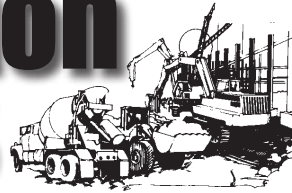


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# Construction NEWS



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## **Business Management**

# Three Percent Withholding Plan Threatens Construction Industry

By RICHARD E. GAVIN, CPA, CCIFP

A few years ago, a provision was put in place to ensure tax compliance by vendors that contract with certain governmental entities. This rule requires the withholding of three percent of all payments for products and services made by the federal, state or local governments that have total expenditures of \$100 million or more. This will affect our entire



region no matter if your firm is based in Westchester, New York City, Long Island, or elsewhere in the area. This rule could potentially ruin joint venture opportunities, create and worsen cash flow issues, lower equity, and affect contractors' ability to obtain bonding—all very important to the industry.

Withholding applies to the total contract—not to the net revenue generated from a project. For construction contractors, this means the government is withholding funds necessary to complete a project, such as those necessary to pay for subcontractors, and any material and supplies used. This will greatly affect any construction company in the area that performs public work. It will force companies to dip into reserves (if they have them) and could create serious problems for companies that are pass-through entities (S-

Corporations and partnerships).

For example, a general contractor may hold one government contract that is estimated to be completed in one year for \$20 million.

This law requires withholding of \$600,000 on that contract. Meanwhile, the contractor expects to net approximately 2.5 percent, or \$500,000, after paying for supplies, services, subcontractors and other ordinary business expenses. The

federal tax on the revenue generated is at most 35 percent of the revenue, which means the maximum tax owed on the \$20-million project is \$175,000 (35 percent of \$500,000). Ultimately, the government has withheld \$600,000 for \$175,000 in tax liability.

It is essential to proactively plan for tax liabilities, but this withholding rule would force contractors to wait to collect 3 percent of the fees for all public projects they complete. As in the example previously stated, this would cause issues for all contractors involved in the project—not just the general contractor. Subcontractors would not be paid in a timely fashion. Materials would need to be purchased with longer payment cycles. Cash flow issues would start to affect all parties, deteriorating profits, stretching resources, and placing unnecessary stress on the entire industry.

In addition to retainage issues, the less profit you have, the less equity you will accumulate. This will increase bonding costs (which all contractors are required to carry) or possibly result in the denial of

not exist prior to this contract opportunity. These joint ventures have no reserves available to reach for when withholding exceeds costs to complete the contract and will need to rely on additional unanticipated capital from each of the joint venture partners.

There are some politicians who are trying to repeal the withholding of government contracts. We need to support them in their mission. This provision will impact construction firms across

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surety credit. If cash flow is very poor, this can create substantial issues when trying to obtain bonds. This will drive up the cost of construction, eliminating many smaller firms from the public market.

Withholding creates substantial reporting burdens on S-Corps and other pass through entities. Those withholdings need to be accounted for and reported to all partners in the partnership. This will significantly impact the preparation of their tax returns, specifically their personal tax liability. In addition, joint ventures would diminish in the marketplace. This may result in fewer bidders for large public construction projects. Many contractors form joint ventures for one specific project; they usually do not have a backup of savings, as the entity did

the region, lowering your chances to compete and eliminating a substantial number of opportunities for your firm. In this tough economic environment, this additional stress on the industry could be paralyzing to construction companies.

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