

The Taxman Cometh

With the results of the recent mid-term elections changing control of both Houses of Congress, questions or proposals regarding possible changes to the federal tax law can be expected. However, one tax law, which is already enacted, will bite contractors performing public projects beginning on January 1, 2011.

As part of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222), Congress included a special withholding section (Section 511) for the apparent purpose of combating alleged tax evasion by contractors. Under the new law, the United States Government, every state, every political subdivision of a state and instrumentality of the foregoing (including multi-state agencies) making total payments of property or services of \$100 million or more per year (all contracts) will be required to withhold 3% from all payments made to contractors for goods and services. This law applies to construction contractors, service coordinators, as well as other entities furnishing goods and services.

This withholding is based on the total contract price rather than the projected net earnings. It is separate from the progress retention, which is typically reduced as the work progresses. As many general contractors and construction managers perform projects with margins of 3% or less, this withholding will adversely impact cash flow and funds necessary to pay subcontractors and suppliers to complete the work. Consider the following example:

A contractor is awarded a \$5 million contract to be performed within a one-year period. Under this law, the public agency is required to withhold for federal income tax purposes, \$150,000 of the contract revenue. If the contractor actually nets 3% on this contract, its maximum tax is 35% of the net or \$52,500.00 (35% of \$150,000). The amount being withheld for tax purposes is nearly three times the maximum tax liability. Viewed differently, for the contractor to have a tax obligation of \$150,000 on the \$5 million contract, it would have to net slightly more than \$428,571 on that contract. ($\$428,571 \times 35\% = \$149,999.85$) or approximately 8.57%. The implications for cash flow projections and project financing (payments to subcontractors or suppliers) are obvious.

In the waning moment of the 2006 Republican led Congress, a bill was narrowly rejected, which would have accelerated the effective date of this withholding to as early as January 1, 2007! Unless repealed, this effort may be renewed as the new Congress seeks means to enhance revenue. Call NUCA for more information.

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