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EXAMINING EXPIRING TAX INCENTIVES AND THE NEEDS OF SMALL BUSINESS

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

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EXAMINING EXPIRINGTAX INCENTIVES AND THE NEEDS OF SMALL BUSINESS

Thursday, September 11, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:05 a.m., inRoom 1539, Longworth House Office Building, Hon. Nydia M. Velázquez [Chair of the Committee] Presiding.

Present: Representatives Velázquez, Cuellar, Altmire, Clarke, Ellsworth, Hirono, Chabot, Akin, and Gohmert.

Chairwoman VELÁZQUEZ. Good morning. This hearing of the Small Business Committee is now called to order.

Entrepreneurs play a host of unique and integral roles in the American business world. They are economists for innovation, they are engines of job growth and, perhaps most importantly, they are agents of economic turnaround. During the past recessions, small businesses have led the charge towards financial recovery.

Today, in the face of soaring inflation and stagnating salaries, we clearly need their help to bring the market back on track. But in order for this to happen, entrepreneurs must have the tools necessary for growth. Targeted tax relief is an important means for encouraging small business development. By promoting investment and research, it sparks entrepreneurial expansion and economy progress.

In today's hearing, we are going to look at a number of specific incentives that do just that. Many of the incentives we will examine today were included as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. To make room for all the tax measures that benefited large corporations, these were enacted on a temporary basis. In order to further small business growth, they will have to be extended. In moving forward with this task, it is important to focus on those tax breaks that galvanize the job market and bolster emerging industries.

Incentives for tech startups will accomplish that goal. After all, innovation has long been a springboard to economic recovery. For example, the dot.com boom of the mid-1990s pulled us out of decline and breathed new life into the American marketplace. Today we need to tap that same spirit of innovation. Tax breaks that incentivize tech startups will drive millions of dollars into the economy and create hundreds of thousands of new jobs. With unemployment at its highest point in 5 years, we could use that kind of boost to the workforce.

Flexible depreciation schedules present another crucial incentive for entrepreneurs. These provisions encourage small firms to invest in their own growth and development. If business owners are willing to make popular investments, it only makes sense to provide them with the innovation to do so. This particular impetus not only bolsters small firms, but also puts cash back into the economy. Every small business purchase of a good or service gives an added life to the industry that provides it.

Targeted relief does more than advance entrepreneurial development. It also promotes investment in our communities. The benefits of incentives that encourage financiers to put money into small firms in low-income neighborhoods are twofold. These provisions both open up new markets and revitalize struggling regions. Tax breaks that bring jobs and capital to low-income communities will be a tremendous boom to the small business world and the economy as a whole.

These kind of incentives, coupled with a number of other items we will look at, present an important means for revitalizing the marketplace. Small firms are the engine that drive the American commerce. When they do well, we all do well. Extending the provisions discussed today will give them the security they need in order to grow and the certainty they need in order to help strengthen and expand our economy.

[The prepared statement of the Chairwoman can be found in the appendix at page 29.]

With that, I would like to thank all of the witnesses for taking time off your busy, busy schedule to be here with us today. And I yield to the Ranking Member, Mr. Chabot, for his opening statement.

Mr. CHABOT. Thank you, Madam Chairwoman, for yielding. And before I turn to the subject of taxes, I want to pause to note the significance of this day, the seventh anniversary of the 2001 terrorist attacks on our Nation. The Chairwoman, I know, lost many constituents and friends on that day. And our thoughts and prayers are with those who lost their lives and were so affected by that tragic event, and with their families and our brave servicemen and -women who are serving our Nation both in this country and around the world.

Now, Madam Chairwoman, I want to say that I do appreciate your holding this important hearing on extending the temporary tax provisions commonly known as tax extenders. We have an outstanding panel of experts to advise us today, and I look forward to all of their testimony. And a special welcome to Tom Shepherd, who is from my district in Cincinnati, Ohio, whom I will introduce later.

Small businesses as well as working families are experiencing difficult times. Gas prices are high, food prices are rising and people, unfortunately, are losing their homes. Tax relief is absolutely critical to small businesses, particularly in times of economic uncertainty.

According to a recent NFIB survey, small businesses ranked Federal tax on business income as one of their top five concerns. There are many steps that Congress can take to alleviate the tax burden, including eliminating the current Tax Code and starting over. Our

61,000 page Tax Code, which has not had a substantial revision since 1986, should in my view be terminated. The Code's complexity is staggering. For small businesses, most of them which do not have the resources to hire technical tax experts, it can prove difficult to navigate. According to the Small Businesses Administration Office of Advocacy, small businesses with fewer than 20 employees spend over $1,200 per employee to comply with tax paperwork, recordkeeping and reporting requirements.

Until we terminate the Code and start over, which doesn't seem to be on the near-term horizon, unfortunately, Congress must act every year to renew the temporary tax provisions that expire or—that they are renewed from year to year is the way we have been handling them up here. This year, Congress must again take up legislation to renew these provisions. This is, in my view, a very poor tax policy and makes it extremely difficult for any business, especially a small one, to budget and plan for the future.

However, these temporary tax credits are critical for small firms to grow and create the jobs that help to strengthen our economy. These are the incentives the companies use to develop new technologies, hire new workers, and invest in their communities. Particularly in a time of slowing economic growth, small companies simply cannot absorb tax increases.

Renewing the temporary tax provisions is important, but we must also make the 2001 and 2003 tax cuts permanent. They are scheduled to sunset in 2010, so not far down the road. And if they do, on January 1, 2011, the American people will face the largest tax increase in history, a $683 billion increase. According to the Joint Committee on Taxation, failing to extend these cuts would cause 31 million families with children to pay an average tax increase of $1,025 because of the reduction in the value of the child tax credit from 1,000 down to 500. Almost 30 million married couples will have to pay an average tax increase of $686 resulting from the return of the marriage penalty; 91 million taxpayers will have to pay an average of $498, so almost $500 more because of the loss of the 10 percent tax bracket which is lower than most.

5.5 million taxpayers who were benefiting from the deduction for student loan interest and employer educational benefits would have to pay an average of $286 more in their taxes.

Two million families who adopt a child will pay an average of $156 more in taxes; 28 million savers and investors will pay an average of $1,800 more in taxes due to the end of lower tax rates on long-term capital gains and dividends.

The 2001 and 2003 tax cuts included an across-the-board cut for all working Americans, which is vital since 85 percent of small businesses file as individuals. According to the Heritage Foundation study, the failure to renew these cuts would cost the Cincinnati area, my community, the economy there, approximately $200 million annually in economic growth, including 1,900 lost jobs and a tax increase of $1,300 per taxpayer per year.

At one of our Committee hearings, the issue of flow-through income, when business owners include company revenues on their individual income tax returns, was raised. As one small business owner testified, quote, many folks in Congress think they are rais-

ing taxes only on the wealthy, but I am here to tell you that these rate increases will strike at the heart of small businesses, unquote.

One final point. For the overall health of the economy, Congress must curtail wasteful Federal spending. Cutting spending and working towards a balanced budget is critical not only for our economic security but also for our national security. These steps would help small businesses through our current economic challenges. I look forward to hearing the recommendations of our distinguished panel of experts here this morning.

And, Madam Chairwoman, I again want to thank you for holding this important hearing and I yield back the balance of our time.

[The prepared statement of Mr. Chabot can be found in the appendix at page 31.]

Chairwoman VELÁZQUEZ. Thank you. And it is my pleasure to welcome our first witness, Mr. Feraci. Mr. Manning Feraci is the Vice President of Federal Affairs to the National Biodiesel Board. Prior to work for NBB, Mr. Manning served as the chief of staff to Congressman Kenny Hulshof. Founded in 1992, the National Biodiesel Board is the national trade association representing the biodiesel industry as the coordinating body for research and development in the United States. Mr. Feraci, you will have 5 minutes.

STATEMENT OF MANNING FERACI, VICE PRESIDENT OF FEDERAL AFFAIRS, NATIONAL BIODIESEL BOARD

Mr. FERACI. Chairwoman Velázquez, Ranking Member Chabot, members of the Committee, the National Biodiesel Board, and many small businesses that make up our trade association, appreciate the opportunity to be here today to tell you about the importance of the biodiesel tax incentive to our industry.

The National Biodiesel Board is, as I alluded to, the trade association for the U.S. biodiesel industry and we represent the breadth of the entire industry. You have everything from the producers who are actually making the fuel, the fuel marketers, the feedstock providers who are providing the material from which we are making the fuel. So we have a pretty good perspective in terms of what is going on in the biodiesel industry.

Biodiesel itself is a diesel replacement fuel. It is produced typically from animal fats or vegetable oil. Soybean oil is typically the feedstock that is used in the United States. However, over time, you have seen an increased diversification in the feedstock that is used. And you basically react the animal fat or the vegetable oil with alcohol, remove the glycerin and refine it until you hit a fuel specification that is determined by an international consensus body known as ASTM.

We take very seriously fuel quality efforts. We vigorously test our fuel. We encourage our members to engage in our fuel quality program because consumers have to be confident that we are putting a quality fuel into the marketplace. And we feel confident that we are.

In the marketplace, our fuel is typically blended with conventional diesel fuel. Usually it blends at 20 percent or below in the marketplace. And typically what you have are ″below the rack″ jobbers who are buying the fuel from our plant and blending it below

the rack. We have penetration at about 42 fuel terminals right now.

And just to give you some perspective, there are 1,500 fuel terminals nationwide. Ethanol is at about half of those terminals. We are at 42. Now, we expect that number to go up over time, and we certainly want to see that happen because our goal is to get greater penetration into fuel infrastructure so that we get to more consumers with our fuel.

The tax incentive that I want to visit on here briefly was initially enacted in 2004, as part of the American Jobs Creation Act, subsequently extended as part of the Energy Policy Act of 2005, and it expires at the end of this year. It is a dollar-per-gallon blenders' excise tax credit that you get if you make the fuel from virgin vegetable oils or animal fat. Whereas it is 50 cents per gallon if you make it from second-use oils such as yellow grease or restaurant grease. The fuel has to meet ASTM D6751, which is the fuel specification, and section 211 requirements of the Clean Air Act to qualify for the tax incentive. And the credit is claimed at the point that the biodiesel is blended with conventional diesel fuel. And everyone who claims it has to register with the IRS to claim that credit.

The one commentary that you can make on the existing biodiesel tax incentive is that it is working and all you have to do is look back. In 2004 when the credit was enacted, you had 25 million gallons of production in the United States. In 2007, we had 500 million gallons of production in the U.S. So if the idea is to increase the production and use of biodiesel, there is a pretty compelling case to be made that the biodiesel tax incentive is working. And not only is it working, there is a very compelling public policy rationale to be made for why we should encourage the production and use of biodiesel in the United States.

The first and most obvious is it is going to reduce our dependence on foreign oil. The 500 million gallons of biodiesel produced in the United States represents displacing 20 million barrels of oil. Ours is an extremely efficient fuel. We have a 3.5 to 1 energy balance. So that means for every unit of energy it takes to make a gallon of biodiesel, you get 3.5 units of energy out of it. And those are numbers that come from NREL, so they are extremely credible.

So we are an efficient fuel that is going to help reduce our dependence on foreign oil. We are extremely good for the environment. The USDA/DOE model has us as reducing greenhouse gas emissions by 78 percent. And most importantly, we are creating good green jobs in rural America. We support over 21,000 jobs, added $4 billion to the U.S. economy in 2007 alone. The most important thing, though, is that all these benefits that we get are all in jeopardy if the tax incentive is not extended, because it ends at the end of this current year, on December 31st. Absent that credit, because of the way it functions, is to make biodiesel price competitive with petroleum diesel fuel. Absent that tax incentive—and I'm not trying to be dramatic— our guys are just not going to produce fuel.

So, Madam Chairwoman, Ranking Member Chabot, I appreciate you having this hearing. It is absolutely vital to our industry that this tax incentive be extended. I would be willing to take any questions you may have.

Chairwoman VELÁZQUEZ. Thank you, Mr. Feraci.

[The prepared statement of Mr. Feraci can be found in the appendix at page 33.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. Joseph E. Clements. He is a restaurateur from Baton Rouge, Louisiana. Mr. Clements is also a certified public accountant by training and his company, Clements Management, currently operates nine Burger King restaurants in central Louisiana. Mr. Clements is here to testify on behalf of the National Restaurant Association founded in 1919. The association is the leading business association for the restaurant industry. Welcome, sir.

STATEMENT OF JOSEPH E. CLEMENTS, RESTAURATEUR, CLEMENTS MANAGEMENT, LLC, BATON ROUGE, LOUISIANA, ON BEHALF OF THE NATIONAL RESTAURANT ASSOCIATION

Mr. CLEMENTS. Thank you, Madam Chairwoman, Mr. Chabot. I would like to thank the members of the Committee for the invitation to offer testimony today on behalf of the National Restaurant Association about ways in which to update the Tax Code and help stimulate the economy.

As stated, I have been in the restaurant business for 13 years and I currently own and operate NINE Burger King franchise restaurants in Louisiana, and I employ approximately 300 people. Prior to my entry into the restaurant business, I practiced public accounting for almost 19 years, where my firm provided services to small businesses just like the one I own today.

I am here today to discuss the need for reforms and the depreciation schedules, specifically to shorten the lives of the write-off of the restaurant buildings and improvements to 15-year lives. This would create an immediate economic activity within the industry, which in turn would reverberate throughout the economy.

There is currently legislation pending in the 110th Congress which addresses accelerated depreciation. H.R. 3622, championed by Congressmen Kendrick Meek of Florida and Patrick Tiberi of Ohio, would make permanent a 15-year depreciable life for newly constructed restaurants, as well as for improvements on restaurants. The bill currently enjoys bipartisan support with over 160 cosponsors, including 18 members of this Committee.

There is no question that restaurant depreciation schedules are outdated. According to the Tax Code, restaurant buildings have a useful life of 39-1/2 years over which they can be written off. To suggest that a restaurant building's useful life is 39-1/2 years is just ludicrous. The wear and tear on restaurant buildings is probably greater on this type of building than on any other type of building. Indeed, this is evidenced by the frequency by which restaurant buildings are remodeled, renovated or even rebuilt.

Over the years, Congress has made many changes to the depreciation schedules. There have been changes that have split the industry between leased properties and owner-occupied properties, and there have been changes to specific industries which are competitors to the restaurants, such as convenience stores and gas stations. And there have been changes allowing faster write-offs for improvements but not for new construction, placing certain businesses in an economic disadvantaged position. I maintain, however,

that the Tax Code should not pick winners and losers in the restaurant industry, but it should allow a level playing field on which all can play.

Finally, it is widely recognized that the restaurant business is one of the more risky ventures that one can undertake in our economy. Opening a restaurant requires an enormous investment in capital, most of which is spent on the building or the improvements. Most restaurateurs finance their buildings or improvements over a 12- to 15-year term. Adjusting the appreciable lives to match these terms more closely reflects the actual cash expenditures of the asset.

The purpose of this hearing is not to discuss the merits of this issue but rather, more importantly, whether this tax provision will help small businesses and hence spur growth in a struggling economy. We believe these changes will have a dramatic and immediate effect, given that the average cost of an update or remodel of a restaurant ranges from $250,000 to $400,000 according to the NRA. Or in my personal case, a new Burger King restaurant costs $800,000.

This year alone, the restaurant industry is expected to spend in excess of $5.5 billion on capital expenditures for building construction and renovations. These are dollars that will be spent in the construction industry and will further grow the economy.

And finally, if there is any question as to whether this provision would immediately spur activity, look at what happened when Congress enacted the provision to provide restaurants with a 15-year schedule on improvements made to restaurants from the 2004 bill. The following year, in 2005, the year that the provision went into effect, the restaurant industry spent more than $7.4 billion on new structures and improvements, a 42 percent increase over the 5.2 spent in 2004, according to the Census Bureau. Additional spending fueled by a shorter depreciation schedule created thousands of jobs in the construction-related industries across the country.

With a more predictable schedule, we anticipate that these spending numbers will grow as restaurateurs have the ability to plan new construction and improvements farther out than 1 or 2 years.

All of this information is addressed in my written testimony, as well as a detailed explanation of the issues. In respect for everyone's time, I will not read the rest of them today, but I would ask that you look at them in the written testimony.

We urge the members of this Committee to consider this information as evidence of the need to help the restaurant industry keep strong in order to keep the Nation's economy overall strong.

Again, I would like to thank you on behalf of the National Restaurant Association for the opportunity to provide this testimony. And I thank those members of the Committee who have cosponsored this legislation, and we appreciate your support. I will be happy to answer any questions that you may have on this information.

Chairwoman VELÁZQUEZ. Thank you, Mr. Clements.

[The prepared statement of Mr. Clements can be found in the appendix at page 37.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. Larry Kilduff. Larry Kilduff is the president and management member of the Kilduff Company based in Milwaukee, Wisconsin. The Kilduff Company is a privately held real estate development company. Mr. Kilduff has over 22 years of involvement in retail and other commercial development projects across the country. He is here to testify on behalf of the International Council of Shopping Centers. With over 75,000 members, ICSC is the leading trade association of the retail development community. Welcome.

STATEMENT OF LARRY KILDUFF, THE KILDUFF COMPANY, MILWAUKEE, WISCONSIN, ON BEHALF OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. KILDUFF. As mentioned, my name is Larry Kilduff. I am the chairman of the Environmental Policy Committee and recent past Central Division Government Relations Co-Chair for ICSC. I am also the founder—to supplement that volunteer work—of the Kilduff Company in Mequon, Wisconsin.

