FULL COMMITTEE HEARING ON ECONOMIC RECOVERY: TAX STIMULUS ITEMS THAT BENEFITTED SMALL BUSINESS WITH A LOOK AHEAD

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HOUSE OF REPRESENTATIVES

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FULL COMMITTEE HEARING ON ECONOMIC RECOVERY: TAX STIMULUS ITEMS THAT BENEFITTED SMALL BUSINESS WITH A LOOK AHEAD

Wednesday, July 15, 2009

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

The Committee met, pursuant to call, at 1:00 p.m., in Room 2360 Rayburn House Office Building, Hon. Nydia Velázquez [chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Moore, Dahlkemper, Kilpatrick, Ellsworth, Graves, Luetkemeyer and Coffman.

Chairwoman VELÁZQUEZ. I call this hearing of the House Small Business Committee to order.

This past February, Congress approved landmark legislation to revive our struggling economy. In passing the American Recovery and Reinvestment Act, Congress laid the groundwork for long-term, sustainable growth. That bill contained several small business provisions, and I am pleased to say many of them are already working for entrepreneurs.

Six months after the Recovery Act was signed into law, the clouds are starting to clear. To begin, loans from the SBA are up dramatically. As of June, the agency has supported more than $6 billion in lending. Just as importantly, small business credit markets are coming back to life. Loan volumes in the secondary market jumped from under $100 million in December to $360 million last month.

So things are looking up. Still, small firms continue to face challenges in accessing capital, and it would be wrong to say that we are out of the woods just yet.

While we are still only one quarter of the way into a sweeping two-year plan, this is a good time to stop and check our bearings.

Today, we are going to evaluate the progress made thus far. Witnesses and Committee members will discuss the Recovery Act's small business tax provisions. In doing so, we can hopefully pinpoint where we have made headway and identify areas in which there are still strides to be made.

Regardless of the economic climate, tax policy is a critical tool for growth. So in drafting the Recovery Act, it only makes sense to include relief for entrepreneurs. Already provisions for increased expensing limits and bonus depreciation are helping small firms expand. They are also creating new avenues for growth.

Some of the most important provisions in the Recovery Act are those that invest in new industries. Small firms are already leading the Green Revolution. Increases in clean energy tax credits are helping that process along and generating tremendous opportunity for small firms.

In a recent survey by the Air Conditioning Contractors of America, 75 percent of respondents said that they have seen improved sales. Because the efficiency sector is dominated by entrepreneurs, good news for green businesses is good news for small businesses.

Clearly, we have come a long way since February. The Recovery Act is not just growing new industries like renewable energy. It is also reinvesting in old ones, like construction and manufacturing. In May, orders for manufactured goods, the kind that the Recovery Act lets firms depreciate, show up $2.8 billion.

Meanwhile, entrepreneurs in the construction business stand to win billions of dollars in infrastructure contracts. That is thanks largely to the Recovery Act's Build America bonds. As of early June, those tax exempt bonds helped finance $12 billion in new projects.

I think we can all agree that these are promising bright spots, but signs of recovery should not be cause for complacency. In seeing the recovery process through, we will need to be patient, and we will need to be sure all opportunities are on the table.

In terms of success provisions, it makes sense to consider increases or extensions. At the same time there are a number of suggested measures that hold very real potential and are worth a second look.

In moving forward, it is important to remember one thing. These are exceptional times. They cannot be met with apprehension. They cannot be addressed with inaction. We need to confirm them head on within innovative solutions. That is why it's so important that our policies invest in small firms. They are the ones offering fresh solutions, and they are the ones leading the way back to prosperity.

I would like to thank the witnesses in advance for their testimony, and I'm glad that they were able to make the trip to Washington to be with us this afternoon and look forward to hearing from them.

So with that I yield to the Ranking Member, Mr. Graves for his opening statement.

Mr. GRAVES. Thank you, Madam Chair, and thank you for calling this hearing on the nation's economic recovery and the tax provisions in the stimulus package. Thank you to all of our witnesses for being here today to share your testimony.

We are all concerned about the economy, but small firms with thin margins and lack of capital are particularly struggling. The stimulus was signed into law on February 17th, 2009, with pledges of job creation and help for small businesses. Although the overall package's hefty price tag was $800 billion, only a fraction, less than one percent of it, was devoted to helping small businesses recover. Unfortunately, the promised jobs have not been created and the economic recovery has not materialized.

Instead, the June national unemployment rate was 9.5 percent, the worst in 26 years. We were told that it could rise to ten percent

in the coming months, despite promises in January that it would not top eight percent if the stimulus package was signed into law.

The May unemployment rate in Missouri was nine percent, the highest on record, and is even higher in some other states. All of the spending in the stimulus has consequences. According to the nonpartisan Congressional Budget Office, the federal deficit will reach a staggering 1.8 trillion in 2009 and 9.1 trillion by 2019, increasing the national debt to 82 percent of GDP.

We must do better. America's small business need our help to create jobs and turn the economy around. Unfortunately, the stimulus' tax provisions are simply operating at the edges of the economy. Although the stimulus' tax provisions can be helpful, the broader, long-term answer to small businesses' economic recovery is income tax rate reductions.

In addition, small companies need predictability in the tax code. We need to extend tax relief for more than a single year so these firms can budget and plan for investment.

Small businesses need to keep more of what they earn. Tax rate reductions would help them to invest in their companies so that they can expand higher workers and get our economy moving again. Any new taxes to pay for health care reform, such as the proposed surtax on those with incomes over $280,000 will devastate the many small business owners who pay business taxes on their individual returns.

I support temporary tax relief, but we need to go further. Making the 2001-2003 tax benefits permanent would give small firms the confidence to purchase new equipment and hire more workers. That is why I introduced legislation to permanently extend the 2001-2003 provisions, and I hope Congress will act to provide this predictability to our nation's businesses.

Again, Madam Chairman, thank you for calling this important hearing today, and I look forward to hearing the testimony from our witnesses.

Chairwoman VELÁZQUEZ. Thank you, Mr. Graves.

And it is my pleasure to introduce our first witness, Mr. Stan Johnson, Jr. He is the president of Stan's Heating and Air Conditioning located in Austin Texas. This company was founded in 1954 to fulfill the need for a high quality HVAC service company in central Texas.

Mr. Johnson is testifying on behalf of the Air Conditioning Contractors of America. The ACCA is a group of over 4,000 air conditioning contractors.

Welcome, sir. You will have five minutes to make your remarks.

STATEMENT OF STAN JOHNSON, JR., STAN'S HEATING AND AIR CONDITIONING, ON BEHALF OF AIR CONDITIONING CONTRACTORS OF AMERICA

Mr. JOHNSON. Thank you for the opportunity to provide testimony on behalf of the small business service contractors that make up the heating, ventilation, air conditioning and refrigeration industry.

My name is Stan Johnson, Jr. I am president of Stan's Heating and Air Conditioning, a heating, cooling, and indoor air quality company located in Austin, Texas metropolitan area. My company

has been serving residential and commercial customers for over 55 years. We have gone from humble beginnings and now employ more than 40 workers. I come before you as Chairman of the Board of ACCA, as you have heard.

Every day more than 4,000 ACCA member companies across the nation help homeowners, small business owners, and building managers realize the comfort and cost benefits of efficient HVACR equipment. Eighty-one percent of ACCA's member companies have less than 50 employs, and 50 percent have less than 20 employs. My comments this afternoon summarize my written submission and focus on some of the expanded energy tax incentives passed as part of a stimulus bill, and their impact on the residential and small business commercial clients of ACCA members. I hope that my testimony will help to inform future policy decisions that further assist small businesses in these trying economic times.

ACCA believes that tax credits are the best way to encourage homeowners and building owners to reach and obtain higher efficiency HVACR equipment. Tax credits help soften the blow of the new equipment investment cost and shorten the payback period. I can attest that three-fourths, but not all of our member companies have seen positive proof that tax credits in the stimulus package are working.

The stimulus bill includes several important changes and modifications to existing tax credits for homeowners found under Sections 25(c) and 25(d) of the Internal Revenue Code. Under the old Section 25(c) tax credits, homeowners could only claim up to $300 for installing qualified HVAC or hot water equipment in 2009. The stimulus bill boosted the value of the 25(c) tax credits to 30 percent of the installed cost up to a $1,500 cap and extended the credit through 2010.

Under the old Section 25(d) of the tax code, a homeowner who installed a qualified geothermal heat pump through 2016 could claim a $2,000 tax credit. Geothermal systems require higher initial investment cost, but run with dramatically lower operating costs. The stimulus bill removed the $2,000 cap and boosted the geothermal tax credit to 30 percent of the installed cost with no cap.

In a survey conducted in May, 50 percent of ACCA member companies saw a small increase and 25 percent saw a significant increase in the sales of qualified, high efficiency HVAC equipment. One ACCA member commented that without the $1,500 tax credit, we would have had massive temporary and some permanent layoffs. Instead, we have been able to keep steady work during a traditionally slow time.

Another member recently commented that the credits provided a big boost to their sales, leading to a 20 percent increase in replacements over the last year. Indeed, the higher value tax credits are helping the homeowners elect to replace equipment instead of repair as long as they can get credit.

And the boost to the geothermal system tax credits has been a real home run. Interest in sales of geothermal equipment has seen a tremendous spike. My own company has seen a geothermal business go from zero percent of our business in June of 2008 to over 30 percent of our business in June of 2009.

But the gains as a result of the tax code changes in the stimulus bill have not been without unintended consequences. A seemingly small increase in the minimum SEER and EER, energy efficiency qualifying standards that was made late in the legislative process has created a lot of confusion for manufacturers, distributors, contractors, and homeowners.

As a result, consumer choices for some homes have become limited, making it difficult for homeowners to take advantage of the tax credits in some situations. There is no doubt the tax credits and stimulus bill have made high efficiency HVAC equipment more affordable for homeowners. However, the stimulus lacked a companion incentive for commercial and small business building owners. The committee's report last year on seven ways to stimulate the economy by letting the Internal Revenue Code showcase the disparity of how commercial; HVACR equipment may only be depreciated over 39 years, but because the expected life span of properly maintained HVACR equipment is only 15 to 20 years, commercial building owners have little or no incentive to upgrade to newer, more efficiency, energy efficient equipment. The industry replaces a larger percentage of old systems in residential applications compared to old systems in commercial applications.

ACCA supports passage of H.R. 2198 introduced by Representatives Melissa Bean and Peter Hoekstra to correct this disparity and reduce the holding period to a more realistic 20 years for HVACR equipment that is ten percent more efficient than the federal minimum standards, and a 25 year schedule for all other new HVACR equipment.

ACCA also endorses the idea of allowing small businesses to expense the purchase of HVACR equipment or allowing bonus depreciation of 50 percent of the installed cost in the year the equipment was placed into service.

Still another option would be to extend the residential tax credits to qualified small businesses. Many small businesses from professional offices located in condo townhouse projects to small shopping centers utilize the same HVAC equipment found in residential homes, but because this equipment is installed in commercial property, it cannot qualify for a tax credit.

With that I will conclude my comments and I will be happy to answer any questions you may have.

Thank you, again, for this opportunity to testify before you.

[The prepared statement of Mr. Johnson is included in the appendix.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Johnson.

Our next witness is Mr. Charles McMillan. he is the Director of Realty Relations and Broker of Record for Coldwell Banker Residential Broker in Dallas, Texas. He currently serves as president of the National Association of Realtors, NAR is America's largest trade association representing 1.3 million members involved in all aspects of the residential and commercial real estate industries.

Welcome, sir.

STATEMENT OF CHARLES McMILLAN, DIRECTOR OF REALTY RELATIONS AND BROKER OF RECORD, COLDWELL BANKER RESIDENTIAL BROKERAGE, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

Mr. MCMILLAN. Thank you, Chairwoman Velázquez, distinguished members of the Committee.

I am Charles McMillan, 2009 president of the National Association of Realtors and a broker from Dallas, Texas. I am here today on behalf of more than 1.1 million members of the National Association who deeply appreciate Congress' efforts to help small businesses recover and prosper during the current economic crisis. It is our belief that the 2009 stimulus legislation has provided helpful relief to America's small business owners, including the Realtors, by helping to stabilize the housing market and stimulate the economy.

I want to focus my remarks today on three solutions in particular and provide some comments as you have requested on what more can be done. First, Realtors appreciate actions take by Congress to provide tax incentives that would stimulate housing investment, especially among new home buyers. Early in 2008, NAR advocated for a tax credit for purchases of a principal residence. Initially Congress created a $7,500 refundable credit for first time buyers, which was in effect from April 2008 through June 30, 2009.

Because buyers were required to repay the amount, the credit was more like an interest free loan, and few consumers took advantage of it.

The 2009 stimulus increased the amount of the credit to $8,000. It eliminated the repayment requirement, and extended the credit from June 30th, 2009, to December 1st, 2009.

With these improvements, it appears that the 2009 tax credit is being used. Realtors continue to receive many calls seeking information on the credit and our Website has received a steady volume of hits, and according to market data, during the first quarter of 2009, first time home buyers accounted for more than half of the purchases in 134 of the 152 metropolitan markets that we track. That is a significant increase from the average 30 to 40 percent of home buyers.

NAR's research department is working to compile additional information about first-time buyers, and we will be pleased to share those profiles with you as we gather that information. Today we ask that Congress take additional steps to insure that the tax credit continues to support America's housing and economic recovery.

One, we ask that you eliminate the repayment requirement for 2008 purchasers. It is unfair that some buyers will be penalized simply for buying a few months before the 2009 improvements to the 2008 credit were passed.

Two, we urge Congress to extend the tax credit's December 1st expiration date through next year.

Three, we ask that Congress make the credit available to all purchasers and at least consider increasing the amount of the credit.

The second provision I want to touch on briefly is the action taken by Congress in 2007 to provide relief from the mortgage cancellation tax. This provision has proven invaluable to many sellers and has made the time consuming burden of completing a short

sale simpler. Congress recently extended this tax relief through 2012. We greatly appreciate those efforts, Madam Chairman.

However, Realtors ask that you consider making this relief a permanent part of the tax code.

Finally, the stimulus bill also provided fee waivers for some Small Business Administration programs, raises the guarantee on another, and created a new loan program. Again, we applaud those efforts.

In conclusion, real estate is small business at its best. By enacting provisions that stabilize America's real estate markets, you are helping small businesses and America's communities thrive and prosper.

Once again, we thank you for your efforts today. America's Realtors stand ready to work with you on the additional measures that I have spoken of and on other solutions that will help the real estate industry lead our nation into a new era of economic strength.

Thank you, again, for inviting me to share our views, and I will be happy to answer any questions from the members.

[The prepared statement of Mr. McMillan is included in the appendix.]

Chairwoman VELÁZQUEZ. Thank you, Mr. McMillan.

Our next witness is Mr. Douglas Woods. He is the president of the Association for Manufacturing Technology. Prior to joining AMT, Mr. Woods worked at everything from small tool and die shops up to multi-billion dollar machine tool corporations. AMT was founded in 1902 to represent and promote the interests of American providers of manufacturing machinery and equipment.

Welcome.

STATEMENT OF DOUGLAS WOODS, PRESIDENT, THE ASSOCIATION OF MANUFACTURING TECHNOLOGY

Mr. WOODS. Thank you, Madam Chairwoman, and I also want to thank all of the members of the Committee. I certainly appreciate the efforts that you have already put out on behalf of small business--in particular, manufacturing.

AMT represents over 400 companies that are involved in making all of the equipment that is essentially used in manufacturing all of the products used within the United States and around the world. We make the equipment that everybody else uses to make the products that you see every day all around you.

We have about 310,000 skilled employees involved in our industry--engineers, mechanics, electricians, tool makers, and the managers and owners of the businesses--and a lot of our businesses are small businesses, earning ten million or less. Essentially 60 percent of our members would qualify as a small business, and 83 percent of the manufacturing industry as a whole would represent small businesses.

