

Government Withholding Relief Coalition

REPEAL SECTION 511 OF THE TAX RECONCILIATION ACT OF 2005 (P.L. 109-222)

Repeal Is Needed As Soon As Possible. While this requirement is not set to go into effect until January 1, 2012, companies, as well as federal, state, and local governments are spending funds trying to prepare for implementation now. These are needless preparation expenses, particularly during rough economic times, for a requirement that most believe should never have been enacted and should be repealed.

Implementation Expenses Are Wasteful. It is a wasteful expense for companies, especially at this time. Companies should not be spending money on preparing to comply when they should be using money to ameliorate some of the liquidity challenges currently faced by companies, i.e., companies could use money to meet pension funding requirements, retain employees and create jobs, purchase capital assets, and ease crunch in commercial paper markets.

One-Year Delay is Not a Solution. The one-year delay in the Economic Stimulus bill is positive in the sense that it demonstrates that Congress realizes there are issues with implementing the withholding. However, merely delaying the effective date is not a solution because there is still no equitable, practical, or cost-effective way to implement this new requirement.

DoD Estimated Costs to Implement Law at \$17 Billion. The Department of Defense estimates that the costs to comply with the 3% withholding requirement will be over \$17 billion over the first five years. DoD's estimated costs are already substantially more than any savings, and the rest of the federal government and state and local governments will have enormous costs as well.

Costs Will Be Greater Than the Increased Revenue to the Government. The estimated \$215 million per year of increased revenue due to increased tax compliance will be less (we believe far less) than the additional costs of implementing and administering the withholding requirement for governments and businesses.

Broad Impact. Not only are payments on contracts affected, but Medicare payments, Farm payments, and some grants are subject to the withholding as well. This provision adversely impacts many businesses and industries that it may not have been intended to affect.

Private Sector Administrative Costs. The administrative costs to companies, as well as to governments, are substantial. Companies' internal systems are not set up to track these payments, which will become extraordinarily complex when involved in complex business ventures with multiple partners or subsidiaries. For companies receiving thousands of government payments per year at multiple locations, this will be very administratively time consuming and costly.

\$6 Billion Of The Estimated \$7 Billion In "Increased Revenue" From 2011 To 2015 Comes From An Accounting Gimmick. Actual Savings Are Only Around \$215 Million Per Year. The provision is aimed at collecting underreported tax revenues and increased tax compliance. While an admirable goal, the bulk of the \$7 billion revenue score is due to the acceleration of tax receipts during the transition year and not an actual revenue increase from improved tax compliance. The provision generates only \$215 million in 2012 and increases slightly in each of the following years.

Commercial Items. Governments have been moving toward obtaining commercial products and services at commercial prices (products/prices that are the same in the private sector marketplace). This provision severely alters this system that has shown great progress in reducing prices to the government. This will put government at a severe, competitive disadvantage relative to private sector firms buying the same products and services (GSA Schedules prices may have to be altered).

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Credit Card Purchases. Large amounts of government purchases are made with government-issued credit cards. There is no realistic way for the government to withhold 3% on payments in this situation where the credit card company is essentially the go-between. As stated in DoD's April 14, 2008 cost impact study, the "processing banks for purchase cards have advised DoD and GSA that they will not change their commercial processes to execute section 511 withholds on the behalf of DoD or any other agency." Therefore, if the 3% withholding requirement becomes effective, the federal government and state and local governments will no longer have the ability to use purchase cards, and they will have to forgo the billions of dollars in savings.

Profit At End Of Contract Life, Withholding Throughout. With many industries, particularly construction and shipbuilding, profits are at the end of the life of a multi-year contract. In these situations, the contractor will have little or no tax liability in the early years of the contract despite having 3% withheld throughout the life of the contract.

Government Prime Contractors Subcontract Significant Percentages Of The Overall Contract Value. Companies of all sizes, but particularly small businesses, obtain large value government contracts and then subcontract significant portions of it. 3% of the total contract value could, in these cases, be over the actual tax liability.

Contract Value=\$100 :: 3%=\$3 withheld

Subcontract 75% (that is not abnormal in some sectors)

Only \$25 left for small business prime contractor

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. Some companies may also be forced to 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.

Companies Forced To Increase Debt Level Or Line Of Credit. Many contractors will have to take on higher levels of debt in order to ensure regular cash flows necessary for operations. Companies will be forced to finance the extra amounts being withheld.

