

This report is submitted in response to the House of Representatives Report of the Committee on Armed Services accompanying the National Defense Authorization Act for Fiscal Year 2008, H.R. 110-146, which requested the Department of Defense (DoD) to assess the impacts of compliance with section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Public Law 109-222, including the cost of modifications to defense financial accounting systems, additional personnel costs, and anticipated consequences for defense contractors in terms of performance, subcontract management, and cost escalation. Section 511 generally requires federal, state, and local governments to withhold and remit to the Internal Revenue Service (IRS) three percent of payments made to contractors or other entities for goods and services, effective January 01, 2011.

The IRS is developing implementing regulations to establish the process for the section 511 withholds, including how and when amounts withheld in excess of an entity's tax obligation will be returned to the entity. Until the IRS publishes the implementing regulations, the impact of section 511 will not be fully known. For this report, DoD relied on the following key assumptions regarding how the IRS will implement section 511:

Key Assumptions:

1. The IRS will establish a process for the section 511 withholds that is similar to the process the IRS established for backup withholding, 26 U.S.C. 3406(b). Therefore:

a. DoD will be required to withhold three percent of the affected payments, remit the withholds to the IRS, and report the amount of payments and associated withholds to both the IRS and the payees.

b. Payees will be required to recover excess withholds through the normal federal income tax process, not DoD.

2. The IRS will not allow payees to offset the amounts withheld under section 511 against estimated quarterly income or payroll tax obligations. Therefore, companies that properly pay their tax obligations will experience cash shortages equal to the amounts withheld until the amounts are recovered through the normal federal income tax process.

3. The IRS will not exclude third party payments (e.g., commercial purchase card, PowerTrack). Therefore, DoD will lose its ability to use the commercial purchase card and other third party payment mechanisms because DoD will be unable to execute the section 511 withholds against those payments.

4. The IRS will exclude Government employees' official travel expense, e.g. hotel, meals, airfare. However, the IRS has advised DoD that their implementing regulations may require application of the withholds to these payments.

5. The IRS will not apply the withholding requirements to prime contractors' payments to their subcontractors. The IRS has solicited public comments on how to apply the withhold requirements to subcontractors.

6. The cost for the IRS, other Federal Agencies, State and Local Governments, and their suppliers are not included in DoD's estimated cost impact.

Cost Impact and Other Concerns:

As detailed below, DoD anticipates the costs for DoD to comply with section 511 will be significant - over \$17 billion for the first five years. In addition, DoD is concerned that the withhold will:

1. Limit the number of companies willing to enter into the government market, thereby reducing competition and access to new technologies.
2. Significantly restrict the available cash of tax-compliant companies that could otherwise be used to develop new technologies.
3. Exacerbate current procurement personnel staffing shortages by the additional workload that will result from the alternate use of purchase orders or other traditional, paper-intensive processes.

The estimated cost impact below includes (1) the costs for DoD to implement and manage section 511 within DoD and (2) the additional cost escalation DoD will pay its contractors as a result of section 511.

Section 511 Cost Impact for DoD
Amounts in 2007 Dollars

		<u>Note</u>
Costs for DoD to Comply:		
Nonrecurring Costs:		
Year 1 (2009-2011)	\$ 22,312,500	1
Year 2	N/A	
Recurring Annual Costs	\$ 844,282,917	2
Cost Escalation from DoD Contractors:		
Nonrecurring Costs:		
Year 1 (2009-2011)	\$ 5,224,716,425	3
Year 2	\$ 261,235,821	3
Recurring Annual Costs	\$ 1,424,730,385	4
Cost for DoD to Implement and Manage for the First Five Years	\$17,637,038,720	5

Explanatory Notes:

1. **Nonrecurring Costs Within DoD.** The estimated nonrecurring costs to modify DoD's accounting and entitlement systems to comply with section 511 are:

	Cost Per System	Number of Systems	Total
Accounting	625,000	11	\$ 6,875,000
Entitlement	812,500	19	15,437,500
Total			<u>\$ 22,312,500</u>

2. **Recurring Annual Costs Within DoD.** The estimated recurring annual costs to comply with section 511 are:

No Commercial Purchase Card	\$839,212,500
Section 511 Reporting and Reconciliation	5,070,417
Total Recurring	<u>\$844,282,917</u>

a. **No Commercial Purchase Card.** The commercial purchase card is a charge card issued as part of the General Services Administration's (GSA) SmartPay® Program, which provides commercial purchase card services to approximately 350 Government agencies and organizations. The program enables agencies to avoid an estimated \$1.4 billion in administrative processing costs annually on relatively low-cost purchases through the use of a streamlined, commercial buying process.