While we are a small industry by numbers, we are actually quite enormously important from the standpoint of what it is that we provide. We are the fundamental backbone for any progress that would be made in alternative energy programs, health care initiatives, defense industry strength. It is a tremendously important industry but at the same time, we are seeing the devastation of this

recession on our industry like all the other industries are, and maybe even a little bit more so because of being capital intensive.

Essentially, we were the first ones into the recession, and unfortunately we are going to be the last ones out, and so we certainly appreciate the attention of this Committee to the important needs of our members.

Some of the impact of the recession can be evidenced by the fact that, from last year, t sales declined 60 percent for our average members from 2008 to 2009. In addition to that, we did for President Obama's Automotive Task Force a recent survey of our members, and 30 percent of them are saying that within six months they will be out of business if something does not change with the credit industry and/or the current economic situation. So obviously this is critically important.

Our focus at AMT is in the next six months. If we cannot help our members survive the next six months, some of these discussions may be somewhat irrelevant. The number one issue we are faced with is the credit issue--while all others things tie together, the credit issue is a major point.

The provisions that the Committee has done in the reinvestment act have been great. The 90 percent loan guarantee and the waiving of the fees have been phenomenal but unfortunately, if you still cannot get the credit, the fact that there is a guarantee does not really help, and it has been a problem.

The bonus depreciation and the enhanced Section 179 expensing are great things, as well. We really appreciate that. Unfortunately, if companies are not making a profit, it is very difficult to use those. So they are not meeting the need of our members right now.

The net operating loss carryback that is fantastic and can be used, but we certainly need to have that brought forward in 2009-2010 because fortunately for our industry at the beginning of 2008, we were actually making some money. So we cannot take advantage of them until we really get into 2009 and 2010 where we really do have problems.

As for the energy-related tax incentives you provided, some of our members are taking advantage of those, but there is some ambiguity in some of the definitions and rules so its diffucult to figure out which ventures actually qualify. So not a large number of people actually may take an advantage of those.

Obviously, we are as concerned, as Representative Graves pointed out in the beginning, that only $200 billion of ARRA's 787 billion are actually being provided in funds and being committed, and with the lack of credit, again, that still is the number one issue for us.

So, I would like to offer some suggestions that might be of immediate help that we certainly could use from a small business standpoint, and I say that as a recent small business person; I just took over this position as an association one would be to try to get maybe a temporary reprieve on the federal business taxes like FICA, which Representative Schock and Nye from this Committee have talked about, which would be very important.

Also, easing some of the risk requirements on banks who that making credits to small business in the manufacturing area and possibly offering a temporary stay on certain covenant violations on

loans that lenders would be actually providing to small businesses, maybe take a look at loosening the rope. Do not let it go. It might seem counter intuitive to actually increase what are the guidelines for somebody that might be in violation, but I think it is critically important to look at maybe secondary items like backlogs, employment records, other things that would measure the performance to pay back that loan besides just cash, which right now everybody would probably be in violation of.

Longer term, some things such as tax credits for exporting products in 2009 would help trade balance issues and get people exporting their products. As I talked about extending bonus depreciation and enhanced Sec. 179 expensing through 2010 and beyond would be very helpful. The 5-year net operating loss carryback, if we can get 2009 and 2010 included, and possibly look at some companies with revenues over the $15 million so that more of our customers could also be included in that because they are the ones buying the equipment.

And in some of the legislation that has already been put out there, the ″IMPACT″ Act and The Build Manufacturing Act, two good proposals that already are out there, if aspects of those bills could be included, that would be fantastic.

So the most important thing with all of those said, all of those would be for naught if we start imposing any other new programs that put taxes onto businesses. So I implore the Committee to do the best they can to avoid any burden on these taxpayers going forward.

And with that I would like to submit if I could a request to have my written testimony submitted to the Committee hearing record if that is possible.

Chairwoman VELÁZQUEZ. Without objection.

Mr. WOODS. Thank you.

[The prepared statement of Mr. Woods is included in the appendix.]

Chairwoman VELÁZQUEZ. Thank you so much, Mr. Woods.

Our next witness is Mr. Rea Hederman. Mr. Hederman is a Senior Policy Analyst and Assistant Director for the Center for Data Analysis in the Heritage Foundation. Me. Hederman joined the Heritage in 1995. The foundation is a broadly supported public policy research institute is Washington, D.C.

Welcome.

STATEMENT OF REA HEDERMAN, JR., SENIOR POLICY ANALYST AND ASSISTANT DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Mr. HEDERMAN. Thank you.

Chairwoman Velázquez, Ranking Member Graves and other distinguished members of the Committee, thank you for having me to speak on the important topic of the 2009 stimulus impact on small business and entrepreneurial activity.

The American Recovery and Reinvestment Act contained a number of provisions aimed at boosting the economic output of small businesses either through tax incentives, loan guarantees, or some other government initiatives. These provisions included an increase

in bonus expensing, bonus depreciation of qualified investment expenses.

Bonus depreciation and expensing provisions are important and proper tax policy tools for stimulating economic activity. This is why these provisions have been included in previous tax and stimulus bills.

Specifically, these tools encourage companies to increase investment output and expand activity in the short run. Basically what the federal government is saying is that we are having a fire sale on capital, and if you act now, you will be able to expand quickly and more efficiently.

Unfortunately, the effectiveness of these proposals may be limited. Since these provisions have expiration dates, small businesses may have difficulty expanding before the calendar year and taking advantage of these. And current evidence suggests that small businesses have not been able to respond to the latest stimulus proposals.

For example, a recent survey of small business owners indicated they have the same level of capital expenditure and growth in their business plans today as they did prior to the expansion of the bonus depreciation. Even worse, the number of small business owners planning an expansion over the next year is declining, and we see these numbers showing up in the macro economic indicators as nonresidential fixed investment has been declining over the last three quarters.

As many Americans are painfully aware, unemployment has climbed steadily, reaching 9.5 percent by the end of this year despite projections from the administration's economic team that the unemployment rate would not pass eight percent. Few of the benefits touted by some of the stimulus proposals have been seen to date.

While bonus depreciation expenses were an appropriate policy move earlier this year, small business requires Congress to take bold action now. Small businesses are some of the strongest pillars of employment in the economy. Research shows that job creation from small businesses and start-up companies have helped limit previous recessions. In fact, over 50 percent of Fortune 500 companies were either founded in a recession or bear market economy. While this may seem counter intuitive, this is an example of the economic cycle at work and how new companies arising that employ more and more people help in ending a recession.

Pro growth tax policies can boost small businesses and entrepreneurs, as small businesses expand and hire new employees, offsetting job losses from larger, more established firms. Good economic policies reward these successful companies instead of penalizing their success through higher taxes.

It is never too late to enact good economic policies. This Congress can establish a foundation for strong economic growth by enacting strong, good tax policy. First, Congress should make permanent the small business tax relief that was enacted in 2001-2003 and the bonus depreciation bills that were enacted earlier in this year. Entrepreneurs saw a decline in the marginal tax rates thanks to JGTRRA and EGTRRA in 2001 and 2003. Small businesses benefited from lower capital cost as capital gains and dividend taxes

were reduced. Lower capital cost means that more small businesses can be created, as the risk premium for business start-ups decline.

Unfortunately, capital gains and marginal tax rates are scheduled to quickly increase. These higher taxes are already being calculated by many businesses as they plan for future investment and expansion. These higher tax rates will offset the smaller provisions in the stimulus bill and hinder future investment.

Small businesses are also very, very labor intensive. Unfortunately, right now wages are flatter, declining in the last quarter and work hours have been shrinking. With the minimum wage expanded to increase over ten percent, companies will have limited capability to pass on these wage increases to their employers. Historically, a minimum wage increase of this magnitude results in employment losses for small business of one percent. So I would like to urge Congress and the Committee to think about delaying the minimum wage increase until the economy is more stable. This impact will be detrimental to many small businesses who are already short staffed.

Finally, House Ways and Means Chairman Charlie Rangel announced this tax plan that establishes a surtax on many successful companies. The number of people affected by this tax increase, about 20 percent of them will have a half of their income from small business type associations in income. A tax increase of this magnitude will continue to result in job losses and slow economic growth.

I would like to thank the Committee for giving me this time. I would like to answer any questions, and if I could submit my testimony to the record.

Chairwoman VELÁZQUEZ. Without objection.

Mr. HEDERMAN. Thank you

[The prepared statement of Mr. Hederman is included in the appendix.]

Chairwoman VELÁZQUEZ. And out next witness is Mr. Paul Merski. He is the Senior Vice President and Chief Economist for the Independent Community Bankers of America. Mr. Merski has more than 25 years of government relations experience in the public and private sector. ICBA represents 5,000 community banks of all sizes and charter types throughout the United States.

Welcome.

STATEMENT OF PAUL MERSKI, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. MERSKI. Thank you, Madam Chair, Ranking Member Graves, and members of the Committee.

I am very pleased to be here to represent our 5,000 community banks nationwide.

Much Monday morning quarterbacking has been taking place with the economic stimulus package that was passed back in February. Without a doubt, the severe economic recession did require a sizable fiscal stimulus, and ICBA was pleased that in the $787 billion package many good, positive tax relief measures were included.

While the bulk of the recovery package enacted did focus on spending initiative, beneficial tax relief and reform items are having a very positive effect. Specifically, tax item we see helping the economy include the $8,000 first time home buyer tax credit, the extension of the alternative minimum tax that prevented 26 million people from being forced into paying additional AMT taxes, and there was some beneficial tax relief for municipal bonds.

Additionally, the net operating loss provisions, the immediate $250,000 small business expensing, and of course, the major SBA loan program enhancements are all helping many small businesses survive and preserve capital during this recession.

However, the difficult credit market and a depressed economy continues to weigh very heavily on our nation's small businesses. ICBA believes additional target tax actions are warranted to boost our long-term economic growth. ICBA recommends and supports a broad, five-year net operating loss carryback and extended home buyer tax credit, robust SBA lending programs, and Subchapter S tax reforms.

At a minimum during these difficult economic times, the tax burden on struggling small business owners should not be increased.

Additionally, for the stimulus measures to be successful, the unduly burdensome and overly aggressive bank exams that are taking place must be addressed. Community banks need the flexibility and the capital to support their small business customers on Main Street America.

One of the largest underlying problems preventing our economic recovery is still the housing sector. Millions of small businesses are suffering the fallout from the dramatic decline in the housing sector because 45 percent of small business loans are backed by some type of real estate collateral. Financial institutions in general have already written down over 600 billion in real estate assets, and that continues. Bank regulators are aggressively forcing even further write-downs, forcing banks to raise even more capital or cut back on their lending.

This vicious cycle in the housing sector must be stopped. The current home buyer tax credit is helping, but we recommend it boosted past November and extended to all home buyers, not just first time home buyers.

The Recovery Act did include some positive Subchapter S reforms, but more could be done there as well. More than four million small businesses are structured as S corporations, including one-third of all banks. Given today's tight capital markets, attracting capital and funds is critical. Yet the limits that are placed on Sub S corporations prevent them from raising capital.

In order to increase the ability for small businesses to raise private capital, you should increase the number of allowable Sub S shareholders, allow IRA investments in Sub S corporations, and permit Sub S corporations to issue preferred stock. Given the financial meltdown was caused by asset concentration in the largest financial conglomerates, out tax policies must preserve a diversified financial system with capital available for community banks.

ICBA supported and expanded NOL provision in the economic stimulus package, but more needs to be done there, too, and other witnesses have already suggested something we support, that is ex-

panding the net operating loss carryback which would preserve capital for businesses during this difficult recession.

Today more than half of all small business income earned in the United States is earned through pass-through entities, such as Sub S corporations that pay the individual income tax. Therefore, Congress must be extremely mindful of how increasing the income tax rates will impact small businesses.

In conclusion, the tax and SBA items passed in the Recovery Act are helping. ICBA pledges to work with the Small Business Committee to ensure our nation's small businesses have the capital they need to invest, grow, and provide jobs.

Thank you.

[The prepared statement of Mr. Merski is included in the appendix.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Merski.

Mr. Johnson, if I may, I would like to address my first question to you. There has been much discussion in the national media about the number of jobs lost since we passed the Economic Recovery Act, and you explain in your testimony that nearly 75 percent of those surveyed by your organization benefited from the tax credit for HVAC equipment. I just would like for you to comment as to where would your industry be today if that credit had not been enacted into law.

Mr. JOHNSON. Madam Chairwoman, there is no doubt that there has been a constriction in our industry in the number of jobs. There is also no doubt that it would be worse if the tax credits had not been out there to encourage homeowners to seriously consider the alternative of taking advantage of the program, the tax credit program, and moving ahead if needed equipment replacement, creating a win-win situation. It created jobs, and it saved energy at the same time, helped the homeowners cut their utility bills. So it was a win all the way around the block.

Yes, we absolutely created jobs. Within my own company as an example, we had about a ten percent layoff of staff, and it would have been much worse if we had not had the opportunity to increase business.

Chairwoman VELÁZQUEZ. Of the tax provisions that were included in the Economic Recovery package, can you tell me one or two that should either be extended or expanded?

Mr. JOHNSON. The provisions that are in there should be continued. The $1,500 tax credit, again, if you look at the total picture of where we are trying to go with this country, the things that the HVACR industry offers are not only job creation, but they are also the greenhouse gas issues that we look at and everything else. So it is wins on multiple levels. So extending the tax credits for residential applications would be a tremendous benefit.

What really needs to be looked at is doing something with commercial businesses. Commercial small businesses, commercial buildings, we actually do more work on older equipment in commercial applications than we do in residential applications because there is no incentive whatsoever, including the depreciation issues. So there really needs to be some work in that area.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Woods, one of the reasons that firms are struggling to secure financing is dwindling cash flow, and the net operating loss provision in the Recovery Act was designed to permit once profitable small businesses to offset current losses, thereby reducing the taxes owed.

Do you believe that the provision has improved the cash flow and ability to access credit?

Mr. WOODS. Madam Chairwoman, there is no question that that is a good initiative. However, as I was suggested in my testimony, in 2008, our companies were making a profit. As we go into 2009, now is when our companies are in their most desperate situation. If you can carry the provision forward to 2009 and hopefully into 2010 (because I do not think we are going to come out of this fast enough in our industry, as I mentioned, with us being first in and last out) it would be very beneficial for us.

Chairwoman VELÁZQUEZ. So you are telling us that Congress should expand it beyond 2009.

Mr. WOODS. Absolutely, absolutely. That is where the net benefit will happen.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Johnson, you mentioned how the depreciation schedules have not been updated to match the useful life of certain property. How does the failure of the tax code to reflect business operations affect your company? And can you offer real life examples of how it alters the decisions of your customers?

Mr. JOHNSON. Well, the existing tax codes for commercial customers allows a depreciation schedule on equipment of 39 years. Equipment only last 15 to 20 years. On top of that, you have got to consider that a lot of small businesses are in a lease situation. They are leasing a property to run their business out of, and the leases are uniformly written where the tenant is responsible. So he has got a short, maybe a five-year lease. If he has to replace air conditioning equipment, he has got a 39 year window to write it down in. There is no incentive to do anything but to patch together an old piece of inefficient equipment.

And so we find ourselves going out and patching equipment and continuing to keep what is effectively six and seven, eight SEER or EER equipment running as opposed to reducing the carbon footprint and reducing the utility consumption and helping the small businessman.

Chairwoman VELÁZQUEZ. Mr. McMillan or maybe Mr. Merski, because you make reference to the housing crisis and how important is the home buyer's tax credit that has proven to be an ineffective means of stimulating our economy or at least the housing economy, but its temporary nature is designed to encourage home buyers to act now.

However, there are discussions and, you, Mr. McMillan, suggested or recommended that issue be extended. The issue that I would like for you to react is that some people are saying that since there is discussion going on in Congress about extending it and maybe to increase the tax credit, that that would discourage buyers from going into the market and purchasing those homes now. How would you react to that?

Mr. MCMILLAN. Thank you, Madam Chairman.

