

Testimony of
Vincent Iannelli
on behalf of
The Associated General Contractors of America
Presented to the
U.S. House of Representatives
Committee on Small Business
For a hearing on
The New Hidden Tax on Small Business
March 22, 2007



Building Your Quality of Life

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 32,000 firms, including 7,000 of America's leading general contractors, and over 11,000 specialty-contracting firms. More than 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation/utilities installation for housing development, and more. Visit the AGC Web site at www.agc.org. AGC members are "Building Your Quality of Life."

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Thank you Chairwoman Velázquez and Ranking Member Chabot for this opportunity to testify on the new three percent withholding law. I am testifying on behalf of the Associated General Contractors of America (AGC), a national trade association representing more than 32,000 companies, including 7,000 of America's leading general contractors and 11,000 specialty contractors. AGC is the voice of the construction industry.

I am Vincent Iannelli, President of Iannelli Construction Company Inc, and a member of the General Building Contractors of New York State, an AGC chapter. My dad started our company in 1958, and now my brother Thomas and I run it. My daughter Carla started working with us two years ago. Iannelli Construction is a family business.

We are also 99% public works. My dad at one time bid on more private jobs, but he eventually decided to focus 100% on public jobs, and we still follow that tradition. Periodically we have built hospitals, stadiums, university buildings, and nursing homes, but right now we mostly focus on school buildings.

As the construction industry representative today, I am also here speaking for many of the concerns shared by the Construction Organizations for Sensible Taxation (COST) Coalition. Members include the Air Conditioning Contractors of America, the American Council of Engineering Companies, the American Subcontractors Association, the Associated Builders and Contractors, the Construction Management Association of America, the Finishing Contractors Association, the Independent Electrical Contractors, Inc., the Mason Contractors Association of America, the Mechanical Contractors Association of America, the National Association of Surety Bond Producers, the National Electrical Contractors Association, the National Roofing Contractors Association, the National Utility Contractors Association, the Plumbing-Heating-Cooling Contractors-National Association, the Sheet Metal and Air Conditioning Contractors' National Association.

The construction industry is a significant source of jobs. We provide jobs for 7.7 million employees—more than 5% of the total nonfarm workforce. Even as homebuilding has declined recently, nonresidential construction has added 185,000 jobs in the past year—nearly 9% of all net new jobs.

We also provide good-paying jobs. In January 2007, seasonally adjusted hourly earnings in construction averaged \$20.51, 20% higher than the average for all private industry nonsupervisory workers, according to BLS.

Construction makes a disproportionately large contribution to GDP. The value of construction put in place in 2006 totaled \$1.2 trillion, 9% of gross domestic product (GDP). Residential spending totaled \$639 billion; nonresidential, \$559 billion.

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The typical construction firm size is very small. In 2005, there were 831,000 construction establishments with 6.8 million paid employees, plus more than two million firms without paid employees—mainly self-employed individuals but also partnerships and holding companies. Thus, average employment was only eight per establishment. Small business is big in construction. In 2005, 91% of construction establishments had fewer than 20 employees. Only 1% had 100 or more.

The 2006 Construction Industry Annual Financial Survey, conducted by the Construction Financial Management Assn. (www.cfma.org), included responses from 495 companies. Earnings after taxes in the most recent fiscal year averaged 2.1%, up from 1.6% in 2005.

Today, Iannelli Construction works 99% of the time on school construction. We employ six full time employees in the office, and 10-20 in the field, depending on how much work we have. We are 100% union, working mostly with the local carpenters and masonry unions.

We work at all hours, both day and night. Interior and exterior school renovations are all at night, when kids aren't in school. New school construction is during the day. Contracts take from a year to three years to complete and we work in all five Burroughs.

All of my public projects have retainage. The public owner holds back from five to ten percent of each progress payment until the project has been substantially completed, in order to keep a monetary incentive over the contractor to ensure the project is finished. Normally, after a project has been certified 95% complete, the retainage will drop to 2.5%. It has sometimes taken me years to receive that final 2.5% when the contract has been completed.

In addition, some public owners hold out 5% of the project for closeout. In addition to the retainage which held on until the project is entirely complete, public owners also hold onto an additional 5% to ensure the final punch list is complete. They slowly release this money in increments as we close out and work through the punch list. If the contract has phases, then this money is returned at the end of each phase.

Because these are public projects, all of our jobs are bonded. Having bonds on projects ensures the taxpayers that the jobs will be completed at no additional cost to the public. The project must be completed for the price and in the time negotiated under the contract. The construction contractor is responsible for purchasing the bond, and if something happens to the company, the bonding company liquidates the contractor's assets to complete the project. The taxpayer is protected.