The Kilduff Company participates in development and consulting projects in retail marketplaces around the country ; however, our passion and specialty is urban redevelopment and revitalization. We have made an indelible mark in neighborhoods throughout the United States by applying unique talents and philosophies to assist communities and individual developers in their economic renovation efforts.

I am here today representing our trade association, the International Council of Shopping Centers, which was founded in 1957 and is currently more than 75,000 members strong in over 90 countries, including shopping center owners, developers, managers, marketing specialists, investors, lenders, retailers and all other professional endeavors that participate in our industry, including academics and public officials.

I am here today specifically because of the concern over the so-called tax extender legislation and that it continues to languish. This legislation contains a number of tax provisions that expired at the end of 2007 or are set to expire in 2008. In particular, ICSC supports the immediate extension of the 15-year depreciation for leasehold improvements, brownfields expensing, a new market tax credit and a number of energy tax incentive provisions.

One of the most important obligations of a shopping center owner is to provide modern, efficient and environmentally sound retail space for tenants and the public. Owners must periodically refurbish or replace, usually every 5 to 10 years, many components of their buildings. Sometimes these requirements are in the lease and they are required to be. They are paid for by landlords or paid for in part by landlords through incentives back to the tenants. The 5- to 10-year lease period is fairly common in our industry. These improvements can be fairly substantial. They can include HVAC. They can include interior walls, plumbing, electrical, things that have to comply with ever-changing codes for building construction and also for environmental improvements. The 15-year depreciation period for such leasehold improvements more closely reflects, although it doesn't perfectly match, but it does more closely reflect

the active life of these improvements and the market practices of today's environment.

In Alaska, a friend of ours who owns a family shopping center—they have owned it for many, many years and developed it in Anchorage—and as it has continued to grow, it has become a major shopping center in that area and yet is still a family-owned business. It is faced with the dilemma of having to try and make a decision as to whether to make a substantial renovation of the property. With a 15-year depreciation schedule and with a shopping center that size, notwithstanding the size of the shopping center, the owner is small. The margins are very thin, and the decision to go forward may or may not be completely reliant on the possibility of the depreciation schedule being 15 years and being made permanent.

Brownfields remediation expensing is also very important to small developers. As a small developer who focuses on urban projects, I wrestle with my share of environmentally contaminated properties and developed a good deal of experience with these properties, both with the clean-up of brownfields and assisting others in that endeavor. Just as my Alaska example shows, with the leasehold depreciation schedule, this program for remediation expensing is vital.

I am currently involved in a project in the early due diligence stages in Kenosha, Wisconsin. It is a 40-acre mixed-use development adjacent to retail and commercial that consists primarily of senior housing and multifamily residential. This is an infield project that will ultimately, upon completion, generate a tax increment of over $80 million. And while my company is small, the group of people that we have put together to do a project of this magnitude is looking forward to doing it. It is adjacent to a landfill that has been active for over 30 years. This landfill is part of the project. Without the cleanup of that landfill, this project can't go forward. The property is owned by the same people. The city is afraid to test it. The landowner doesn't want to test it. Nobody wants to know what is in it until they know how they are going to pay for cleaning it up. And this could very well affect our ability to go forward.

When we measure risk profile for a project like this, if we look at it and say we don't know what it is going to cost to clean it up, we won't know what it is going to cost to clean it up until we test. Once we test we may have to acknowledge what is in there, and somebody in this picture is going to be responsible for it. We have to look very, very hard at whether or not we can even make that effort. Knowing that you could at least appreciate the expense of that cleanup can have a major impact on that.

With urban projects, it is also very important to mention that anything that can measure or level the playing field with risk can be very, very important.

And I would urge you also to consider the bill that was forwarded by Mike Turner and Stephanie Tubbs Jones. I realize there is no time for Congress to pass H.R. 3080 this year, the Brownfields Cleanup Act, but Representative Tubbs Jones understood that making the transferable tax credit available to small businesses could tip the balance in that very decision-making.

We also do support new market tax credits. The process is cumbersome and sometimes doesn't do as good a job as it could, but it also falls into that category of things that help balance the imbalance in urban redevelopment.

And then lastly, we would also look at your support for commercial building tax deductions. And carried interest—we believe that the carried interest problem is significant as it relates to the small businesses in this country. And I would love to entertain questions on that if you have any interest.

At this time, I think I would just like to thank you, Madam Chairwoman, for your prompt enactment of the tax extenders legislation. It is necessary for economic growth, job creation and capital investment and energy security. And ICSC looks forward to working with you and the entire Congress on doing so. Thank you very much.

Chairwoman VELÁZQUEZ. Thank you, Mr. Kilduff.

[The prepared statement of Mr. Kilduff can be found in the appendix at page 42.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. Leo Berlinghieri. Mr. Berlinghieri is the Chief Executive Officer and President of MKS Instruments in Andover, Massachusetts. MKS Instruments is a global provider of process control solutions for advanced manufacturing processes. He is here to testify on behalf of Semiconductor Equipment and Materials International, or SEMI. SEMI is the global representative of the microelectronic ecosystem industry. Welcome.

STATEMENT OF LEO BERLINGHIERI, MKS INSTRUMENTS, INC., ANDOVER, MASSACHUSETTS, ON BEHALF OF SEMICONDUCTOR EQUIPMENT AND MATERIALS INTERNATIONAL (SEMI)

Mr. BERLINGHIERI. Good morning. Thank you, Madam Chairwoman and Ranking Member Chabot and the Committee, for having me here today to speak. As Madam Chairwoman noted, I am the CEO and President of MKS Instruments, so part of the interest is personal to MKS Instruments. But also I will be the chairman on the North American Advisory Board of SEMI beginning next year. And we represent about 800 companies involved in the semiconductor, photovoltaics, and display industry, which about 80 percent of those companies are small businesses. So I am speaking on behalf of both organizations.

We provide products to equipment makers involved in semiconductor manufacturing, displays, in photovoltaics and other advanced technologies.

Today I would like to talk about two components of the tax extenders bills that are of great importance to MKS and the other semiconductor companies and SEMI members. These issues are the R&D tax credit and the commercial investment tax credit for solar energy.

In terms of the R&D tax credit, MKS Instruments employs about 500 engineering professionals. We expect to spend about $80 million in R&D this year. That is about 10 percent of our revenues. And that is fairly common for the industries that we represent. R&D spending goes towards the salaries for our engineering peo-

ple, engineering consulting, and towards the cost of materials for R&D and for the tools that we use. Initial R&D investment of $1 million, or slightly more than that, recurring each year generates about 11 to $12 million of revenue each year. And with over 5 to 7 years of a product life cycle, that would be somewhere between 50 and 75 million in revenue over that life cycle. So the R&D tax credit is an important incentive to locate this value-added investment in the United States.

In addition to these jobs, there is really a direct benefit to the U.S. Government. And I did a couple of quick back-of-the-envelope calculations. We estimate that the typical R&D credit for us gives us about $2 million of credit. As a conservative estimate, if you look at about a 15 percent profit level, pretax profit level, on that 50 million in revenue resulting from the R&D projects, that would give us a profit of about 7-1/2 million. We assume that the tax rate at 36 percent for business would provide a return in the corporation taxes to the government of about $2.7 million. And that excludes the additional tax benefits from hiring people in the R&D area, so their actual personal incomes, as well as all of the supply chain that would be either providing materials or services for us as well.

The R&D tax credit has a long history of strong bipartisan bicameral support. It is unfortunate it expired 8 months ago. Growth of the American economy is closely tied to the ability of our companies to make sustained commitment to long-term investment in R&D. The credit provides a critical, effective, and proven incentive for companies like MKS to increase our R&D spending in the United States. It is a stimulus for U.S. investment, innovation, wage growth, consumption and exports.

While the R&D tax credit is expired, many countries such as Ireland, Canada, and China have more attractive R&D incentives luring research jobs away from the United States. The United States used to have the best R&D tax credit, and now we have moved way down the ladder in that list of countries. They have made it a priority and we have not. I urge Congress, before adjournment, to enact a seamless multiyear extension of a strengthened R&D tax credit .

The second issue is the commercial investment tax credit for solar energy. Solar energy is a new market for MKS instruments and many of the other SEMI companies as well. The materials and equipment used in the semiconductor industry are very similar to what is to be used in the solar energy industry. At the time when America's energy independence is more crucial than ever, solar energy and other means of alternative energies are expected to boom. The commercial investment tax credit for solar energy expires at the end of this year.

Unfortunately, due to the uncertainty of an ITC extension, solar projects in the United States have already been put on hold. The commercial ITC for solar energy is a critical incentive for companies to locate their solar energy manufacturing facilities and projects within the United States. Again, just like the R&D tax credit, these investments produce jobs. According to a Navigant Consulting study, if extended, the solar energy ITC is expected to

create almost 40,000 more jobs and about $8 billion in investments. If it is not extended, those jobs and investments will go elsewhere.

Other nations have very generous incentive packages for solar energy and are leading in the investment in this area. If Congress fails to extend the credits, it will cause America to fall further behind and ensure that these investments are made overseas.

There is no doubt that our country will be a user of solar energy. The question is whether we will be a producer of the equipment and the panels and the installation kits.

I urge Congress, before adjournment, to approve an 8-year extension of the commercial investment tax credit for solar energy.

In closing, let me reiterate what is at stake here is American jobs and investments in crucial technologies. Tax policies are a key factor for companies when they are deciding to invest, and we are faced with some stiff competition abroad. This is a very limited window of opportunity to extend the credits this year. I urge Congress to make this a top priority, ensure that the R&D tax credit and a commercial investment tax credit for solar energy are extended before Congress adjourns. We cannot afford to wait.

I thank you and I look forward to any questions that I can answer.

Chairwoman VELÁZQUEZ. Thank you, Mr. Berlinghieri.

[The prepared statement of Mr. Berlinghieri can be found in the appendix at page 51.]

Chairwoman VELÁZQUEZ. Now the Chair recognizes the Ranking Member for the purpose of introducing our next witness.

Mr. CHABOT. Thank you very much, Madam Chair. And I am pleased to introduce Tom Shepherd, who is Chairman and CEO of the Shepherd Chemical Company, which is based in Norwood, Ohio, which is in the First Congressional District, the district that I have the honor to represent. And he also has the Shepherd Color Company. Both companies are family-owned small businesses with over 400 employees. Shepherd Chemical was established back in 1916, and Mr. Shepherd is the fourth-generation Shepherd to run the family businesses.

Mr. Shepherd serves on the Executive Committee of the American Chemistry Council and chairs its Small Business Council. He is also a member of the Executive Committee of the Cobalt Institute. He received a B.A. In biology from Princeton University and a master's degree in management from Northwestern University. We are pleased to have you here today, Tom, and we look forward to your testimony.

STATEMENT OF TOM SHEPHERD, CHAIRMAN AND CEO, THE SHEPHERD CHEMICAL COMPANY, NORWOOD, OHIO

Mr. SHEPHERD. Thank you Congressman Chabot. Thank you, Chairwoman Velázquez and members of the Committee. I represent only Shepherd Chemical and Shepherd Color. We are custom and specialty metal-based chemicals manufacturers that make life better, safer, and healthier. Our core purpose is to have a positive impact on people's lives, specifically our employees, our customers, our communities and our shareholders.

Central to our strategy is the development of engineered products and innovative technology. This is what we like to do and this

is what allows us to compete successfully around the world. R&D, as you know, can be expensive. We rely on dozens of chemists and engineers, and millions of dollars in technical assets to create new and novel materials for a wide variety of uses.

Recent developments include additives for high-pressure lubricants, gas generants for air bags, infrared reflective pigments for cool-roof technology, cathode materials for lithium-ion batteries, additives for biodegradeable plastics, and catalysts for sealants for energy-efficient windows.

My company takes full advantage of the research and development tax credit, but I need to tell you that I am quite conflicted about this program. On one hand, it brings welcome relief from our onerous tax burden. I believe our government is wise to let my companies keep more of the money we have earned, and we are happy to do so. I assure you that we invest that money wisely. Also, of all the things that our government does with the taxes we pay, investing in businesses and activities that create value and jobs is one of the best. When business is encouraged and not discouraged, lots of good things happen.

On the other hand, I believe businesses should invest in research and experimentation because it is good for that business. To invest for other reasons, such as gaining a tax credit, seems to be a bad idea. So if the purpose of the tax credit is to stimulate and reward investments and research and experimentation, I might urge you to consider what is assuredly a more effective and efficient way. My suggestion is to reduce the income tax in general, and especially if small business performance is the target, to eliminate the estate tax which is especially detrimental to small businesses.

If our government were to lower taxes, the reward for creating value would increase. If the reward for creating value were to increase, more people would try harder to do so. And if more people would try harder to do so, more would succeed and more value would be created and more jobs would be created and more people would be self-sufficient and fewer people would be in need of assistance and more people would have the means to take care of those that are, so government would have to spend less. And if government had to spend less, they could tax us less, and the whole cycle could play out again. I really believe it is that simple.

Unfortunately, over the years we have made it complex. However, in the likely event that taxes continue to be levied as they are today, and if we are intent on spending them for the betterment of America, I believe doing so in support of businesses and activities that create value and new jobs is a good investment with a strong pay-off. If this is the case, then I am strongly in favor of the R&D tax credit.

I do have one caveat. My understanding is that the R&D tax credit saves my companies about 15 percent of our yearly increase in research and experimentation expenditures. While I do not turn up my nose at this kind of money, it is not nearly enough to influence how I invest in R&D. I invest in R&D because it makes sense for my business, not because of the R&D tax credit. If given the opportunity, I would love to talk about the estate tax. Thank you.

Chairwoman VELÁZQUEZ. Thank you. Mr. Shepherd.

[The prepared statement of Mr. Shepherd can be found in the appendix at page 60.]

Chairwoman VELÁZQUEZ. I would like to address my first question to Mr. Feraci. For small communities, the biodiesel tax incentive has been the linchpin of small business development and investment, especially in rural America. Can you explain the link between the tax credit and rural communities?

Mr. FERACI. Absolutely. You are absolutely correct. What you saw at the beginning of the biodiesel industry when it was in its infancy, and even as it has continued to grow, is that given the opportunity to add value to their agriculture products, you had soybean farmers who would come together and form cooperatives and then hence to buy biodiesel production facilities. The industry has matured beyond then, but if you take a look at where we are located and where we are producing jobs, it is largely in rural communities. So not only do you have the jobs that you are getting in the plants, but you have everything in the fuel distribution chain, you have everything that you are getting from the agriculture community as well, and then various feedstock providers adding value to their products. So I think in terms of job creation in rural communities, we add a lot.

Chairwoman VELÁZQUEZ. You mentioned in 2004, when it was the first year that the biodiesel tax incentive was in effect, we had an output of only 25 million gallons of fuel and then today the output is up to 500 million. Do you have any data that shows how many jobs were created as a result of that?

Mr. FERACI. Sure. And a study that we had commissioned internally to get a good handle on that. Right now in 2007, we have supported over 21,000 jobs, added over $4 billion to the overall economy from our industry. And if you go out to these biodiesel plants and you see them, typically they are smaller producers and they are small businesses for the most part.

Just to give you some perspective the larger side of our facilities are going to be 100 million gallon production. That is as big as it gets. But your typical plant is going to be a 15 million gallon plant or smaller. And it will be a small number of employees, but they are doing good paying jobs, good green jobs, that are obviously of benefit to the local community.

Chairwoman VELÁZQUEZ. And if the tax incentives will continue, will be extended, do you have any numbers as to how many jobs will be created in the future?

Mr. FERACI. Sure. Again, the same analysis that we had done of—what we would anticipate to have in the industry would happen if the tax incentive is extended, we would expect to create a projected—a little over 38,000 jobs, add another $26 billion to the economy between now and 2012.

But you touch on a great point. The extension of the tax incentive is extremely vital to that. Because the way that that functions is it makes our fuel price competitive with petroleum diesel in the marketplace. And there is a compelling public policy reason to do that from an energy security standpoint, obviously the job creation standpoint, the environmental standpoint. But the way the credit itself functions is if it goes away, all of the sudden our fuel is a lot less competitive. And right now, obviously, where fuel prices

are, consumers are very sensitive to that. And I think that you would see production in the industry all but halt or be severely curtailed at the least.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Clements, in your testimony you focus on the importance on the 15-year depreciation schedule for qualified restaurant improvements, and this credit expires on December 31, 2007. Given that we are 9 months into the year and it has yet to be extended, have you seen any projects either delayed or terminated because of the fact that it expired and it has not been extended?

Mr. CLEMENTS. I have not seen that personally, but I do have a situation where people in 2007 saw an opportunity to develop a new restaurant. I know specifically of one fellow franchisee of mine that began the process in 2007 based on the understanding and expectation that these extenders would be passed. He started the project. He is now almost complete with the project. And he is sitting in a very different financial situation today than he was when he started the project because the extenders have not been put together and passed. So that situation could have affected that building project. I can't say for certain it did or did not. But certainly the fact that you can match the cash flow of the tax depreciation and the taxes to the payment of the building, the cost of the building, or the improvements, certainly allows for an accelerated interest in the project.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Berlinghieri, a recent study revealed that over 25 percent of companies claiming R&D credits have assets of less than $1 million. Those are small businesses.

Can you talk to us about the importance of the credit for small businesses making significant investment in research and how does it create opportunities for future expansion?

Mr. BERLINGHIERI. I think one of the key things in the industry that I am involved with and representing SEMI in is that our industry is very dynamic and things change very quickly. And so in order to be a leader in producing either semiconductor chips or solar panels, it is required that on a regular basis we change the technology and bring lower costs to be able to produce products.