When DoD uses the commercial purchase card, DoD does not make a direct payment to the contractor. Instead, the processing banks for the commercial purchase card pay the contractor and DoD subsequently reimburses the processing banks. The processing banks have advised DoD and GSA that they will not change their commercial process to execute the section 511 withholds on the behalf of DoD or any other agency. Therefore, DoD will be unable to execute the withhold required by section 511 on commercial purchase card transactions and will lose its ability to use the commercial purchase card. DoD estimates the costs to acquire goods and services that were previously acquired using the commercial purchase cards as follows:

Contract Costs	\$728,000,000
Payment Costs	55,612,500
Lost Rebates	55,600,000
Total	<u>\$ 839,212,500</u>

(1) Contract Costs. The General Services Administration (GSA) estimates the commercial purchase card saves the Government between \$54 and \$92 for each purchase made using the card instead of purchase orders or other traditional, paper intensive processes. Consistent with that range, DoD used a midrange of \$72.80 per transaction to calculate the anticipated additional contract costs. Historically, DoD uses the commercial purchase card annually for approximately 10,000,000 transactions. Therefore, the estimated additional contract costs are:

$$\$72.80 \text{ per transaction} \times 10,000,000 \text{ transactions} = \$728,000,000$$

(2) Payment Costs. The \$54 to \$92 range of estimated cost savings from the commercial purchase card includes some savings attributable to commercial purchase card payments. However, we do not believe the savings in the \$72.80 midpoint used above is sufficient to address the anticipated additional payment costs that will result from the loss of the commercial purchase card. DoD anticipates an additional 1,261 payment personnel will be needed. The additional personnel costs are:

	GS-5	GS-6	Total
Cost Per Person	\$ 41,700	\$ 46,500	\$ 44,102
Number of People	630	631	1,261
Total	\$ 26,271,000	\$ 29,341,500	\$ 55,612,500

(3) Lost Rebates. Under the commercial purchase card program, agencies receive refunds based on net charge volume. For fiscal year 2007, DoD's rebate was \$55,600,000. The rebates will not continue if DoD cannot use the commercial purchase card.

b. Section 511 Reporting and Reconciliation. The costs for the section 511 withhold reporting and reconciliation requirements include the cost for 20 additional employees to support the section 511 reporting and reconciliation requirements, the anticipated annual statement costs, and record retention costs.

Labor	\$1,224,000
Other	3,846,417
Total	<u>\$5,070,417</u>

3. Nonrecurring Cost Escalation from DoD Contractors. The nonrecurring costs are the costs for DoD contractors to modify their accounting and payment systems to track, reconcile, and report the section 511 withholds. The scope of required changes will vary greatly by company. A small business may only need to modify policies and procedures and train its staff. Larger, more sophisticated companies will likely have to modify their complex Enterprise Resource Planning (ERP) systems.

To calculate the costs for DoD contractors to modify systems in preparation for the 2011 effective date of section 511, DoD used the same number of vendors DoD acquired goods and services from in 2007 and the assumptions shown below for the sizes of the companies and scope of required changes.