Contractors must purchase several kinds of bonds for a project, but one specific bond – performance bonds – guarantees certain tax behavior by the constructor. The performance bond ensures that payroll taxes will be paid on behalf of the employees working at that site. If the government determines that payroll taxes have not been

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properly withheld and remitted, then the government can ask the bond provider to fill in the gap. The bond provider then goes after the constructor for those funds, but the taxpayer – and the employee – is protected. If the company is not paying these taxes it will not qualify for the bond. If the company can not get the bond, they are not qualified to bid on government contracts, or will lose their contract.

As you can see, there are several protections in current law for the taxpayer on public projects. Five to ten percent retainage, five percent close out costs, and several layers of bonds, all paid for by the constructor during the construction process.

Now the federal government has added an additional layer by requiring three percent withholding on payments for goods and services from every level of government, federal, state, and local. This new requirement plus the retainage and close out costs could add up to 15% of every progress payment. All to ensure that the contractor makes tax payments that are required to be paid by the bond that is required just to be qualified to bid on the project.

This kind of a hit to my cash flow also makes it more costly for me to purchase the bonds necessary. Surety companies, who provide the bonds, study my books in detail before offering coverage. Based on past performances, the ability to perform the work for which I bid, and my cash flow, a surety gives Iannelli Construction a bond rating which governs the price of the bonds, and how much bonded coverage I can receive. For example, a surety might offer coverage for \$10 million worth of work, at a cost of 1%. If a surety thought I was a risk because my cash flow had been restricted by retainage, closeout costs and this new 3% withholding, it may only cover \$5 million for 3%. That coverage governs the size of contracts I can bid on, as the maximum amount I can have under contract at any one time would be either \$10 million, or \$5 million. My ability to get bonding, which again depends on my cash flow, directly impacts how much work my company can take on.

That is just one of the reasons why cash flow is so important. Another is my ability to pay my suppliers, sub contractors and service providers. Some suppliers ask for payment up front, which means I am paying for things before being reimbursed by the government. The additional 3% withholding will make this process even worse, which could possibly hamper the ability of some general contractors to pay their subcontractors in a timely manner, or cause them to pay them short. Subcontractors, often small businesses, also have a tight cash flow and need to be paid on time; this could hurt many and send them right out of business.

I've been asked if I will bid up projects, tacking on an additional one or two percent. I can't, because there is always someone willing to do the job without doing that. The climate for projects I bid on is very tight. Someone will suffer through the situation instead, and that person will get the project if I out-price them. Right after Sept 11, insurance costs skyrocketed, and we could not control it. Even then, contractors didn't increase costs overall, because there was always someone who wouldn't raise their prices. The competitive bid process really helps keep costs down for the public owner.

I've also been asked if I think people will get out of the public works business. I know that I won't, and I don't think others will either. People who bid on public projects have already encountered layers of bureaucracy and paper work, and this will be one more. For some, it may be the final straw, but for most, I imagine they continue the work.

What is frustrating is the government is penalizing the good contractors for paying their taxes and paying their payroll taxes in a timely manner. The government requires that construction contractors obtain a bond to insure our taxes are paid. There should be a better way to do this. The agencies and construction managers that we do work for, we have to pre-qualify every couple of years, and one of the questions during the process is if we pay your taxes. The agency looks into this, and some want tax returns for two or three years. If you can't come up with that, then you aren't qualified to bid on the jobs. You have to pay taxes on time. Just shut people down if after awhile they aren't paying their taxes. I don't get it. I just want to pay my bills, do my work.

Finally, we are concerned about implementation. In general, we know this will affect cash flow. But there will also be real trouble in the implementation regulations.

TIMING OF WITHHOLDING

The assumed timing of the withholding for constructors is at the time of each progress payment. Nevertheless, it appears the IRS could regulate that timing. Two obvious choices would be withholding 3% of the contract from the first progress payments, and holding on to it until the contract has been completed, or withholding at the end of the contract from the final progress payments.

We believe withholding the necessary 3% from the first progress payments would be intolerable, and damage cash flow to the extent even more contractors would be forced from the government sector. In addition, as change orders and contracts often change during the building process, it would be impossible to know what 3% of the entire contract cost would actually equate.

BONDING

AGC believes that the IRS should more proactively use the protection of performance bonds to ensure proper payroll withholding by constructors in order to close the tax gap. Furthermore, due to this third party guarantee already provided under current law, AGC requests the IRS consider an industry-specific waiver be created for construction. Under this scenario, a constructor who has a performance bond and has won a section 511 government contract would not have 3% or any extra withholding applied to contracts as the bond guarantees the payment. Those constructors working on projects which did not require the performance bond could proactively provide that bonding as a way to ensure compliance and avoid the 3% withholding.

