the IRS would withhold 3% as a prepayment of tax. If the GC has multiple government jobs and the margins are not adequate, the GC may experience a critical cash flow shortage while waiting for its tax refund. This will make public work less attractive to construction companies and reduce the number of contractors who undertake public projects.

Retainage

It is common practice for project owners to withhold at least 5% of a contract's total value until the project is complete. This withholding is called retainage. Government withholding of 3%, plus retainage of 5%, equals an automatic 8% cash deficit for the life of the project.

Only the largest contractors can absorb a project cash deficit of 8%, making it very difficult for smaller construction companies to compete for public work. If the market forces small, niche contractors to perform public work, they will have to reduce their workforce. This is likely to decrease payroll taxes and increase unemployment.

RAISE PRICES ON PUBLIC WORK

Bonding

Almost all contractors must obtain bonds to secure their work. Most government construction projects require contractors to secure surety bonds before they can bid on or perform certain construction contracts. Surety companies underwrite a contractor's creditworthiness primarily through an analysis of its balance sheet, in particular its working capital, which is the contractor's current assets minus its current liabilities.

The most important element of working capital is cash. Many sureties use a "10 times working capital" model to calculate a contractor's maximum bonding capacity. A 3% reduction in working capital reduces bonding capacity, which diminishes the ability of construction companies to bid on certain projects.

Many contractors cannot afford to bid on public projects under this provision. Their only choice will be to forego public work or to increase the price of their bids.

RECOMMENDATION

CFMA strongly believes that mandatory 3% withholding of governmental payments should be repealed. It will significantly impact contractors and displace construction workers. The unintended consequences of this provision will constrict the pool of construction companies that can perform public work, decrease competition in this sector, and lead to price increases.

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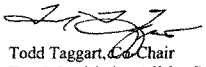
[1] CFMA's Construction Industry Annual Financial Survey provides comprehensive, aggregate information organized by contractor type, dollar volume, and geographic region. In the 2006 survey, more than 500 respondents submitted their company's financial data, 495 of these submissions were included in the composite operating margin statistic

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

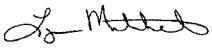
The Source and Resource for Construction Financial Professionals

As a participant in an industry exceeding $1 trillion in revenue, approximately 8% of the U.S. Gross Domestic Product (GDP), CFMA appreciates the opportunity to comment on these issues. If there are questions regarding our position, please contact Lynn Mitchell, Co-Chair, Tax & Legislative Affairs Committee, at 609-452-8000 (ext. 240).

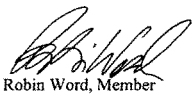
Sincerely,



Todd Taggart, Co-Chair
Tax & Legislative Affairs Committee



G. Lynn Mitchell, Co-Chair
Tax & Legislative Affairs Committee



Robin Word, Member
Tax & Legislative Affairs Committee

Statement for the Record
of the
Construction Management Association of America

"The New Hidden Tax on Small Business"

House Committee on Small Business

March 22, 2007

The Construction Management Association of America (CMAA) respectfully submits a statement for the record for the March 22, 2007 hearing held by the House Committee on Small Business titled: "The New Hidden Tax on Small Business."

CMAA is a twenty-five year old national industry association whose mission is "to promote professionalism and excellence in the management of the construction process." CMAA represents more than 4,000 private and public firms, agencies, and individuals throughout the nation who are dedicated to the practice of construction management (CM).

Construction management is a professional service that applies effective management techniques to the planning, design, and construction of a project from inception to completion. This discipline and management system has been developed expressly to promote the successful execution of capital projects for owners. More and more public and private owners are relying on construction managers to represent them on projects and to utilize their expertise to control time, cost, and quality—resulting in the successful completion of all types of projects.

CMAA applauds Chairwoman Velázquez and Ranking Member Chabot for holding this important hearing related to Section 511 of the Tax Increase Prevention and Reconciliation Act (PL 109-222).

Section 511 mandates that federal, state, and local governments withhold three percent from all payments for goods and services beginning in 2011. Specifically, the provision would:

- Withhold taxes at a rate of three percent on all government payments for products and services made by the federal, state, and local governments with expenditures of $100 million or more.

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www.cmaanet.org

- Affect payments for goods and services under government contracts, as well as payments to any person for a service or product provided to a government entity.

The goal of Section 511 is to safeguard against business tax evasion. Although CMAA certainly agrees that all companies should pay their tax liability, CMAA is very concerned about the impact and the unintended consequences of Section 511 on all companies that receive contracts or other forms of payment from the government.

- **Negative impact on cash flow.** Section 511 will clearly have an adverse impact on the cash flows of companies. Companies will lose vital funds needed to operate day-to-day activities and will be forced to pass along the added costs to customers or finance the additional amount. The ability of construction companies to afford or receive necessary bonds will also be impacted by a reduction in cash flow.

- **Administrative costs.** Compliance with Section 511 will result in significant administrative costs and information reporting requirements for governments and companies.