In the supply chain that we have—as I mentioned, many of them are small businesses and also with SEMI itself, 80 percent of the members are small businesses—that investment allows us—as I mentioned that back-of-the-envelope calculation, we are often able to get about 10 times the revenue per that investment. And so what that does is provides manufacturing jobs for all of those companies, their suppliers in producing materials or machines parts or services. So it has a cascading effect completely down our supply chain in terms of creating employment and revenue, I think, for the government as well.

Chairwoman VELÁZQUEZ. Very good. Thank you.

Mr. Kilduff, the tax extender that allowed for a 15-year write-off on this whole improvement, I know that is critical to your industry. This Committee has held hearings on the Tax Code and we have heard from many entrepreneurs about the need to modernize the Tax Code. Can you discuss the economic effect that outdated provisions can have on small businesses?

Mr. KILDUFF. Yes, ma'am, I can, with particular regard to the leasehold depreciation portion of this. Most shopping centers—and our industry is made up of a vast number of different types of people. The larger developers tend to make all the headlines and make the biggest projects. But there are an enormous number of smaller developers.

My company, I have four people in my office. And we are able with a small office to put together a coalition of capital partners and others to make big projects go. The reality is that most of those shopping center owners are owning shopping centers that are 75- to 80,000 square feet, might have a majority of that space be leased to small tenants. Those tenants turn over on leases every 5 years. And if you have got a Subway Sandwich shop in a particular space and they move out in 5 years. And somebody wants to put in a dental office, you literally have to tear out all of that work. And you can be four or five tenants down the road on a 39-year depreciation schedule, still amortizing that first tenant. And so it is a significant impact. Significant impact.

Chairwoman VELÁZQUEZ. Thank you.

Now I recognize Mr. Chabot, and then I will have other questions for the second round.

Mr. CHABOT. Thank you, Madam Chair.

Mr. Feraci, I will begin with you, if I can. Back in April, I toured one of the companies in my congressional district, it was the Peter Kramer North American Company. It is a full-line oil/chemical supplier. And during my visit, one of the folks there, his name is Michael Dow, he was one of their account executives, stressed that if the production tax credits were not extended, it would be almost impossible for them to make a profit.

Is that unique to them, or do you think that that is the case in a lot of businesses across the country?

Mr. FERACI. Peter Kramer is a member of ours, and I am glad you were out to see their facility. I am sure it was impressive. The experience that you heard there at your plant visit would be the exact same thing that you would hear at pretty much every other biodiesel plant that you went to: large, small, multi-feedstocks. It really wouldn't matter. They would tell you the same thing, given the important role that that tax incentive plays in making us price-competitive in the marketplace.

Mr. CHABOT. Thank you. And you had also mentioned in your testimony about the efficiency of biodiesel, and I think you mentioned that it was about for every—the input being 1, the output is like 3-1/2 times the output. How does that compare with ethanol? Could you comment on that?

Mr. FERACI. I am not sure—I have seen different numbers for ethanol. Ethanol has a positive energy balance. I believe ours is higher. 3.5 to 1 is an extremely efficient fuel.

Mr. CHABOT. The numbers that I remember are pretty close, actually. Not to yours, but I think you got as much energy out almost as you put in. So there was a real concern about that especially, arguably, if you are driving up food costs and other things at the same time. So it sounds like you all are quite efficient, and I think it is something that bears looking into.

Mr. Clements, if I could go to you next. Restaurants are often open long hours and experience high customer traffic and renovate frequently. Could you expand a little bit on the importance of the 15-year depreciation schedule? And I know you mentioned that Pat Tiberi—and we have a lot of bills. That is something that after this meeting I am going to go back and look at very closely, because I know philosophically over the years we have been in favor of that, and I am inclined to go on that bill as well myself. So if you could just talk about that briefly.

Mr. CLEMENTS. I would be glad to. Perhaps the best way to approach it is to let you hear an example in my own situation. I am a Burger King franchisee. I sign a franchise agreement for every location that I operate and it is a 20-year agreement. Within that 20 years, I am required to do a pretty substantial remodel at 10 years. Obviously, I have to maintain the facility and keep all the repairs and maintenance up and keep up with the cosmetics and decor of the day.

At the end of 20 years, assuming I want to renew that—and in most cases I would—then I have got to do beyond a substantial—it is almost in a lot of cases what we would call a ″scrape and rebuild″ where I tear the facility down and I just completely rebuild it, or I go down to the concrete and four walls and put a new roof on it, put new air conditioners on it, put new interior walls, new plumbing, new electrical. So I have just about rebuilt the entire building, and yet I am only halfway through the life of the 39-1/2 years. So from an economic standpoint, I am sitting there still trying to figure out how to write off the rest of the building from the first round, and I am incurring just about as much in cost on the second round. So I hope that helps explain the scenario.

Mr. CHABOT. Yes. Thank you.

Mr. Shepherd, let me go to you next, if I can. You had, I think, concluded in your testimony by saying—and I quote, I believe—if given the opportunity, I would love to talk about the estate tax. So I would like to give you that opportunity.

Mr. SHEPHERD. Thank you very much. For my company and many small businesses, we are privately held and we are an S corporation, so all the profit from our company flows through to the owners, and we pay taxes not on our salary but on the entire profit of the company. Every year, almost 50 percent of that income is taxed. And that will be so for my entire working life.

I am fourth generation, as Mr. Chabot mentioned. I have a strong desire to pass along to my kids who are looking like they will be capable of handling this. When I die, depending on what the law is at the time, maybe 50 percent of the accumulated wealth will then be taxed again. So 50 percent on income throughout my life and then another 50 percent on the accumulation when I die. We, of course, are preparing for that. We expect it to happen. I would love for it to not happen because it is an incredible waste.

Every year, my salary, which is typical for my position in the marketplace, is more than completely consumed by taxes on that salary and premiums to pay for life insurance that hopefully will be sufficient to pay the tax when I die.

And we also spend a fair amount of time just figuring out how to plan our estate for that transition, and a lot of money—I just paid an $8,000 check to a lawyer to help figure all this out.

So how do my family and I live if all my salary is going elsewhere? We have to pull equity out of the company and that is equity that would otherwise be invested towards more chemists, more laboratory equipment, more capacity, any number of things. But my preference, as I stated, is that rather than an R&D tax credit, which I love by the way, because it offsets this stuff a bit, I would much rather just be able to keep the money that we make through hard work and manufacturing. We have proven that we are a good investment and I think we would be a good investment going forward.

Mr. CHABOT. One quick follow-up question. When you said you could invest the money back in the company, would that perhaps allow the company to grow and potentially hire more employees as well, so other people are benefiting in the community?

Mr. SHEPHERD. Yes. Let me elaborate on that. Twenty-five years ago, we had about 150 employees. Now we have about 450. We grow.

Mr. CHABOT. Thank you very much. Madam Chair, rather than ask questions, I think I would like to defer to my colleagues. And if you are doing another round, I will come back and get these gentlemen the next round. Thank you, yield back.

Chairwoman VELÁZQUEZ. Ms. Hirono.

Ms. HIRONO. Thank you, Madam Chair. I am particularly interested in the biodiesel industry and I visited with specific biodiesel—I hope they are members of your organization.

Mr. FERACI. They are not members, but we deal with them.

Ms. HIRONO. Good. They should become members, probably. And the great thing about biodiesel is that it uses products. And in the case of specific biodiesel, you use hotel and restaurant oil which otherwise would have to be disposed of with expense to those businesses.

So, Madam Chair, I just wanted to mention to you that when I visited with them, that one of the first questions they asked is whether we were going to extend the biodiesel tax. And this was a real-life example of how the tax policies that we adopt here have an impact. And members of the industries, most of whom are small businesses as you mentioned, they pay attention to what we are doing. So thank you for that.

And, Mr. Clements, I just also wanted to mention that this Committee has focused on the 15-year provision before, and so I want to thank you for coming and reiterating the importance of that time frame for restaurant renovations.

Mr. CLEMENTS. We appreciate your work. Thank you very much.

Ms. HIRONO. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Mr. Gohmert.

Mr. GOHMERT. Thank you, Madam Chair. And I really appreciate you having this hearing. I think this is terrific. I appreciate you all being here and the testimony. It is the kind of things people in Congress need to be reminded of, apparently, constantly. Apparently there is not a long-term memory here, and so we need that encouragement on a regular basis.

Mr. Shepherd, one of the last things you said is that if you had to pay tax twice on the same income, you said it would be, a quote, waste, unquote. And I would submit to you that it would only be a waste if you feel like you might happen to be able to spend money better than the wonderful people here in Washington. But otherwise, you know, somebody may need another monument to themselves up here or something like that.

Chairwoman VELÁZQUEZ. Bridge to nowhere.

Mr. GOHMERT. We had a small business congressional delegation trip to China 3 years ago, and one of the things we did was talk to CEOs, people that had moved businesses to China. And I went with the impression—I am from East Texas. I went with the impression that probably they were just moving over there for cheap labor. And that was what we were told, a small part of the reason. But the driving force for most of them was the dramatic decrease in taxes. And that China was even flexible, if it was a big enough business, on negotiating income tax; and that when they looked at a corporate tax, half of what we have here in the U.S., and the advantages that they were able to have, even though they had better quality control in the United States, they like being in the United States, they just couldn't turn down that kind of tax break.

And then since I have been here, I have come to know John Bruton, who took over as Prime Minister in Ireland when they had one of the worst economies in the world. And now, as I understand it, they may be one of the top five fastest growing economies. And as best I can read and see, it sounds like the sole reason they turned that whole nation around from being one of the worst to one of the best as far as the economies was they dramatically dropped the business tax, and now businesses are moving in there, people have jobs again, the kids are not rushing to get out of Ireland. And then, of course, they turned things around there, they did, by dropping their taxes. And now the European Union has John Bruton as their Ambassador to the U.S. They wanted his input on how we turn Europe around, and now I understand that much of the European Union is looking at dropping taxes and following that lead. And we seem to be the only advanced Nation in the world that is talking about increasing our taxes instead of decreasing them.

And as far as the discussion about the death tax, there have been some good points made about that. But I can't forget this gentleman in my district in East Texas, he is a small business owner. They are in the timber business and they have a bunch of land. And they are land-rich and money-poor, but he approached me and he said, "You have got to do something about the death tax." I am sure you are aware in 2010 there will be no death tax, right?

Mr. SHEPHERD. For a moment.

Mr. GOHMERT. For that year. And then in 2011, it kicks back to the 55 percent that basically—a socialist notion that the government needs half—over half of the estate that has been accumulated is by taxes having been paid on all of that. And he said, "My children are all grown. They are in the business, and they got together and hired an accountant who has advised them that if I die in 2010, they keep all of the estate, but if I have the indecency to make it to January 1 of 2011, they are going to lose half of the estate. And they are kind of encouraging me that," you know, not to

take care of himself. And he said, I am beginning to get a little worried if I make it to December of that year, if you guys in Washington haven't done something—

He was kind of kidding, but you could see there was concern in his eyes.

So anyway, I appreciate, Madam Chair, your having this hearing. I think everybody in Washington needs to be reminded we are hurting our country by overly taxing the people that are providing the jobs. We thank you.

Chairwoman VELÁZQUEZ. Thank you, Mr. Gohmert.

Mr. Ellsworth.

Mr. ELLSWORTH. Thank you, Madam Chair.

I just made a note to myself, don't build any monuments to myself, and if I build a bridge in Indiana, it should go somewhere. I also was going to give Mr. Shepherd a chance to elaborate. So thank you, Mr. Chabot. Mr. Kilduff, you are going to benefit from Mr. Chabot recognizing Mr. Shepherd.

You said you would like to address the carried interest. Sometimes in Washington—as you know, we implemented PAYGO, and you caught that as a pay-for. Would you elaborate? I will give you my 5 minutes to elaborate on that unintended consequence. It is something that happens to us quite a bit up here, and obviously that is something we don't like. But please elaborate on that. Help us understand better how that affects you.

Mr. KILDUFF. Sure. I would love to.

I think in my notes somewhere I have the exact year. I think it is 2006. The last numbers we have, somewhere near 50 percent, around 46 percent of all partnership tax returns that were filed in the United States were filed on real estate. And the typical form of ownership of real estate—and, frankly, my own company, my operating company, is an LLC, which is taxed as a partnership.

When a small business developer puts together a project, like a shopping center project, you would go out and you would solicit the lease possibility from a food store. You would run the feasibility on the property. You would analyze all the costs. You would put all of that together, and then you would go to someone else as a capital partner, and you would say, look at what we have here. We have this opportunity to do this great project, and I am prepared to give you a significant portion of the ownership in it if you are prepared to risk your capital.

And they would come back and say, well, we will pay you a small fee, which is taxed as ordinary income, for managing this project, and we will allow you to keep a carried interest. We don't typically call it that. That is a financial term. In real estate we usually just call it just an ownership interest. But we will allow to you keep a carried interest in this project, and when it is ultimately sold or whatever, you will benefit for having put this whole thing together, for having used your ingenuity, for having risked everything you own, because every time I sign a loan at the bank, my home, my children's education and everything is at risk, so I had better be right.

But all I will earn in a project like that until they are paid back, until the project is successful and ultimately possibly until the project is sold is that small fee, which is taxed as ordinary income

on a regular basis. My entire interest in that project will be taxed as if I were a hedge fund operator, and that is a significant issue.

And there are many, many more small partnerships and small projects in real estate investments in small companies like mine than there are hedge funds. And without beating up hedge funds, I just think there is a distinction there. And I don't know that anybody intended to harm the entrepreneur's efforts to put together a coalition of investors and partners to build something by taking away their incentive at the end of the day.

Mr. ELLSWORTH. Thank you very much.

Madam Chair, I would yield back.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Feraci, right now the United States can import biodiesel from another country, capture the tax incentive, and we ship that product to another country for their benefits. They call this practice splash and dash. Can you discuss this issue on what the biodiesel industry's position is on such activity? And in what ways do you think we can stop these abuses to our Tax Code?

Mr. FERACI. Sure. I would be happy to talk about it.

You described what a splash and dash transaction is pretty accurately. What you have is a situation where you take finished biodiesel produced in a third country, say Argentina, and then it will come to the United States. It will be splash-blended with diesel fuel—because remember, that is the event that triggers a tax benefit—and then that fuel will ultimately be shipped to a third country for end use.

Now, if you look at that, there is clearly no sort of energy or tax policy justification whatsoever for a transaction like that. And the National Biodiesel Board is vehemently opposed to splash and dash. We have been working for years to try to shut these sort of transactions down. I can tell you it was clearly unintended—no one foresaw this when the tax incentive was put in place in 2004 that this was going to happen.

Now, the good news is H.R. 6049, the energy and tax extender package that passed the House prior to Memorial Day, as well as 335, which is the Baucus-Reid bill, and the McConnell-Grassley substitute as well all address this in the same way. And what it says is that fuel produced outside the United States for use outside the United States will not qualify for the tax incentives. So if you think of how that transaction works, that would shut it down. And furthermore, the effective date in all three of those packages is May 15 of this year, which was the date of first committee action in the Ways and Means Committee when they marked it up. So we are fully supportive of that provision. We think it is a good provision. These sort of transactions need to end.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Berlinghieri, the investment tax credit, we know, is essential to the solar power industry. And the growth of solar power has formed new businesses that play a variety of roles in manufacturing and installation. Can you talk to us about how this technology has presented business opportunity for small businesses?

Mr. BERLINGHIERI. Yes. In an effort to make solar power cost-effective and allow consumers to afford to buy solar power, and today it requires, I believe, tax incentives for consumers as well to be

able to do that, the processes that are used to make a more effective solar power are very similar to the semiconductor manufacturing processes. And so there is a number of companies that have either been in semiconductors only that have been able to enter into the solar market and design equipment that will help make those tools, which obviously are employing people, and then actually make solar panels, which are also employing people as well.

So again, we are able to produce equipment for solar, for making solar panels. We are able to produce those. Unfortunately, without those incentives, it is likely that the control of that will be outside of the United States, which we already have issues with in terms of our fuels and other resources.

Chairwoman VELÁZQUEZ. So if the tax incentives are in place, do you have any projections in terms of numbers of jobs?

Mr. BERLINGHIERI. Well, I had quoted the study that was done that at least over the next—I believe it was the next couple of years, that that could provide about 40,000 jobs if the incentives were in place so that the equipment companies and the producers of those panels, installers could be in the United States. That would be at stake as well as about an $8 billion capital investment.

Chairwoman VELÁZQUEZ. Yeah. Mr. Shepherd, as you know, our economy is becoming increasingly global. And as a result, investors are deciding between putting their capital in U.S. firms versus our foreign competitors. If the R&E credit is not extended, do you believe investors may be more likely to invest their money abroad?

Mr. SHEPHERD. I am sure they will. That won't be our incentive. We are going to follow our customers where it makes sense. We have a couple manufacturing facilities over in Europe. We bought them back in the 1990s when our customers were going global. We have a lot of business in China. For various reasons we have decided not to put a facility there.

I am sure plenty of people will be influenced by the presence or absence of an R&D tax credit. I don't think it is going to make any difference to us.

Chairwoman VELÁZQUEZ. Thank you.

Now I recognize Mr. Chabot.

Mr. CHABOT. Thank you, Madam Chair.

Mr. Kilduff, I will come back to you now, if I can now. The redevelopment of idle urban retail centers, some of which are affected by brownfields, as you had mentioned, seems to be a key to revitalizing struggling neighborhoods. And I have some neighborhoods like that in my area in Cincinnati. Could you tell us how the expensing incentive has helped your company to undertake these new projects?

