

Three Percent Withholding Tax

OVERVIEW

Hidden in the fine print of a 2005 tax law was a provision (Section 511) that requires 3 percent of payments be withheld from government contractors for goods and services provided to federal, state, and local governments and their agencies.

On May 17, 2006, President George W. Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005, which extended various tax provisions scheduled to expire, including alternative minimum tax relief and lower capital gains and dividends tax rates. While Section 511 was not in the original House- or Senate-approved bill, it was inserted during the House-Senate conference negotiations at the last hour as a “revenue raiser” to fund other tax cuts in the legislation.

Section 511, which initially was slated to take effect in 2011, specifically affects payments for goods and services under contracts with any governmental entity that has total annual expenditures equal to \$100 million or more. This includes many state and local jurisdictions such as school districts, water authorities and others. The American Recovery and Reinvestment Act of 2009 included a one-year deferral (until 2012) of the implementation of this provision. On May 9, 2011, the Internal Revenue Service deferred the effective date for an additional year, until 2013.

Section 511 is especially onerous for the construction industry because construction contractors typically average a profit margin under 3 percent. In addition to withholding 3 percent, construction contractors face retainage between 5 percent and 10 percent, putting them at an 8 percent to 13 percent cash deficit.

Further, federal law requires contractors to carry several types of bonds provided by surety companies that look at

cash flow when deciding whether to “bond” a contract. This withholding provision will impede cash flow and possibly lead to denial of coverage.

Not only will Section 511 deplete a contractor’s profit, it also will reduce sorely needed operating capital. Contractors will be forced to raise their proposal price to account for this new financing burden, and the taxpayers’ cost of construction will increase. Or worse, small businesses will be driven out of government contracting causing the same impact: taxpayers’ cost of construction will increase. Government agencies have already demonstrated this expected price increase in studies of their contracting costs.

ABC continues to work with a coalition of broad-based business and taxpayer groups led by the U.S. Chamber of Commerce to repeal Section 511 before its effective date. Cash flow and profitability are major concerns for all businesses in this current economy and Section 511 will compound this problem by limiting businesses’ operating capital and cash on hand. Businesses do not need these additional burdens while the industry and economy begin to recover.

ABC SUPPORTS

- Full repeal of Section 511.
- S. 89, introduced by Sen. David Vitter (R-La.), S. 164, introduced by Sen. Scott Brown (R-Mass.) and H.R. 674, introduced by Rep. Wally Herger (R-Calif.), which would repeal Section 511.

ABC OPPOSES

- Implementation of Section 511.