- **No relationship to taxable income.** The withholding is based on revenues from government payments with no relationship to a companies' taxable income. The result is harm to a companies' cash flow.

- **Three percent withholding is excessive.** Some construction management firms do not make a three percent profit on a contract. Requiring a tax withholding in excess of expected profits would be extremely burdensome for companies, especially small businesses.

- **Unfair impact to honest taxpayers.** Section 511 would treat honest taxpayers the same as those who are illegally avoiding payment of their tax obligations. More effort and resources should be put toward enforcing current tax laws and targeting those companies who are cheating on their taxes, instead of adding to the burden of honest businesses.

Section 511 will clearly cause more harm then good and have a negative impact on both large and small businesses who work with federal, state, and local governments. CMAA supports full repeal of Section 511 and urges all Committee members to cosponsor repeal legislation (H.R. 1023), which was introduced by Congressman Kendrick Meek (D-FL) and Congressman Wally Herger (R-CA).

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for Government
Procurement

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Statement for the Record

March 22, 2007
House Committee on Small Business Hearing: The New Hidden Tax on Small Business

The Coalition for Government Procurement wishes to thank Chairwoman Nydia Velázquez and the members of the House Small Business Committee for holding this hearing on the issues surrounding Section 511 of the Tax Increase Prevention and Reconciliation Act (PL 109-222).

The Coalition for Government Procurement is a non-profit association of companies that sell commercial services and products to the federal government primarily through MAS contracts and GWACs. Our membership includes small and large businesses and accounts for 70% of sales on the GSA schedule program. Over 42% of our members are small businesses.

Section 511 created a sweeping requirement mandating that federal, state, and local governments withhold three percent from all payments for goods and services. This provision, which becomes effective in 2011, will affect all government contracts.

Our membership strongly believes that everyone should pay their full tax liability. Companies that do not pay their taxes enjoy an unfair competitive advantage and increase the burden on honest taxpayers. However, Section 511 received no congressional or public input before being inserted into legislation during closed-door conference negotiations. Due to this lack of vetting, the proposal contains numerous deficiencies:

Decreased Competition in the Federal Marketplace. Commercial firms will be forced out of the federal marketplace due to the increased cost of doing business with the government. A small business that receives 90% of their revenue from government business will find it difficult to stay afloat and will eventually be driven out of the federal marketplace and out of business.

Costs Will Be Greater Than the Increased Revenue to the Government. The additional costs of implementing and administering the withholding

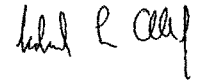
requirement for governments and businesses will be far greater than the estimated $215 million per year of increased revenue.

Private Sector Administrative Costs. The administrative costs to companies, as well as to governments, are substantial. Companies' internal systems are not equipped to track these payments, which will become extraordinarily complex for small businesses.

Costs will be Passed Through to Government. Companies will be forced to pass some of the 3% withholding costs through to its customer, the government; therefore, contractor bids to governments will be higher, and governments will be forced to pay more.

Costs will be Passed Down to Subcontractors (generally Small Businesses). Some companies may also be forced to pass some of the 3% withholding costs down to their subcontractors. This hurts the small businesses lower on the supply chain.

Sincerely,



Larry Allen
Executive Vice President

March 21, 2007

The Honorable Nydia Velazquez
Chair

The Honorable Steve Chabot
Ranking Member

Committee on Small Business
U.S. House of Representatives
2360 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairwoman Velazquez and Representative Chabot:

Thank you for holding an important hearing about the detrimental effects of a new tax withholding on Federal contract and other payments that was contained in section 511 of the "Tax Increase Prevention and Reconciliation Act of 2005" (P.L. 109-222).

I respectfully request that this letter be included in the record for the hearing entitled, "The New Hidden Tax on Small Business." I write today on behalf of the Contract Services Association (CSA) and its member companies.

By way of background, CSA is the nation's oldest and largest association of service contractors representing over 200 companies that provide a wide array of services to Federal, state, and local governments. CSA members perform over $40 billion in government contracts annually and employ nearly 500,000 workers, with nearly two-thirds of CSA companies using private sector union labor. CSA members represent the diversity of the government services industry and include small businesses, 8(a)-certified companies, small disadvantaged businesses, women-owned, HubZone, Native American owned firms and global multi-billion dollar corporations. CSA promotes 'Excellence in Contracting' by offering significant professional development opportunities for government contractors and government employees, including the only program manager certification program for service contractors.

As you know, section 511 mandates the withholding of a three percent tax on all payments made by government entities. The language was approved without any deliberation or committee hearings and has a very broad impact. Not only are payments on contracts affected, but Medicare, farm, disaster, and grant payments will have 3 percent withheld as well.

Specifically, we are deeply concerned about the impact of this provision on companies, especially small businesses, which receive contracts from all levels of government. The withholding will impinge upon a company's cash flow that is needed for day-to-day operations and thus be particularly detrimental to small businesses and entrepreneurial and start-up companies. In the service contracting industry, where pre-tax profit margins are usually between

3-5%, service contractors will lose vital funds needed to operate daily activities and finance new jobs.

