

STATEMENT OF STEPHEN E. SANDHERR
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PUBLIC HEARING
WITHHOLDING ON PAYMENTS BY GOVERNMENT ENTITIES TO PERSONS
PROVIDING PROPERTY OR SERVICES
INTERNAL REVENUE SERVICE
SEPTEMBER 12, 2011

- Good morning. My name is Steve Sandherr. I am the Chief Executive Officer of the Associated General Contractors of America. Thank you for the opportunity to testify on the proposed regulations regarding 3 percent government withholding.

- My testimony will focus on four key points:
 - AGC opposes 3 percent government withholding and is working with Congress to repeal the law. Repeal is a top legislative priority for AGC members.

 - AGC supports delaying the effective date for 3 percent government withholding.

 - AGC opposes the proposed effective date for 3 percent government withholding of payments under all contracts – new and existing – after December 31, 2013.

- AGC recommends that the IRS provide additional guidance to assist pass-through and joint venture taxpayers comply with 3 percent government withholding.
- Founded in 1918, the Associated General Contractors of America is leading association for the construction industry in the United States representing more than 32,000 firms, including 7,500 general contractors that are engaged in building the nation's commercial facilities and public works. AGC member contractors are prime contractors for property and services contracted by government entities subject to 3 percent government withholding under section 3402(t) of the Internal Revenue Code.
- AGC believes that 3 percent government withholding will have such an adverse impact on the construction industry that it should be repealed; however, AGC understands that until the law is repealed, the IRS is mandated to implement the law. AGC supports delaying the effective date of the final regulations but does not support the change in the proposed regulations that would subject payments under all contracts – new and existing – to 3 percent government withholding after December 31, 2013.
- Construction contracts often cover multiple years due to the long-term nature of infrastructure and other construction projects. Contracts that will exist on January 1, 2014 will have been negotiated without accounting for the financial impact of 3 percent government withholding.

- AGC can state with assurance that 3 percent government withholding will result in overwithholding on every construction contract. Nowhere else in the tax system is a taxpayer required to prepay more than it reasonably expects to owe. Three percent withholding will reduce the cash flow upon which every construction contractor is dependent to bid for and complete government work. The effect of 3 percent withholding will also trickle down and be a drag on many segments of the economy.
- According to the Construction Financial Management Association's 2010 survey, the net earnings before income taxes in the construction industry averaged 3.5 percent.
- This means that on a \$10 million contract, a contractor could expect to net \$350,000 on that contract and expect to pay 35 percent, or \$122,500, at most, in income taxes. However, the government will have withheld \$300,000, or \$177,500 more than potential taxes owed. This is overwithholding by roughly 250 percent and a \$177,500 interest-free loan to the government.
- Since 3 percent is withheld from every progress payment and not just from the final payment, the contractor will often have to borrow money throughout the course of construction to pay for the labor, materials, supplies, and equipment to complete the project and run his or her company. Payments to subcontractors could also be affected, impacting the cash flow needs of these businesses as well. It may also stimulate

disputes between prime contractors and subcontractors over payment issues and requirements under “pay-if-paid” clauses and the Miller Act.

- Furthermore, 3 percent is also on top of, or included in, any retainage (often 5 to 10 percent) that may be held by local, state, or the federal government on a progress payment. As a result, the government may hold back up to 13 percent on each progress payment to a contractor.
- In addition, federal law requires that construction contracts carry several types of bonds to compete for business. Bonds are basically a promise to liquidate a contractor’s assets to pay suppliers and subcontractors, and to finish the contract. If a contractor has less cash on hand because they have had 3 percent withheld from every project, they will have their bonding authority reduced, or their coverage may be denied. This is a particular concern for small businesses trying to compete in the construction marketplace where capacity is down 30 percent due to the recession and weak recovery.
- Three percent government withholding will also cost construction contractors more in administrative costs. Even a small contractor can expect to pay roughly \$50,000 a year to comply with 3 percent government withholding; the largest contractors face nearly a \$50 million a year burden.
- Moreover, at a time when public budgets are tight, the cost for federal, state, and local governments to comply with 3 percent withholding is

estimated at over \$20 billion over five years – for a law that was expected to net around \$11 billion for the government over 10 years.