There really are two distinct issues. We have seen instant response to the tax credit in terms of the increase in existing home sales month after month over the past four months. One unintended consequence of the discussion about future actions in Congress is that first-time home buyers anticipating those things taking place take themselves out of the market and sit on the fence and wait, and that's kind of catastrophic right now. We have an excitement back into the marketplace brought on by the tax credit. We really need to reduce our inventory at this point so that it contributes immeasurably in healing the economy.

There is discussion going on in other areas of the Congress about increasing the credit. I mentioned it here because we cannot encourage it in too many places.

Chairwoman VELÁZQUEZ. Mr. Merski, one of the requirements to be on this corporation is that it cannot have a nonresident alien as a shareholder. This means that some investors cannot invest in U.S. firms. With credit at a near standstill, does it make sense to have such a limitation on capital options?

Mr. MERSKI. Well, that is an excellent observation and question, Madam Chair. At a time when small businesses and even small community banks that are small businesses as well are trying to raise capital, the last thing we should do is have these restrictions on private sector individuals that want to invest in small businesses, and by restricting shareholder investment in a Sub S corporation, you're preventing them from attracting the capital that they need.

So you should really be looking at opportunities to take off all the restrictions on capital investment in small businesses. On the one hand, you have the federal government issuing TARP money, government taxpayer money to small businesses yet, on the other hand, restricting private investment in small businesses.

So your point is a good one, and we should take off all the restrictions that are preventing small businesses from getting shareholder investment.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Graves, I have further questions, and in the second round I will come back to other witnesses again.

Mr. GRAVES. Thank you, Madam Chair.

As I mentioned in my opening statement, I have introduced legislation to permanently extend the 2001-2003 tax cuts, and my question is to all of you, and it will start with Mr. Johnson. Do you think this is going to provide businesses with some predictability in the tax code which will allow them obviously to purchase new equipment, keep their head above water, hire more workers, whatever the case may be?

Mr. JOHNSON. There is undoubtedly a nervousness in the small business community about where are we going next. It is the whole program, but certainly there is fear about committing to spending money for anything because we do not know where we are going. We do not know what we are going to be doing a year from now. So that certainly would be a step in the right direction to help us get started.

Mr. GRAVES. Mr. McMillan?

Mr. MCMILLAN. I would echo Mr. Johnson's comments. In the world of the entrepreneur, which primarily includes most real estate practitioners, predictability is extremely important, and there is a reticence to expand and extend your resources and capabilities without that degree of predictability.

Mr. GRAVES. Mr. Merski?

Mr. MERSKI. Well, without extending the 2001 and 2003 tax cuts, you could see marginal tax rates on small business income exceeding 50 percent. The tax that you are talking about includes dividends, capital gains, the individual income tax, and as we pointed out in our testimony, half of small business income would be subject to an increase in the individual income tax if those rates would go up. So it would be very important to preserve that are on small businesses now and not have that fear that tax rates are going to go up and scare off investment in small business.

Mr. GRAVES. Mr. Woods?

Mr. WOODS. I would say it is an unequivocal yes, and I think you could look at it from two different perspectives. As somebody who used to run a Subchapter S company, I think the important word that you brought up was the predictability. I personally would make decisions of having to invest in my company, my personal money, depending on what is going on. Knowing what was going on from the tax standpoint and what I would have available for money to actually put back into my company was critical. Not understanding what might happen certainly left me at odds as to whether or not I needed to keep money on the sidelines, not knowing what would happen next or whether I can put it into my company and be more productive. So no question.

Mr. GRAVES. Mr. Hederman.

Mr. HEDERMAN. Absolutely. What we have seen in academic literature is that permanent tax cuts provide a lot more economic growth in temporary tax cuts for some of the reasons that my co-panelists have already espoused. Predictability and stability are very key for the business sector and for economic growth.

If you are looking forward to whether or not you are going to make a decision to invest perhaps, for example, in a small business start-up where the small business will expand, being able to predict what your tax rate is going to be, how much you are going to put at risk in the economy, those are important factors that go in economic growth and because investment is so far looking at one of the biggest impacts of possible expiration of these taxes is going to be to hinder investment.

Chairwoman VELÁZQUEZ. The Chair recognizes Mr. Ellsworth.

Mr. ELLSWORTH. Thank you, Madam Chair.

Mr. Merski, as you're probably aware, our offices, sometimes Congress becomes the complaint department to the United States. I get a lot of calls in my office about the unavailability of credit with everything going on, and as a representative for the bankers, they call me. People go into their banks, places they have been doing business with forever, good ratings, never defaulted on a loan. You know the whole story.

Can you go through? You mentioned some of that in your testimony, but some of the reasons, just some ABCs on why these people feel they are not able to get credit now at the banks they have

been going to for years so that I can go back and have a better idea of what to tell them when they call me? Is that a fair question to you?

Mr. MERSKI. That is an excellent question, and that is something that is a severe problem out there in the economy right now, the small business access to credit. The bottom line is that banks do not make any money and do not make any profits if they are not lending. Community banks want to lend. All banks want to lend to help those small businesses. The credit environment out there, the risk, what the regulators are doing to community banks is preventing the community banks from lending as well as they could to small business owners. Regulators want them to increase capital. Regulators are forcing write-downs on properties that shouldn't be written down. The regulatory environment is making it near impossible for banks, even banks that have capital to do lending. So banks are scared to do lending now.

Also, the tax environment. If you do not know what the tax environment is going to be like a year from now, it is difficult to lend. So anything that could be done by Congress to have more sensible regulation.

The community banks did not cause this financial crisis. This was caused by exotic products being crafted by Wall Street and the risk taken there on Wall Street, but it is having, as you point out, a tremendous impact on Main Street and the ability for small businesses to get credit.

Another point I will just say briefly is that the secondary market for small business loans and other types of credit is still frozen. So more policies need to address the secondary market so that loans that are made by financial institutions can be sold into the secondary market so they can make fresh loans.

Mr. ELLSWORTH. Thank you, Mr. Merski.

Mr. Hederman, you talked about just even today we have heard about tax credits for heating and air conditioning, for replacement windows, extending the 2001-2003 tax cuts. It seems like now Cash for Clunkers, you name it; there is a tax credit for just about everything and every industry.

Can you tell me it seems like if we simplified the tax code overall in this country, wouldn't it be easier and would we need all of the credits and different tax cuts for specifics? Can you tell me what the foundation or even your personal view on what our tax code should look like in a perfect world? It might do all of this and the tax code would not have to be, you know, two feet thick.

Mr. HEDERMAN. You make an excellent point Congressman. I mean, what we see is whenever we enact certain types of tax credits, tax subsidies, we create distortions in the tax code, which provides distortions in the economic behavior. People instead of investing in an item, they might choose to invest in Item B simply because that is being subsidized through taxpayers.

I think if we want to look back at the time period and said what was good tax policy, we cleaned up the tax code. I think we can look back to 1986 where former Chairman Dan Rostenkowski, Senator Bradley, President Reagan engaged what I think a lot of people think is one of the best public policy initiatives enacted in this town where they sat there and they said the tax code is simply too

confusing. There are too many deductions. There are too many credits. People are taking these write-offs for things they don't want to buy simply so they can pay less taxes. If we get rid of some of these taxes, some of these credits, we promote better economic behavior. We eliminate a lot of these tax distortions that you point out, and you are able to give just about everybody a tax cut by lowering the tax rates for all Americans.

Instead of trying to sit there and pick winners and losers of who deserves a tax credit, you are sitting there cutting taxes for everyone. Everybody can benefit, and that is what most economists agree will provide the most economic growth going forward, and I think that those types of reforms are going to be most important as the tax code continues to be more complicated as it has been with the addition of all the credits since 1986.

Mr. ELLSWORTH. My wife and I still do our own taxes, and I will give credit mostly to my wife who does it, but again, we are of average intelligence, but the book we go through is this thick, and it is extremely difficult to go through, and yet we still have to fund the highways, our law enforcement, our military, all the things, the services that we come to expect in this country and we deserve.

So I appreciate the input, and I think that is where we need to start moving towards a reasonable and fair tax code in this country that might solve a lot of this.

thank you, Madam Chair. I yield back.

Chairwoman VELÁZQUEZ. Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

I appreciate the opportunities this afternoon to discuss this with this panel. They have got a lot of expertise here, and I certainly appreciate your comments.

Mr. Woods, your comments are a great concern to me because I have got a lot of tool and die manufacturers in my district. They rely on the aircraft industry and the automobile industry, which is really struggling in that area. Thirty percent of them will be out of business in the next six months. That certainly gives me moment for pause.

I do not know if we can enact anything quickly enough to help those industries to get back on their feet, but I certainly appreciate your remarks this afternoon. One of the things that I want to ask is I know that Mr. Hederman has made some comments with regards to tax policy. I know we are in the process of obtaining this week some new tax proposals that would really impact the private small business guys here with regards to health insurance stuff, to be able to pay for this.

If we allow the 2001-2003 tax cuts to expire and then put on top of them additional taxes which are being proposed, we are looking at close to 65 percent tax rates for small business people who four million of the businesses are S corps which are going to pay on those income taxes. That is going to decimate in my judgment. I would like for you to address that question if you would, please.

Mr. WOODS. Sure. One of the things that always disturbs me is when I read the paper about some of the ways to pay for some of these programs, which you know, we all agree that we need to have programs. Everybody wants to have good health care. Everybody wants to have the clean environment. Everybody wants to take

care of energy independence. All of us, absolutely, but the problem is you cannot do all of those things on the backs of small business; and you need to be careful about trying to do all of those things before the end of the year as if there is some magic thing that happens at the end of the year.

Right now small businesses are in the worst situation they have been in probably 80 years, and to enact anything additional on top of that right now would be devastating. When we collected the information for the automotive task force in looking at who was going to be around and who was not going to be around, it became clear pretty quickly that the six month window was imperative. And trying to find something from the standpoint of a program that could come forward now and help them was, you know, life and death.

The thought of having something additional on top of all the problems we are already trying to sort through essentially puts these businesses into a situation where if they are going to put their last gasp of putting their home up if it was not already up or borrowing the kid's college fund to try to get through just to make it to the other side of this; if they thought on top of doing that to make it through this that they were then going to have these additional taxes on top, I think a lot more are going to throw the towel in because it is a self-defeating prophecy. They really cannot get there.

So I can tell you from my personal experience as a business owner, again, I have only been running the association for two months. My whole life I have been a business owner. It would be devastating.

Mr. LUETKEMEYER. I appreciate your position because you guys have been on both sides of the table, which gives you a very unique perspective, and I appreciate that.

Mr. Merski, very quickly, one of the things that has concerned me is that community banking folks are the ones that really are the glue that holds our economy together, I believe, from the standpoint that they make the loans to small businesses, which small businesses then hire the people and develop the products and make our country go.

So to me they are the glue that holds it together. Yet they are the ones who are struggling with a lot of the stuff that is going on, and the regulatory environment that we are in is a real problem. I have had some discussions with the FDIC and the Federal Reserve folks, and there seems to be a disconnect.

Have you in your organization or you and your organization; have you discussed with the FDIC, the Fed., the Comptroller, any of these regulatory groups to come up with some sort of a mindset on how to address these problems, how to work with the banks?

Because there is a huge disconnect right now between what is going on in the field and what is going on in D.C., and it needs to be resolved if we are ever going to get out of this mess.

Mr. MERSKI. Well, absolutely, Congressman, that is a tremendous concern throughout the community banking industry from the pressure that the regulators have swung the pendulum way too far in the other direction and are stifling the bank's ability to do lending, even banks that are well capitalized, well run, know their customers, know their small business owners and their communities.

The over-regulation, the excessive examinations are forcing bankers to pull in, and it is a very highly regulated industry where the regulator can shut you down and bankers that are in fear of these regulators are pulling in their lending, and that is a severe problem that's causing a downward spiral in the ability for small businesses to get the credit that they need.

So, yes, something needs to be done there. We have been working very well with the regulatory agencies to make sure that regulation is fair but also regulation is such that it does not stifle the ability of banks to lend.

Chairwoman VELÁZQUEZ. Would the gentleman yield for a second?

Mr. LUETKEMEYER. Yes. Thank you, Madam Chairwoman.

Chairwoman VELÁZQUEZ. I hear that there are so many regulations then, the regulatory burden on community banks and small banks, and that there are too many regulations, but on the other hand, what caused the crisis that we are in? It was the lack of oversight or too many regulations?

Mr. MERSKI. Well, there is a discrepancy in the application of regulation, where you had highly regulated, well overseen community banks where the regulators are in the bank every year examining everything that they do, and then you had a lot of gray area, non-bank lenders. You had a lot of Wall Street exotic products that were outside of the regulatory oversight. So with the financial regulation reform that is being presented now, we are trying to make sure that the unregulated sector of the financial industry is brought in under that same regulatory oversight that is given to community financial institutions.

So it was the discrepancy in the application of regulation. Many financial entities were completely unregulated or beyond the scope of what the FDIC and OCC does. So you raise an excellent point. The regulation has to be fair across the board so you do not have these gaps.

Chairwoman VELÁZQUEZ. Thank you for yielding.

Do you have any more questions?

Mr. Moore.

Mr. MOORE. Thank you, Madam Chair.

To Mr. Johnson and Mr. Woods, many economists say that it will be at least 18 months and possibly two years or longer before the United States returns to strong economic growth capable of creating a substantial number of jobs, and many of the tax provisions being discussed today are temporary. For example, the increased Section 179 expensing ends after tax year 2009. The expansion of next operating loss carry-back is good for only tax years '08 and '09, and tax break s for consumers, such as the first time home buyer credit are also limited to just this year.

In your opinion will your business or other businesses have sufficient funds to expand and grow your business should the economy begin to recover next year and are these tax changes providing you with enough of a boost not just to survive this year, but to plan for the future?

Mr. JOHNSON. You know, part of the problem, Congressman, is that our businesses are so interrelated to other businesses that it is a bigger problem than just our problem. For example, the air

conditioning industry is very tied to the housing industry. If the housing industry is doing badly, guess what. We are going to be doing poorly also, and we are seeing that. That is happening to us right now.

So as we look at how long it takes the other segments of our industries in this country to recover, we are going to have to see how long it's going to take us to recover, and we are going to be someplace behind them, getting back up to speed.

Do I think that we have enough? We]are playing it very close to the vest and trying to be as conservative as we can in our daily operating methods and what we are doing, how we are doing what we are reporting.

Mr. MOORE. Mr. Woods, do you have any comments?

Mr. WOODS. Yes. I would just mention clearly I am not an economist, and I am sure I am nowhere near as smart as my fellow panelists are on economic matters, but what I do know for sure is that we as an industry, a manufacturing industry, are not going to be coming out of this in 2009, and that is a fact. Six months ago when we first started getting into this, we might have thought that actually by 2010 it would be a good year and things would be going well again for our industry, and with the data information and clear evidence of companies that are disappearing and in deep trouble and what we see on the horizon, we doubt that to be the case in 2010.

So to answer your question, programs obviously need to be somewhat elastic to what is currently going on in the economy, but it would be safe to say that for 2009 and 2010, they will clearly need those break opportunities, and if they have losses in those years, then your programs that actually allow you to take advantage of the losses need to be then harvested or utilized as you get past 2010.

Mr. MOORE. Thanks to the panel, I yield back, Madam Chair.

Chairwoman VELÁZQUEZ. Ms. Dahlkemper.

Ms. DAHLKEMPER. Thank you. Thank you, Madam Chair.

I wanted to ask you a question since this is fresh, what we are looking at right now, in terms of the health care. This kind of relates back into taxes, but eight percent that is being proposed for small businesses to cover health care costs if they do not provide health care for their employees, I mean, I come out of a small business. My husband is still running that business, and we were talking about this payroll, eight percent of your payroll, and actually what we pay for our health care now, that actually would be a pretty good deal for us.