PAYROLL WITHHOLDING

It has been suggested that the 3% withholding could also be used to offset payroll withholding. Not only is it illegal, we believe it is highly problematic. Employers are

required to file and remit the withholding from their employee's paycheck the day after they pay the employee. Not doing so can get an owner thrown in jail, and for good reason. Indeed, remitting payroll withholding is a personal, not company, liability for some employers, because of the set-up of their company. This is not company money, this is money that actually belongs to the employee, and the employer is acting as a third party to ensure payment is made. To use these funds to offset taxes owed by the company denies the nature of this relationship, and the reason for the criminal and civil liability.

Further, by allowing this process, the federal government actually weakens the laws designed to protect both the taxpayer and the IRS. The IRS would be relying on an outside party (the section 511 government agency) to accurately and timely withhold the 3% of the payment on behalf of the company, who would then immediately claim this withholding (regardless of when the 511 government agency actually remit the withholding to the IRS) as payment legally required by them on their employee's behalf. The employer would then pocket the money they withhold from the employee. This opens the system to more fraud and abuse by those who are currently the trouble-makers. It also creates a system where employers are claiming withholding funds that may not yet have arrived at the IRS, impacting the cash flow of the federal government.

AGC taxpaying members don't believe this solution helps close the loophole or narrow the tax gap, as desired by members of Congress. Indeed, we believe it opens up the system to more problems.

ESOPs

As you may know, many construction companies have and continue to become Employee Stock Ownership Plans (or ESOPs). Due to their nature, these companies do not owe federal income tax; nevertheless, if the company performs work, they owe payroll withholding for their employees.

For these companies, this 3% withholding is a direct loan to the government, as there is no income tax to offset against. If the federal government includes payroll withholding as an item to be offset against, this may mitigate the cash flow burden, but would still create further loopholes for fraudulent companies to cheat the system.

S CORPS

Sixty percent of businesses in the construction industry are S corporations, which means the corporate income tax is paid at the shareholder level. Just last year, Congress increased the number of shareholders in an S corp to 99. While 99 shareholders is uncommon, family owned businesses often have many shareholders, especially as families grow and expand. All shareholders pay the business' income tax on their personal taxes, and then would be required to keep track of this 3% withholding through the year for tax purposes. They and their accountants will be using their great record-keeping systems in order to ensure funds are not lost along the way or over-counted. The IRS will be counted on for having increased capacity in its record keeping

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system as well. This has the promise of resulting in a lot of extra records, files, and paperwork, and could easily lead to more fraud and abuse in the system.

Congress should act in this area, before the regulators get started, to not penalize pass-through corporations that pay their taxes at the shareholder level.

JOINT VENTURES (JVs)

As government construction contracts have grown, expanded, and become more complicated, construction companies have had to increasingly work together to tackle large projects. Especially in federal highway work, often two companies will join together, one with paving capabilities and the other specializing in bridge work for example, and form a joint venture to bid on the work. JVs are normally set up in two different ways: integrated and non-integrated. Regardless of the method used, JVs are also commonly used in order to spread contract risk and increase bonding capacity.

Non-integrated JVs are typically bound by a contract, where each party takes on a specific scope of work (i.e. bridge building) and is responsible for the profits and losses from that specific work.

AGC has specific concerns with section 511 withholding and non-integrated JVs. Non-integrated JVs by nature do not carry an income tax liability at the entity level; all taxes are incurred by the venture partners. The partners themselves are then responsible for their own quarterly filings and payroll withholding requirements. Withholding 3% of the contract at the JV level creates unintended consequences and complications as the JV doesn't actually owe taxes.

Integrated joint ventures are often legal partnerships, LLC, or S Corps that are formed and each partner receives a percentage of the profit or loss depending on their interest in it. Again, the integrated JV does not remit any payroll withholding, as it subcontracts out 100% of the work to the venture parties. The integrated JV may have an income tax liability depending on its legal form of business. Nevertheless, the burden created by the over withholding on cash flow is then passed on to parties of the JV, which are in many cases S corps. This dividing up of the section 511 withholding becomes increasingly burdensome.

Regardless of the method of integration, the contract or partnership stipulates the amount of working capital each partner contributes to the JV. The JV doesn't have any other finances. Cash flow, which is important to every construction company, is magnified with a JV as there is no savings or any other income for the entity to use to prepay and prepare for the construction project. In this case, the over withholding by the government has to come from the working capital, which then must be increased by each of the partners. This increases the cost of doing business, decreases bonding capacity, increases the cost of the bonds, and over-burdens constructors trying to complete a project.

AGC believes that Joint-Ventures must be given special consideration as the IRS is writing regulations.

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A majority of AGC contractors work on some kind of government contract every year, and this 3% withholding will have a large impact on the construction industry. The provision is unnecessary because the performance bonds required for federal work ensure tax compliance. The 3% withholding exceeds the average net revenue on construction projects. We ask for your help to repeal this unfair, burdensome, and overly-complicated law.

Again, thank you for the opportunity to testify today on behalf of AGC. I look forward to your questions.