Moreover, many of these contractors will have to take on higher levels of debt in order to ensure regular cash flows necessary for operations, forcing these companies to finance the extra amounts being withheld. Unfortunately, the increase in financing costs will likely cause the small businesses to pass these additional expenses on to the government customers. Alternatively, some companies may also pass some of the withholding amount down to their subcontractors who in turn will pass it onto their subcontractors. This hurts the supply chain, particularly small businesses lower on the supply chain.

This provision is also harmful to the government. In recent years, governments have been moving toward obtaining commercial products and services at commercial prices (products/prices that are the same in the private sector marketplace). Commercial companies are unlikely to be willing to sell the government if subject to such a withholding in payments. This will put the government at a severe, competitive disadvantage relative to private sector firms buying the same products and services.

We believe that any increase in tax revenue will be far outweighed by the additional costs to businesses and governments to implement and administer this poorly vetted policy. CSA urges you to carefully consider the unnecessary burden that this withholding would have on the ability of the Federal government to efficiently and effectively operate with the support of its private-sector business partners, many of whom are small businesses.

We again thank you for highlighting the importance of this issue by holding this hearing. I urge you to support the repeal of this harmful withholding provision. By doing so, you will be supporting small businesses and good government policy.

We look forward to working with you in the future. Should you have any questions, please do not hesitate to contact me or Colleen Preston, CSA's Senior Vice-President for Public Policy, at 703-243-2020.

Sincerely,

Barry Cullen
President

STATEMENT

OF

DONALD C. ALEXANDER

FOR THE

HOUSE SMALL BUSINESS COMMITTEE HEARING TITLED

"THE NEW HIDDEN TAX ON SMALL BUSINESS"

MARCH 22, 2007

I. *General: Tax Gap and Remedies*

Recently we have heard much about the "tax gap", the annual difference between the amount of Federal taxes that should be collected and the amount actually collected. The tax gap is said to amount to a gross $345 billion, with about $50 billion later recovered by IRS's enforcement efforts. Some, including me, think the gap is actually considerably larger because some revenue sources (excise and estate taxes and the illegal sector) are partially or fully excluded from its base and its compliance percentages are optimistic. In any event, there is a large number to work with. How can noncompliance be reduced without imposing unfair burdens upon compliant taxpayers?

Since IRS efforts to enforce the law are not counted, we must turn to mandated withholding and document matching. GAO believes that an effective withholding system produces 99 percent compliance, and an effective system of document matching (information returns) is close behind at about 96 percent. However, when there is neither withholding nor document matching, compliance can fall below 50 percent. Various remedies have been proposed. Among these is reporting of tax basis by brokers. If that proposal were adopted, it might seem advisable to distinguish between giant organizations with the needed data and capability and small brokerage houses with neither. Similar recommendations have been made regarding state and local property taxes and mortgage interest. Another recommendation would call for reporting of some auction and Internet transactions. Proposals like those have merit but should be carefully designed to prevent unintended consequences.

II. *What Not To Do: Withholding on Government Contract Revenue*

Provisions calling for tightened information reporting and especially withholding should be carefully considered and tested before enactment. Will the anticipated increase in compliance resulting from the proposal justify the burden and cost imposed on taxpayers? The poster child of what not to do is the subject of your hearing today: the recently enacted provision requiring withholding at a three percent rate on gross payments to government contractors. While a description of the provision claims that it "balances the goal of greater compliance with concerns regarding administrative burdens of imposing withholding", the revenue estimate demonstrates there is *no* such balance. In 2011, the year in which the provision is scheduled to become effective, the estimate shows a revenue increase of $6.079 billion. In the following year, however, the increase is only $215 million, and subsequent increases above that $215 million

base are less than $10 million annually. Little analysis is needed to show that the enormous number – more than $6 billion in increased revenues in the initial year – is *not* attributable to increased compliance. Instead, it simply represents the float – advance overpayment of tax revenue renewed annually without interest. Only the comparatively tiny revenue numbers in 2012-2014 (and their 2011 counterpart – the corresponding small portion of the $6.079 billion) constitute revenue from expected increased compliance, the asserted justification for the provision.

This provision did not appear in either the House or the Senate version of H.R. 4295, the Tax Increase Prevention and Reconciliation Act of 2005. Instead it was added in the last throes of the Conference as a revenue raiser required for compliance with the Budget Resolution for fiscal year 2006. Thus, there was no real opportunity to consider the merit (or lack of merit) of this provision or to test the assumptions on which it was based.

Withholding on gross revenues is a blunt instrument likely to have a drastic adverse effect. For example, the profit margin on government construction contracts is frequently less than three percent. In such situations, each year the required advance payment labeled as income tax would exceed the total profit. This heavy burden upon the contractor would produce only a negligible increase in compliance compared to information reporting.

