

**Testimony of the Electronic Industries Alliance**  
**Submitted to the House Small Business Committee**  
**for its hearing on**  
**“The New Hidden Tax on Small Business”**

**March 22, 2007**

The Electronic Industries Alliance (EIA) appreciates the opportunity offered by the Committee on Small Business to provide the views of our membership on Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005<sup>1</sup>, which mandated a 3% withholding tax on government payments and is scheduled to take effect in 2011. Since the law’s passage last year, EIA has opposed the provision, and we strongly support its repeal<sup>2</sup>.

EIA represents nearly 1,300 members across the spectrum of the high-technology and electronics industries, whose products and services range from the smallest electronic components to the most complex systems used by defense, space and industry, including the full range of information and communications technology (ICT) equipment and computer hardware. On behalf of our member companies of all sizes but particularly those that are small businesses, we would like to share our concerns about the impending law.

**Importance of Small Businesses to Government**

In Section 8(d) of the Small Business Act, Congress stated that “[i]t is the policy of the United States that small business concerns have the maximum practicable opportunity to participate in the performance of contracts let by any federal agency, including contracts and subcontracts...”<sup>3</sup> The 3% withholding tax will have a detrimental impact on small businesses that serve as prime contractors, detracting significantly from the government-wide small business contracting goal established by Congress of at least 23% of the total value of all federal prime contract awards each fiscal year.<sup>4</sup>

Because the Internal Revenue Service and U.S. Treasury Department have not yet promulgated the rules to implement the withholding tax, it is unclear at this point what the full

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<sup>1</sup> P.L. 109-222

<sup>2</sup> H.R. 1023, introduced Feb. 13, 2007, by Representatives Kendrick Meek (D-Fla.) and Wally Herger (R-Calif.)

<sup>3</sup> 15 U.S.C. § 637(d)

<sup>4</sup> 15 U.S.C. § 644(g)(1)

direct and indirect impact to subcontractors would be. However, if the terms and conditions of a contract provide for the ability of the prime contractor to flow down the immediate cost of the withholding tax to subcontractors, subcontractors would have to implement complex procedures in order to track and eventually recoup any costs passed down by the prime contractor.

### **Increased Costs for Small Businesses and Government**

One of EIA's primary concerns, particularly for smaller entities, is the burden of new administrative costs that companies will be forced to incur if this legislation takes effect. Many of our member companies' internal financial systems – especially at those of our companies that are primarily commercial entities – are not currently designed to track payments specifically from government customers, and making the necessary changes to do so will impose significant costs. Over the longer term, companies can build systems to track prepayments, but this will take time and money, and the costs will necessarily be borne by the government as they are built into program expenses for government customers.

The increased administrative expense to process, account for and reconcile tax withholdings will make it more difficult for companies to compete on a level playing field in the global marketplace, as well as domestically on contracts with non-government customers, with those companies that do not conduct business with the U.S. or state governments.

The implementation of a 3% withholding tax would undoubtedly raise the cost of doing business with the government and provide a significant deterrent for companies for which government contracts are not their primary business. In addition to the annual processing costs, companies would need to modify the systems that handle billing, accounts receivable, and tax transactions, as well as develop the supporting documentation.

Ironically, the implementation of the 3% withholding tax designed to address non-compliance is also likely to cost the government more as companies pass the additional costs they will incur back to their customer – the government. The increased administrative expense associated with the withholding process would be allowable and therefore would be incorporated into future bids to the U.S. government. The increased interest expense caused by the adverse impact the withholding process is expected to have on cash flow would not be allowable as a direct charge to the U.S. government, but in practicality, it would be part of the margin or profit a company would be willing to accept on future bids.

The U.S. government acquisition workforce – and that at the Defense Department in particular – has moved in recent years towards procuring “to the maximum extent practicable” commercial off-the-shelf (COTS) items, which are the same as those sold in the private sector marketplace and are purchased at the same price.<sup>5</sup> This preference has reduced prices significantly and saved U.S. taxpayers money. However, the imposition of a 3% withholding tax on government sales will signify a large step backwards in this progress.

In the case of many commodity hardware vendors represented by EIA, 3% can exceed companies’ profit margins on desktop, laptop and printer sales to the government. As a result, these companies have said they will need to increase prices for government sales, or they will simply decide not to pursue certain opportunities for government sales. The U.S. government, and especially the warfighter, deserves access to the best technology at the best prices. A withholding tax undermines the government policy for the past 15 years of capitalizing on commercial products and processes to meet its needs for better, faster and cheaper products with the latest commercial technologies.

### **Impact on Cash Flow**

The issue of cash flow is a particularly important one for smaller companies, which rely more heavily on regular streams of funding for operations. From an invoicing and collections viewpoint, cash flow will be adversely impacted in three ways: 1) invoice preparation will take longer; 2) invoice payment by the government will be extended; and, 3) the probability that contracts will require a suspension of payments to permit payment system reconciliation will increase as the number of withholdings increases.

One of EIA’s larger companies has estimated that the cash flow impact associated with these processing delays would exceed \$90 million for the company. While this figure would obviously be less for a small business, it provides a measure of the expected impact the withholding tax would have on a single company doing significant business with the government.

From a tax perspective, cash flow will be adversely impacted for companies that have tax obligations lower than the amounts that would be taken through the applications of a 3% withholding tax. In the highly competitive federal marketplace, it is not unusual for companies to

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<sup>5</sup> Federal Acquisition Streamlining Act (FASA), Section 8104

have net pre-tax margins that are substantially lower than the 8.6% margin that would equate to income tax equal to 3% of sales (i.e.,  $8.6\% \times 35\% \text{ tax rate} = 3\%$ ). While the excess would be refunded upon a company's submission of its annual federal income tax return, the funds would not have been available throughout the tax year. This interest-free loan to the government could significantly harm the ability of smaller companies in particular to invest in more meaningful areas such as R&D and the workforce, thereby undercutting their ability to compete and to grow their businesses.

Many government contractors are likely to require higher levels of debt to ensure necessary cash flows if the withholding tax takes effect. With the anticipated delay in payment processing and the likelihood of over-taxation mentioned above, companies will also incur an additional annual interest expense.

### **Small Business Competitiveness**

Companies that do significant amounts of business with the government will also be forced to increase prices for their non-government customers. Under many companies' current cost accounting practices, the administrative effort to process, account-for and reconcile tax withholding would be an indirect expense and allocated over the entire sales base. The portion of the expense allocated to domestic non-government and international sales would increase a company's costs to the customer, which would place the company at a competitive disadvantage against those without the unique withholding requirement.

EIA believes an income tax collection process that is not directly connected with income expectations is a mistake and will likely make conditions considerably worse for companies experiencing financial performance problems, including many that would most likely fall in the small and small disadvantaged businesses categories.

### **Conclusion**

EIA strongly believes that companies providing goods and services to the government should comply with federal, state, and local tax requirements – companies that do not comply have an unfair competitive advantage over law-abiding contractors that pay their taxes. However, withholding on government payments is not the answer. That is why EIA strongly supports H.R. 1023 to repeal Section 511, sponsored by Representatives Meek and Herger. We believe there

can be a more rationalized and reasonable approach that encourages tax compliance but does not place undue burden on companies or federal, state, and local government agencies. In light of our significant concerns about the current law, we believe that repeal of the withholding tax is critical to the competitiveness of our member companies and particularly of our small business members.