So I guess I just want your opinion. Mr. Woods, I have a lot of small, you know, manufacturers in my district in Pennsylvania, and, Mr. Johnson, my company is design-build. But I am just curious how that would affect those in your association.

Mr. WOODS. You actually have a fantastic region in Erie, Pennsylvania for our members. There is a number of great ones there, including our past chairman. Yes, while that may seem like one facet of that overall bill which I did not get a chance to read all 1,018 pages, there are certainly elements that may be beneficial, and I am sure there could be 300 of the 1,000 that are great pro-

grams. The eight percent by itself would certainly seem to be a nice, viable number compared to other costs.

I think the concern gets to be just any additive cost, any additive tax at this point, and the unknowns of all of the other potential costs that go along with it. So that by itself seemingly may be good if you weren't doing some other program already as a percentage of payroll.

I think the bigger issue gets to be all of the other potential costs to get associated with that as you unravel the implementation of the full program.

Ms. DAHLKEMPER. Right now, what would you say percentage-wise is your association providing health care? Do you have any idea what that is?

Mr. WOODS. I could not tell you what the number is. I can tell you that the whole time that I was in business in Rochester, New York up the throughway from your neighborhood, almost all the companies in Rochester that were in the tool and die and manufacturing industry, almost everybody I knew was in it, but I could not give you an actual statistic for our association.

I would be happy to get back to you with that.

Ms. DAHLKEMPER. I would appreciate that if you could. I am trying to get some sense on this.

Mr. Johnson.

Mr. JOHNSON. And I thank you for the question. Let me tell you that in February we had a national meeting in Fort Worth, Texas, and we had a town hall meeting at that national convention that focused on health care, and we voted in the room. There were 500 or so people probably in that room, and we voted. About 60 or 70 percent of our membership were in support of what President Obama had on the table at that time. That support has evaporated. They are taking too much money. There were suggestions being made on how to do this that did not sound nearly as expensive as what we are seeing today, and small business cannot support.

Ms. DAHLKEMPER. Can you elaborate on that a little bit about what specifics you are talking about?

Mr. JOHNSON. Well, I wish I could, and like Mr. Woods, I had not read the entire package, but the dollar amount that is attached to it and the hit that we are going to take for it are not proper or correct.

We provide insurance at my company. We provide insurance for our employees. We pay a great deal of the cost ourselves, and we want to continue that program, but I think within our industry we recognized there was some need for reform nationally, and there are things that need to be done.

But the dollar amount that is being put on the package is going to hurt small business tremendously, and the support that we showed in February is not there today.

Ms. DAHLKEMPER. Mr. McMillan, did you want to comment?

Mr. MCMILLAN. I would. Thank you, ma'am.

Even though you did not direct the question at me, there is a crisis in health care in the Realtor family. We have 1.1 million Realtors, and health care is not available to us, period, as a small business structure. We have more than 300,000 Realtors who have no

access to health care at all. When we couple that with the average age being around between 50 to 52, it is a high risk problem.

The other Realtors who do have health care have it through a spouse being employed in another industry. So thank you for letting me contribute that.

Ms. DAHLKEMPER. Thank you. I yield back.

Chairwoman VELÁZQUEZ. Mr. Graves, do you have any other questions?

Okay. I do have a question for Mr. Johnson. Based on the fair question that Ms. Dahlkemper approached before, and that is what percentage of your payroll represents the health care insurance that you provide to your workers?

Mr. JOHNSON. What percentage do we pay?

Chairwoman VELÁZQUEZ. Yes.

Mr. JOHNSON. I believe that we pay 80 percent. I would have to go back and check, but we pay about 80 percent of the premiums for the employees.

Chairwoman VELÁZQUEZ. And that represents what percentage of your entire payroll or your expenses?

Mr. JOHNSON. I am sorry. I do not know exactly the answer to that. It is probably two percent, a pretty small number.

Chairwoman VELÁZQUEZ. Okay. Mr. McMillan, FHA approved lenders recently approved a bridge loan program that allows first time buyers to use their federal tax credit to cover closing costs or a downpayment. Have you seen more taxpayers taking advantage of this program to get more people into homes?

Mr. MCMILLAN. Madam Chairman, there is a pent up demand for this, and we are grateful that FHA permitted that, but there are only 11 states that have the capability to offer the FHA program, and they do so by having a nonprofit housing entity at the state level that is a pass-through similar to one of the taxing entities. When you file your taxes, you can get a bridge loan at closing.

In the other states, the National Association of Realtors has tried to provide information to members so that those who do not have that state program, can create similar programs in their states, but it is an excellent program. There is great demand throughout the nation for money tied to the tax credit at closing as opposed to waiting to file, but it is not available in all states.

Chairwoman VELÁZQUEZ. Great. Right now the credit is $8,000. Is there a number that you propose that will help the housing market?

Mr. MCMILLAN. Madam Chair, any increase to the $8,000 will be helpful. The numbers that I have seen thrown out there is almost a doubling, an increase to $15,000. We think it would be awfully helpful if the tax credit could be extended beyond being available only to first time home buyers, to all home buyers because there is a tremendous amount of inventory that must be absorbed before we can get back on track.

Chairwoman VELÁZQUEZ. Okay. Do any of the members here have any other questions to the witnesses?

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Just a quick question. Mr. McMillan, your group does not have a group health policy that all of your membership could participate in?

Mr. MCMILLAN. Congressman, we do not. My limited understanding of that is the type of organization that we have, we are prohibited from having such. I do not understand the complexities of the insurance industry, but there are groups, small businesses of our size who are involved with unions who certainly could have health care with shops of four to five, 20 people, but we do not qualify under that.

Mr. LUETKEMEYER. Well, my thought process was that there are a lot of proposals out there, but one is to allow small businesses to be able to pool together, and I think your group is a perfect group to look at from the standpoint that you could pull together as a state or as a total organization or as a region to be able to find a way to provide that kind of coverage for your group and be able then to find a way to lower your cost.

So I appreciate your comments.

That is all I have, Madam Chairman.

Mr. MCMILLAN. Thank you, sir.

Chairwoman VELÁZQUEZ. Thank you very much.

And we will continue to have discussions regarding the tax provisions in the stimulus package since there are discussions about extending or expanding some of those tax credits and have discussion with the Ways and Means Committee to share with them our concerns regarding those provisions that are having a positive impact on small businesses.

With that, I just want to take this opportunity to really thank all of you for coming before our Committee today, and I ask unanimous consent that members will have five days to submit a statement and supporting materials for the record.

Without objection, so ordered.

This hearing is now adjourned.

Thank you.

[Whereupon, at 2:20 p.m., the Committee meeting was concluded.]

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

SAM GRAVES, MISSOURI
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 Velazquez, Chairwoman
House Committee on Small Business
"Economic Recovery: Tax Stimulus Items that Benefitted Small Businesses with a Look Ahead"
Wednesday, July 15, 2009

This past February, Congress approved landmark legislation to revive our struggling economy. In passing the American Recovery and Reinvestment Act, Congress laid the groundwork for long-term, sustainable growth. That bill contained several small business provisions, and I'm pleased to say many of them are already working for our entrepreneurs.

Six months after the Recovery Act was signed into law, the clouds are starting to clear. To begin, lending from the SBA is up dramatically. As of June, the agency had supported $6 billion in loans. Just as importantly, small business credit markets are coming back to life. Loan volumes in the secondary market jumped from under $100 million in December to $360 million last month. So things are looking up. Still, small firms continue to face challenges in accessing capital, and it would be wrong to say we are out of the woods just yet.

While we are still only *one quarter* of the way into a sweeping *two-year* plan, this is a good time to stop and check our bearings.

Today, we are going to evaluate the progress made thus far. Witnesses and committee Members will discuss the Recovery Act's small business tax provisions. In doing so, we can hopefully pinpoint where we've made headway, and identify areas in which there are still strides to be made.

Regardless of the economic climate, tax policy is a critical tool for growth. So in drafting the Recovery Act, it only made sense to include relief for entrepreneurs. Already, provisions for increased expensing limits and bonus depreciation are helping small firms expand. They are also creating new avenues for growth.

Some of the most important provisions in the Recovery Act are those that invest in new industries. Small firms are already leading the Green Revolution. Increases in clean energy tax credits are helping that process along, and generating tremendous opportunity for small firms. In a recent survey by the Air Conditioning Contractors of America, 75% of respondents said they had seen improved sales. Because the efficiency sector is dominated by entrepreneurs, good news for *green* businesses is good news for *small* businesses.

---more---

Clearly, we've come a long way since February. The Recovery Act is not just growing new industries like renewable energy. It is also reinvesting in old ones, like construction and manufacturing. In May, orders for manufactured goods--the kind that the Recovery Act lets firms depreciate--shot up $2.8 billion. Meanwhile, entrepreneurs in the construction business stand to win billions of dollars in infrastructure contracts. That is thanks largely to the Recovery Act's Build America bonds. As of early June, those tax-exempt bonds had helped finance $12 billion in new projects.

I think we can all agree that these are promising bright spots. But signs of recovery should not be cause for complacency. In seeing the recovery process through, we will need to be patient. And we will need to be sure all options are on the table. In terms of successful provisions, it may make sense to consider increases or extensions. At the same time, there are a number of suggested measures that hold very real potential, and are worth a second look.

In moving forward, it is important to remember one thing--these are exceptional times. They cannot be met with apprehension. They cannot be addressed with inaction. We need to confront them head on, with innovative solutions. That's why it is so important that our policies invest in small firms. They are the ones offering fresh solutions, and they are the ones leading the way back to prosperity.

# # #

U.S. HOUSE OF REPRESENTATIVES

SMALL BUSINESS COMMITTEE REPUBLICANS

REPRESENTATIVE SAM GRAVES, RANKING MEMBER

Statement of Ranking Member Sam Graves
House Committee on Small Business
Hearing: "Economic Recovery: Tax Stimulus Items that Benefitted Small Business with a Look Ahead"
July 15, 2009

Madam Chairwoman, thank you for calling this hearing today on our nation's economic recovery, and the tax provisions in the stimulus. Welcome to all of our witnesses, who have come to share their testimony. We are all concerned about the economy. But small firms, with thin margins and a lack of capital, are particularly struggling.

The stimulus was signed into law on February 17, 2009, with pledges of job creation and help for small businesses. Although the overall package's hefty price tag was $800 billion, only a fraction – less than 1% -- of it was devoted to helping small businesses recover. Unfortunately, the promised jobs have not been created, and the economic recovery has not materialized.

Instead, the June national unemployment rate was 9.5%, the worst in 26 years. We are told that it could rise to 10% in the coming months, despite promises in January that it would not top 8% if the stimulus became law. The May unemployment rate in Missouri was 9%, the highest on record, and it is even higher in some states.

All of the spending in the stimulus has consequences. According to the nonpartisan Congressional Budget Office, the federal deficit will reach a staggering $1.8 trillion in 2009 and $9.1 trillion by 2019, increasing the national debt to 82% of GDP.

We must do better. America's small businesses need our help to create jobs and turn this economy around. Unfortunately, the stimulus' tax provisions are simply operating at the edges of the economy. Although the stimulus' tax provisions can be helpful, the

broader, longer-term answer to small business' economic recovery is income tax rate reductions. In addition, small companies need predictability in the tax code. We need to extend tax relief for more than a single year, so these firms can budget and plan for investment.

Small businesses need to keep more of what they earn. Tax rate reductions would help them to invest in their companies, so they can expand, hire workers and get our economy moving again. Any new taxes to pay for health care reform -- such as the proposed surtax on those with incomes over $280,000 -- will devastate the many small business owners who pay business taxes on their individual returns.

I support temporary tax relief. But we need to go further. Making the 2001 and 2003 tax benefits permanent would give small firms the confidence to purchase new equipment and hire more workers. That's why I introduced legislation to permanently extend the 2001 and 2003 provisions. I hope Congress will act to provide this predictability for our nation's businesses.

Again, Madam Chairwoman, thank you for calling this important hearing today. I look forward to the testimony and our discussion.

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Written Testimony of

Stan Johnson, Jr.

President,

Stan's Heating and Air Conditioning.

Austin, Texas

On Behalf of the

Air Conditioning Contractors of America (ACCA)

Submitted To the House Small Business Committee

Full Committee Hearing on

"Economic Recovery: Tax Stimulus Items That Benefited Small Business with a Look Ahead"

2360 Rayburn House Office Building
July 15, 2009

Chairwoman Velazquez, Ranking Member Graves and members of the Small Business Committee, thank you for the opportunity to provide testimony on behalf of the small business service contractors that make up the heating, ventilation, air conditioning, and refrigeration industry.

My name is Stan Johnson, Jr., and I am the President of Stan's Heating and Air Conditioning, a heating, cooling, and indoor air quality service company located in the Austin, Texas, metro area. My company has been serving residential and commercial customers for more than 55 years. We have grown from humble beginnings and we now employ more than 40 workers.

This afternoon I come before you as the Chairman of the Board of the Air Conditioning Contractors of America (ACCA). Every day, more than 4,000 ACCA member companies across the nation help homeowners, small business owners, and building managers realize the comfort, convenience, and cost benefits of energy efficient HVACR equipment. Eighty-one percent of ACCA's member companies have less than 50 employees, and 50% have less than 20 employees.

My comments today will focus on how some of the energy tax incentives passed as part of the stimulus bill (American Recovery and Reinvestment Act of 2009, Public Law 111-5) have impacted ACCA's members and their residential and commercial customers. I hope that my testimony today will inform future policy decisions that further assist small businesses in these trying economic times.

Tax Credits Work

ACCA believes that tax credits are the best way to encourage homeowners and building owners to reach for and obtain higher efficiency HVAC equipment. Replacing or installing a new furnace, boiler, central air conditioner, or heat pump can be an expensive investment in a home or building. Tax credits help soften the initial costs and shorten the payback period. I can affirm that many, but not all, of ACCA's member companies have seen the positive benefits of the residential tax credits working since the passage of the stimulus bill.

Energy Use and Efficiency Possibilities

Increased efficiency is the low hanging fruit in the effort to reduce energy consumption, lower greenhouse gas emissions, and stimulate the economy. According to the Department of Energy's 2005 Buildings Energy Databook and the Energy Information Administration, residential buildings account for 22% of all US energy consumption. Of that, 30.7% goes toward space heating and 12.3% goes toward space cooling, with another 12.2% going toward water heating. Commercial buildings account another 18% of total US energy consumption. Within those buildings, 14.2% of the energy consumed goes toward space heating, 13.1% goes toward space cooling, and 6% goes toward ventilation.

All told, nearly $142 billion was spent nationally in 2005 on space heating and cooling for both residential and commercial buildings combined.

Now consider that according to the 2005 Residential Energy Consumption Survey, 39% of the residential central air conditioners and 60% of residential heating equipment were more than 10 years old. Since 1990, only 30% of commercial buildings have had their main heating equipment replaced, and only 37% have had their main cooling equipment replaced.

In the last fifteen years, the efficiencies for central air conditioners, heat pumps, and furnaces have increased tremendously, both through mandatory minimum regulations and research and development by equipment manufacturers. In some cases, when a homeowner replaces their old equipment, they can expect to double or even triple their efficiency ratings. While higher efficiency HVAC equipment can be more expensive to purchase and install, it does result in lower utility bills, healthier indoor air quality, less energy consumption, and fewer emitted greenhouse gases. Many homeowners see a payback on their investment in as little as five years.

Residential Tax Credits history
In an effort to drive new equipment installations, the Energy Policy Act of 2005 (Public Law 109-58) created residential energy tax credits under Section 25C of the Internal Revenue Code for taxpayers who made qualified home improvements to their primary residence in 2006 and 2007. Qualified improvements included energy efficient furnaces and boilers, central air conditioners, heat pumps, ceiling fans, windows and doors, roofing shingles, and insulation. A taxpayer was limited to $500 in lifetime claims and the tax credits were capped by improvement type. For example, a qualified furnace was worth a maximum $150 in tax credits, while a qualified central air conditioner, heat pump, or hot water heater was worth a maximum $300 in tax credits.