Note that Treasury did not propose the enacted approach, but instead requested further information reporting. Indeed, this remains Treasury's proposal. Despite claims to the contrary, an effective reporting mechanism was *not* in place for governmental payments to corporate contractors. Substantially all the revenue resulting from increased compliance by governmental contractors would have been produced by information reporting, and that should have been the first and only choice. Taxwriters should learn from the government contracts example: don't overdo it. The example itself should be promptly repealed and replaced by information reporting.

Testimony of the Electronic Industries Alliance

Submitted to the House Small Business Committee
for its hearing on
"The New Hidden Tax on Small Business"

March 22, 2007

The Electronic Industries Alliance (EIA) appreciates the opportunity offered by the Committee on Small Business to provide the views of our membership on Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005[1], which mandated a 3% withholding tax on government payments and is scheduled to take effect in 2011. Since the law's passage last year, EIA has opposed the provision, and we strongly support its repeal[2].

EIA represents nearly 1,300 members across the spectrum of the high-technology and electronics industries, whose products and services range from the smallest electronic components to the most complex systems used by defense, space and industry, including the full range of information and communications technology (ICT) equipment and computer hardware. On behalf of our member companies of all sizes but particularly those that are small businesses, we would like to share our concerns about the impending law.

Importance of Small Businesses to Government

In Section 8(d) of the Small Business Act, Congress stated that "[i]t is the policy of the United States that small business concerns have the maximum practicable opportunity to participate in the performance of contracts let by any federal agency, including contracts and subcontracts…"[3] The 3% withholding tax will have a detrimental impact on small businesses that serve as prime contractors, detracting significantly from the government-wide small business contracting goal established by Congress of at least 23% of the total value of all federal prime contract awards each fiscal year.[4]

Because the Internal Revenue Service and U.S. Treasury Department have not yet promulgated the rules to implement the withholding tax, it is unclear at this point what the full

[1] P.L. 109-222
[2] H.R. 1023, introduced Feb. 13, 2007, by Representatives Kendrick Meek (D-Fla.) and Wally Herger (R-Calif.)
[3] 15 U.S.C. § 637(d)
[4] 15 U.S.C. § 644(g)(1)

direct and indirect impact to subcontractors would be. However, if the terms and conditions of a contract provide for the ability of the prime contractor to flow down the immediate cost of the withholding tax to subcontractors, subcontractors would have to implement complex procedures in order to track and eventually recoup any costs passed down by the prime contractor.

Increased Costs for Small Businesses and Government

One of EIA's primary concerns, particularly for smaller entities, is the burden of new administrative costs that companies will be forced to incur if this legislation takes effect. Many of our member companies' internal financial systems – especially at those of our companies that are primarily commercial entities – are not currently designed to track payments specifically from government customers, and making the necessary changes to do so will impose significant costs. Over the longer term, companies can build systems to track prepayments, but this will take time and money, and the costs will necessarily be borne by the government as they are built into program expenses for government customers.

The increased administrative expense to process, account for and reconcile tax withholdings will make it more difficult for companies to compete on a level playing field in the global marketplace, as well as domestically on contracts with non-government customers, with those companies that do not conduct business with the U.S. or state governments.

The implementation of a 3% withholding tax would undoubtedly raise the cost of doing business with the government and provide a significant deterrent for companies for which government contracts are not their primary business. In addition to the annual processing costs, companies would need to modify the systems that handle billing, accounts receivable, and tax transactions, as well as develop the supporting documentation.

Ironically, the implementation of the 3% withholding tax designed to address non-compliance is also likely to cost the government more as companies pass the additional costs they will incur back to their customer – the government. The increased administrative expense associated with the withholding process would be allowable and therefore would be incorporated into future bids to the U.S government. The increased interest expense caused by the adverse impact the withholding process is expected to have on cash flow would not be allowable as a direct charge to the U.S. government, but in practicality, it would be part of the margin or profit a company would be willing to accept on future bids.

The U.S. government acquisition workforce – and that at the Defense Department in particular – has moved in recent years towards procuring "to the maximum extent practicable" commercial off-the-shelf (COTS) items, which are the same as those sold in the private sector marketplace and are purchased at the same price.[5] This preference has reduced prices significantly and saved U.S. taxpayers money. However, the imposition of a 3% withholding tax on government sales will signify a large step backwards in this progress.

In the case of many commodity hardware vendors represented by EIA, 3% can exceed companies' profit margins on desktop, laptop and printer sales to the government. As a result, these companies have said they will need to increase prices for government sales, or they will simply decide not to pursue certain opportunities for government sales. The U.S. government, and especially the warfighter, deserves access to the best technology at the best prices. A withholding tax undermines the government policy for the past 15 years of capitalizing on commercial products and processes to meet its needs for better, faster and cheaper products with the latest commercial technologies.