Mr. KILDUFF. Well, the expensing provision helps because the brownfield and the cleanup costs are incurred at the very beginning of the project. They are a large unknown. In the real estate developing business, everything from the ground up is something that you have a pretty good handle on. You know what the building is going to cost because you can get estimates. You have engineers that can give you costs on many things. But the minute you put a shovel in the ground, or, in the case of an urban redevelopment, the minute you have to start taking a building down and you don't know what is inside it, the risk factor goes up extraordinarily. And

so looking at a cleanup of a brownfield as an exercise and an additional cost to the project, not knowing how much it is going to cost, but knowing that if you have to incur that cost, at least you will be able to expense it and not have to depreciate it as if it were a part of the building over a long period of time significantly affects your go or no go decision because this is the front end. So many projects, you don't even know they didn't—you don't even know they didn't happen. You know, they just didn't happen. You don't know if anybody ever looked at them or not.

Mr. CHABOT. Okay. Also the New Markets Tax Credit encourages private investment in underserved areas, and I also have a number of those areas in my district. We have worked with new markets and had things actually occur that wouldn't otherwise have occurred. Could you discuss new market and how—

Mr. KILDUFF. Sure. You know, I have been involved in the New Markets Tax Credits program for a long time in the sense that I was involved with two organizations, LISC and the Enterprise Foundation, when they originally were trying to come up with the program. It was originally—the concept was that it was going to be similar to the tax credit housing project type of thing where it was going to provide equity, and it was going to fill the gap. In many of these redevelopment projects, there is a significant gap between risk and return and the risk and return in some other project somewhere else that will attract the capital instead. So the New Market Tax Credit does serve that purpose, and it has worked with some effect.

I will tell you that for many small developers, it has been challenging to use the program because it is complicated. And the allocation of the tax credits often go to banks, and those banks often have selected or elected to offer the value of that credit at slightly below the mortgage rate at the going time and retain most of that leverage or most of that additional gap-filling possibility for themselves. While we support the renewal of that program, I would also urge the Congress to looking at streamlining that program and making it more targeted toward the actual purpose that it was intended.

Mr. CHABOT. Thank you.

Mr. Berlinghieri, do you believe that the R&E credit would be more effective, especially for small firms, if it could be made permanent; you know, if we knew it was going to be in existence, we could count on it, depend on it?

Mr. BERLINGHIERI. Yes, I would believe so. I think when we look at our businesses, and especially in the area of product development and R&D, the long-term commitment to activities are critical. Most products take multiple years to get to market from concept to release and design. So I think that that—that is critical to us. That is why we have asked for it to be extended beyond this annual type of activity to 8 years so that we can make a long-term investment and know that it is not going to dry up a year later.

And so it does—our model and I think the members of SEMI who are doing R&D have a long-term commitment to R&D, and they need it in order to produce a product. It is not a 6-month activity. It is a multiple-year activity.

Mr. CHABOT. Thank you.

And finally, Mr. Shepherd, we had talked about the death tax or the Federal estate tax earlier. I would like to give you one opportunity again to go on another issue. We talked just briefly about LIFO and the challenges, problems, et cetera. Could you tell us what LIFO is and what you think ought to be done about that?

Mr. SHEPHERD. Certainly. Thank you.

LIFO is a method by which profits are determined for purposes of tax. It stands for ″last in, first out.″ My business is very heavily raw material-intensive involving many commodities, and the prices on commodities change over time. Last in, first out says that when I determine my profit, I am looking at my most recent price on a raw material purchase rather than my most distant. The profit is calculated based on my replacement cost of that raw material rather than what I spent to buy the raw material several months ago.

I understand there are discussions going on to eliminate the LIFO provision. That would be disastrous and I think it would be wrong-headed. We do a lot of business with a metal called cobalt, and included a chart with my written statement that shows the volatility in the price of cobalt. As you can see it is quite volatile. And if the price started at $10, and at the end of the year it is $20, the first in, first out method, which is what we would be looking at if LIFO went away, would assign profit to our company for the $10 per pound not the price of cobalt increased. That is not real profit and it is not money that we have available. We have invested all that so-called profit back into working capital for our company, to pay for the cobalt that is in our inventory.

So if LIFO were eliminated, and we switched to FIFO, at the very time that we are cash-strapped because the price of cobalt has gone from $10 to $20, the government, under FIFO rules, would be looking for dramatically increased taxes. And then on the other hand, when the price of cobalt retreats from $20 back to $10, FIFO rules recognize negative profits (and therefore minimal taxes) at the very time the decrease in our inventory investment makes taxes more affordable. So it would create tremendous complexity in our cash management and great inefficiencies, because when it is time to invest, we wouldn't have the cash, and at other times we would just be flush with cash.

Mr. CHABOT. Okay. Thank you.

I don't want to open it up too much, but the other gentlemen here, do you all agree that also would be a significant problem in various other industries and something that we ought to be advised of and take into consideration in our tax policies? Is that a concern or—is there anybody that disagrees with that point of view?

Mr. CLEMENTS. I want to speak as a CPA. He is absolutely correct in what he is saying.

Chairwoman VELÁZQUEZ. Would you please be brief since we are going to recess at 11:45?

Mr. CLEMENTS. In my business it is not very significant because we have a small investment in inventory. I am sure he has got a significant investment. It is exactly like he said.

Mr. SHEPHERD. One last comment. Right now, because over time the price of our raw materials have gone up more than they have come down, we have about a $40 million LIFO reserve. If suddenly that went away, and that $40 million was recognized as income, we

would have $20 million tax bill to pay. We don't have that kind of cash hanging around. That could put us out of business.

Mr. CHABOT. Thank you very much. Yield back.

Chairwoman VELÁZQUEZ. Ms. Clarke.

Ms. CLARKE. Thank you, Madam Chair and Ranking Member Chabot.

I am sorry, gentlemen, I didn't get a chance to really hear as much of your testimony as I would have liked. I had another hearing simultaneously. But I did want to get here to ask some questions because I am concerned about the expiration of these tax credits.

My first question is to Mr. Feraci and Mr. Shepherd. Due to a research and development tax credit expiring last year, thousands of jobs were at risk, according to the Information Technology Association of America. These jobs stimulate more spending, business growth, which creates even more jobs. Now many companies no longer can rely on this credit. How did this R&D tax credit impact your business in your industry? Can you tell us just briefly?

Mr. FERACI. A lot of our members aren't taking the R&E credits as much, but I can speak to the biodiesel tax incentive and the impact it is having. With the tax incentive, we are going to continue growing. We are going to continue creating jobs and adding+ to the overall economy. And we are going to continue being a part of our answer to our energy security issues, be part of answering the issues in terms of addressing climate change.

Ms. CLARKE. Uh-huh.

Mr. FERACI. If the tax incentive expires, because of the way we are structured, because of the impact it has in terms of being very fungible to make our fuel price competitive, those jobs are going to dry up. So a lapse would be pretty devastating to our industry.

Ms. CLARKE. Mr. Shepherd.

Mr. SHEPHERD. Yes. Thanks for the opportunity.

I really can't speak for our industry. I don't intend to.

As for our companies, the R&D tax credit is really not so big an amount of money that it drives much of anything. We are happy to get it. My real message here was taxes in general are very onerous, and if the way to reduce my taxes is to get an R&D tax credit, I am happy to have it. But really other taxes play a much bigger role.

Ms. CLARKE. You think if it were made more meaningful in terms of how it impacts on your business—in other words, if it were to give you the type of cushioning you need to move forward with new innovation, it would be something desirable?

Mr. SHEPHERD. We are a very innovative and technically driven company. If it were bigger and more meaningful, it would absolutely influence us.

Ms. CLARKE. Mr. Kilduff, how has the New Markets Tax Credit been a powerful tool to spur small business development in low-income communities throughout the United States, from your perspective? And does this credit stimulate investments in businesses such as neighborhoods, retail stores and inner-city shopping centers? And would you agree that the New Markets Tax Credit has created jobs in economically distressed neighborhoods? If so, do you have evidence supporting that claim?

Mr. KILDUFF. Yes, ma'am. Actually that is an area that I participated in, not exclusively, but a great deal of my business is in underserved markets. There is always an equity gap in an underserved market project. There is a gap between the potential return and the costs based on the opportunity to do things in other markets would be easier. And New Market Tax Credits, brownfield expensing—brownfield tax credits, if we could get a bill passed to do that, those things all add tools to the chest to allow us to even consider those projects. They have worked significantly. The tax credit program is a little cumbersome, and I would urge some review of how those credits are allocated to the organizations that pass them out, but it is significant. It is significant.

Ms. CLARKE. And then just in closing, Mr. Shepherd, do you believe that there should be a repeal of the deduction for expenses related to domestic energy production under the American Jobs Creation Act of 2004?

Mr. SHEPHERD. I don't know. I am not very familiar with the American Jobs Creation Act.

Ms. CLARKE. Okay. Madam Chair, thank you very much.

Chairwoman VELÁZQUEZ. Mr. Akin?

Mr. AKIN. I am sorry that I haven't had a chance to join you because we have multiple committees at the same time. But I did note yesterday—I guess it was yesterday's Wall Street Journal that they were saying something about a tremendous oversupply of strip malls and malls in general, everything like that. Does that mean that we don't need the tax credits, we have already overbuilt? Or what do you think about that?

Mr. KILDUFF. You know, my dear friend Gar Herring was quoted in that article. And we are going to have a talk, he and I. I am not so sure that everybody would agree with the entire article in terms of the overbuilding.

I think, having been in the real estate business as long as I have, since before the 1986 tax change, and watched capital structures change, I think retail is suffering some of the consequences of weakness in other parts of the economy. But frankly, we are much better as an industry now about building things that are preleased and building things that are necessary at the time and are substantially reviewed. That does not mean, though, that if everybody starts losing their homes, and other businesses start closing, and people stop shopping, that it is not going to look like we have too much retail, or that some retailers aren't then going to have to retrench, close doors, potentially even declare bankruptcy, which then fulfills that cycle and puts us in that position. I would submit to you that it is not quite like that.

Having said all that, even through all of these endeavors in what is primarily a suburban development business that has taken place in the last 10 years, many of the projects in the urban markets still haven't been done, and they haven't been done in part because those were easier to do. And the reason they are easier to do is because when you measure them under the same time frame and same parameters as those urban deals, the suburban deals always came out on top. So things that could be used to help manage that and put the projects where many people are living, which have been abandoned for some 30, 40 years, could be of significant value.

Mr. AKIN. Thank you for answering that question. It does obviously depend on your assumptions and parameters and where the economy is going and all that.

One other quick question. I don't know that this was something that you had addressed specifically or not. As a guy who has been here now 8 years, when we did the dividend capital gains tax cut, which was politically a pretty unpopular thing to do, it appeared that almost immediately after that there were three charts that I have in my office and there was a tremendous effect on the economy.

The first thing was we were running at losing about 140,000 jobs a month rate. And almost instantaneously, first quarter of 2003, when we did dividends capital gains, we turned around and saw a fairly steady increase in jobs, at about 160,000 jobs gained per month. Very big turnaround.

The gross domestic product had been very erratic, up and down, for the first number of the—because I came in with the President, so the 2001, 2002 were very up and down for quarterly gross domestic product. That jumped up about—from about 1.4 average, but it was erratic, to about up into the fours.

And the third thing was that government revenues also jumped up significantly. Even though we did a tax cut, the result was you had enough business stimulation from dividends capital gains apparently that you had a tremendous increase in Federal revenues. Now, I am making the assumption that there was a causal relationship between the dividends capital gains tax cut and what happened to the economy. That may or may not be true.

Is it your opinion that that tax cut is very important to business in general, or do you think there is other tax cuts you think are far more valuable?

Mr. KILDUFF. Well, in my business as a real estate developer, it is probably the single most important thing that we look at in terms of whether we build something, how long we hold it, what we do with it, how we structure the capital. So capital gains taxes would be significant for us, and increases there would be more devastating than many other things.

The capital—the carried interest issue is also of significant importance for that very same reason, because most mall developers own things that they don't profit from until it is ultimately sold at the end of the day because everybody else has to be paid back first. We are in the risk position. So those things combined could be devastating to small businesses.

Mr. AKIN. Other members of the panel, is that an important tax cut, dividends capital gains, relative to your businesses?

Mr. BERLINGHIERI. Well, I think the way I would comment on it is we are expected to make a significant return on investments that we make. When I get a personal tax cut, I probably get a one-for-one return, and sometimes I may not even do that. But as a responsibility for our business, I have got to make a bigger return on it. So I think that investment does look for a larger return that creates more jobs and a healthier economy. So I absolutely believe that is the case.

Mr. AKIN. Okay.

Mr. SHEPHERD. I would just say that anything that reduces the capital gains tax helps markets be more efficient, which allows money to go towards the best opportunity rather than being constrained by some artificial barrier.

Mr. AKIN. So you are saying the dividend capital gains tax cut, from your point of view, is very important to the strength of the economy?

Mr. SHEPHERD. I think it is very important. I think it should be cut further.

Mr. AKIN. Okay. Thank you, Madam Chair. I would vote for that, too, by the way.

Chairwoman VELÁZQUEZ. Unfortunately we don't live in the perfect world, right? Okay.

Mr. CHABOT. We are trying to make it such, though.

Chairwoman VELÁZQUEZ. Well, you have tried for 12 years. Okay.

Thank you so very much for your insights and great discussion that we had in this hearing. Let me just say that as the 110th Congress comes to an end, this Committee will continue to work with the leadership and our colleagues in the Ways and Means Committee to make sure that some of these extenders are signed into law, are passed. Some of these provisions have already passed the House. So we need to get the Senate to act. And we will continue to highlight with our leadership the important consequences of these tax extenders when it comes to small businesses in this country.

Thank you very much. And with that, I ask unanimous consent that Members will have 5 days to submit a statement and supporting materials for the record. Without objection, so ordered.

Chairwoman VELÁZQUEZ. This hearing is now adjourned.

[Whereupon, at 11:35 a.m., the committee was adjourned.]

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

STEVE CHABOT, OHIO
RANKING MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
Of the Honorable Nydia M. Velazquez, Chairwoman
United States House of Representatives, Committee on Small Business
Full Committee Hearing: "Tax Extenders: Continuing Opportunities for Small Business Growth and Development"
Thursday, September 11, 2008, 10 a.m.

Entrepreneurs play a host of unique and integral roles in the American business world. They are catalysts for innovation. They are engines of job growth. And, perhaps most importantly, they are agents of economic turnaround. During past recessions, small businesses have led the charge towards financial recovery. Today, in the face of soaring inflation and stagnating salaries, we clearly need their help to bring the market back on track. But in order for this to happen, entrepreneurs must have the tools necessary for growth.

Targeted tax relief is an important means for encouraging small business development. By promoting investment and research, it spurs entrepreneurial expansion and economic progress. In today's hearing, we are going to look at a number of specific incentives that do just that.

Many of the incentives we will examine today were included as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. To make room for other tax measures that benefited large corporations, these were enacted on a temporary basis. In order to further small business growth, they will have to be extended.

In moving forward with this task, it is important to focus on those tax breaks that galvanize the job market and bolster emerging industries. Incentives for tech startups would accomplish that goal. After all, innovation has long been a springboard to economic recovery. For example, the dotcom boom of the mid 1990's pulled us out of decline and breathed new life into the American marketplace. Today, we need to tap that same spirit of innovation. Tax breaks that incentivize tech startups would drive millions of dollars into the economy and create hundreds of thousands of new jobs. With unemployment at its highest point in 5 years, we could use that kind of boost to the workforce.

Flexible depreciation schedules present another crucial incentive for entrepreneurs. These provisions encourage small firms to invest in their own growth and development. If business owners are willing to make capital investments, it only makes sense to provide them with the motivation to do so. This particular impetus not only bolsters small firms, but also puts cash back into the economy. Every small business purchase of a good or service gives a needed lift to the industry that provides it.

Targeted relief does more than advance entrepreneurial development. It also promotes investment in our communities. The benefits of incentives that encourage financiers to put money into small firms in low-income neighborhoods are twofold. These provisions both open up new markets *and* revitalize struggling regions. Tax breaks that bring jobs and capital to low-income communities would be a tremendous boon to the small business world, and the economy as a whole.

These kinds of incentives, coupled with a number of other items we will look at, present an important means for revitalizing the marketplace. Small firms are the engine that drives American commerce-- When they do well, we all do well. Extending the provisions discussed today would give them the security they need in order to grow, and the certainty they need in order to help strengthen and expand our economy.

U.S. House of Representatives
SMALL BUSINESS COMMITTEE
Wednesday, September 11, 2008
Representative Steve Chabot, Republican Leader

Opening Statement of Ranking Member Steve Chabot

"Examining Expiring Tax Provisions and the Needs of Small Businesses"

"Thank you, Madam Chairwoman, for yielding.

"Before I turn to the subject of taxes, I want to pause to note the significance of this day: the seventh anniversary of the tragic 2001 terrorist attacks on the Unites States. The Chairwoman, I am sure, lost many constituents and friends. Our thoughts and prayers are with those who lost their lives, with their families, and our brave service men and women fighting for our freedom around the world.

"Madam Chairwoman, I appreciate your holding this important hearing on extending the temporary tax provisions, commonly known as "tax extenders."
We have an outstanding panel of experts to advise us today, and I look forward to their testimony. A special welcome to Tom Shepherd from Cincinnati, who I will introduce later.