- Another concern for AGC on applying 3 percent government withholding to existing contracts is that there may be a breach of contract at the federal level under the Federal Acquisition Regulations (FAR) and Contract Dispute Act. That is because the FAR states that all retention is to be released on completion and acceptance of the project. The problem and potential breach for non-payment becomes obvious when the project is complete and accepted by the owner. The retention can no longer be held under the contract. This would be a basis for a Contract Dispute Act claim and the contractor could be entitled to interest or other remedy. AGC recommends that the IRS look into this issue further and, if necessary, offer guidance on how the transition for existing long-term contracts would work.
- In particular, 3 percent government withholding puts an undue burden on pass-through entities and joint ventures. Nearly all of these entities do not have business income tax liability so they will have to track and report the appropriate amount of 3 percent withholding to each shareholder in the S corporation, member of the limited liability company, partner in the partnership, or party of the joint venture. This extra layer of administrative cost and complexity will also burden every project and every contractor, and it will be very difficult for government withholding entities to ensure compliance.

- Consequently, each individual taxpayer will have his or her own tax returns and tax liabilities affected by 3 percent government withholding, and each will have made an interest-free loan to the government. Further, some taxpayers may not receive credit for the withholding until two to three years later.
- Further, refunds of withheld funds will go to the individual taxpayers of the entities and not back to the operating cash of the company doing the work.
- Because pass-through entities and joint ventures are prevalent in the construction industry – more than 6 out of 10 construction companies are S corporations – AGC recommends that the IRS provide guidance on how the 3 percent withholding should be accounted for within these entities. That guidance should include how to apportion withholding from these entities to the individual taxpayers, and should allow for application of withheld sums to quarterly estimated taxes. AGC prefers that pass-through entities and joint ventures that do not owe business income taxes should be exempt from 3 percent government withholding.
- For all of these reasons, AGC opposes 3 percent government withholding and supports full repeal. There are plenty of safeguards that already exist in addition to the tax code to ensure that contractors pay their taxes, including performance bonds, retainage, and pre-qualification.

- Implementation of 3 percent government withholding could not come at a worse time for the industry. The construction industry went into a recession a year and a half before the overall economy and still has not emerged from it.
- The total value of construction put in place was \$1.2 trillion in 2006. That number shrunk to about \$800 billion in 2010. The industry has lost over 2 million jobs – nearly a third of its workers – and its unemployment rate in August 2011 was 13.5 percent.
- Tough economic times have made competition for jobs fierce and profit margins tight. A recent survey of AGC members found that in 2011, nearly 30 percent of them felt forced by market conditions to reduce profit margins. Three percent of AGC members felt that the economy was so bad they would be forced to bid projects at a loss.
- Contractors and government entities alike cannot afford to increase their bids to cope with 3 percent government withholding now or when the law goes into effect.
- Because construction projects are often long-term and contracts are multi-year, AGC opposes the proposed regulation that would apply 3 percent government withholding to payments under all contracts – new and existing – after December 31, 2013. There are contracts in place today that extend past December 31, 2013. These contracts will have been negotiated

when 3 percent withholding was not in effect and economic conditions precluded accounting for it.

- In the absence of repeal, further delay would protect contractors from the adverse financial impact of 3 percent government withholding. Delay also offers the opportunity for the IRS to provide additional guidance for pass-through entities and joint ventures, and give state and local governments more time to prepare their systems and processes for compliance.
- If 3 percent withholding is not repealed, the IRS may consider implementing the law at the federal level first, while giving state and local governments more time to prepare, and to address issues before broader implementation.
- Thank you again for the opportunity to testify this morning. I look forward to responding to any questions you may have.