Impact on Cash Flow

The issue of cash flow is a particularly important one for smaller companies, which rely more heavily on regular streams of funding for operations. From an invoicing and collections viewpoint, cash flow will be adversely impacted in three ways: 1) invoice preparation will take longer; 2) invoice payment by the government will be extended; and, 3) the probability that contracts will require a suspension of payments to permit payment system reconciliation will increase as the number of withholdings increases.

One of EIA's larger companies has estimated that the cash flow impact associated with these processing delays would exceed $90 million for the company. While this figure would obviously be less for a small business, it provides a measure of the expected impact the withholding tax would have on a single company doing significant business with the government.

From a tax perspective, cash flow will be adversely impacted for companies that have tax obligations lower than the amounts that would be taken through the applications of a 3% withholding tax. In the highly competitive federal marketplace, it is not unusual for companies to

[5] Federal Acquisition Streamlining Act (FASA), Section 8104

have net pre-tax margins that are substantially lower than the 8.6% margin that would equate to income tax equal to 3% of sales (i.e., 8.6% x 35% tax rate = 3%). While the excess would be refunded upon a company's submission of its annual federal income tax return, the funds would not have been available throughout the tax year. This interest-free loan to the government could significantly harm the ability of smaller companies in particular to invest in more meaningful areas such as R&D and the workforce, thereby undercutting their ability to compete and to grow their businesses.

Many government contractors are likely to require higher levels of debt to ensure necessary cash flows if the withholding tax takes effect. With the anticipated delay in payment processing and the likelihood of over-taxation mentioned above, companies will also incur an additional annual interest expense.

Small Business Competitiveness

Companies that do significant amounts of business with the government will also be forced to increase prices for their non-government customers. Under many companies' current cost accounting practices, the administrative effort to process, account-for and reconcile tax withholding would be an indirect expense and allocated over the entire sales base. The portion of the expense allocated to domestic non-government and international sales would increase a company's costs to the customer, which would place the company at a competitive disadvantage against those without the unique withholding requirement.

EIA believes an income tax collection process that is not directly connected with income expectations is a mistake and will likely make conditions considerably worse for companies experiencing financial performance problems, including many that would most likely fall in the small and small disadvantaged businesses categories.

Conclusion

EIA strongly believes that companies providing goods and services to the government should comply with federal, state, and local tax requirements – companies that do not comply have an unfair competitive advantage over law-abiding contractors that pay their taxes. However, withholding on government payments is not the answer. That is why EIA strongly supports H.R. 1023 to repeal Section 511, sponsored by Representatives Meek and Herger. We believe there

can be a more rationalized and reasonable approach that encourages tax compliance but does not place undue burden on companies or federal, state, and local government agencies. In light of our significant concerns about the current law, we believe that repeal of the withholding tax is critical to the competitiveness of our member companies and particularly of our small business members.

Statement for the Record

Government Withholding Relief Coalition

ON: THE NEW HIDDEN TAX ON SMALL BUSINESS

TO: THE HOUSE COMMITTEE ON SMALL BUSINESS

DATE: MARCH 22, 2007

The undersigned organizations of the Government Withholding Relief Coalition wish to thank Chairwoman Nydia Velázquez and the members of the House Small Business Committee for holding this hearing on the issues surrounding Section 511 of the Tax Increase Prevention and Reconciliation Act (PL 109-222).

The Government Withholding Relief Coalition was formed after the passage of the tax reconciliation bill by organizations concerned about the disruptive effect this provision will have on our members. The Coalition today has over 55 members representing both small and large businesses with a wide range of industry viewpoints.

Section 511 created a sweeping requirement mandating that federal, state, and local governments withhold three percent from all payments for goods and services. This provision, which becomes effective for all payments made after December 31, 2010, will affect all government contracts as well as other payments, such as Medicare, disaster and farm payments.

The members of the Coalition strongly believe that everyone should pay their full tax liability. Companies that do not pay their taxes enjoy an unfair competitive advantage and increase the burden on honest taxpayers. However, Section 511 received no congressional or public input before being inserted into legislation during closed-door conference negotiations. Due to the absence of congressional and general public scrutiny, the legislative provision contains numerous deficiencies.

- **Significant increases in private-sector administrative costs.** The administrative costs to companies – as well as governments – to comply with this withholding requirement will be substantial. Companies' internal systems are not set up to track the amounts withheld from invoice payments. This will significantly complicate the estimating of tax liabilities on quarterly tax payments. For companies receiving thousands of government payments per year, this will be administratively time consuming and costly.

- **Adverse effects on cash flows of companies.** Compliance with Section 511 will reduce cash assets that are used to pay company employees and other day-to-day expenses. Start-up firms and some industries will be severely impacted by this reduction in cash receipts. For instance, in many construction projects profits are not realized until the end of a multiyear contract. Despite this, contractors will have had three percent withheld throughout the life of the contract.

- **Unfairly burdens honest taxpayers.** More efforts should be focused on identifying and prosecuting, if appropriate, the actual tax cheats rather than adding to the administrative burden placed on honest businesses. This proposal treats tax-compliant businesses the same as those illegally avoiding the payment of their tax obligations. The extra cost to implement the provision will, in our opinion, far exceed the additional tax gap revenues it is estimated by the Joint Committee on Taxation to raise.