"Small businesses, as well as working families, are experiencing difficult times. Gas prices are high, food prices are rising, and people are losing their homes.

"Tax relief is absolutely critical to small businesses, particularly in times of economic uncertainty. According to a recent NFIB survey, small businesses ranked federal tax on business income as one of their top five concerns.

"There are many steps that Congress can take to alleviate the tax burden, including eliminating the current tax code and starting over. Our 61,000 page tax code, which has not had a substantial revision since 1986, should be terminated. The code's complexity is staggering. For most small businesses, which do not have the resources to hire technical tax experts, it can prove difficult to navigate. According to the Small Business Administration's Office of Advocacy, small businesses with fewer than twenty employees spend over $1200 per employee to comply with tax paperwork, recordkeeping and reporting requirements.

"Until we terminate the code and start over, which doesn't seem to be on the near-term horizon, Congress must act every year to renew the temporary tax provisions that expire, are renewed for one year and expire, year after year. This year, Congress must again take up legislation to renew these provisions. This is terrible tax policy, and makes it extremely difficult for any business, especially a small one, to budget and plan for the future.

"However, these temporary tax credits are critical for small firms to grow and create the jobs that help to strengthen our economy. These are the incentives that companies use to develop new technologies, hire new workers and invest in their communities. Particularly in a time of slowing economic growth, small companies simply cannot absorb tax increases.

"Renewing the temporary tax provisions is important. But we must also make the 2001 and 2003 tax cuts permanent. They are scheduled to sunset in 2010, and if they do, on January 1, 2011, the American people will face the largest tax increase in history – a $683 billion dollar increase. According to the Joint Committee on Taxation, failing to extend these cuts would cause:

- 31 million families with children to pay an average tax increase of $1,025 because of the reduction in value of the child tax credit

- Almost 30 million married couples to pay an average tax increase of $686 resulting from the return of the marriage penalty

- 91 million taxpayers to pay an average of $498 more because of the loss of the 10% tax bracket

- 5.5 million taxpayers who were benefiting from the deduction for student loan interest and employer educational benefits to pay an average of $286 more in taxes

- 2 million families who adopt a child will pay an average of $156 more in taxes

- 28 million savers and investors who will pay an average of $1,885 more in taxes due to the end of lower tax rates on long-term capital gains and dividends

"The 2001 and 2003 tax cuts included an across-the-board cut for all working Americans, which is vital since about 85% of small businesses file as individuals. According to a Heritage Foundation study, the failure to renew these cuts would cost the Cincinnati area economy approximately $200 million dollars annually in economic growth, including 1900 lost jobs, and a tax increase of $1300 per taxpayer per year.

"At one of our Committee hearings, the issue of flow-through income – when business owners include company revenues on their individual income tax returns – was raised. As one small business owner testified: "Many folks in Congress think they are raising taxes only on the wealthy. But I'm here to tell you that these rate increases will strike at the heart of small businesses."

"One final point. For the overall health of the economy, Congress must curtail wasteful federal spending. Cutting spending and working towards a balanced budget is critical not only for our economic security, but also our national security.

"These steps would help small businesses through our current economic challenges. I look forward to hearing the recommendations of our distinguished panel of experts. Madam Chairwoman, thank you for holding this important hearing."

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Testimony of Manning Feraci
Vice President of Federal Affairs, National Biodiesel Board
Before the U.S. House Committee on Small Business
September 11, 2008

Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee, I thank you for the opportunity to testify today on behalf of the National Biodiesel Board (NBB) about the importance of the biodiesel tax incentive to the many small businesses that comprise the U.S. biodiesel industry.

About NBB: NBB is the national trade association representing the biodiesel industry as the coordinating body for research and development in the United States. It was founded in 1992 by state soybean commodity groups who were funding biodiesel research and development programs. Since that time, the NBB has developed into a comprehensive industry association which coordinates and interacts with a broad range of cooperators including industry, government and academia. NBB's membership is comprised of biodiesel producers; state, national and international feedstock and feedstock processor organizations; fuel marketers and distributors; and technology providers.

Background and Industry Overview: Biodiesel is a diesel fuel replacement that is made from agricultural oils, fats and waste greases that meets a specific commercial fuel definition and specification. The fuel is produced by reacting feedstock with an alcohol to remove the glycerin and meet the D6751 fuel specifications set forth by the American Society for Testing and Materials (ASTM International). Biodiesel is one of the best-tested alternative fuels in the country and the only alternative fuel to meet all of the testing requirements of the 1990 amendments to the Clean Air Act.

Biodiesel is primarily marketed as a blended product with conventional diesel fuel, typically in concentrations up to 20%. It is distributed utilizing the exiting fuel distribution infrastructure with blending most commonly occurring "below the rack" by fuel jobbers. Biodiesel is beginning to be distributed through the petroleum terminal system. To date, biodiesel is available in approximately 42 fuel distribution terminals. The biodiesel industry has committed funds to study the technical needs required for moving biodiesel through U.S. pipelines. Already, biodiesel is moved through pipelines in Europe and extending that capability in the U.S. would significantly increase biodiesel penetration in the U.S. diesel fuel market.

The biodiesel industry has shown steady growth over the last 15 years. In 2007, the industry produced 500 million gallons of biodiesel and is on pace to increase production above those levels in 2008. Today, there are 171 plants in operation with the capacity to produce more than

2.24 billion gallons of biodiesel and 60 new plants under construction or expansion, which will add an estimated new capacity of nearly 1.13 billion gallons.

Background on the Biodiesel Tax Incentive: The biodiesel tax incentive was enacted in 2004 as part of the American Jobs Creation Act (P.L. 108-357). The incentive was subsequently extended through December 31, 2008 as part of the Energy Policy Act of 2005 (P.L. 109-190). Thus, under current law, the incentive is set to expire at the end of calendar year 2008.

The biodiesel tax incentive is a $1 per gallon blenders excise tax credit that can be claimed on biodiesel produced from virgin vegetable oils and animal fats. Biodiesel produced from yellow grease or second use oils, such as restaurant grease, qualify for a 50 cents per gallon excise tax credit. To qualify for the biodiesel tax incentive, the biodiesel must by statute meet both the ASTM D6751 fuel specification and the Environmental Protection Agency's (EPA) registration requirements under Section 211 of the Clean Air Act.

The blenders excise tax credit is claimed at the point where biodiesel is blended with conventional diesel fuel. Blenders are required to register with the Internal Revenue Service (IRS) to claim the incentive. The excise tax credit can be used to offset a blender's fuel excise tax liability. To the degree that the incentive exceeds excise tax liability, eligible taxpayers may claim a refund from the IRS. This structure accomplishes the incentive's policy objective of helping to make biodiesel price competitive with conventional diesel fuel.

Biodiesel Tax Incentive Success Story: The biodiesel tax incentive has helped achieve the worthwhile policy goal of increasing the production and use of biodiesel in the U.S. In 2004, when the incentive was initially enacted, the U.S. produced 25 million gallons. In 2007, that number rose to 500 million gallons, and we anticipate that production will exceed that amount in the current year. The 500 million gallons of biodiesel produced in 2007 displaced 20 million barrels of petroleum.

Biodiesel Public Policy Benefits: There is a compelling public policy argument to be made to justify increased biodiesel production and use in the U.S., and the biodiesel tax incentive is an integral part of a sound public policy framework that will allow biodiesel to play a constructive role as part of the nation's overall energy strategy.

Biodiesel Reduces our Dependence on Foreign Oil: Biodiesel can play a major role in expanding domestic refining capacity and reducing our reliance on foreign oil. Increased use of renewables in the transportation sector can play a significant role in helping achieve the objective of displacing foreign petroleum with domestically produced renewable fuel. Merrill Lynch commodity strategist Francisco Blanch says that oil and gasoline prices would be about 15% higher if biofuel producers were not increasing their output.

The 500 million gallons of biodiesel produced in the U.S. in 2007 displaced 20 million barrels of petroleum, and increased production and use of biodiesel will further displace foreign oil. In addition, biodiesel is an extremely efficient fuel that creates 3.5 units of energy for every unit of fuel that is required to produce the fuel.

Biodiesel is Good for the Environment: Biodiesel is an environmentally safe fuel, and is the most viable transportation fuel when measuring its carbon footprint, life cycle and energy balance. The USDA/DoE lifecycle study shows a 78% reduction in lifecycle CO2 for B100. 1 billion gallons of biodiesel will reduce current life cycle greenhouse gas emissions by 16.12 billion pounds, the equivalent of removing 1.4 million passenger vehicles from U.S. roads. In

2007 alone, biodiesel's contribution to reducing greenhouse gas emissions was equal to removing 700,000 passenger vehicles from America's roadways.

Biodiesel's emissions significantly outperform petroleum based diesel. Research conducted in the U.S. shows biodiesel emissions have decreased levels of all target polycyclic aromatic hydrocarbons (PAH) and nitrited PAH compounds, as compared to petroleum diesel exhaust. These compounds have been identified as potential cancer causing compounds.

Biodiesel is the only alternative fuel to voluntarily perform EPA Tier I and Tier II testing to quantify emission characteristics and health effects. That study found that B20 (20% biodiesel blended with 80% conventional diesel fuel) provided significant reductions in the total hydrocarbons; carbon monoxide; and total particulate matter. Typically, emissions of nitrogen oxides are either slightly reduced or slightly increased depending on the duty cycle of the engine and testing methods used. Research also documents the fact that the ozone forming potential of the hydrocarbon emissions of pure biodiesel is nearly 50% less than that of petroleum fuel. Pure biodiesel typically does not contain sulfur and therefore reduces sulfur dioxide exhaust from diesel engines to virtually zero.

Biodiesel helps preserve and protect natural resources. For every one unit of energy needed to produce biodiesel, 3.5 units of energy are gained. This is the highest energy balance of any fuel. Because of this high energy balance and since it is domestically produced, biodiesel use can greatly contribute to domestic energy security.

The Biodiesel Industry is Creating Green Jobs and Making a Positive Contribution to the Economy: In 2007 alone, the U.S. biodiesel industry contributed over $4.1 billion to the nation's Gross Domestic Product (GDP) and supported 21,803 jobs. In addition, economic modeling suggests that a vibrant biodiesel industry will positively impact the U.S. economy in multiple ways. America's biodiesel industry will add $26 billion to the U.S. economy between 2007 and 2012, assuming biodiesel growth reaches 1 billion gallons of annual production by 2012. Biodiesel production will create a projected 38,856 new jobs in all sectors of the economy and additional tax revenues from biodiesel production will more than pay for the federal tax incentives provided to the industry. Equally as important, it will keep billions of dollars in America that would otherwise be spent on foreign oil.

Extension of the Biodiesel Tax Incentive is Vital to the U.S. Biodiesel Industry: As was mentioned earlier in this testimony, the biodiesel tax incentive is set to expire on December 31, 2008. Expiration of the incentive would have a catastrophic impact on the U.S. biodiesel industry, and the NBB urges Congress to approve and the President to sign an extension of the incentive before the end of the year.

The biodiesel blenders excise tax is structured in a manner that helps make biodiesel price competitive with conventional diesel fuel. If the tax incentive is allowed to expire at the end of the year, the price of biodiesel will be significantly higher than petroleum diesel, thus significantly reducing demand and making it nearly impossible for biodiesel plants to produce fuel at a profit. Thus, it is safe to assume that if the biodiesel tax incentive lapses, biodiesel production in the U.S. will halt or at a minimum be severely curtailed, and the energy security, environmental, and job creation benefits that the nation realizes from biodiesel production will be lost.

Prior to Memorial Day, H.R. 6049 was approved by the U.S. House. The legislation would provide a one year extension of the biodiesel tax incentive. In addition, the legislation included changes to the incentive that enjoy the strong support of industry including:

- Provides $1 per gallon incentive, regardless of feedstock used to produce biodiesel. This will encourage the expanded use of waste oils in fuel production and greatly simplify the administration of the tax incentive for both taxpayers and the IRS.

- Closes the so-called splash and dash loophole that allows foreign produced biodiesel to enter the U.S.; claim the U.S. biodiesel tax incentive; and then be sent to a third country for final use. There is no energy or tax policy justification for this sort of activity, and the NBB strongly supports closing this loophole.

- Properly defines co-processed renewable diesel as it applies to the renewable diesel tax incentive.

Both the Baucus/Reid and McConnell/Grassley energy and tax extenders packages that have been unveiled in the Senate contain similar biodiesel provisions as those contained in H.R. 6049.

For the sake of the biodiesel industry and the sake of America's need to achieve energy independence, the NBB urges Congress to extend the biodiesel tax incentive prior to adjournment. A lapse in the incentive will be a devastating setback to an industry that has the capacity to make a positive contribution in breaking our dependence on foreign oil.

Again, Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee, I sincerely appreciate the opportunity to testify before you today, and would be more than happy to answer any questions you may have.

REPRESENTING THE RESTAURANT INDUSTRY
The Cornerstone of the Economy, Career Opportunities and Community Involvement

Written Testimony

of

Joe Clements
Clements Management, LLC

for the hearing

Examining Expiring Tax Incentives
and the Needs of Small Businesses

before the

U.S. House of Representatives
Committee on Small Business

on behalf of the

National Restaurant Association

Thursday, September 11, 2008

1200 SEVENTEENTH STREET, NW • WASHINGTON, DC 20036-3097
TEL: 202.331.5900 • FAX: 202.331.2429 • WWW.RESTAURANT.ORG

Chairwoman Velazquez, Ranking member Chabot, members of the House Committee on Small Business; thank you for the opportunity to testify before you today of behalf of the National Restaurant Association. My name is Joe Clements of Clements Management, LLC and I am a Burger King franchisee in Louisiana. I am also a Certified Public Accountant by training and education, so I know how much taxes can impact small businesses like mine. I'm here today to urge Congress and this Committee to extend and include 15-year depreciation schedules for new restaurant construction and improvements in this year's tax extenders package.

I have been in the restaurant business for 13 years. I initially entered the business by acquiring 6 Burger King restaurants from an existing franchisee who happened to be a client of mine. I currently own and operate 9 Burger King restaurants in 6 cities. Prior to my entry into the restaurant business, I practiced public accounting for 19 years where my firm provided services to many small business clients. During my years in public practice, the tax laws became more and more complex, and the burden on small businesses, my clients, became greater and greater.

I am proud to be a part of an industry that plays such a significant role in this nation's economy. There are 945,000 restaurant/foodservice outlets in this country. Seven out of ten restaurants are single-unit operators. The restaurant industry is an industry of small businesses.

This year the restaurant industry is estimated to generate $558 billion in sales, with an overall economic impact of $1.3 trillion. Every dollar spent dining out generates $2.34 in business for other industries.

We are the nation's second largest employer outside the government, employing more than 13.1 million people, representing more than 9 percent of the job-base. We are truly the cornerstone of this nation's economy.

On any given day 133 million individuals are patrons of a food establishment. Given the industry's contributions to the economy, we strongly urge the Congress to include 15-year restaurant depreciation for new restaurants and improvements to the 2008 tax extenders legislation.

More Accurate Depreciation Schedules Should Be Included in Tax Extenders

Depreciation schedules for commercial real estate, including restaurant buildings, have not been significantly revised since they were established decades ago. It is time these schedules more accurately reflect the life of the property. According to the tax code, commercial real estate generally has a 39 1/2-year depreciable life for the original building and for any subsequent renovations or improvements to the building. Restaurants have gained some temporary relief for improvements before, but not for new construction and not reliable relief that will encourage longer term investment and planning.

Restaurants operate on industry average margins of four to six percent and every penny counts, especially for small businesses and franchisees like me. Depreciating property over a shorter amount of time has a direct impact on a restaurant's bottom line by allowing a restaurateur the immediate cash flow to reinvest in their business.

Changes have been made that allow certain industries that directly compete with restaurants to benefit from shorter schedules. These schedules range from seven years for food outlets located in amusement parks to 15 years for convenience stores attached to gas stations. This favorable depreciation schedule has allowed convenience stores to expand and improve their foodservice options – a direct competitor to quick service restaurant operators.

Restaurant Building Depreciation

Past changes to the depreciation schedule for certain industries and the exclusion of the new restaurant construction provision have placed certain businesses at an economic disadvantage. The tax code should not pick winners and losers in the restaurant industry; it should allow a level playing field on which all can compete.

Within the retail industry, restaurants have a unique case for accelerated depreciation schedules. As mentioned earlier, 133 million individuals are patrons of the industry on a daily basis. Restaurants must constantly make changes to keep up with the daily structural and cosmetic wear and tear caused by customers and employees. Restaurants get more customer traffic than other commercial businesses. Many are open 24 hours a day, seven days a week. This heavy use accelerates deterioration of a restaurant building's entrance, lobbies, flooring, restrooms, and interior walls. Restaurant building structures therefore experience a daily human "assault" unlike that borne by any other types of buildings in the retail industry.

Most restaurants remodel and update their building structures every six to eight years – a much shorter timeframe than is reflected in the current depreciation schedule. Many of these refurbishments are not treated as improvements under the tax code, but as new construction because these remodeling projects require changes to structural walls. Thus creating layer upon layer of depreciation schedules for every periodic update or new construction.

Also, many franchise agreements contractually require the evaluation of the location, and quality and configuration of the restaurant structures routinely. As for me, Burger King requires a remodel of the facility at 10 year and a complete renovation at 20 years. Franchisees are small business owners and they bear the cost of updating their buildings or completing scrape and re-build projects. While these scrape and re-build projects may be considered renovations in their agreements, the tax code treats these as new construction. Thus, they currently are depreciated over 39 ½ years.