As a testament to the tax credits effectiveness, according to the Internal Revenue Service, in 2006, 1,674,696 US taxpayers filed Form 5695 to claim the tax credits for HVAC equipment. Figures have not yet been released for 2007.

The Emergency Economic Security Act of 2008 (Public Law 110-343) (EESA) extended the residential energy tax credits under Section 25C for the year 2009 (skipping 2008).

The Stimulus Bill
Section 1121 of the American Recovery and Reinvestment Act of 2009 (Public Law 111-5), also known as the stimulus bill, included several important changes and modifications to Section 25C. First, taxpayers can now claim 30% of the installed costs of qualified improvements with a maximum allowable credit of $1,500. Second, the lifetime cap of $500 was rescinded, allowing taxpayers who may have already claimed credits in 2006 or 2007 to "wipe the slate clean" and claim more credits. Third, the stimulus bill extended the term of the tax credit until December 31, 2010.

Stimulus Benefits
In a survey of the ACCA membership that was conducted three months after the stimulus bill passed, 50% of ACCA member companies saw a small increase and 25% saw a "significant" increase in the sales of qualified high efficiency HVAC equipment.

One ACCA member commented that "without the $1500 tax credit, we would have had massive temporary and some permanent layoffs. Instead, we have been able to keep steady work during a traditionally slow time."

Another member recently commented that in the first five months the credits provided a big boost to their sales, leading to a 20% increase in replacements over the last year.

The stimulus bill's impact has been felt in both the heating and cooling markets. An ACCA member from a northern state has seen a doubling of the purchase of qualified furnaces. Another northern state contractors said that his customers "are replacing functioning furnaces in order to take advantage of the tax credits and get a more efficient unit."

Indeed, the higher value tax credits are helping homeowners elect to replace equipment that may be in need of repair, reversing a three year trend in the industry.

Still another ACCA member said, "we have been going flat out since the first two warm days in April. We are having a year more like 2007 (our best) than 2008 when we were off 15% gross sales. We find ourselves replacing a lot of units that are still working - but the customer sees this period as a time to go ahead and make the switch.

Geothermal Systems
Section 1122 of the stimulus bill also made substantial changes to Section 25D of the tax code that deals with residential energy efficient properties such as geothermal heat pumps, solar and wind power generators, and fuel cell technologies.

Geothermal heat pump systems require a higher initial investment costs but run with dramatically lower operating costs. In some cases, the installation costs can exceed $100,000.

Under the old Section 25D of the tax code, a homeowner who installed a qualified geothermal heat pump could claim a maximum tax credit of $2,000. The stimulus bill increased the value of the tax credit to 30% of the installed costs *with no cap*. A taxpayer who incurs $50,000 in installation costs could claim a tax credit worth $15,000.

The interest in and sales of geothermal equipment has also seen a tremendous spike. According to comments from ACCA members, "the boost to the geothermal systems have hit a home run." My own company has seen geothermal go from 0% of business in June 2008 to over 30% of business in June 2009.

The Unintended Consequences
But the gains as a result of the tax code changes in the stimulus bill have not been without unintended consequences. One other significant change to Section 25C in the stimulus bill also made changes to the qualifying criteria for some of the residential HVAC equipment. For example, the stimulus bill lowered the minimum energy efficiency standard for boilers and heat pumps to help more homeowners take advantage of the tax credits. Unfortunately, the minimum energy efficiency standard for central air

conditioners and hot water heaters increased, pushing this equipment farther away from many taxpayers.

For central air conditioners, the minimum qualifying energy efficiency rating increased from 15 SEER and 12.5 EER to 16 SEER and 13 EER. SEER and EER are measures of energy efficiency, similar to miles per gallon in an automobile. This seemingly slight uptick has had unintended negative consequences for homeowners and the HVAC industry.

Some homeowners cannot justify the higher costs of a 16 SEER / 13 EER system, even with the tax credits. At the same time, many larger systems cannot meet the new 16 SEER/13 EER minimum standard, all but disqualifying them from the tax credits.

Next steps – Commercial Incentives
One glaring omission in the stimulus bill was an incentive for commercial buildings owners to take advantage of higher efficiency equipment. Commercial building owners and small businesses need the same type of incentives that residential homeowners are enjoying. As Congress contemplates next steps to address recovery, it should consider providing some of the following options.

Accelerated Depreciation
Under current tax law, commercial HVACR equipment may only be depreciated over 39 years. But because the expected lifespan of properly maintained HVACR equipment is only 15 to 20 years, commercial building owners have little or no incentive to upgrade to newer, more energy efficient HVACR equipment.

ACCA supports the passage of HR 2198, introduced by Representatives Melissa Bean and Peter Hoekstra, to correct this disparity and reduce the holding period to a more realistic 20 years for HVACR equipment that is 10% more efficient than the federal minimum standards and a 25 year schedule for all other HVACR equipment.

In addition to providing a more realistic depreciation schedule, HR 2198 promotes economic stimulus and energy conservation. This important legislation would uncork domestic job creation at the manufacturing, distribution, and contractor segments in the emerging green market economy. Providing a financial incentive to building owners now would encourage them to upgrade to more energy efficient equipment instead of waiting until their outdated equipment breaks down beyond repair, which is the current practice today.

Increasing the Commercial Building Tax Deduction
While the current Commercial Building Tax Deduction (Section 179 of the Internal Revenue Code) allows commercial buildings owners to claim up to $1.80 per square for qualified improvements to a buildings overall performance, it is still out of reach to most small businesses. ACCA supports efforts to increase this incentive to at least $3.00 per square foot. Increasing the amount would give building owners a real incentive to make energy efficiency improvements and take advantage of the incentive.

Residential equipment in a commercial setting

Still another option would be to extend the residential tax credits to qualified small businesses. Many small businesses, from professional offices located in townhouses to small shopping centers, utilize the same HVAC equipment found in residential homes. But because this equipment is installed in a commercial property it cannot qualify for the tax credit.

Consumer Credit

Finally, I want to touch on one issue that has impacted the entire small business economy – access to credit. The tightening credit markets have hit both the small business members of ACCA and their residential and commercial customers. Many homeowners use short term credit to finance new HVAC equipment. More and more consumers are finding it harder to get financing, or financing on good terms, to pay for these energy efficiency improvements. Congress needs to closely monitor this situation and be prepared to address it should things get worse.

ACCA and its industry partners foresee a wealth of *job creation and economic development* opportunities from the burgeoning "green movement". The majority of residential and commercial HVAC equipment sold in the United States is manufactured and warehoused in the United States. And the installation jobs held by contractors cannot be exported.

The potential for America's small businesses and the HVACR contractors that service those small businesses, for job creation, economic growth, and environmental protection are limitless.

With that I will conclude my comments and would be happy to answer any questions you may have. Thank you again for this opportunity to testify before you.

HOUSE COMMITTEE ON SMALL BUSINESS

Economic Recovery:

Tax Stimulus Items that Benefitted Small Business and a Look Ahead

July 15, 2009

Madame Chairman and Members of the Committee. I am Charles McMillan, 2009 President of the National Association of Realtors. I am a real estate broker from Dallas, Texas. I am here to testify on behalf of more than 1.1 million REALTORS® who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others who are engaged in all aspects of the real estate industry. Members belong to one or more of some 1,400 local associations/boards and 54 state and territory associations of REALTORS.

The NATIONAL ASSOCIATION OF REALTORS deeply appreciates Congress's efforts in seeking solutions to the housing crisis that has had such a negative impact on the economy since 2007. Not only did the 2009 stimulus legislation contain helpful relief, but other tax bills in enacted in 2007 and 2008 also included provisions that all contribute to the stabilization of housing markets. Those 2007 and 2008 provisions were also refined and/or extended in the 2009 stimulus bill, so let me enumerate the helpful things that Congress has done.

Mortgage Cancellation Relief

Until Congress changed the law in 2007, homeowners who sold their houses for less than they owed on the mortgage found that they actually had to pay tax on their loss. Under the rules in effect until 2007, when a lender forgave any portion of a mortgage debt, the amount forgiven was treated as ordinary income to the seller and taxed at ordinary rates. So, at the time of sale, these unfortunate borrowers suffered what, for most, would have been the biggest economic loss of a lifetime, left the settlement with no cash at all and then had to pay additional taxes. Fortunately, until 2007 very few homeowners experienced this sad outcome.

Over the past thirty years, some housing markets have experienced downturns. These occurred in the early 1980's (Texas and Oklahoma), late 80's (the Northeast), the early 1990's (Los Angeles). These downturns were always highly localized and were the result of downturns in particular industries. When those local industries stabilized, housing rebounded quickly. The experience of a national downturn such as we have experienced in the past three years, however, has been unknown since the Great Depression.

In 2007, Congress enacted a relief provision so that when a person sold his/her principal residence for less than the amount of the outstanding mortgage balance, any amount that the lender forgave would NOT be treated as taxable income, so there would be no tax burden. Chairman Rangel and his staff were very helpful in crafting a very workable rule that nonetheless maintained adequate anti-abuse rules. Homeowners receive no relief for any cash-out refinancing or for home equity lines of credit. We are satisfied that this is a fair result.

The 2007 relief provision was originally slated to be in effect from January 1, 2007 through December 31, 2009. When it became apparent that the housing crisis would persist beyond 2009, Congress used stimulus legislation to extend the provision through December 31, 2012.

This provision has proven invaluable to sellers and has eliminated at least one obstacle to the time-consuming burden of completing a short sale (one in which there are insufficient funds to pay off existing mortgages). Sellers in short sales are relieved of the challenge of figuring out how to pay taxes on the phantom income generated by the forgiven debt. While we believe this relief should be a permanent provision in the Code, we recognize the difficulties Congress has in scoring and paying for tax law changes. We are pleased that it will be in effect for an additional three years.

First-time Homebuyer Tax Credit

Early in 2008, within weeks of the enactment of the mortgage cancellation debt relief, it was apparent that the housing crisis would deepen. At that time, a group of about fifteen of NAR's opinion leaders met to review several ideas for shoring up the housing market, establishing a floor for falling prices and clearing an overhang of excess inventory of homes for sale. The group discussed a variety of possibilities, including special above-the-line deductions for mortgage interest and/or property taxes, expansion of mortgage revenue bond eligibility, investor incentives (including suspension or relaxation of the passive loss rules) and tax credits for the purchase of a home.

The group agreed that the most immediate bump would come from creating a tax credit for purchasers of a principal residence. An optimal credit could be monetized so that purchasers could, in effect, apply the credit toward a downpayment and closing costs. An optimal credit would be refundable so that overpayments of tax could actually generate some funds for improvements when the purchase was complete. An optimal credit would also be a fairly significant amount of money, perhaps as much as the $15,000 proposed by Senator Johnny Isakson in early 2008. In all events, a credit should be sufficiently generous that it would be perceived as a genuine incentive.

The group recognized, as well, that a credit limited to first-time purchasers would provide the best mechanism for clearing over-abundant inventory of homes for sale. At the same time, the group also believed that a credit available to all purchasers would generate more transactions and thus enhance the perception that markets were active. In the end, the 2008 version of the tax credit was a $7500 refundable credit limited to first-time purchasers of a principal residence, scheduled to be effective between April 2008 and June 30, 2009. The credit was finally enacted July 30, 2008. Thus, much of the active summer buying and selling season had passed. Regrettably, Congress was unable to devise a workable mechanism that would allow lenders to monetize the credit in advance of purchase. (We note that at least 15 state housing

agencies have devised programs that enable purchasers to monetize the credit. We salute their efforts.)

The 2008 credit was part of a "paid-for" tax bill. NAR accepted that reality and agreed to the pay-for provisions that were drawn from the housing industry. (These included the repayment feature of the credit and a limitation on the $500,000 capital gains exclusion for individuals who converted a vacation home or rental property to a principal residence and then later sold the converted home.) One flaw in those pay-fors was evident even before the credit was enacted.

The 2008 $7500 tax credit included a requirement that the credit amount be repaid, starting with the 2010 tax returns that would come due in 2011. Thus, what was created as an incentive was, in reality, simply an interest-free loan. Accordingly, homebuyers did not embrace the credit as eagerly as we would have hoped. Our members reported that prospective purchasers perceived the credit as a debt.

First-time homebuyers are, by definition, less familiar with the day-to-day or month-to-month financial flows inherent in homeownership. Our members found that potential buyers simply did not want to incur a 30-year mortgage and an additional 15-year, $500 annual debt load. Uncertainty about the 15-year repayment requirement was exacerbated by the fact that no one, including the IRS, could describe the mechanics for making the annual payments. To date, no guidance has been issued to clarify the compliance mechanisms for the repayment.

By the end of 2008, financial markets and, to a lesser extent, the housing market were in free-fall. Thus, the tax provision in the 2009 stimulus that most directly assisted the housing market and real estate business operations was an increase and an extension of the $7500 tax credit. The 2009 stimulus increased the amount of the credit to $8000, retained its refundable feature and extended the duration of the credit from June 30, 2009 to December 1, 2009. The extension of the duration of the credit was especially helpful, as it includes the more active summer and fall sales periods.

Notably, the 2009 version of the tax credit does NOT include any repayment requirement. Consequently, our members consider ongoing requirement to repay the 2008 repayment as particularly unfair. Some have even called it a bait and switch. Certainly it is an anomalous result to leave 2008 purchasers saddled with repayments while 2009 buyers receive a larger tax credit that is not repaid. While Realtors and consumers understand that everyone who qualified for the credit in 2008 knew the rules, they still view the repayment of the 2008 credit as unfair.

We also question the merits of the repayment from the perspective of sound tax administration. We do not believe it is in the best interest of either those who used the credit or of the IRS to maintain a 15-year repayment and/or recapture program for a provision that was in effect for only eight months. We ask that Congress consider eliminating the repayment requirement for 2008 purchasers.

Realtor anecdotes indicate that the 2009 tax credit has been widely embraced. Also, our staff continues to receive many calls seeking clarification of various applications of the credit and our website devoted to the credit continues to receive a steady volume of hits. We are unable to either make a guess or to report any official data, however, about how many individuals and families have *actually* used either the 2008 or the 2009 tax credit. The only source of this information will be the IRS.

The credit for both 2008 and 2009 purchases is claimed on a 2008 tax return (or is yet to be claimed on either an amended 2008 return or a 2009 return filed in 2010). Thus, only the IRS will have accurate data specifying how many taxpayers took advantage of this important provision. Not surprisingly, the IRS has not yet compiled even preliminary 2008 data on the credit, as those returns are still being filed. Additional amended 2008 returns claiming the credit will be filed throughout the year, and some 2009 purchasers will opt to claim the credit

on their 2009 returns. Thus, no official information on credit utilization is likely to become available until late in the year or even some time next year.

We can tell you some things about the performance of the market, however. Historically, between 35 and 40 percent of the home sales in any particular year are purchases by first-time homebuyers. During the first quarter of 2009, however, *more than half* of the purchases in 134 of the 152 metropolitan markets we track were made by first-time buyers. Moreover, the gradual but steady uptick of existing home sales between March and June of this year suggest a direct correlation between enactment of the stimulus and awareness and utilization of the tax credit. Our Research Department is working to compile additional information about first-time buyers, and we will be pleased to share those profiles with you as we gather information.

We also point out that the borrowing patterns of these purchasers suggest a greater likelihood of market stability going forward. In 2006, 71% of all mortgages were fixed-rate instruments. By 2008, this portion had climbed to 91%. During 2006, 23% of borrowers had some form of adjustable rate mortgage. (Much of the so-called subprime crisis arose because of ill-advised adjustable rate mortgages.) In 2008, only 6% of mortgages carried adjustable rates. In addition, most lenders are again requiring downpayments. Even the FHA program now requires a 3.5% downpayment. During the boom the FHA had products available that required no downpayment whatever. We believe, again based on anecdotes, that some lenders have returned to the long-ago standard of requiring downpayments closer to 10% to 20%. All this suggests a commitment from both borrowers and lenders for greater stability and accountability in home purchases.