- **Withholding is not based on a taxpayer's expected liability**. This is unlike withholding on employees' earnings, which can be adjusted through the W-4 form to more closely reflect the individual's tax liability. Section 511 is based on a company's revenue stream, with no relationship to tax liability. Therefore, companies with tight margins will have their cash flows unnecessarily constrained, which will impinge on cash needed for day-to-day operations.

- **An interest-free loan to the federal government**. Most of the $7 billion in revenue occurs in the first year of implementation and is due to an accounting gimmick whereby companies are forced to prepay their taxes and effectively provide the federal government with an interest-free loan. The estimated annual increase in tax compliance is about $250 million per year.

- **Section 511 is causing problems now**. Government contracts frequently cover periods of 5 years or longer in length. This means that companies entering into these long-term contracts must consider in their pricing the additional administrative and financing costs to implement this requirement. The additional expenses incurred by contractors will increase the costs of goods and services associated with the three percent withholding.

Section 511 will have broad and deleterious effects on both small and large firms doing business with federal, state, or local governments. Ultimately, the increased costs for these services will be passed on to the individual taxpayer with a negligible increase in federal tax revenues. In short, the costs far outweigh the benefits. The Coalition and the undersigned organizations feel that for these reasons Section 511 should be fully repealed and we urge committee members to cosponsor H.R. 1023, a repeal bill introduced by Representatives Kendrick Meek (D-Florida) and Wally Herger (R-California).

Sincerely,

Government Withholding Relief Coalition

Aerospace Industries Association
Air Transport Association
America's Health Insurance Plans
American Congress on Surveying and Mapping
American Council of Engineering Companies
American Farm Bureau Federation
American Institute of Architects
American Moving and Storage Association
American Nursery and Landscape Association
American Road & Transportation Builders Association
American Shipbuilding Association
American Society of Civil Engineers
American Supply Association

American Trucking Associations
Associated Builders and Contractors
Coalition for Government Procurement
CompTIA
Construction Management Association of America
Contract Services Association
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Independent Electrical Contractors, Inc
Information Technology Association of America
International Foodservice Distributors Association
Management Association for Private Photogrammetric Surveyors
Mason Contractors Association of America
Mechanical Contractors Association of America
Messenger Courier Association of the Americas
National Association for Self-Employed
National Association of Credit Management
National Association of Manufacturers
National Burglar and Fire Alarm Association
National Defense Industrial Association
National Electrical Contractors Association
National Federation of Independent Business
National Italian-American Business Association
National Precast Concrete Association
National Office Products Alliance
National Roofing Contractors Association
National Small Business Association
National Society of Professional Engineers
National Society of Professional Surveyors
National Wooden Pallet and Container Association
Office Furniture Dealers Alliance
Plumbing-Heating-Cooling Contractors - National Association
Printing Industries of America
Professional Services Council
Security Industry Association
Small Business & Entrepreneurship Council
The Associated General Contractors of America
The Financial Services Roundtable
U.S. Chamber of Commerce
United States Telecom Association
Women Impacting Public Policy

Government Finance Officers Association (GFOA)
International City/County Management Association (ICMA)
National Association of Counties (NACo)
National Association of County Treasurers and Finance Officers (NACTFO)
National Association of State Auditors, Comptrollers and Treasurers (NASACT)
National Association of State Budget Officers (NASBO)
National Association of State Retirement Administrators (NASRA)
National Council on Teacher Retirement (NCTR)
National League of Cities (NLC)
United States Conference of Mayors (USCM)

Committee on Small Business
United States House of Representatives
Hearing on "The New Hidden Tax on Small Business"
March 22, 2007

Chairman Velásquez, Ranking Member Chabot, and members of the Small Business Committee:

Our bipartisan organizations representing state and local governments nationwide applaud your decision to hold this hearing and appreciate the opportunity to provide written testimony on Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"). We applaud the committee for taking an interest in this critical federalism issue and urge you to cosponsor H.R. 1023, legislation introduced by Representatives Kendrick Meek (D-Florida) and Wally Herger (R-California) to repeal Section 511 of TIPRA.

Section 511 – which did not appear in either the House- or Senate-passed version of TIPRA but was used as a revenue-raiser in the conference agreement – will in effect impose a 3 percent federal sales tax on nearly every purchase made by a state and many counties and cities beginning in 2011. Businesses may claim this tax as prepayment of their federal income taxes in the following year. However, in effect, this tax will be only partially refundable for many small businesses. Our member state and local governments and public officials are extremely concerned about the impact this provision will have on competitive bidding for government contracts and the price that state and local governments will pay for purchases of goods and services. Many small businesses will simply refuse to do business with government; others will pass along the cost of this requirement.