The above-mentioned renovations and structural improvements made to restaurants every six to eight years come at an average cost of $250,000 - $400,000. This year alone, the restaurant industry is expected to spend in excess of $5.5 billion on capital expenditures for building construction and renovations. The restaurant industry is projected to spend over $70 billion over the next ten years for building construction and renovations. These more-than-modest expenditures in turn have a significant economic impact on businesses performing these renovations. Like the restaurant industry, growth in the construction industry will reverberate throughout the economy. According to the Bureau of Economic Analysis, every dollar spent in the construction industry generates an additional $2.39 in spending in the rest of the economy, while every $1 million spent in the construction industry creates more than 28 jobs in the overall economy.

If there is any question whether shortened deprecation schedules would spur economic activity consider the fact that after Congress enacted the restaurant improvement provisions in 2004, the restaurant industry spent more than $7.4 billion on new structures and building improvements in 2005 – a 42 percent increase over the $5.2 billion spent in 2004 (according to the U.S. Census Bureau).

The additional spending – fueled by a shorter depreciation schedule – created thousands of jobs in construction-related industries across the country. With more predictability in the tax code and the inclusion of new restaurant construction on a 15-year schedule, we anticipate that these spending numbers will grow as restaurateurs have the ability to plan new building and improvement projects farther out than one or two years.

Legislative History of Accelerated Restaurant Depreciation

The economic stimulus package passed in the 107th Congress, allowed for 30 percent bonus depreciation for certain assets, (such as assets depreciated over a 20 year schedule or less). As part of the 9/11 economic stimulus package, this provision was expanded to include any leasehold improvements (currently depreciated over a 39 ½ year schedule). However, owner-occupied properties were not included.

The American Jobs Creation Act of 2004 established that restaurants could depreciate qualified restaurant building improvement costs over 15 years for property in place by the end of 2005. This provision applied to both leased and owner-occupied buildings. The Tax Relief and Health Care Act of 2006 extended the existing provision through the end of 2007.

The Minimum Wage/Small Business Tax Relief bill (H.R. 2) that passed the Senate on February 1, 2007 contained a provision which would have extended the improvement piece through March 31, 2008, and would also have added 15-year depreciation for new restaurant construction from the date of enactment through March 31, 2008. A subsequent Senate Finance Committee package included the extension of qualified leasehold and restaurant improvements through December 31, 2008 and added new construction from the date of enactment through December 31, 2008. However, all depreciation provisions were removed from the final package that was enacted into law.

As of January 1, 2008 all schedules reverted back to 39 1/2 years, including improvements made to restaurant structures both leased and owner-occupied. When Congress passed and the President signed the Economic Stimulus Act of 2008, the legislation included a bonus depreciation tax provision as well as increased Sec. 179 small business expensing. However, the restaurant industry can not take advantage of the bonus depreciation provision for even the improvements we had previously because the provision only applies to property on a 20 year or less depreciation schedule. As a result, the positive impact of the economic stimulus package was not as great as it could have been for the restaurant industry and our communities.

Several 2008 tax extenders proposals include a 15-year depreciation provision for improvements and newly constructed restaurants. We urge Congress to extend the improvements provision and include new restaurant construction as qualified property in the final tax package.

There is broad support for the idea that restaurant improvements and new construction should be on a 15 year schedule. There are currently two bipartisan bills in the 110th Congress which address restaurant depreciation for new construction and improvements. H.R. 3622, championed by Congressmen Kendrick Meek (D-FL-17th) and Patrick Tiberi (R-OH-12th), would make permanent a 15 year depreciation schedule for newly constructed restaurants as well as restaurant improvements. The bill currently enjoys the bipartisan support with 161 cosponsors, including 18 members of this committee. Senators Kay Bailey Hutchison (R-TX) and Jon Kyl (R-AZ) introduced companion legislation, S. 2170, which also enjoys bipartisan support in the Senate.

Conclusion

We urge Congress to consider this information as evidence of the need to keep the restaurant industry strong in order to help the nation's overall economy. The House Small Business Committee has been a staunch advocate of tax relief for the country's small businesses, including restaurants. We encourage the committee to continue to support H.R. 3622 and push for inclusion of 15-year depreciation schedules for new restaurant construction and improvements in the 2008 tax extenders bill.

Thank you.

International Council of Shopping Centers

UNITED STATES
HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

"Expiring Tax Incentives and the Needs of Small Businesses"

STATEMENT OF
LAWRENCE E. KILDUFF
PRESIDENT
THE KILDUFF COMPANY
ON BEHALF OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

1539 LONGWORTH HOUSE OFFICE BUILDING

SEPTEMBER 11, 2008

Thank you Chairwoman Velazquez and Ranking Member Chabot for conducting today's hearing on "Expiring Tax Incentives and the Needs of Small Businesses."

My name is Larry Kilduff. I am the Chairman of the Environmental Policy Committee and recent past Central Division Government Relations Co-Chair of the International Council of Shopping Centers ("ICSC"). I am also the president and founder of The Kilduff Company, a national retail development and consulting firm in Mequon, Wisconsin.

The Kilduff Company participates in development and consulting projects in all retail marketplaces. However, our passion and specialty is urban redevelopment and revitalization. We have made an indelible mark on neighborhoods throughout the United States by applying our unique talents and philosophy to assist communities and individual developers in their economic renovation efforts.

Founded in 1957, ICSC is the premier global trade association for the shopping center industry. Its more than 75,000 members in over 90 countries include shopping center owners, developers, managers, marketing specialists, investors, lenders, retailers and other professionals as well as academics and public officials.

I am appearing today on behalf of ICSC and its members who have been significantly impacted because the so-called tax "extenders" legislation continues to languish. This legislation contains a number of tax provisions that expired at the end of 2007 or are set to expire at the end of 2008.

In particular, ICSC supports immediate extensions of the 15-year depreciation for leasehold improvements, brownfields expensing, the new markets tax credit ("NMTC") and a number of energy tax incentive provisions.

Fifteen-Year Depreciation for Leasehold Improvements

Prior to 1981, building owners could recover the costs of leasehold improvements over the term of the lease to the tenant. This reflected the fact that leasehold improvements for one tenant are rarely suitable for another. In 1981, a single depreciation life of 15 years was established for all buildings and all improvements made within. Later, the recovery period for all non-residential real property, including leasehold improvements, was increased to 39 years. This is clearly not a reasonable depreciation schedule for leasehold improvements. The American Jobs Creation Act of 2004 recognized this and provided for a temporary reduction in the depreciation period for the leasehold improvements from 39 years to 15 years, which better reflects the actual life of such improvements. ICSC believes that 15 years is a reasonable schedule for the depreciation of leasehold improvements and should be made permanent.

One of the most important obligations of shopping center owners is providing modern, efficient and environmentally-sound retail space for their tenants and the public. Owners must periodically refurbish and replace (usually every 5 to 10 years) many components of their buildings, including internal walls, partitions, lighting, plumbing, flooring and communication outlets, in order to meet the specific needs of their tenants and to comply with ever-changing government regulations. The 15-year depreciation period for such leasehold improvements more closely reflects the actual life of these improvements in light of market practices.

For example, in Alaska I know of a family-owned shopping center currently considering whether or not to move forward with an expansion of the center. The improvements to this property would lead to considerable associated economic activity, construction jobs, and investment in the local economy. However, the decision to make this investment at this time has to make economic sense. A 39-year depreciation schedule for the eventual leasehold improvements just does not make sense to this small developer, whereas the 15-year depreciation schedule that is more in line with the usefulness of the improvements will allow this project to move forward. The margin on this investment is so thin, that the depreciation schedule is a factor holding-up this expansion. Real business decisions are being made, and small businesses will not take on the risk associated with these investments without certainty about the tax consequences.

Brownfields Remediation Expensing

As a small developer who focuses on urban and suburban projects I have wrestled with more than my share of environmentally contaminated properties and have developed a great deal of experience with contaminated property cleanup and brownfields remediation programs.

Just as my example in Alaska shows the need for extending the expedited leasehold depreciation schedule, small businesses also need Section 179 expensing to be extended now. It is often a very expensive endeavor to clean-up a brownfields site. A small real estate business has to raise or contribute those funds upfront. A larger company may have the cash flow to float the investment, but a small guy does not. Being able to deduct legitimate business expenses each year is vital to small businesses with – by definition – small capitalization. This expensing provision is key to the economic decision making of small businesses.

Currently, I am involved in the early due-diligence stages of a 40 acre urban infill development in Kenosha, Wisconsin. The parcel is adjacent to a landfill that has been active for over 30 years. The degree of contamination is unknown, but the decision to acquire and clean this site will depend upon our ability to quantify the cost and the risk involved. The ability to utilize Section 179 brownfields remediation expensing is a large part of that decision-making process. If the project is not economically feasible, the City of Kenosha will lose a significant Senior Housing and multifamily residential development as well as the recreational area and projected increase in property tax increment of $80 million at completion.

The Section 179 brownfields remediation expensing provision allows property developers to deduct the expenses of brownfields cleanups rather than require them to be treated as a capital improvement. In my opinion, it is inappropriate for the expenses associated with the mandated cleanup of previously contaminated real property to be charged as capital improvement costs and I strongly believe that expensing of brownfields cleanup costs should be made permanent. Until this provision can be made permanent, ICSC will continue to push for the temporary extension of brownfields remediation expensing as a key component to brownfields cleanup across the country.

The New Markets Tax Credit

The NMTC provides a tax credit to encourage private capital investment in eligible low-income communities. Thus, the credit encourages private investment in community development. Indeed, the credit encourages new investment in the underserved areas that would not occur in the absence of these credits.

The NMTC plays an important role in redeveloping and revitalizing economically distressed communities. Therefore, it is imperative that the credit be extended, as these communities are already experiencing the impact of the recent economic downturn. Without an extension, these communities with the greatest need for redevelopment and revitalization will suffer the greatest harm.

Energy Tax Incentives

Various energy tax incentives require extension before they expire at the end of 2008. ICSC is closely watching for the energy tax credit for solar energy, the commercial building tax deduction and the new investment tax credit for combined heat and power systems.

Solar Energy Tax Credit

In most cases, current technologies for onsite power generation are generally not economically suitable for retail installation without federal and state incentives. However, we believe that these incentives will lead to greater production of renewable power generating equipment (such as solar panels) and that the higher production will lower the unit price over time. Capitalizing on the expected capabilities of future technologies, the cost for renewable energy will become

competitive with coal-fired utility-provided electricity and hopefully these incentives will not be necessary one day. But today, they absolutely are required.

Commercial Building Tax Deduction

The Commercial Building Tax Deduction ("CBTD") is set to expire on December 31 of this year, unless Congress and the President authorize an extension. Established through the Energy Policy Act of 2005, the CBTD encourages the use of energy-efficient equipment and design techniques in new and existing buildings.

However, the current provisions are complex and set unrealistically high hurdles for retail real estate to overcome before a building owner can qualify for CBTD. To receive the maximum deduction, the CBTD requires rather extreme increases in energy efficiencies to "push the envelope" on economics and technology. Although we strongly believe in an incentive-based approach to energy efficiency, if Congress is truly interested in creating incentives for a rapid and more broadly implemented energy efficiency initiative it should lower the targeted percentage of efficiency gains so that more small businesses can take advantage of them. After all, it really isn't an incentive if no one can use it.

Carried Interest

Finally, I must make one comment about a tax proposal that is not a tax extender, but has been considered along with the extenders previously as a "pay for." Commonly referred to as "carried interest," this major change in the taxation of capital gains for partnerships would be significantly detrimental to many small real estate businesses. While the stated intent of this tax

increase is to address the perceived tax rate inequity applied to the extreme profits being realized by private equity and hedge fund managers, this legislation will directly impact the real estate industry, as most real estate ventures are organized and taxed as partnerships.

In 2005, the Internal Revenue Service reported that 2.8 million partnership tax returns were filed. Of those filings, 1.3 million were for real estate partnerships, representing 46% of the partnership tax returns.

Unlike some private equity or hedge fund firms, the "carried interest" for the general partner in a real estate endeavor is not guaranteed income. Most real estate partnerships are small businesses and they must exceed a significant contractual "hurdle," allowing the limited partner or investor to realize return on investment before the general partner sees the first dollar of gain and usually only after a significant amount of time has passed.

By undercutting the economic incentive to build a project or redevelop an under utilized property, this change could significantly drive away investment from the commercial real estate sector and truly impact small businesses like the Kilduff Company that are focused on investments that come with inherent risk, such as investment in underserved markets or those associated with a significant environmental cleanup effort. Please consider the impacts of the tax extenders and the necessary offsets when you consider the tax needs of small businesses.

Conclusion

Madame Chairwoman, prompt enactment of the tax extenders legislation is necessary to promote economic growth, job creation, capital investment and energy security. ICSC looks forward to working with Congress to secure enactment of this vital legislation as soon as possible.

Chairwoman Velazquez and Ranking Member Chabot, thank you for holding this hearing and for giving me the opportunity to testify. I welcome any questions you may have.

Leo Berlinghieri
CEO and President, MKS Instruments

U.S. House of Representatives
Committee on Small Business
September 11, 2008

Introduction

Good morning. I am Leo Berlinghieri, the Chief Executive Officer and President of MKS Instruments which is headquartered in Andover, Massachusetts. Thank you for inviting me here to speak today.

MKS Instruments provides instruments, subsystems and process control solutions that improve performance and productivity for a number of advanced manufacturing processes. I brought with me a few photos of some of our products. We serve several markets including companies that make equipment used to produce semiconductors, flat panel displays, solar cells, and other high technology products. MKS Instruments employs close to 3,000 people worldwide and in 2007 we had $780 million in revenue. We also have a long list of small businesses that are in our supply chain.

In addition to my company role, next year I will become Chairman of the North American Advisory Board for Semiconductor Equipment and Materials International, SEMI. SEMI is the global industry association serving the manufacturing supply chains for the microelectronic,

display and photovoltaic industries. SEMI has nearly 800 member companies in the United Sates and approximately 80 percent of these companies are small businesses.

Today I would like to talk about two components of the Tax Extenders Bill that are of great importance to MKS Instruments and other SEMI member companies. These issues are the R&D tax credit and the commercial investment tax credit for solar energy.

R&D Tax Credit

In terms of R&D, MKS Instruments employs over 500 engineering professionals and we expect to spend $80 million on R&D this year, about ten percent of our revenues. That is a common range for our industry. Our R&D spending goes toward salaries for engineers and engineering consultants and toward the cost of materials and tools. An initial R&D investment of one million dollars or a little more, recurring each year, generates about $11-$12 million in revenue each year for about five to seven years. This is about $50-75 million in revenue over a product's life cycle. The R&D tax credit is an important incentive to locate this value-added work in the United States.

In addition to these jobs, there are direct benefits for the U.S. government. Here are some quick back-of-the-envelope calculations. We estimate that the typical R&D credit gives us on average a $2 million credit. At the conservative estimate, 15 percent of $50 million in revenue resulting from the R&D project gives us a pre-tax profit of $7.5 million. We can assume that this is taxed at 36 percent, which would provide a return from the corporation in taxes to the government of

$2.7 million. In addition, the government receives taxes from R&D employees and any other U.S.-based hiring that stems from the associated revenue growth.

The R&D tax credit has a long history of strong bi-partisan, bi-cameral support and it is unfortunate that it expired eight months ago. Growth of the American economy is closely tied to the ability of our companies to make a sustained commitment to long-term, high-cost research and development efforts. The credit provides a critical, effective and proven incentive for companies like MKS to increase their R&D investment in the United States. It is a stimulus for U.S. investment, innovation, wage growth, consumption, and exports.

While the R&D tax credit is expired, many countries such as Ireland, Canada and China have more attractive R&D tax incentives luring research jobs away from the United States. The United States used to have the best R&D tax credit and now we are way down the list as other countries have made this a priority and the United States has not.

I urge Congress, before adjournment, to enact a seamless multi-year extension of a strengthened R&D tax credit.

Commercial Solar Energy Investment Tax Credit

The second issue is the commercial investment tax credit for solar energy. Solar energy is a new market for MKS Instruments and many other SEMI member companies. The materials and equipment used in the semiconductor industry is very similar to what is used in the solar energy industry. At a time when America's energy independence is more crucial than ever; solar energy

and other means of alternative energies are expected to boom. The commercial investment tax credit for solar energy expires at the end of this year. Unfortunately, due to the uncertainty of an ITC extension, solar projects in the United States already have been put on hold.

The commercial ITC for solar energy is a critical incentive for companies to locate their solar energy manufacturing facilities and projects in the United States. Again, just like the R&D tax credit, these investments produce jobs. According to a Navigant Consulting study, if extended, the solar energy ITC is expected to create almost 40,000 more jobs and $8 billion in investments. If it is not extended, those jobs and investments will go elsewhere.

Other nations have very generous incentive packages for solar energy and are leading in investment in this area. If Congress fails to extend the credit, it will cause America to fall further behind and ensure that these investments are made overseas. There is no doubt that our country will be a user of solar energy. The question is whether we will be a producer of the technology or will we have to rely on others?

I urge Congress, before adjournment, to approve an eight-year extension of the commercial investment tax credit for solar energy.

Conclusion

In closing, let me reiterate that what is at stake are American jobs and investments in critical technologies. Tax policies are a key factor for companies when they are deciding where to invest and we are faced with some stiff competition from abroad. There is a very limited

window of opportunity to extend these credits this year. I urge Congress to make this a top priority and ensure that the R&D tax credit and the commercial investment tax credit for solar energy are extended before Congress adjourns for the year. We can not afford to wait.