Ground zero of the housing crisis has been in Nevada, California, Arizona and Florida. We note that these are the very markets that experienced the greatest increase in transaction volumes in the past quarter, though prices have remained low. This increased activity suggests that consumers perceive that prices have stabilized and that it's a good time to buy real estate. Certainly there is more entry-level housing available right now than there has been for more

than a decade. That's not good news for sellers, but it certainly has enhanced the first-time buyer market. NAR's Chief Economist has noted that today's market is really two separate markets – one in which purchases of foreclosures and short sales dominate, and a second, more traditional market, where prices and performance have been more stable.

With respect to prices, we emphasize, as we have throughout this ordeal, that market performance depends completely on where you live and the manner in which your community experienced the 2003 – 2006 boom. Nonetheless, the numbers tell a harsh story. Compared with a year ago, the median price of an existing home across the nation has declined nearly 17%. Compared to 2006, the decline in prices for existing homes is 22% nationally. The following chart shows regional declines between the May 2008 and May 2009 as well as declines between May 2006 and May 2009.

Declines in Median Price of Homes – National, Regional

Time Period	U.S. Median Decline	Northeast Decline	Midwest Decline	South Decline	West Decline
May 2008 – May 2009	16.8%	12.5%	10.4%	9.9%	30.6%
May 2006 – May 2009	22%	10%	13%	14.3%	42.3%

Note that median prices are significantly and unduly depressed because many buyers, including investors, have sought deeply discounted distressed sales – foreclosures and short sales. These below-market transactions accounted for nearly half of all transactions in the first quarter of this year. This weighed down median prices, sometimes to the point that homes were sold for less than it would cost to construct a similar replacement property.

We should point out that in the fall, as we approach the scheduled December 1 expiration of the homebuyer tax credit, more and more consumers will be hard-pressed to complete their

transactions, particularly if they are trying to purchase a home out of foreclosure or in a short sale. Short sales transactions in particular take a very long time to close because the lenders involved are understaffed and also slow to make decisions. It would be a shame if individuals who entered into timely contracts to purchase in good faith, anticipating the benefit of the tax credit, were barred because they were unable to close their transactions because the lenders in short sales or foreclosures failed to act in a timely manner.

To avoid this problem and to continue to move the housing market forward, NAR urges that Congress extend the tax credit's December 1 expiration date through next year. An optimal tax credit provision would eliminate the repayment requirement for 2008 credits, extend the credit through 2010. Many Realtors also support increasing the amount of the credit to something between $10,000 and $15,000 and making the credit available to all purchasers.

Special Property Tax Deduction for Non-itemizers

The 2008 housing legislation that created the homebuyer tax credit also included a provision that allowed taxpayers who do not itemize deductions to take a special deduction for property taxes of up to $500 ($1000 on a joint return) paid in 2008. This provision was extended to include 2009 property tax deductions in the Emergency Economic Stabilization Act enacted in October 2008.

While we have some general policy concerns about the advisability of blurring the distinction between itemizers and non-itemizers, we do acknowledge that this special deduction was in fact a tax cut that likely put additional money in the pockets of homeowners at a time of great economic disruption. Certainly tax cuts of any type were welcome in late 2008 and will remain important to homeowners whose homes have or will continue to lose value during 2009.

Nonetheless, we are hopeful that the tax-writing committees will not adopt additional provisions that blur the boundaries between itemizing deductions and using the standard

deduction without a careful review. The standard deduction is an important simplification mechanism that benefits all taxpayers. A provision like this special property tax deduction adds complexity. Additional complexity is always an undesirable result.

Looking Ahead

One provision of the stimulus legislation was not specifically a tax rule, but could be clarified if the Small Business Administration (SBA) incorporated a tax-based definition as it implements stimulus provisions within its jurisdiction. The stimulus provided fee waivers for some of its programs and also created some new loan programs. However, the SBA's general policy often deems independent contractors ineligible for its programs. Their justification is that most independent contractors are not subject to adequate affiliation and control and are not of adequate size to assure that they are in fact going concerns.

Real estate sales agents, however, follow a business model that addresses the concerns of affiliation and control. Internal Revenue Code Section 3508 allows broker/owners to treat their sales agents as independent contractors so long as the agent (a) has a valid real estate license, (b) has a written contract with the broker/owner that stipulates the independent contractor arrangement and (c) is compensated solely on a commission basis and not on the basis of hours worked. This business model is standard practice throughout the real estate sales industry. Section 3508 has been in effect since 1983. Compliance with its standards is high, and NAR provides periodic reminders to broker/owners to be sure that they have written agreements in place with their agents.

Accordingly, we believe that the SBA should make it clear that independent contractor real estate sales agents who have complied with Internal Revenue Code Section 3508 are eligible for SBA loans. Real estate sales agents are affiliated with brokerages and have great autonomy, but must nonetheless satisfy certain quality standards that the broker/owner might impose. Real estate sales agents need capital for their businesses. Even though they are not responsible

for providing bricks and mortar for a business, they must still provide much or all of their electronic equipment (cell phones, pagers, GPS and similar voice and text devices) and office equipment that might include copiers, scanners, fax machines and similar devices. Every real estate sales agent must have a car (or sometimes two) in order to show property to their clients. Accordingly, sales agents' capital requirements are genuine and can be quite substantial expenses, particularly when business is slow.

We believe that it is in the best interest of the SBA in administering its programs consistently across the US to provide explicit guidance that real estate sales agents who satisfy the requirements of Code Section 3508 will be eligible for SBA loans. In terms of affiliation and control, the relationship of a sales agent to the broker/owner is analogous to the relationship between a franchisor and franchisee. Franchisees are eligible for SBA loans. We believe that the sales agent/broker relationship is simply a smaller scale version of the franchisor/franchisee relationship.

NAR is surveying its membership to learn more about their experiences with the SBA and SBA loan programs. We will be pleased to share our findings when our survey work is complete.

Conclusion

NAR appreciates this opportunity to provide comments about the stimulus package. Congress has been responsive and creative in seeking tax solutions and in enhancing FHA and other federal housing programs.

Historically, housing has led the country into every recovery following a recession. Certainly this recession will be no exception. In fact, our view, shared by many, is that this recession *cannot* end until housing markets recover. The most effective action in Congress would be an extension of the homebuyer tax credit through 2010. This is our highest priority with respect to the tax credit. In the interest of fairness to consumers and in the furtherance of better tax

administration, we also urge Congress to eliminate the credit repayment requirement for purchasers who bought in 2008 and utilized the $7500 tax credit. Other changes, including increasing the amount of the credit and/or expanding the universe of eligible purchasers would be useful enhancements, as well.

NAR collects and analyses extensive data about the performance of the housing market. We would be pleased to answer questions that the Committee might have.

Testimony of

R. Michael S. Menzies, Sr.
President and CEO, Easton Bank and Trust Company
Easton, Maryland

On behalf of the
Independent Community Bankers of America

Before the

United States House of Representatives
Committee on Small Business

Hearing on

"Economic Recovery: Tax Stimulus Items that Benefitted Small Business with a Look Ahead"

July 15, 2009
Washington, D.C.

Chairwoman Velazquez, Ranking Member Graves, Members of the Committee, my name is Michael Menzies. I am the President and CEO of Easton Bank and Trust Company in Easton, Maryland and the Chairman of the Independent Community Bankers of America[1]. Easton Bank is a state-chartered community bank with $150 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on the tax stimulus items in the recovery package and additional tax recommendations to boost our economy.

Summary of Testimony

- The severe economic recession justified a sizable economic stimulus, including tax relief measures. The ICBA was pleased that the $787 billion Economic Recovery and Reinvestment Act (ARRA) enacted in February contained several ICBA-backed tax relief measures to help boost small businesses.

- Small businesses are benefitting from key tax relief measures in ARRA, including the first-time homebuyer tax credit, AMT relief, municipal bond initiatives, and small business immediate expensing.

- While the ARRA tax relief measures are helping, economic woes continue to plague the small business sector. To complement the aggressive monetary easing by the Federal Reserve Board, ICBA believes additional targeted fiscal policy action is warranted to boost long-term economic growth.

- ICBA recommends and supports expanded fiscal incentives including small business tax relief, a broad five-year net operation loss carryback, an extended homebuyer tax credit, robust SBA lending programs, and Subchapter S tax reforms.

- Small business access to credit is critical for an economic recovery. Therefore, unduly burdensome and overly aggressive bank exams and onerous new regulations on community banks must be avoided to support small business lending and economic strength.

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

Small Business and Community Banks Key to Recovery
America's small businesses are critical to supporting our economic recovery. Small businesses represent a whopping 99% of all employer firms and employ half of the private sector workers. The more than 26 million small businesses in the U.S. have created 70 percent of the net new jobs over the past decade. With the unemployment rate reaching 9.5 percent, the viability of small businesses is more important than ever. ICBA appreciates this important forum to address tax items that can help small businesses and our recovery. The impact tax policies have on small business is substantial. For most small businesses, after labor costs, taxes are the second most expensive item in their budget.

Community banks are small businesses too and are essential to the success of small firms nationwide. Community banks specialize in small business relationship lending. Community banks stick with their local communities and small business customers in good times and in bad. Community banks serve a vital role in small business lending and local economic activity. For their size, community banks are disproportionately large small business lenders. While community banks represent about 12% of all bank assets, they make 31% of the dollar amount of all small business loans less than $1 million. Notably, half of all small business loans under $100,000 are made by community banks.

Economic Recovery Package Important
The severe economic recession justified a sizable economic stimulus, including tax relief measures for individuals and small businesses. The ICBA was pleased the $787 billion Economic Recovery and Reinvestment Act (ARRA) enacted in February contained several ICBA-backed tax relief measures to help boost small businesses.

While the bulk of the recovery package enacted was focused on spending initiatives, tax relief and reform items included will have a positive impact. Specifically, tax items we see helping the economy include the $8,000 first-time homebuyer tax credit, the extension of alternative minimum tax relief that prevented 26 million additional taxpayers from paying the AMT, and the tax-exempt municipal bond measures. Additionally, the limited net operating loss reform, the immediate $250,000 small business expensing, and the major Small Business Administration loan program enhancements enacted are all helping many small businesses ride out this deep recession.

Homebuyer Tax Credit
In order to address a slowing economy, ICBA recommended a first-time homebuyer tax credit in early 2008. A first-time homebuyer tax credit was initially enacted in a 2008 stimulus plan and expanded in the Recovery Act of 2009. The National Association of Realtors reports that an increased number of individuals are shopping for a home based on the homebuyer tax incentive and existing home sales have increased in the past two months. ICBA believes the homebuyer tax credit is having a positive impact in a very difficult housing market.

However, the housing sector remains a troubled spot for the economy and can use additional support. ICBA strongly supports additional targeted housing tax incentives to arrest the downward spiral in the housing market. One of the largest underlying

problems preventing an economic recovery remains declining home prices. Housing and household related spending typically accounts for 20 percent of the nation's Gross Domestic Product (GDP). Plunging home values are putting record numbers of borrowers' underwater and fueling record foreclosures. Millions of small businesses are suffering the fallout from the dramatic decline in the housing market.

The broad credit markets have been severely damaged by the sharp decline in housing prices and real estate collateral. Some 45% of small business loans outstanding are collateralized by real estate. Small business owners in particular often rely on their homes for collateral and widely use home equity loans and lines of credit. Without further fiscal policy assistance to address the struggling housing sector, additional declines in the credit availability for small businesses will jeopardize their ongoing viability.

Financial institutions in general have already experienced more than $600 billion in real estate related asset writedowns and credit losses in this recession. Bank regulators are aggressively forcing further write-downs on real estate, forcing banks to raise even more capital or curtail lending. When lenders lack capital, they are unable to lend to small business and consumers, exacerbating the economic downturn. Additionally, declining home values and rising foreclosures increase stress in the credit markets by jeopardizing the value of a range of mortgage-backed securities and crimping liquidity.

The vicious downward cycle in the housing sector must be stopped. The current homebuyer tax credit is working but is set to expire in November. This is too soon and the credit may be too limited to boost the housing market back to robust levels. ICBA respectfully recommends that Congress increase the first-time homebuyer tax credit to $15,000; allow it to be used by all homebuyers -- not just first-time buyers, and to extend it through 2010. The housing market must be stabilized and growing in order to achieve a sustained economic recovery. Stabilizing real estate prices will better allow small businesses to use their real estate values as collateral for credit. An extended and expanded homebuyer-tax credit will help.

Flexibility for S Corporations

The Recovery Act did include positive ICBA-backed S Corp. reforms for the built in gains (BIG) tax treatment. The Recovery Act allowed $415 million to reduce the BIG tax holding period to seven year from ten. ICBA supports enactment of further reforms in the bipartisan "S Corp. Modernization Act of 2009," H.R. 2910 introduced by Reps. Ron Kind (D-WI) and Wally Herger (R-CA) in the House and S. 996 introduced by Sens. Blanche Lincoln (D-AR) and Orrin Hatch (R-UT) in the Senate. Specifically, this legislation would make permanent the temporary seven-year BIG tax holding period enacted in the Recovery Act and expand S Corp. IRA shareholder availability.

ICBA believes additional tax reform would go a long way in helping the nation's most prevalent type of small business corporation. More than four million small businesses are structured as Subchapter S corporations including one-third of all banks. S Corp.

community banks are well-positioned to help boost lending throughout communities across America.

However, many onerous rules and obstacles prevent S corporation small businesses and community banks from reaching their full potential. For small businesses, raising capital is critical to the start-up, survival, and growth of the business. Given today's tight capital markets, attracting funds is critical for small business. However, arbitrary and restrictive limits on Subchapter S businesses jeopardize their ability to raise capital.

Specifically, current tax law restricts the number and types of individuals or entities that may own S corporation stock. S corporations may not have more than 100 shareholders, new IRA shareholders, and can only have one class of stock outstanding. ICBA believes these restrictions should be immediately reformed to spur more private sector solutions for small businesses to attract capital as Treasury is injecting taxpayer funds as capital into banks. In order to increase the options for small businesses to raise capital from the private sector, ICBA recommends:

- Increasing the maximum number of allowable S corporation shareholders to 150 from 100;
- Allowing IRAs as eligible S corporation shareholders;
- Permitting the issuance of preferred stock for all S corporations; and
- Preventing punitive IRS Subchapter S "TEFRA" change.

Increase the maximum number of S corporation shareholders to 150
Bank regulators are demanding banks raise additional capital given the current economic slowdown. Unfortunately, arbitrary and restrictive limits on the number of allowable Subchapter S shareholders can jeopardize the ability of S corporations to raise capital. Notably, other business forms such as limited liability corporations (LLCs) and partnerships have no restrictions on the number of shareholders. When the S corporation rules were first enacted, the maximum number of shareholders was ten. Throughout the period 1976-1982 Congress increased the number to 35. The Small Business Job Protection Act increased the maximum number of eligible S corporation shareholders from 35 to 75 for tax years beginning after December 31, 1996. The American Jobs Creation Act of 2004 increased the number of eligible shareholders from 75 to 100. However, similar pass-through tax structures have no shareholder limits at all. Today, the rigid Subchapter S shareholder limits are out of sync with the modern capital and operating needs of small businesses.

Reflecting their nature, many community banks were created by involving a large number of shareholders in a community to raise capital. This helps assure that the institutions are widely owned by members of the local communities they serve. The provision of the S corporation rules limiting the number of shareholders to no more than 100 often forces community banks that wish to become an S corporation to disenfranchise shareholders, severely limiting ownership and its ability to raise capital in the future.

ICBA recommends increasing the maximum number of allowable S corporation shareholders to 150. ICBA believes that increasing the number of allowable shareholders will permit more

community banks to make the S corporation election, raise additional capital and, at the same time, continue to be widely owned by members of their communities.