The conference report on TIPRA acknowledges that Section 511 will impose an intergovernmental mandate with costs above the threshold of the Unfunded Mandates Reform Act. This will be the first time ever that federal tax withholding and reporting are imposed on the purchase of goods as well as services and the requirement only applies to the public sector. Aside from the increase in the cost of goods and services, it will also require states, cities and counties to reprogram or purchase new accounts

payable systems, hire additional staff and essentially serve as branch offices for the Internal Revenue Service. In addition, since there is no minimum transaction on this provision, even a state, county or city employee who buys a $10 screwdriver will have to pay the hardware store $9.70 and send the remainder to the IRS.

This provision of TIPRA is absurd. Most of its $7 billion in revenue occurs in the first year and is due to an accounting gimmick whereby tax payments are accelerated into the prior year. After 2011 the Joint Committee on Taxation has estimated that the annual increase in federal revenue will be less than $300 million per year. The costs for state and local governments to comply with the requirement will likely exceed that amount.

If you have any questions about the impact of this provision on state and local governments or our support for H.R. 1023, please contact our Washington Representatives:

Susan Gaffney, GFOA, 202-393-8020
Rob Carty, ICMA, 202-962-3560
Alysoun McLaughlin, NACo/NACTFO, 202-942-4254
Cornelia Chebinou, NASACT, 202-624-5451
Brian Sigritz, NASBO, 202-624-8439
Jeannine Markoe Raymond, NASRA, 202-624-1417
Leigh Snell, NCTR, 202-684-5236
Carolyn Coleman, NLC, 202-626-3023
Larry Jones, USCM, 202 861-6709

Statement to the House Committee on Small Business
in regard to
Section 511 of the Tax Reconciliation Act
by the
National Electrical Contractors Association
3 Bethesda Metro Center
Bethesda, Maryland

The National Electrical Contractors Association (NECA) and its member electrical contracting companies would like to recommend the full and total repeal of Section 511 of the Tax Reconciliation Act (P.L. 109-222: H.R. 4297). This ultimately unfair law is an accounting gimmick that produces no significant revenue, yet causes immense problems for state and local governments and businesses – especially in the construction industry.

The National Electrical Contractors Association (NECA) is the nationally-recognized organization speaking for the electrical construction industry. Our industry is comprised of over 63,000 electrical construction contracting firms, employing over 770,000 electrical workers, producing an annual volume of over $125 billion. NECA's membership is organized into 119 chapters, located in nearly every state.

Background

In May of 2006, the President signed into law a bill known as the HR 4297, the Tax Increase Prevention and Reconciliation Act. The measure was a mix of small tax provisions, including extension of capital gains tax rates, increased expensing provisions for small businesses and some alternative minimum tax relief. To offset these revenue-negative provisions it also contained sixteen "revenue offset" provisions to make the bill revenue neutral.

The House and Senate had passed differing versions of this measure and, as is normal in such cases, had gone to Conference to work out the differences and come out with a single final bill. A Conference is not supposed to include provisions that were not addressed in either House or Senate versions. In the case of HR 4297, normal Conference procedure was violated with grave consequences for the construction industry. Going into Conference, the House and the Senate versions of the measure contained several provisions that would help contractors and nothing that would have caused contractors any serious problems. Coming out of Conference, a provision had been added that had a sweeping and potentially extremely harmful impact on contractors. This provision, which would go into effect in the year 2011, requires a 3% withholding on any payments made to businesses under a contract with a government entity. Every government body with an annual contracting budget of $100 million or more (not just construction contracting) must withhold 3% from every payment on its contracts. No hearings on this provision were ever held and no assessment of its impact on those affected by it was ever considered.

What is at Stake?

The withholding provision punishes many businesses in an attempt to "catch" those few businesses that are avoiding their tax liabilities. It forces companies to provide government entities with what is, in effect, an interest-free loan on moneys that may not even be due - with little indication of when those moneys will be returned or establishing any procedure for such refund.

The 3% withholding critically affects company cash flow, especially in the construction Industry, where pre-tax profit margins rarely meet or exceed 3%. The withholding is based on gross revenues from contract payments, and has no relationship to a company's actual taxable income. This is especially damaging in construction since contractors already often face a percentage of up to 10% of progress payments due them retained by the owner as security. This means that payments to workers and suppliers, which cannot be put off by the contractor, must be financed. At least the contractor knows he will be receiving the retainage upon completion of the job. The 3% withholding law takes away an additional 3% of the payment due the contractor – and with no date certain when he may be able to get that money refunded. Further, the amount being withheld is, at a minimum, three times the maximum tax liability that would ever be due. If this withheld money must

be replaced to pay wages and suppliers, it will have to be financed. This, in turn, inevitably will inevitably lead to higher construction prices to f3ederal, state and local governments, which can ill afford those increases.