Nonrecurring Cost Escalation from DoD Contractors

Company Size and Type of Change	No. of Vendors	Cost Per System	Total
Very small - no change	64,107	-	
Under 20 employees - manual	256,428	2,000	\$ 512,855,600
Under 20 employees - simple system	250,017	5,000	1,250,085,525
20 to 500 employees - noncomplex system	38,464	20,000	769,283,400
20 to 500 employees - complex-system	25,643	50,000	1,282,139,000
Over 500 employees - noncomplex system	2,564	100,000	256,427,800
Over 500 employees - ERP system	1,923	200,000	384,641,700
Over 500 employees - complex ERP system	1,282	350,000	448,748,650
Over 500 employees - multiple ERP systems	641	500,000	320,534,750
Total			<u>\$5,224,716,425</u>

DoD’s vendor base is constantly changing. For the purpose of this estimate, DoD assumed its vendor base would change 5 percent annually and that new vendors will require system changes similar to the changes discussed above. The amounts estimated per year for 2012 through 2015 were computed as follows:

$$\$5,224,716,425 \times 5 \text{ percent change in vendor base} = \$261,235,821$$

4. Recurring Cost Escalation from DoD Contractors. The recurring costs are the costs to execute the withhold requirements. As shown below, the two most significant costs are the additional cost resulting from the loss of the commercial purchase card and increased contractor financing costs.

No Commercial Purchase Card	\$ 728,000,000
Financing Costs	598,750,685
Accounting and Other Expense	97,979,700
Total	<u>\$1,424,730,385</u>

a. No Commercial Purchase Card. As discussed in Note 2a(1) above, we estimate that the commercial purchase card saves DoD \$72.80 per transaction. DoD assumes contractors have similar savings and estimated the costs using DoD's approximate transaction count as detailed below:

$$\$72.80 \text{ per transaction} \times 10,000,000 \text{ DoD transactions} = \$728,000,000$$

b. Financing Costs. The increased contract financing costs were computed using DoD's 2007 payments and the ten-year average prime interest rate adjusted to reflect a range of credit ratings (e.g., outstanding, good, average, and poor).

DoD Payments	\$320,000,000,000
Section 511 Withhold Percentage	3%
Section 511 Withhold Amount	<u>\$ 9,600,000,000</u>
Financing Costs	<u>\$ 598,750,685</u>

c. Accounting and Other Expenses. The accounting and other expenses include the costs to record, reconcile, report, and recover the section 511 withholds and additional costs for processing more complex accounting transactions.

Section 511 Reporting and Reconciliation	\$80,479,700
Transaction Processing Inefficiencies	<u>17,500,000</u>
Total	<u>\$97,979,700</u>

5. The costs for DoD to implement and manage section 511 for the first five years are computed as follows:

	Costs		Total
	Nonrecurring	Recurring	
2009	\$ 2,098,811,570	-	\$ 2,098,811,570
2010	2,098,811,570	-	2,098,811,570
2011	1,049,405,785	\$ 2,269,013,202	3,318,419,087
2012	261,235,821	2,269,013,202	2,530,249,123
2013	261,235,821	2,269,013,202	2,530,249,123
2014	261,235,821	2,269,013,202	2,530,249,123
2015	261,235,821	2,269,013,202	2,530,249,123
Total	<u>\$6,291,972,210</u>	<u>\$ 11,345,066,510</u>	<u>\$17,637,038,720</u>

a. DoD will begin modifying its accounting and entitlements systems in 2009 in preparation for the January 1, 2011 effective date of section 511 and assumes its contractors will do the same. For this report, DoD assumes the nonrecurring costs for DoD and its contractors to modify their systems will be incurred as follows:

	Nonrecurring Year 1 Costs			Allocation Percent	Amount Per Year
	DoD	DoD Contractors	Total		
2009	22,312,500	5,224,716,425	5,247,028,925	40%	\$2,098,811,570
2010	22,312,500	5,224,716,425	5,247,028,925	40%	2,098,811,570
2011	22,312,500	5,224,716,425	5,247,028,925	20%	1,049,405,785
Total				100%	\$5,247,028,925

b. The computation for the \$453,937,641 nonrecurring costs in 2012 through 2015 is detailed in Note 3 above.

c. The recurring annual costs are computed as follows:

Costs for DoD to Comply (Note 2)	844,282,917
Cost Escalation from DoD Contractors (Note 4)	1,424,730,385
Total	<u>\$ 2,269,013,302</u>