Allow new IRAs as eligible S corporation shareholders
Many of the nation's banks need to raise additional capital if they are going to be able to increase lending. Current law restricts the types of individuals or entities that may own S corporation stock. S corporation community banks seeking to raise capital may not allow new IRA shareholders. Traditional and Roth IRA stock are permitted only to the extent that that IRA stock was held on or before October 22, 2004. Subchapter S community banks are put at a disadvantage relative to other less restrictive business forms in their ability to attract capital due to the rigid IRA shareholder restriction.

ICBA recommends that new IRA investments in a Subchapter S bank be allowed regardless of timing. IRA shareholders should be allowed to participate in Subchapter S corporations. ICBA believes this will grant more community banks the needed flexibility in attracting IRA shareholder capital from existing owners and new shareholders. Having adequate bank capital is critical to ongoing small business lending.

Allow community bank S corporations to issue certain preferred stock
Current law only allows S corporations to have one class of stock outstanding. C corporations that want to make the S corporation election must eliminate any second class of stock prior to the effective date of the S corporation election. Likewise, issuing a second stock class by an S corporation terminates its S corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution by their regulators. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth and to continue providing new loans. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so they can protect their independent status and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S corporation banks are not allowed to issue commonly used preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S corporation purposes. This would help more community banks become eligible to make the S corporation election as well as help those that currently are S corporations seeking to raise additional capital. Allowing community bank S corporations to issue preferred stock would allow them to reduce the burden of double taxation like other pass-through entities and, at the same time, fund future growth. To provide community banks one more important option in attracting capital to fund business operations and serve their communities.

Small businesses including community banks are dealing with frozen capital markets and the near-impossibility of raising new capital. Immediate adoption of the S Corp. reforms listed above would go a long way in creating addition private sector capital-raising options.

Prevent the Sub S "TEFRA" disallowance proposed IRS change
The Recovery Act did include a beneficial ICBA-advanced municipal bond measure to increase qualified bank-owned muni bond issuances from $10 million to $30 million annually. This will allow more community banks to help finance local projects at competitive funding levels.

ICBA wants to highlight a counterproductive IRS proposed rule that would greatly threaten the strength of Subchapter S banks and municipal bond offerings. The proposed IRS rule would reverse long-standing tax treatment and precedent on the use of "bank qualified" bonds that are permissible investments for banks. Banks are allowed to invest in bank qualified tax-exempt bonds in order to help cities and towns served by community banks finance needed local projects such as schools, water treatment plants, firehouses and hospitals in an affordable way. As the Recovery Act seeks to expand municipal construction projects and boost economic activity, this is no time to for the IRS to jeopardize bond financing. The proposed regulation should be withdrawn.

Unfortunately, the IRS proposed a new regulation that would contradict an existing statute. (IRS Proposed Regulation §1.1363-1(b) (IRS-REG-158677-05).) The community banking industry has in good faith relied on the statute and informal IRS guidance in applying the so-called "TEFRA tax disallowance" for Subchapter S banks that hold bank qualified bonds for the past seven tax years or more. The existing practice by S corporation banks, that the 20% TEFRA disallowance terminates three years after the S election, is soundly based on existing law. The IRS should not have the authority to override a statute with a regulation. The ICBA believes this proposed regulation is unwarranted, and if further advanced, would be tremendously damaging to Subchapter S banks, their taxpaying shareholders and the communities they serve. The ICBA strongly opposes the proposed regulation and has respectfully urged the IRS to promptly withdraw it.

Expand the Loss Carryback to Five Years or More
ICBA supported an expanded net operation loss (NOL) provision in the Recovery Act. While a NOL provision was included, it was severely limited to businesses with $15 million or less in gross receipts. ICBA recommends enacting an expanded NOL that would allow more small business to preserve their cash flow and ride out the recession.

One-third of banks nationwide, more than 2,657, reported a loss in their latest FDIC quarterly banking profile. Allowing community banks and small businesses with $10 billion in assets or less to simply spread out their current losses to preserve capital to leverage for lending would help entire communities weather the deep recession. Expanding the current Net Operation Loss Carryback (NOL) period to five years or more from two years will help free up small business resources now to help support investment and employment at a time when capital is needed most. Expanding the NOL to a five-year carryback simply allows businesses to accelerate the use of allowable NOL deductions that can be claimed in future years under current law anyway.

A recent report by the Congressional Research Service helps support the ICBA-backed net operating loss tax relief. The May 27 CRS report notes most economists agree that U.S. companies would benefit from a longer net operating loss carryback than the current two years period. The CRS report says the carryback period should last through the typical business cycle (six years) to help smooth the peaks and valleys in income

ICBA supports the bipartisan "Net Operating Loss Carryback Act," H.R. 2452 introduced by Reps. Richard Neal (D-MA) and Patrick Tiberi (R-OH) in the House and S. 823 introduced by Sens. Max Baucus (D-MT) and Olympia Snowe (R-ME) in the Senate. This act would allow a five-year NOL carryback which would provide businesses with addition cash flow they can use to stay afloat during the recession.

Preserve 35% Top Marginal Tax Rate on Subchapter S Income
Maintaining cash flow is vital to the ongoing survival of any small business and taxes are typically the second highest expense for a business after labor costs. As pass-through tax entities, Subchapter S taxes are paid at the individual income tax level. Marginal income tax rates do play a critical role in a small business' viability, entrepreneurial activity, and choice of business form. Today more than half of all business income earned in the United States is earned by pass-through entities such as S corporations and limited liability corporations. Therefore, increases in the individual income tax rates will have a dramatic impact on small businesses.

ICBA believes it is important to consider maintaining parity between the top corporate and individual income tax rates in the Code. Currently, many tax increase proposals are being floated to cover hundreds of billions in proposed health care reforms, including tax hikes that would fall disproportionately on small business income. During this difficult economic period, at a minimum, the current top tax rate of 35% should be preserved on both small business Subchapter S income and C corporation income, not increased. This will afford lenders and investors more confidence in extending small business capital.

Finalize SBA Secondary Market Programs
Madam Chair, the Small Business Committee helped include more than $700 million in beneficial SBA loan program incentives in the Recovery Act. Some community bankers are now making more SBA loans than they had done last year and SBA lending is now starting to recover from extremely depressed levels. Additionally, there has been some recent thawing in the SBA secondary market as the prices paid for SBA loans has increased slightly. However, the overall weak secondary market for small business loans continues to impede the flow of credit to small business.

Several ICBA-backed programs have been launched to help unfreeze the frozen secondary market for pools of Small Business Administration (SBA) guaranteed loans, including the Term Asset-Backed Securities Loan Facility (TALF) and a new SBA secondary market facility. The TALF, conducted through the Federal Reserve and U.S. Treasury, was intended to extend billions in nonrecourse loans to holders of high-quality

asset-backed securities (ABS) backed by consumer and small business loans in a bid to free up the frozen ABS market.

Specifically, the TALF program for SBA secondary market loan pools is very close to success. Unfortunately, one obstacle requiring third-party direct competitor primary dealers to be middlemen has completely stalled the program. SBA loan poolers will not turn over their customers to their direct competitors, nor have the primary dealers engaged in the program to date. ICBA recommends either eliminating the primary dealer middlemen in the process or allowing the Federal Reserve Bank of New York to work as the intermediary with the existing SBA loan poolers.

Similarly, the new SBA secondary market program is close to success but the debate over potential additional fees to operate the program has stalled its launch. ICBA recommends using the enacted substantial funded budget authority to run the program in combination with user fees so as not to hamper the program with unworkable double fees.

The SBA loan program enhancements in the Recovery Act to reduce fees and increase the guaranty levels are working. ICBA believes with additional minor adjustments, the targeted SBA secondary market programs will help keep money flowing to consumers and small businesses providing the intended results.

Overzealous Bank Regulation Hurting Small Business Lending and Recovery
Monetary and fiscal stimulus will not achieve its intended benefit if banks are forced to pull-in their lending due to overly restrictive regulations. The flow of bank credit is essential to a strong economy. Unfortunately pro-cyclical bank regulatory policies continue to jeopardize credit availability for many small businesses. ICBA believes the bank regulatory pendulum has swung too far and is crushing many community banks' ability to lend to deserving small businesses. Community banks did not cause the current financial crisis fostered by the missteps of the too-big-to-fail banks. Unfortunately, bank regulators are often applying crippling regulatory exams and policies across-the-board.

Community bankers nationwide continue to report to ICBA about overzealous and unduly, overreaching examiners second guessing bankers and appraisers and demanding overly aggressive write-downs and reclassifications of viable and performing commercial real estate loans and other assets. Examiners are requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.

Other bankers are concerned that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that is unjustified in today's economic climate and could ultimately lead to capital problems at otherwise healthy banks.

This examination environment is exacerbating the contraction in credit for small businesses as community bankers must avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital. While it is expected and understandable that examiners will be more thorough and careful during a credit downturn, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic and adverse impact on the ability of community banks to provide small business loans and the ability to support economic growth.

Regulatory Restructuring Concerns

The Administration and Congress are also advancing proposals to restructure the financial regulatory system, causing community bankers great concern about the potential impact. Any restructuring of our financial regulatory system should first recognize the fact that the current system that applies to community banks has worked appropriately and the highly-regulated community banking sector did not trigger the current financial crisis. Therefore, ICBA believes any plan should not unnecessarily disrupt community banking and small business credit.

ICBA believes reforms should focus on filling in regulatory gaps by regulating unregulated institutions and instruments, such as credit default swaps, off balance sheet schemes, and providing more effective regulation of under-regulated entities in the financial services sector, such as non-FDIC insured mortgage companies and mortgage brokers. Regulatory restructuring should address the systemic risk taxpayers just witnessed caused by the nation's largest too-big-to-fail institutions and focus efforts on eliminating future systemic risk.

Conclusion

The tax and small business lending items passed in ARRA in February are having a positive impact on our economy. Additional tax policy reforms and rational banks regulation make sense in order to help small businesses and the economy reach full potential. ICBA pledges to work with the Small Business Committee to ensure the nation's small businesses receive positive tax treatment and have the access to capital they need to invest, grow, and to provide jobs and economic growth. Thank you.

Testimony of

Douglas K. Woods

President
AMT – The Association For Manufacturing Technology
McLean, Virginia
Before the
United States House Committee on Small Business
July 15, 2009

"Economic Recovery: Tax Stimulus Items that Benefitted Small Business with a Look Ahead"

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"Economic Recovery: Tax Stimulus Items that Benefitted Small Business with a Look Ahead"

Madam Chairwoman, Members of the Committee, I appreciate having the opportunity to be here today to testify on behalf of America's manufacturing technology industry.

I am President of AMT – The Association For Manufacturing Technology, one of the oldest trade associations representing one of the oldest trades in America. We serve more than 400 manufacturing technology providers located throughout the United States – including almost the entire universe of U.S.-based machine tool builders.

AMT's members cover the full range of engineering and manufacturing capabilities – from product innovation and design to assembly and installation services for a diverse range of technologies including automation, material cutting and forming, workholding, assembly, inspection and testing, and computer communications and control systems. The industry's 310,000 highly-skilled employees include engineers, tool and die makers, mechanics, electricians, application engineers, and managers – the majority of whom work for companies that are small businesses. More than half of AMT's member companies, in fact, have annual revenues under $10 million and only a handful have more than 500 employees.

Though we are a relatively small industry in terms of numbers, what we contribute has an enormous impact on America's ability to manufacture – and to manufacture competitively. Our companies provide the means by which all other manufacturers produce goods, and we provide the innovation that ensures those goods are world-class. Without our manufacturing technology companies, no other American manufacturing would be possible in the United States unless those who manufacture parts and finished products – be they cars, wind turbines, medical devices or defense systems – reached outside our borders and relied completely on foreign technology.

Madam Chairwoman, I emphasize what we do to underscore a simple fact: As an industry, we are critical to achieving many of the priorities this Congress and the Administration have put forward. Our products now make possible a strong national defense, modern communications, affordable farm products, fuel-efficient transportation, innovative medical procedures, space exploration, and the everyday conveniences we take for granted. But if we are to provide

medical care to all Americans, advanced manufacturing technology solutions will be a necessary piece of that puzzle. If we are to move toward energy independence, we need innovations in manufacturing technology to get us there. And if we want to continue to rely on a strong national defense to protect our citizens, the most sophisticated manufacturing technology must be a critical component of our strategy.

Unfortunately, our industry has not been immune to the heavy and deep recession that has burdened and, in some cases, felled companies in other American industries. Manufacturing as a whole has been among the greatest victims of this recession – and manufacturing technology, in particular, is in the worst of all spots because we are the first to feel the impact of an economic downturn and one of the last to recover. Our customers immediately reduce their capital expenditures at the first sign of trouble and, even when signs of recovery begin, they are reluctant to invest until they are sure things are turning around.

Because of the impact this current recession is having on our companies, I again deeply appreciate the fact this Committee is looking at what has been done to help pull our country out of recession, and what more could be done to help ensure that recovery.

THE STATE OF AMERICA'S MANUFACTURING TECHNOLOGY INDUSTRY

Madam Chairwoman, I am a newcomer to the Washington area and to my job as AMT's president. But I am not new to the industry AMT represents. I literally grew up in the manufacturing technology arena and have witnessed firsthand some truly difficult economic times. But the depth and the breadth of this current recession are like nothing I have experienced before – and while I keep reading reports that an economic recovery is on the horizon, I remain skeptical because, for AMT members, there are still no signs that point to a turnaround.

Recent data compiled by AMT show that for the first half of 2009, consumption in the manufacturing technology industry is down more than 60% from over a year ago. And it's even worse in some of the industry's specific sectors. One of the most important of those sectors – machine tools – is down a whopping 70%. Moreover, a survey conducted by AMT at the request of President Obama's Auto Task Force indicates that as many as one third of our members will be out of business by the end of the year if economic circumstances don't improve.

As a result, AMT is focusing its efforts and resources right now on helping our members simply survive the next six months. And our Number One worry is lack of available credit – that remains the biggest problem driving all others.

Last year, the manufacturing technology industry was poised for a successful 2008. Thanks in part to the 50% bonus depreciation and the enhanced Section 179 expensing provisions of the initial 2008 stimulus law, orders that might have been placed later on were pulled into the 2008 cycle. At the time, access to working capital was not a major problem for our companies or their customers. But as 2008 wound down and the economic recession began to take hold, cancellation of orders began to fall on our companies at the start of 2009, in January and February. Now, many companies are hoping to merely break even in the third and fourth quarters this year, as some of them have suffered through months without a single new order. Backlogged orders are basically what is keeping our companies alive now.

Traditionally, businesses have turned to banks to help tide them over during downturns. But banks are not extending credit under the current economic circumstances – even to companies with which they have had long and successful histories. And for those manufacturing technology companies even remotely exposed to the U.S. auto makers, the crisis in Detroit has only exacerbated the problem. During a May hearing before this Committee, AMT Board

member Carl Reed, President and CEO of Abbott Workholding Products, Inc., in Manhattan, Kansas, testified about the hardships facing AMT members who supply the auto industry. He warned about the impact the auto industry meltdown has had on these companies, as well as on the ripple effects that are continuing on them and on any sector with even the slightest link to the automotive supply chain. Since that May hearing, General Motors filed for – and has just emerged from – Chapter 11 bankruptcy protection, and the business environment for our members and their customers has continued to deteriorate. Key auto suppliers also have filed for bankruptcy protection and others have had to sue their second-tier suppliers to honor contracts to supply raw materials and key components.

THE ARRA HAS HAD MINIMAL, IF ANY, EFFECT TO DATE

I know – and greatly appreciate – that the House Committee on Small Business recognized early on the difficulty many small businesses were facing (or might face) in obtaining credit. And through the Committee's leadership, provisions were included in the American Recovery and Reinvestment Act of 2009 (ARRA) to help mitigate that problem.