Thank you.

Ms. Velazquez, Mr. Chabot, and members of the Committee, my name is Tom Shepherd. I am Chairman and CEO of The Shepherd Chemical Company and The Shepherd Color Company. These companies, based in Cincinnati, Ohio are fourth generation family owned businesses that manufacture metal based specialty chemicals and pigments. The reason we exist, as expressed in our Core Purpose, is to "Enhance People's Lives." We are a world-class company. We sell throughout the world. And we compete with companies from around the world. As a result of our success we are able to employ over 400 people, and thereby support over 400 families, in southwest Ohio and around the world.

I am pleased to speak before the U.S. House of Representatives Committee on Small Business hearing on "Examining Expiring Tax Incentives and the Needs of Small Businesses." I will begin with a few words on expiring tax incentives and then use the balance of my statement to address the needs of small businesses with a specific focus on tax issues. I want to thank Ms. Velazquez and Mr. Chabot for this opportunity to speak before the Committee and thank as well, Deputy Staff Director, Jan Oliver, for her help in preparing to do so.

With a focus on innovation and customization the Shepherd family of companies relies on dozens of chemists and engineers to create new and novel materials for a wide variety of uses. Our products serve as, or contribute to the production of, petroleum purification catalysts, polymer cross-linking catalysts, additives for high pressure lubricants, gas generants for air bags, infrared reflective pigments for cool roof technology, cathode materials for lithium ion batteries, rubber adhesion promoters for radial tires, environmentally sound corrosion inhibitors, color systems for glass, metal and plastic architectural siding, additives for biodegradable plastics, sealants for energy efficient windows, and several other products. We manufacture things that make life better, safer, and healthier.

With our focus on engineered products and innovative technology we conduct a great deal of research and experimentation as a matter of course. As you might imagine, our Research and Development expenses are considerable. I encourage the Committee to endorse the continuation and strengthening of the Research and Experimentation Tax Credit. Such an investment of taxpayers' money will pay large dividends in the form of high paying jobs and an improved quality of life.

As for the needs of small businesses, I refer to Aesop's fable about The Goose that Laid the Golden Eggs.

> A man and his wife had the good fortune to possess a goose which laid a golden egg every day. Lucky though they were, they soon began to think they were not getting rich fast enough, and, imagining the bird must be made of gold inside, they decided to kill it. Then, they thought, they could obtain the whole store of precious metal at once, but when they cut the goose open, they found it was like any other goose.

Like the couple in Aesop's fable, many in our government seem confused about the source of America's prosperity. It is healthy businesses, and healthy businesses alone, that generate the money for taxes, jobs, healthcare, business growth, reinvestment, charitable organizations, government, roads, security, regulatory agencies, environmental innovations, and so forth. While many in our government are wise enough not to go after American businesses with a hatchet, they seem to have no problem administering regular doses of poison, or making it easy for others to do so. Misguided legislators, regulators, trial lawyers, environmentalists, activist judges, and unions cannot keep poisoning us and, at the same time, expect us to perform our vital function, or even want to do so if we could. In the end, it is all Americans, in fact all humankind, that suffers as the true source of our prosperity dies off.

What do small businesses need?

1. We need efficient, cost effective transportation for our raw materials, finished products and people.
2. We need protection from thieves, vandals, terrorists, unscrupulous litigation, and unnecessary and onerous regulations.
3. We need free trade arrangements for both our incoming raw materials and our outgoing finished products.
4. We need responsible monetary policy that acknowledges the financial needs of small businesses.
5. We need tax policy that promotes capital investment and savings.
6. We need those in government to spend our money responsibly so that more of the money can be left with those who earn it.

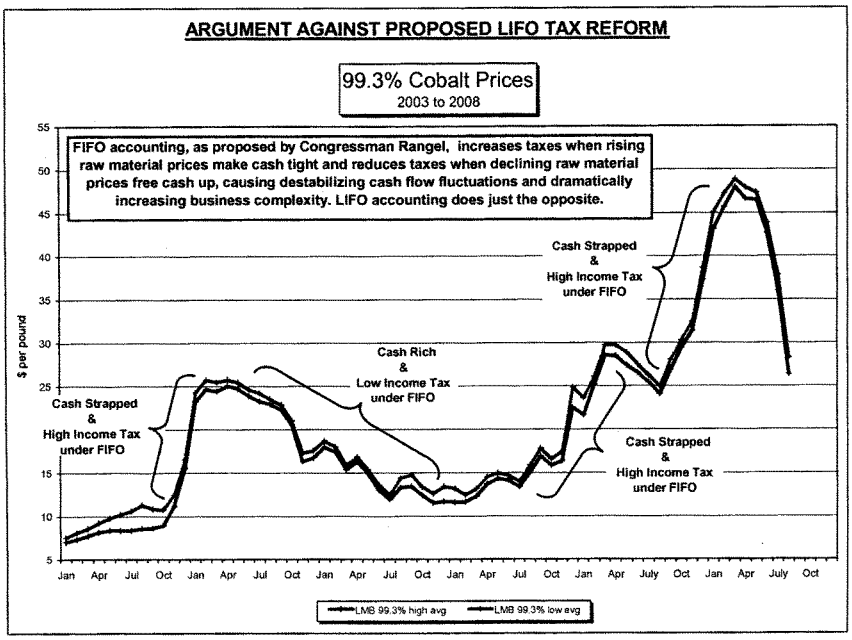
Unfortunately, while we don't always get what we need from our government, we often get what we don't need, and what is harmful to our ability to compete around the world.

1. We get misguided regulations and subsidies that ignore both science and economics.
2. We get restrictions on energy production so that our employees can't afford to drive to work or heat their homes and so that our cost of natural gas is 2 to 10 times that of our foreign competitors.
3. We get pro-union legislation that encourages outsiders to interfere with our relationship with our employees and the way we run our businesses.
4. We get courts and laws that facilitate frivolous and unfounded lawsuits.
5. Specific to the topic of this hearing, taxes and small businesses, we get a tax system that, having taken nearly half of our earnings each year for our entire working lives, takes more than half of what's left over when we die. I am speaking of the estate tax. Not only is this unjust, it also depresses our ability to grow the business and the economy and provide new, higher-paying jobs. I will use myself as an example so as to explain the serious negative effects of this approach. Our policy at my family's companies is to pay wages and salaries consistent with the market. My salary, therefore, is typical within the industry for my role and responsibilities. However, because of the estate tax and my desire to

keep the business in my family when I die, the portion of my salary that is not used to pay taxes on that salary is needed to pay dividends for life insurance, the proceeds of which will pay the estate tax when I die. How do I take care of my family when my entire salary is consumed by taxes and preparation for taxes? By removing cash from the company, in the form of dividends, that might otherwise be invested in technology, growth and jobs.

Small businesses are one of America's greatest assets; they are the American Dream, the primary source of new jobs in America, and the creator of our strong middle class. Our estate tax, which will return to 55% of the value of the estate in 2011, leaves American small business owners with three options, all of which are bad for America. The first option is to use valuable resources and personal energy to create the plan and buy the insurance that will allow the business to stay in the family when we die, as I have done. Although this preserves the family business, it wastes valuable resources and depresses our ability to invest and grow. The second option is to ignore the pending estate tax and fail to prepare for it. This ensures that, upon the owner's death, the company will be wrenched from the arms of the family that built it. The third option is to sell the company before you die in order that you and your family can enjoy the fruits of your labors. However, both the second and third options risk the loss of jobs that so often follow these types of sales.

6. And further to taxes and small businesses, we get threats from prominent politicians that more burdensome taxes are coming. Representative Rangel has proposed discontinuing Last In First Out accounting, commonly referred to as LIFO. Under our current tax system businesses may choose among several methods as to how they will value raw materials for the purpose of calculating profits (revenue less raw material costs and other expenses equals profit). The LIFO method allows businesses to calculate profits using their most recent raw material purchase prices as opposed to their most distant prices. The LIFO method suppresses taxes at the very period that rising raw material prices make cash tight and increases taxes when declining raw material prices free cash up. Under this method, cash flow is steady, thereby encouraging long-term investment and business growth. On the other hand, the First In First Out method, commonly referred to as FIFO, does just the opposite. It increases taxes when rising raw material prices make cash tight and reduces taxes when declining raw material prices free cash up. The result is destabilizing cash flow fluctuations and dramatically increased business complexity. Congressman Rangel wants to eliminate the LIFO option. This is a bad idea for business and another indication that some in our government are confused about the source of our national prosperity.


ARGUMENT AGAINST PROPOSED LIFO TAX REFORM
99.3% Cobalt Prices
2003 to 2008
FIFO accounting, as proposed by Congressman Rangel, increases taxes when rising raw material prices make cash tight and reduces taxes when declining raw material prices free cash up, causing destabilizing cash flow fluctuations and dramatically increasing business complexity. LIFO accounting does just the opposite.
$ per pound
55
50
45
40
35
30
25
15
10
5
Cash Strapped & High Income Tax under FIFO
Cash Rich & Low Income Tax under FIFO
Cash Strapped & High Income Tax under FIFO
Cash Strapped & High Income Tax under FIFO
Jan Apr Jul Oct Jan Apr Jul Oct Jan Apr Jul Oct Jan Apr Jul Oct Jan Apr July Oct Jan Apr July Oct
LME 99.3% high avg
LME 99.3% low avg

Supporting innovation and economic growth

The broad impact of the R&D credit in 2005

Prepared by Ernst & Young LLP for the R&D Credit Coalition

April 2008

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Quality In Everything We Do

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Executive summary

Companies of all sizes, in a wide range of industries, use the research and development (R&D) tax credit across all 50 states of the US. The most recent data on the distribution of R&D credits claimed and R&D activity show:

- 17,700 corporations claimed $6.6 billion R&D credits on their tax returns in 2005. Approximately 11,300 C corporations and 6,400 S corporations, regulated investment companies and real estate investment trusts claimed the credit.
- Corporations claiming the R&D credit in 2005 were roughly equally divided into fourths by size, with 29% of firms with $1 million of assets or less, one fourth with assets of $1-$5 million, one fourth with assets of $5-$25 million and 21% with assets of $25 million or more.
- Firms in all major industries claim the R&D credit, with the principal industries claiming the credit being manufacturing, professional, scientific and technical services and information sectors.
- Firms in the manufacturing, information and services sectors claimed the majority of the R&D credit.
- The value of the R&D credit as a percent of the firm's assets was highest for small firms.
- California reported the largest share of industrial R&D activity, followed by Michigan, New Jersey, Texas and Massachusetts.
- States with the most companies reporting R&D activity include California, Texas, Massachusetts, Florida, Pennsylvania, New York and Michigan.
- On a per capita basis, Connecticut, Delaware, Massachusetts, Michigan, Washington and New Jersey reported the most R&D activity.
- As a percent of private sector gross state product, a few small states like Connecticut, Rhode Island, Delaware and New Hampshire reported a large amount of R&D activity.

The remainder of this paper discusses in detail the distribution of the R&D tax credit claimed over time, across firm size and industry and R&D activity performed by states.[1] A methodology section, describing the data presented in the tables, follows the results.

The R&D tax credit – current law

The R&D tax credit was enacted in 1981 and has been extended 12 times. The R&D tax credit expired on December 31, 2007. The credit has been allowed to expire eight other times. In only one year has the R&D credit not been available since 1981. The credit has become an important factor in US companies' research and development investments, despite the political uncertainty.

The R&D credit is available for qualified research and development expenditures incurred in the United States. The primary categories of qualified R&D expenditures are, in descending order of magnitude:

1. Wages paid to employees performing qualified research activities
2. Supplies used in the conduct of qualified research
3. 65% of amounts paid to outside contractors for the performance of qualified research

The R&D credit consists of three available credits. The regular R&D tax credit is a 20% credit for qualified R&D expenditures in excess of a calculated base amount. The base amount is determined by a statutory formula that reflects the percentage of gross receipts dedicated to R&D expenditures in the four preceding years. In other words, the regular research credit is tied to an increase in R&D intensity (expressed as R&D expenditures as a percent of sales) compared to a fixed historical measure of intensity. The base amount can not be less than 50% of qualified research expenses. In addition, firms can claim 20% tax credit for the amount given to qualified organizations for "basic research" (e.g., university or nonprofit organization research).

There is also an Alternative Incremental Research Credit (AIRC). The AIRC combines a three-tier credit rate ranging from 3% to 5% of the total amount of R&D expenditures above the base amount. Firms that have increased their R&D expenditures, but not their R&D intensity, are eligible for the AIRC.

An Alternative Simplified Credit (ASC) allows a 12% credit for R&D expenditures above 50% of the average qualified research expenditures over the three years before the credit year. The Alternative Simplified Credit was enacted in the Tax Relief and Healthcare Act of 2006.

The R&D tax credit – Returns and credit claimed, 1997-2005

Table 1 shows the trend of R&D tax credits claimed by C corporations from 1997 to 2005. The amount of R&D tax credit claimed increased by almost 50%, and the number of firms claiming it increased by 6%. Most of this increase happened before the recession in 2001. From 2001 to 2003, the amount of R&D tax credit claimed decreased by 25% and the number of corporations claiming it decreased by 7%. Record levels for credits claimed and returns claiming the credit were reached in 2005, with a 34% increase in the R&D tax credit and a 16% increase in the number of corporations claiming it from 2003 to 2005.

Table 1: R&D tax credit claimed by Subchapter C corporations from 1997 to 2005

Year	Credits claimed[1] $millions	Number of returns
1997	4,398	10,668
1999	5,281	10,019
2001	6,356	10,388
2003	4,766	9,697
2005	6,363	11,290

Source: Special IRS/SOI tabulations.

[1] R&D tax credits claimed by all corporations totaled $6,643 million in 2005.

The R&D tax credit – Distribution by firm size

Tax data on R&D credits claimed by corporations is compiled by the Statistics of Income (SOI) division of the Internal Revenue Service (IRS). The data are from special tabulations of IRS/SOI data on R&D credits claimed by all corporations in 2005. In 2005, 17,700 corporations claimed the R&D credit, totaling $6.6 billion.

Chart 1 and Table 2 show the distribution of R&D tax credits claimed in 2005 by firm size, as defined by assets. The R&D tax credit is claimed by both small and large companies. Chart 1 shows the distribution of corporations claiming the R&E tax credit across firm size, with 21% of firms with assets under $500,000, 33% with assets between $50,000 and $5 million, one quarter of firms between $5 million and $25 million and 20% of firms with assets exceeding $25 million. The data is for all active corporations, including Subchapter S corporations, Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs). A similar distribution across firm size occurs for only Subchapter C corporations.

Chart 1: Distribution of firms claiming R&D credits by firm size, by assets, 2005, ($000)

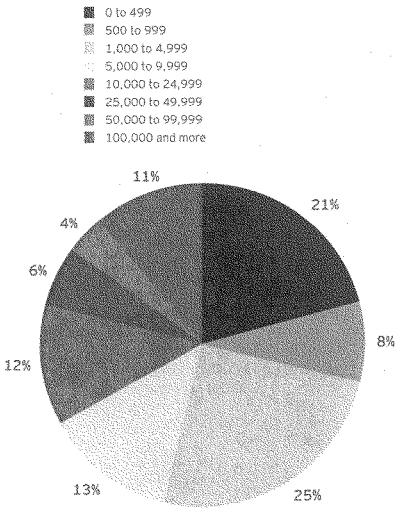
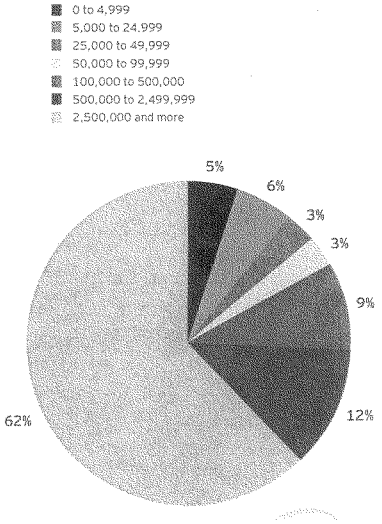


Chart 2: Distribution of R&D credits claimed by firm size, by assets, 2005, ($000)



Source: IRS/SOI, All Corporations.

Chart 2 and Table 2 shows that the amount of tax credit claimed by corporations is concentrated among the largest firms, with assets above $2.5 billion of assets (62% of total R&D tax credits claimed). The distribution of credits claimed is shown for Subchapter C corporations. Pass-through entities, including Subchapter S corporations and RICs and REITs, claimed $300 million of the total $6.6 billion R&D credits claimed in 2005.

Table 2 shows the average R&D credit per return tends to increase with asset size, as would be expected as larger companies have larger qualifying research expenditures. However, this increase is less than proportional to average asset size: as a percentage of average assets, the average amount of tax credit claimed per firm is a decreasing function of firm size, with firms with assets lower than $500,000 claiming an average tax credit of 9.1% of average assets and large corporations claiming an average tax credit of less than 0.05% of average assets.

Table 2: The value of R&D credits claimed by active corporations relative to firm size, 2005

Total assets ($000)	Number of returns	Credits claimed ($ millions)	Per return ($ 000)	Credit as a percentage of average assets
Zero assets	242	$48	$198	-
1-499	3,374	$30	$9	9.0%
500-999	1,423	$27	$19	2.6%
1,000-4,999	4,422	$198	$45	2.1%
5,000-9,999	2,197	$162	$74	1.1%
10,000-24,999	2,197	$242	$110	0.7%
25,000-49,999	1,098	$184	$168	0.5%
50,000-99,999	703	$189	$269	0.4%
100,000-249,999	658	$285	$434	0.3%
250,000-499,999	352	$300	$852	0.2%
500,000-2,499,999	544	$829	$1,524	0.1%
2,500,000 and more	454	$4,149	$9,139	*
Total	**17,664**	**$6,643**	**$376**	*

Source: IRS/SOI, All Corporations.
**Less than 0.05%.*

The R&D tax credit by industry

Table 3 shows the distribution of R&D tax credits claimed by industry. The data are from special tabulations of IRS/SOI data on R&D credits claimed by Subchapter C corporations in 2005.