Construction companies will lose vital funds needed to operate day-to-day activities and finance new jobs as the funds essential to underwriting further business will be tied up in an effort to close the tax gap. The costs to federal, state, and local governments to administer the program will be substantial and the process complex if not impossible. As there is no structure for implementing this 3% withholding in place now, one will need to be constructed. The withholding provision is a costly unfunded mandate on state and local governments, and the gains to the government are cosmetic and minimal.

Conclusion

The National Electrical Contractors Association urges the immediate repeal of Section 511 of the Tax Reconciliation Act.

Thank you for allowing us to submit this statement.

Robert White
Executive Director, Government Affairs
National Electrical Contractors Association

WRITTEN STATEMENT FOR THE RECORD

"The New Hidden Tax on Small Business?"

March 22, 2007

Small Business Committee
United States House of Representatives

Submitted on March 29, 2007 by:

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Protecting Small Business, Promoting Entrepreneurship

The Small Business & Entrepreneurship Council (SBE Council) applauds the leadership of House Small Business Committee Chairwoman Nydia Velázquez and members of the committee who have expressed an interest in reviewing the issue of the forthcoming 3 percent withholding mandate on payments made to government contractors. The provision (Section 511) was included in The Tax Increase Prevention and Reconciliation Act of 2005 (PL 109-222) and takes effect in 2011.

Most certainly, the withholding mandate will impact small businesses that contract with federal, state and local governments; as well as small firms that desire to do business with government. While the aim of the withholding provision is to ensure that government contractors pay their taxes -- that is, it was advanced as a means to close the "tax gap" -- it is the opinion of the SBE Council that lawmakers and policymakers have not fully thought through the unintended consequences of the initiative.

In addition, it appears that there are ways that the federal government can correct this problem before advancing a complex and costly bureaucratic system that would seem to be required in order to manage a collections program that most governments will have to develop, implement and maintain. The Government Accountability Office (GAO), for example, has recommended technology-based solutions -- that federal agencies better communicate and share information by improving the compatibility of their computer systems with the Internal Revenue Service (IRS) to ensure the agency is aware of government contract income.

The GAO has also identified categories of contractors where tax payment and compliance are at issue. That being the case, this should make it easier for the IRS to focus tax-compliance and collection efforts (again, working with the contracting agencies) within these targeted areas. In general, SBE Council believes it will be more efficient – and cost-effective for taxpayers in the long run – for the federal government to improve the compatibility and effectiveness of its computer systems (and its communications with the IRS) before asking governments at all levels to implement a program to support the 3 percent withholding mandate.

In general, more government tax dollars will be needed to track and collect government contracting income. But the withholding scheme will impact governments, and therefore taxpayers, in other ways as well. A survey of SBE Council members who contract with government finds that some will eventually deal with the cost of 3 percent mandate by rolling it back into the contracts. That means the cost of government contracts will invariably increase, which should give pause to lawmakers concerned about using taxpayer dollars in the most effective and efficient manner. In addition, these contractors also report that they may be forced to raise their prices for customers and clients in the non-government sector.

However, and as our survey results find, many of these businesses are not in a competitive position to appreciably raise their contract costs when bidding, or re-bidding as the case may be, on government contracts. The bottom line for these firms is that cash flow will be negatively affected. As it is, managing cash flow in today's business

environment is extremely tedious and demanding. Taking resources away from small firms long before the taxes are due will impose real and significant costs for these enterprises.

Below I have included a few of the many comments received from SBE Council members regarding the impact of the 3 percent withholding mandate:

- "It will be an administrative and financial burden to our organization."

- "It will slow my business down."

- The provision will increase the cost of doing business with the government because "If you are unable to add this 3% to your G&A or Direct Cost line, you cannot be competitive, especially if you are working on close margins like 5%."

- "We will have less cash to invest for continued growth."

- There will be an "additional burden to calculate, reconcile and monitor payment and compliance."

- The "only benefit will be to big business, who can absorb it and amortize it over their enormous contracts."

- The provision will increase costs with respect to "carrying this receivable as well as financing receivables for working capital."

The SBE Council believes the 3 percent withholding mandate must be fully reviewed as a practical and efficient measure. Accelerating the 2011 start date of the provision, as proposed on several occasions to "pay for" new spending programs, should no longer be an option for consideration. In fact, as we have made clear to Congress and the Administration, SBE Council fully supports repeal of the 3 percent withholding provision as embodied in H.R. 1023 proposed by Rep. Kendrick Meek (D-FL) and Wally Herger (R-CA).

In conclusion, SBE Council believes the withholding mandate will add greater strains and complexities to the existing cash flow challenges of small business government contractors; will make small firms less competitive in the government contracting space; will add new costs and bureaucracies for governments, while more efficient solutions appear readily at hand; will increase costs for taxpayers; and will burden firms with new administrative costs, while eating up cash that is needed for business investment and growth In other words, the provision is bad policy on all counts.

Again, the SBE Council is grateful for the leadership of Chairwoman Velázquez on this important matter. Please do not hesitate to contact the SBE Council is you have questions about this statement for the record, or our views on the 3 percent withholding mandate.

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