Companies Who Receive A Higher Percentage Of Their Revenue From Government Payments Will Be Less Competitive. Companies with a high percentage of government business will be at a competitive disadvantage relative to companies with a lower percentage of their revenue coming from government payments. More of their revenue stream will be tied up in withheld payments, leaving less free cash for operating expenses.

Existing Laws Are Sufficient. Existing laws allocate significant enforcement authority to the government to force companies to pay their requisite tax liabilities. The government should better enforce current laws rather than requiring a withholding on tax-compliant companies.

Puts A Heavy Burden On Entrepreneurial And Start-Up Organizations. The withholding will be particularly painful for entrepreneurial and start-up companies that are commonly operating in the red and operating on financing and therefore have no profit or tax liability. The withholding requirement will deprive them of needed capital and force them to wait many months before withheld amounts are refunded.

5-Year Contracts Being Signed Now, Repeal Can't Wait. Government contracts frequently cover periods of 5 years or longer in length. This means that companies entering into these long-term contracts now should be considering in their pricing the additional administrative and financing costs to implement this

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requirement. The additional expenses incurred by contractors will increase the costs of goods and services provided to the government. Section 511 is causing problems in pricing long-term contracts now and repeal is needed immediately.

Change Of Contracts Mid-Stream Entitle Contractors To Receive Equitable Price Adjustments. Due to the lack of implementing regulations, companies and their federal government customers are not currently bidding and negotiating contracts under the assumption that the 3% withholding will be in effect. When the withholding becomes effective in 2011, the government will be forced to withhold 3%, but also to comply with the terms of the contract that do not stipulate withholds. In order to remedy the breach, contractors will be entitled to receive an equitable price adjustment that provides consideration for the administrative and financial impact.

Incorrect Payments Will Be More Difficult And Costly To Reconcile. Governments inevitably make incorrect and late payments. While the government is working on reconciling the differences and correcting the mistake, taxes (or quarterly estimated withholding) will come due. The company will bear the costs of reconciling the government's errors.

An Unfunded Mandate On State And Local Governments. Federal tax compliance enforcement is the function of the IRS, not the state and local governments. This program is an unfair burden on lower levels of government. The cost to administer this program by altering accounting systems will be substantial and the Congressional Budget Office has stated it is an unfunded mandate.

Unconstitutional. The provision, as it relates to state and local governments, may be unconstitutional and will likely be challenged in court on those grounds. Congress isn't allowed to impose affirmative obligations on lower levels of government and the federal government only has jurisdiction that crosses state lines (commerce clause).

More County And City Governments Will Be Affected Than One May Think. Local governments with less than \$100 million in expenditures are exempt from withholding requirement, but still many smaller county and city governments will be affected. Local governments with hospitals, universities, and schools could easily breach the \$100 million mark. This will particularly be problematic for localities that break the threshold in some years due to a large capital project.

Impact on Governmental Entities Under the \$100 Million Threshold. Although entities budgeted to spend under the \$100 million threshold may not be required to withhold the 3%, many of those small government entities access contracts established by larger jurisdictions that are over the \$100 million threshold. If, as expected, vendors add a percentage to their pricing in order to maintain their cash flow, these smaller entities will be paying the increased costs for goods and services, without the benefit of planning for these budget impacts.

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MEDICAL: Medicare Payments

Medicare payments to hospitals and individual physicians will be affected by the 3% withholding as well. This will cause serious cash flow problems for hospitals. The Center for Medicaid and Medicare Services (CMS) will have to significantly alter their systems to implement the provision.

FARM PAYMENTS

Payments to farmers under a government commodity support program (Loan Deficiency Payments) are also subject to the withholding. The government has already set the value of these payments and an arbitrary 3% should not be withheld, especially because LDP's to farmers are highest in years that farmers are most financially strapped due to poor yields. Withholding on these is counterproductive to the program.

GRANTS

Grants to for-profit companies (regardless if they are state or federal) will have 3% withheld. Grants by their definition are allocated to an entity for a specific purpose (i.e. research) and it makes no sense to withhold any percentage of them for tax purposes.

CONSTRUCTION

The 3% withholding significantly affects company cash flow, especially in construction where pre-tax profit margins rarely meet or exceed 3%. This new requirement is based on revenues from government payments with no relationship to a companies' taxable income.

Construction companies will lose vital funds needed to operate day-to-day activities and finance new jobs.