



Statement of Associated Builders and Contractors

Before the
Internal Revenue Service's
Public Hearing on Withholding Under
Internal Revenue Code Section 3402(t)

[RIN 1545-BG45; Docket No. IRS-2008-0104]

Testimony Presented by
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On Behalf of
Associated Builders and Contractors, Inc.

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My name is Rich Shavell. I am President of Shavell & Company, P.A. in Boca Raton, Florida. My testimony today is on behalf of Associated Builders and Contractors. ABC is a national trade association representing 25,000 employers in the commercial and industrial construction industry. A significant number of our members regularly work on public contracts, and many more would like to begin working on public projects. Noteworthy is that a majority of ABC's contractor members are classified as small businesses by the Small Business Administration. Therefore, ABC represents a significant and representative cross-section of the commercial and industrial construction contractors who will be directly impacted by the three percent withholding required under Section 3402(t).

I stand here with great empathy for the daunting task this panel faces in implementing this law. A significant number of written comments were submitted – all of which appear opposed to this law and various aspects of its implementation. While we recognize that IRS cannot change law, we are hopeful our comments are considered in the fashion we submit them: namely, to provide constructive recommendations affecting practical implementation issues.

I will cover three main thoughts while discussing specific provisions in the proposed regs:

1. IRS authority under the statute;
2. Pass through entities; and
3. Policy issues the Treasury Department should consider.

First, regarding IRS statutory authority, we recognize that the strict language of the law did not authorize a de minimis provision so we commend the IRS for proposing rules to eliminate certain payments from Section 3402(t) withholding. ABC believes the \$10,000 payment and the corresponding \$300 impact threshold being proposed is far too low to be a meaningful benefit to any contractor. ABC urges IRS to raise this threshold to at least \$100,000.

In the preamble to the proposed regs the IRS has cited a lack of statutory authority to adopt certain other practical remedial actions. On this point, our previous comments included these four recommendations:

1. Exempting payments from withholding where the three percent rate is expected to exceed the income tax the taxpayer will owe;
2. Permitting the amount withheld from a contractor to be applied against the estimated tax liability for the specific tax quarter in which the withholding takes place and that any excess withholdings should be immediately refunded;
3. Establishing procedures so that vendors who are in compliance with the law are not subject to withholding; and
4. Developing methodology to permit the offset of Section 3402(t) withholding against payroll tax liabilities.

ABC believes it is unreasonable for IRS to read the statute as selectively and narrowly as the preamble asserts. We are hopeful the IRS will reconsider these positions and that IRS will apply its authority in a positive practical manner - similar to addressing

the need for a practical de minimis rule.

Second, there are significant reasons why pass-through entities should be exempted from withholding under the final rule. The obvious point is that these entities do not pay tax.

Also, in written submissions we've highlighted very real circumstances where S corporation shareholders may actually face capital gains tax from the application of Section 1368 because these Section 3402(t) withholdings will have to be treated as deemed distributions. Thus, a withholding that was intended for one purpose at the federal level could result in the imposition of additional tax to the underlying shareholders of the S corporation that Congress never intended when it enacted Section 3402(t).

Another practical concern for construction contractors is the impact these deemed distributions will have on contractors' covenants with credit grantors such as lenders and sureties. It is probable that these potential concerns will preclude many contractors from even bidding on future governmental work, thereby reducing competition while at the same time increasing the government's construction costs. This will further compromise the government's goal of reducing the tax gap through Section 3402(t). ABC urges IRS to exempt, or otherwise exclude, pass-through entities from Section 3402(t).

Our third point is that there are significant policy issues Treasury should consider. This panel has read comments, and today you will surely hear about the damaging effects of Section 3402(t) withholding on cash flow of businesses. At the same time, President Obama has requested the Office of Management and Budget to develop a set of recommendations for a new Executive Order on Federal Regulatory Review. A notice,

published in the February 26, 2009 *Federal Register*, announced that one chief purpose of this regulatory review is “to ensure consistency with Presidential priorities.” And one of those immediate priorities is reviving the American economy. A central component of these efforts has been to direct significant dollars to be invested in construction and other projects in order to loosen up credit, create jobs and stimulate cash flow. ABC believes that unless changes to the current IRS approach are undertaken, there is a very real likelihood that any economic gains that have been made, and the achievement of the President’s goals, will both be severely imperiled if the Section 3402(t) withholding, become effective as currently proposed.

We believe there is an adequate compromise on the cash flow issue that Treasury can get behind as part of its charge. This law was enacted in hopes of impacting the so-called tax gap. Written comments submitted by ABC to the House Committee on Small Business on March 22, 2007 cited “tax gap estimates” in Information Release 2006-28, which reflects the fact that when reporting requirements such as Forms 1099 are required, compliance increases from approximately 57 percent to 96 percent.¹ IRS statistics also indicate that when reporting requirements are elevated to actual withholding requirements, compliance is elevated from 96 percent to 99 percent.² As you can see from the Service’s statistics, taking the extra step of going from reporting to withholdings results in - at best - an *estimated* three percent increase in the compliance rates.

The implication is that if Congress were to simply implement reporting requirements on governmental payments, rather than extending withholdings to the

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>.

payments, a significant level of compliance would still be achieved. 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, and the economy as a whole. Treasury should consider this alternative policy as it is currently charged with reviewing tax issues impacting and impeding economic recovery.

One last policy issue for Treasury to consider is constitutional. ABC believes that Section 3402(t)'s implementation could run afoul of the Fifth Amendment unless the final rule is crafted wisely. Clearly, it would not be of benefit to IRS to go through this rulemaking, only to wind up with a final rule that ends up being struck down in court.

That concludes my formal testimony. We would like to thank IRS & Treasury for the opportunity to testify today and I look forward to any questions you may have.