Firms claiming the R&D tax credit are principally in the manufacturing (44%), professional services (30%) and information (10%) sectors. The manufacturing sector claims the largest share of the R&D tax credit (71%), followed by the professional services and information sectors (10% each). Within the manufacturing sector, the computer and electronic product manufacturing and pharmaceutical/chemical manufacturing subindustries claimed the most R&D credit.

Table 3: Distribution of R&D credits claimed by C corporations, by industry, 2005

R&D Credits by industry	Number of returns	Percent of returns	Credits claimed ($ millions)	Percent of credits
All sectors	11,290	100%	$6,363	100%
Agriculture, forestry, fishing and hunting	61	0.5%	4	0.1%
Mining	19	0.2%	5	0.1%
Utilities	37	0.3%	20	0.3%
Construction	18	0.2%	3	0.1%
Manufacturing	4,921	43.6%	4,529	71.2%
Wholesale trade	594	5.3%	196	3.1%
Retail trade	124	1.1%	40	0.6%
Transportation and warehousing	43	0.4%	9	0.1%
Information	1,076	9.5%	636	10.0%
Finance and insurance	143	1.3%	125	2.0%
Real estate and rental and leasing	14	0.1%	4	0.1%
Services	4,241	37.6%	791	12.4%

Source: Special tabulations requested from IRS/SOI. Figures may not appear to sum due to rounding.

Qualifying research expenditures

The IRS/SOI has published some tabulations of the R&D tax credit for 2003 with more details on the underlying qualifying expenditures and some of the tax credit limitations. These tabulations available on the IRS/SOI Web site involved significant additional resources, so were not available for 2005. The underlying relationships, however, are not expected to change significantly from year-to-year.

Table 4 shows the composition of qualifying research expenditures. Companies' employees' wages and salaries accounted for 70% of qualifying research expenditures. Cost of supplies for research accounted for 16%, and the applicable percentage of contract research (principally wages and salaries of workers of third-party contractors) accounted for 14%.

Table 4: Qualified research expenditures by type

	Regular Tax Credit	Alternative Incremental Tax Credit	Total	Percent[2]
Wages for qualified services	61.2	20.8	82.0	70%
Cost of supplies	14.5	4.2	18.7	16%
Applicable percent of contract research expense	13.3	2.8	16.2	14%
Rental or lease costs of computers	0.3	*	0.3	*
Total qualified research expenses[1]	92.9	28.4	121.5	100%

** Less than $50 million or less than 0.5%*

[1] Does not equal sum of components since some corporations only reported total line.

[2] Percent of reported components.

Dollar amounts are in billions.

Source: IRS/SOI, Table 1 from http://www.irs.gov/taxstats/article/o,,id=164402,00.html

Credit as a percent of qualifying research expenditures

Both the regular R&D credit and the alternative incremental credit apply the credit to qualifying research expenditures above different bases. Thus, the regular R&D credit is smaller than 20% of total qualifying R&D expenditures, and the alternative incremental credit is smaller than the 3% to 5% percent credit rates.

In addition to the incremental nature of both the regular and alternative credit, the regular credit base can not be less than 50% of qualified research expenses. This further reduces the research expenses qualifying for the credit. In 2003, the IRS reports that 78% of the returns claiming the regular credit were subject to the 50% limitation. These firms accounted for 46% of the total qualifying research expenditures and 57% of the R&D regular credit after the limitation.

In 2003, the regular R&D credit of $4.8 billion applied to $93 billion of qualified R&D expenditures, for an average credit rate of 5.1%. The alternative incremental R&D credit of $600 million was applied to $29 billion of qualified R&D expenditures for an average credit rate of 2.1%.

Research and development by state

Tables 5 to 8 present the distribution of industrial R&D performance by state for 2005, the latest year of available data. The data are from the National Science Foundation survey of company funds for R&D, by state.

Industrial R&D activity reported in the NSF survey in 2005 totaled $204 billion, or about 50% more than the amount of qualifying research expenses reported for the R&D tax credit. The definition of R&D expenditures for tax purposes is narrower than the more common measures of R&D, such as used by the NSF.

Table 5 shows the number of firms performing industrial R&D in each state, ranked by the number of firms. Not surprisingly, although firms in every state report R&D activity, most firms with R&D activity are located in large states, with the largest number of firms in California (more than 12% of all firms claiming the tax credit), followed by Texas (5.5% of all firms claiming the credit), Massachusetts (5.2% of all firms claiming the credit) and Florida (5% of all firms claiming the credit).[2]

Table 6 shows the share of the amount of industrial R&D performed in the state, for the top 20 states. Although California is still ranked first (22% of the total amount of R&D performed in the US), it is now followed by Michigan (8%), New Jersey and Texas (6% each).

Table 7 shows the amount of industrial R&D performed by state population in 2005, for the top 20 states. The largest amounts of per capita R&D activity are conducted in smaller states, including Connecticut and Delaware. Massachusetts, Michigan and Washington also have large industrial R&D activity per capita.

Table 8 shows the amount of R&D performance by state as a share of private sector gross domestic product (GSP) in 2005. The highest percentage of business activity in research activity is conducted in Michigan. Some small states, like Connecticut, Rhode Island, Delaware, New Hampshire and Oregon also have a large amount of R&D activity.

Table 5: States ranked by number of firms in the state reporting R&D activity, 2005

State	Number of firms	State	Number of firms
California	5,741	Indiana	615
Texas	2,641	Kentucky	513
Massachusetts	2,478	Delaware	500
Florida	2,392	Nebraska	463
Pennsylvania	2,310	New Hampshire	445
New York	2,213	Iowa	416
Michigan	2,111	Kansas	403
Illinois	2,064	Tennessee	387
Georgia	1,724	Louisiana	332
Colorado	1,450	Arkansas	317
New Jersey	1,424	Nevada	277
Ohio	1,415	Rhode Island	238
Wisconsin	1,358	South Dakota	219
Alabama	1,296	Idaho	171
Utah	1,264	Oklahoma	165
Virginia	1,230	Mississippi	164
Washington	1,229	Maine	154
Minnesota	1,028	Vermont	130
Oregon	1,014	Hawaii	86
Arizona	985	North Dakota	84
North Carolina	907	Montana	58
Maryland	856	West Virginia	51
Connecticut	838	District of Columbia	34
New Mexico	775	Wyoming	33
Missouri	704	Alaska	16
South Carolina	624		

Source: National Science Foundation.

Table 6: Top 20 states ranked by share of industrial R&D performance in 2005

State	Share of total US R&D
California	22.4%
Michigan	8.1%
New Jersey	6.3%
Texas	5.7%
Massachusetts	5.3%
Washington	4.7%
Illinois	4.7%
New York	4.3%
Pennsylvania	4.3%
Connecticut	3.2%
Minnesota	3.0%
Ohio	2.7%
North Carolina	2.5%
Indiana	2.1%
Colorado	2.1%
Oregon	1.6%
Florida	1.5%
Arizona	1.3%
Virginia	1.3%
Wisconsin	1.3%

Source: National Science Foundation.

Table 7: Top 20 states ranked by per capita industrial R&D performed in 2005

State	Per capita R&D
Connecticut	1,835
Delaware	1,765
Massachusetts	1,686
Michigan	1,635
Washington	1,520
New Jersey	1,480
California	1,263
Rhode Island	1,246
Minnesota	1,179
New Hampshire	1,031
Colorado	893
Oregon	885
Illinois	745
Pennsylvania	695
Indiana	690
United States	680
Kansas	667
North Dakota	643
North Carolina	582
Vermont	543

Source: National Science Foundation.

Table B: States ranked by R&D activity as percent of gross state product (GSP), 2005

State	Industrial R&D activity ($ millions)	Private sector gross state product ($ millions)	R&D as % of GSP
Michigan	16,548	332,057	4.98%
Washington	9,555	233,449	4.09%
Massachusetts	10,788	291,776	3.70%
Connecticut	6,442	176,328	3.65%
Rhode Island	1,340	38,160	3.51%
New Jersey	12,902	383,478	3.36%
California	45,618	1,435,610	3.18%
Minnesota	6,053	207,306	2.92%
Delaware	1,490	52,017	2.86%
New Hampshire	1,351	49,161	2.75%
Oregon	3,223	122,121	2.64%
Colorado	4,168	188,879	2.21%
Kansas	1,832	89,350	2.05%
Indiana	4,327	212,463	2.04%
Pennsylvania	8,640	437,693	1.97%
North Dakota	410	21,012	1.95%
Illinois	9,506	500,730	1.90%
United States	**204,250**	**10,892,216**	**1.88%**
Vermont	338	19,963	1.69%
North Carolina	5,051	305,739	1.65%
Idaho	635	39,542	1.61%
Arizona	2,711	185,757	1.46%
Ohio	5,445	393,696	1.38%
Wisconsin	2,660	192,732	1.38%
Utah	1,036	75,777	1.37%
Missouri	2,523	190,015	1.33%
Texas	11,579	882,277	1.31%
Maryland	2,452	203,772	1.20%
South Carolina	1,364	117,441	1.16%
New York	8,819	861,618	1.02%
Iowa	1,029	104,033	0.99%
Virginia	2,683	290,120	0.92%
Maine	331	38,543	0.86%
Georgia	2,226	311,917	0.71%
Nebraska	400	62,166	0.64%
Tennessee	1,150	200,821	0.57%
Kentucky	650	118,016	0.55%
Alabama	698	128,397	0.54%
Florida	2,974	590,516	0.50%
New Mexico	278	56,803	0.49%
West Virginia	205	43,913	0.47%
Oklahoma	401	102,166	0.39%
Nevada	365	99,213	0.37%
Arkansas	262	75,322	0.35%
Hawaii	122	42,515	0.29%
Montana	71	25,066	0.28%
South Dakota	66	26,493	0.25%
Mississippi	147	65,879	0.22%
Louisiana	278	159,901	0.17%
District of Columbia	93	54,453	0.17%
Wyoming	29	23,628	0.12%
Alaska	30	32,416	0.09%

Source: EY calculations based on data from National Science Foundation and Bureau of Economic Analysis.

Conclusion

Businesses can claim a tax credit for their qualified R&D expenditures performed in the United States. The R&D tax credit claimed increased by almost 50% from 1997 to 2005, and the number of firms claiming it increased by 6%.

Companies of all sizes and in all industries claim the R&D tax credit. The distribution of firms claiming the credit is the largest among small and medium size firms. Major users of the R&D credit are in the manufacturing, professional services and information sectors.

R&D activity is conducted across the 50 states. California hosted the largest share of R&D (22%) in the US, with Michigan, New Jersey, Texas, Massachusetts and Washington with at least 5% shares. In addition to these states, Florida, Pennsylvania, New York, Illinois, Georgia, Colorado, Ohio, Wisconsin, Alabama, Utah, Virginia, Minnesota and Oregon had over 1,000 firms in the state conducting R&D. Several smaller states were ranked in the top 10 states in terms of R&D spending per capita: Connecticut, Delaware, Rhode Island and New Hampshire.

Methodology

This study is based upon the Internal Revenue Service's Statistics of Income special tabulations on the R&D tax credit claimed by corporations in 2003 and 2005. The distribution of all active corporations claiming the R&D credit includes both C corporations, S corporations and Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs). The distribution of credits claimed by industry is limited to C corporations.

The study reports the total R&D tax credit claimed by corporations (line 41 of Form 6165). This amount does not reflect the amount of credits received in the current year due to limitations on credits. For example, if the tax credit exceeds current income taxes, the excess credit is not refundable. Excess credits can be carried back against a limited number of prior years' tax liabilities or forward against a limited number of future years' tax liabilities.

Additional detail from special tabulations of the Form 6165 in 2003 provide detail on the composition of qualifying research expenditures, on the split between the regular R&D credit and the alternative incremental R&D credit and the effects of the 50% of base limitation.

The data on industrial R&D performance by state, and funded by companies, reflect the results of the National Science Foundation's annual survey of R&D activity in the US The data is from 2005. According to the survey, industrial R&D funded by companies represented 90% of total industrial R&D activity in 2005 (the remainder being federally funded).

End notes

[1] This study updates the April 2004 report, ***Supporting Innovation and Economic Growth, The Broad Impact of the R&D Tax Credit***, by, Ph.D., Cathy Koch of Washington Council Ernst & Young.

[2] The number of firms reporting research and development expenses in the NSF survey is greater than the number of corporate tax returns claiming the R&D credit for several reasons: (1) several firms may be included in a single consolidated corporate tax return, (2) firms may include noncorporate businesses, such as partnerships and sole proprietorships and (3) not all research expenses qualify for the R&D tax credit.

NAM National Association of Manufacturers

MANUFACTURING MAKES AMERICA STRONG

Statement

of the National Association of Manufacturers

before the Small Business Committee

U.S. House of Representatives

Hearing on Examining Expiring Tax Incentives and the Needs of Small Businesses

Submitted for the Hearing Record of **September 11, 2008**

1331 Pennsylvania Avenue, NW • Washington, DC 20004-1790
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2005.[1] While NAM members of all sizes benefit from the credit, a recent study concluded that the value of the tax credit as a percentage of a company's assets was highest for small companies. This 2008 study of the R&D credit by Ernst & Young[2] shows that nearly 30 percent of the companies claiming the R&D tax credit in 2005 had assets of $1 million or less, and another 25 percent of companies claiming the credit had assets of $1 to $5 million.

The credit is particularly important to small manufacturers—including a number of NAM members—because it helps spur the innovations and technological advances that drive new product development and increased productivity. In a recent survey of NAM's small and medium-size manufacturers conducted in June 2008, respondents said that the two most important factors in improving their company's growth are the development of new or improving existing products and improvements in manufacturing processes.

In recent years, more and more of NAM's small and medium-size member companies are taking advantage of this important incentive. Based on our most recent survey of our small members, 40 percent said they used the credit in 2007. Of those small manufacturers claiming the R&D credit in 2007, 20 percent of the companies used the new federal R&D tax credit formula, the Alternative Simplified Credit (ASC), which was effective only for calendar year 2007. If this credit is extended, we anticipate that an increasing number of small manufacturers will opt to use this simplified credit, particularly if the credit rate increases above 12 percent.

The credit also stimulates job creation. According to the E&Y study, more than 70 percent of credit dollars are attributable to U.S. R&D wages. Moreover, R&D workers themselves appreciate the value of the credit. In recent weeks, the NAM spearheaded an effort to collect the names of more than 3,400 R&D employees from 122 companies in 43 states on a September 10, 2008, letter to Congress urging quick action to restore the R&D tax credit.

Since the R&D tax credit expired at the end of 2007, the cost of performing R&D has increased by $8 billion, a cost shared by thousands of companies, including many small

[1] IRS Statistics of Income-Summer 2008, Data on the federal R&D Tax Credit for Tax Years 2001-2005, pg. 186.
[2] "Supporting innovation and economic growth – The broad impact of the R&D credit in 2005," prepared by Ernst & Young LLP for the R&D Credit Coalition, April 2008., p. 1.

manufacturers. The lack of an R&D credit also has made the U.S. less competitive because many of our economic competitor nations provide more generous R&D tax incentives. Twenty Organization for Economic Cooperation and Development (OECD) countries currently offer R&D tax incentives, the majority of those incentives more generous than the U.S. R&D tax credit that expired in 2007.

In fact, NAM member companies of all sizes, including small companies, are courted by other countries offering stronger and frequently permanent R&D tax incentives to move U.S.-based R&D abroad. The repeated lapses of the R&D tax credit, combined with fierce competition for global R&D investment dollars, are impacting U.S. R&D activity.

In sum, this incentive is of critical importance to American manufacturers, particularly small companies. We strongly urge Congress to act as quickly as possible to seamlessly extend and strengthen this important pro-growth, pro-competitiveness tax incentive. The longer the R&D tax credit is extended, the more certainty companies will have that the credit will exist for the duration of a manufacturing R&D project, typically five to ten years.

Supplemental Sheet

Statement:
For the House Small Business Committee Hearing Record of September 11, 2008, on "Examining Expiring Tax Incentives and the Needs of Small Businesses"

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Statement of Rep. Jason Altmire
Committee on Small Business Hearing
"Examining Expiring Tax Incentives and the
Needs of Small Businesses"
September 11, 2008

Thank you, Chairwoman Velazquez, for holding this important hearing on the impact of expiring tax incentives on small businesses. It is important - during this time of economic uncertainty - that we carefully consider the consequences that the expiration of these tax incentives will have on the future of small businesses around the country.

Small businesses are the backbone of our economy and it is important that we provide targeted tax relief to these businesses to help promote investment. Since coming to Congress, I have voted to pass $50 billion in small business tax cuts to help promote growth and investment. A recent report found that if the solar and wind tax credits are not extended, approximately 116,000 jobs will be lost in these industries by the end of 2009. This is just one example of the staggering impact these expiring tax extenders will have on our workforce and our economy.

Thank you again, Madam Chair, for holding this hearing. I look forward to hearing from our panel today and getting their input on the expiring tax incentives.

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