Among those non-tax provisions were a temporary increase in loan guarantees (90%) and the temporary elimination of borrowing fees in the **Small Business Administration's 7(a) loan** guarantee program. The SBA has reported a more than 30% increase in weekly loan volume since the ARRA was enacted – but our members continue to report an inability to get credit, even government-backed lending, that can help them stay in business and preserve jobs. Many banks are gun-shy about committing resources to companies within an industry that is suffering from insufficient cash flow – which is a leading consideration in obtaining loans. Their skittishness, compounded by a frozen secondary market for those loans, has led banks to cut off credit to many small manufacturers. The SBA loan provisions within the ARRA are good ones. But the jury is still very much out on how effective they can be while banks remain unable or unwilling to lend, government guarantees or not.

Similarly, the tax provisions that AMT sought and strongly appreciate in ARRA are also victims of the economic storm and credit freeze. The **one-year extension through 2009 of both the 50% bonus depreciation** on new equipment purchases and **the enhanced Section 179 expensing** on new and used investments are normally great incentives for our customers to purchase our products. It is near impossible at this point to know, however, how effective these provisions haven proven to be so far this year. What I can tell you, based on countless inquiries that AMT staff has fielded, is that there has been increased interest in these provisions from member and non-member companies alike eager to attract buyers for their equipment and products.

Unfortunately, these two tax provisions – which were the most important ones for our industry in ARRA – were extended for another year just as the economy was free-falling and credit was nowhere to be found. So our companies have been faced with customers who normally might be encouraged by these provisions to invest in equipment but who either cannot get the working capital to do so, have sunk into loss positions this year and no longer qualify, or who are just too reluctant to make investments until they have a better sense of where the economy is headed.

Thankfully, another tax provision contained in the ARRA will afford some help to some businesses that fell into loss positions in 2008. AMT supported the idea of **expanding the Net Operating Loss (NOL) carryback** from two to five years, and I applaud this Committee and the Congress for including that in the ARRA. However, I regret that this help was restricted to only those companies with losses in 2008 and with annual revenues of up to $15 million. While most of our own manufacturing technology companies fall into that small-business bracket, they did not fall into loss positions during 2008 – although some of their larger and most valuable

customers did but do not now qualify for the NOL help because their yearly revenues exceed $15 million. The worst-case losses for both our companies and their customers are falling this year, so the NOL carryback relief is limited unless it is extended to companies experiencing losses in 2009 and 2010 – and to all companies, not merely small ones. If larger companies that are our customers fell into loss situations last year, or this year or the next, and cannot make capital investments, that immediately translates into lost business for our own companies.

In addition to the tax provisions I have mentioned above, the ARRA contained several energy-related tax incentives intended to spur investment in renewable energy production. The most appealing is a new **advanced energy 30% Investment Tax Credit** for companies that retool, expand or create manufacturing facilities to produce products that, in turn, can produce alternative energy from the sun, wind and other renewable resources. We already have a few AMT companies that are making the technologies for wind turbine production, and the whole alternative energy field clearly opens up new possibilities for many manufacturers. Having said that, this new program has not gotten off the ground yet – the rules governing it were not even required by law to be completed until the end of August. As a result, it remains unclear exactly which types of manufacturing ventures would actually qualify and how long it will take for those benefits to be realized.

LOOKING AHEAD

Madam Chairwoman, I know that Congress and the Administration have been committed to doing whatever possible to jolt the economy into recovery – and the ARRA represents a huge federal commitment toward that effort.

But so far, five months after the ARRA became law, only about $200 billion of this $787 billion package of projects and ideas reportedly has been spent or committed – and virtually none of its benefits have yet touched our manufacturing industry. Many of the ARRA's projects, from developing "green" energy to bridge building, have enormous potential to benefit our country, but they are going to be many months if not years in the making. And nothing, so far, has really been able to noticeably affect the huge, underlying problem of lack of credit, which is preventing many businesses from having the working capital they need to keep afloat, to retain their workers and to make capital investments.

I would like to suggest a few proposals I think could provide some badly needed relief to these businesses that could be done quickly and afford immediate relief – and they would ***not*** require new taxpayer dollars or new government programs.

First, to ease credit and provide struggling businesses with working capital, Congress and the Administration could ***temporarily***:

- Give small businesses a six-month reprieve from paying federal business taxes, particularly FICA as well as unemployment insurance and COBRA costs. Legislation has already been introduced by Rep. Walt Minnick of Idaho and your own Committee members Rep. Aaron Schock of Illinois and Virginia Rep. Glenn Nye that could be used as a vehicle to get this idea done.

- Ease for 2009 the risk requirements on banks to encourage them to loosen credit for small businesses, particularly manufacturers.

- Require banks that provide loans to small businesses to suspend for 180 days enforcement of covenant violations to allow these businesses a chance to recover economically without having their existing loans pulled.

These three things alone could be done quickly and could go a long way toward providing some badly needed relief to America's small manufacturers and other businesses that have not benefitted yet from the larger proposals of the ARRA.

Beyond these immediate actions, I would urge Congress to take other actions that could afford significant relief to American manufacturers and other job-providing businesses, including:

- Provide a tax credit to small businesses that export their American-made goods during 2009.

- Extend the current 50% bonus depreciation and enhanced Section 179 expensing, which is already in place this year through the ARRA, through at least 2010.

- Extend the current NOL carryback, which the ARRA also put into place, to include businesses that are in loss positions not only in 2008, but also in 2009 and 2010 – and make that NOL carryback available to all businesses, not just to those with yearly revenues of $15 million or less.

- Rewrite, at least temporarily, the criteria that government SBA's 7(a) loan decisions to move it *away* from cash flow as the primary consideration. More appropriate – but equally valid criteria – for judging the credit worthiness of prospective borrowers in the current economic environment should be used, such as: backlogs, assets, employment levels, and historic performance. The Administration should also move quickly to fulfill its pledge to restore the secondary market for these loans. The launch of that program has been delayed repeatedly.

- Enact legislation that could help at least some sectors of our manufacturing technology industry. A number of proposals already have been introduced in Congress. One, the IMPACT Act by Sen. Sherrod Brown of Ohio, would create state-level revolving loan funds for manufacturers and enhance the effectiveness of the Department of Commerce's Manufacturing Extension Partnership (MEP). Another bill, The BUILD Manufacturing Act (H.R. 2936), has been introduced by your own Committee member Rep. Daniel Lipinski of Illinois, along with Pennsylvania Rep. Tim Murphy. It would create more government-backed loan guarantee programs to help small- to mid-sized businesses.

- Continue support for Research and Development programs and make the R&D Tax Credit permanent. When a recovery does finally take hold, we need to do everything possible to encourage American companies, especially our small businesses, to innovate and to bring those innovations from the shop floor to the commercial marketplace – and to help ensure that these innovations keep America competitive in the world market.

- Consider enacting a direct government loan program to help distressed manufacturers. This Committee took the lead, when ARRA was still being put together, in proposing an SBA direct loan program aimed particularly at those companies unable to obtain bank credit. The Committee's idea was stripped from the ARRA before it became law. I think it was a good idea when your Committee initiated it, and it is proving to be an even more necessary idea as banks continue to withhold credit.

Lastly, Madam Chairwoman, I would urge this Committee and the Congress to resist enacting ***any*** legislation that would impose new tax burdens on American businesses now or down the road – and that includes a host of tax increases that have been considered as a way of paying for other priorities. I think we all share in wanting to ensure that all Americans have good health care and health insurance. We all want energy independence and strong educational opportunities for our children. All of these and other goals are unquestionably important for our

society. But if any or all of them are achieved at the expense of America's businesses – the only providers of jobs outside of government – Congress will undo virtually everything it has been trying to do now to put our economy into recovery.

As someone who has worked all my life in manufacturing, I can tell you that very few companies are going to risk hiring new workers or investing in equipment and technology – even if credit does start flowing and the economy rebounds – if they think they may be hit with even more taxes down the road. And if this Congress makes tax changes, such as restricting deferral on foreign earnings and increasing top tax rates that affect businesses large and small, I can guarantee you that you will push some if not many American businesses out of business or out of the country.

CONCLUSION

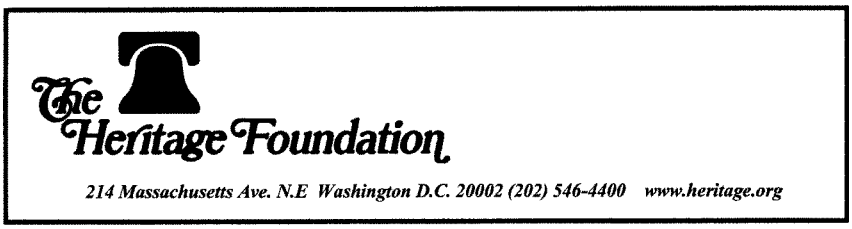
Madam Chairwoman, I truly do believe that the future holds promise and opportunity if our industry can make it through the next six months. Advances in manufacturing technology will enable our customers to produce the next generation American automobile or harness energy in ways still on the drawing board. But for right now, the entire manufacturing sector is caught in a chokehold. That chokehold is tightest around our small businesses, and the programs that were intended to loosen it have not yet served the purpose of getting credit flowing again and putting Americans back to work.

So as Congress moves forward on priorities that affect the entire nation, such as climate change and healthcare, I urge you to consider the overall cost of any of these proposals to America's small manufacturers.

On behalf of AMT, I would also urge you to remember that manufacturing technology is the foundation of the production process. We do not manufacture components parts, but we are even more critical to the end product. We need access to working capital immediately if many of our companies are to stay in business in the coming months.

Without a strong manufacturing technology base in America – those companies that produce the technology on which American defense, energy, agricultural, medical and every other U.S. manufacturing is based – the United States will end up trading our dependency on foreign oil for a new dependency on foreign technology. And that prospect is, for the future of our country, frightening.

Thank you.



CONGRESSIONAL TESTIMONY

2009 Stimulus' Impact on Small Business and Entrepreneurial Activity

Testimony before The Small Business Committee United States House of Representatives

July 15, 2009

Rea S. Hederman, Jr.,
Assistant Director and Senior Policy Analyst
The Center for Data Analysis
The Heritage Foundation

My name is Rea S. Hederman, Jr. I am Assistant Director of and a Senior Policy Analyst in the Center for Data Analysis at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Chairwoman Velazquez, Ranking Member Graves, and other distinguished Members of the Committee, thank you for having me to speak on the important topic of the 2009 stimulus impact on small business and entrepreneurial activity.

2009 Stimulus Bill Provisions
The American Recovery and Reinvestment Act (ARRA) contained a number of provisions aimed at boosting the economic output of small businesses either through tax incentives, loan guarantees or other government initiatives. These provisions included an increase in bonus expensing and bonus depreciation of qualified investment expenses.

Bonus depreciation and expensing have often been included in previous economic stimulus packages. For instance, the 2001 and 2008 stimulus packages signed into law by President Bush contained such proposals.

The Impact of Bonus Depreciation and Expensing
Bonus depreciation and expensing provisions are important and proper tax policy tools for stimulating economic activity. Specifically, these tools encourage companies to increase investment output and expand activity in the short run. The effectiveness of these proposals, however, may be limited. Since the provisions have expiration dates, small businesses may have difficulty expanding their businesses before the end of the calendar year. As a result, some policymakers have considered extending these provisions.

Such an extension, however, would defeat the purpose of speeding up investment decisions. In a policymaker's perfect world, these provisions signal businesses that capital investment will be extremely cheap for one year only. The more these provisions are extended, the fewer businesses will respond with any immediacy—which was, of course, the very purpose of implementing such provisions in the first place.

Current evidence suggests that small businesses have not responded to these latest stimulus proposals. For example, a recent survey of small business owners indicates that many have the same level capital growth in their business plans today as they did prior to passage of bonus depreciation and accelerated expensing. Even worse, the number of small business owners planning an expansion is declining this year.[1]

As many Americans are painfully aware, unemployment climbed steadily, reaching 9.5 percent in June of this year —despite projections from President Obama's economic team that the unemployment rate would not pass 8 percent. Few of the benefits touted by proponents of the

[1]William Dunkelberg and Holly Wade, "NFIB Small Business Trends July 2009", NFIB, July 2009, at *http://www.nfib.com/Portals/0/PDF/sbet/sbet200907.pdf* (July 14, 2009).

stimulus plan have been seen, despite the fact that some of the stimulus payouts have been dispersed ahead of schedule.[2]

What Should Have Been Done

While bonus depreciation and expensing were appropriate policy moves earlier this year, small businesses require Congress to take bold action now. Small businesses are the strongest pillar of employment in the economy. Research shows that job creation from small business and start up companies have helped end previous recession.[3]

Pro-growth tax policies can boost small businesses and entrepreneurs. Successful small businesses expand and hire new employees offsetting job losses from larger, more established firms. Good economic policy is rewarding these successful companies instead of penalizing their success through higher taxes.

Entrepreneurial investments are the key to sustainable growth. The market for investment is the most flexible when there are no taxes that distort decision-making and increase the cost of investment

A stimulus plan that lowered business and personal tax rates would provide both short-term and long-term economic growth. Lower tax rates on business income would

- Reduce marginal effective tax rates on small business from an average of 17.1 percent to an average of 14.8 percent;
- Give about 250,000 small businesses with $500,000–$1 million in aggregate gross income an average tax rate almost 10 percentage points lower; and
- Provide more than 2 million successful small businesses with lower tax rates.[4]

These lower tax rates create more economic growth. Econometric analysis has shown that deficit financed tax cuts are more likely to spur economic growth than government spending.[5] The Heritage Foundation's Center for Data Analysis widely respected economic forecasting model projects that a reduction in the top income tax on business income from 35 to 25 percent would create nearly 500,000 jobs this year, 1.3 million next year, 7.5 million by 2013, and a total of nearly 18 million jobs over the next ten years.

What Can Still Be Done

It is never too late to enact good economic policies. This Congress can establish a foundation for strong economic growth by enacting good tax policy.

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[2]J. D Foster and Rea S. Hederman Jr. "A Third Stimulus? Don't Repeat the Same Failures", Heritage Foundation *WebMemo* No 2533 July 9, 2009 at http://www.heritage.org/Research/Economy/wm2533.cfm

[3]Dane Stangler "The Economic Future Just Happened", Kauffman Foundation, June 9, 2009 at http://www.kauffman.org/uploadedFiles/the-economic-future-just-happened.pdf (July 14, 2009).

[4] Guinevere Nell "The American Option is Good for Small Business." Foundation *WebMemo* No 2261 February 2, 2009 at http://www.heritage.org/Research/Economy/wm2261.cfm

[5]Andrew Mountford and Harald Uhlig "What are the Effects of Fiscal Policy Shocks?" SFB 649 Discussion Paper 2005-039, July 2005; Oliver Blanchard and R. Perrotti "An Empirical Characterization of the dynamic Effects of Changes in Government Spending and Taxes on Output," *Quarterly Journal of Economics*, pp. 1329–1368, 2002.

First, Congress should make permanent the small business tax relief that was enacted in 2001 and 2003. Entrepreneurs saw a decline in their marginal tax rates. Small businesses also benefited from lower capital costs as taxes on capital gains and dividends were reduced. Lower capital costs means that more small businesses can be created as the risk premium for business startups declines. Capital gains and marginal rates are scheduled to increase in 2011. These higher taxes are already being calculated by many businesses as they plan for future investment and expansion. These higher tax rates offset the smaller tax provisions in the stimulus bill and hinder investment.

Small businesses also have high labor costs as compared to other businesses. Currently, wages have been flat or declining over the last quarter and work hours have been shrinking. On July 24, 2009, the minimum wage will be boosted from $6.55 an hour to $7.25, a 10.7 percent increase in a period of flat wage growth. Companies will have limited capacity to pass on these costs to consumers and many will be forced to lay off workers or continue to reduce their hours. Historically, a minimum wage increase of this magnitude results in employment losses for small businesses of 1 percent.[6] This impact will be detrimental to small businesses, many of which are already short-staffed.

Conclusion

While the American Recovery and Reinvestment Act (ARRA) had several provisions aimed at boosting small business' economic output, the stimulus bill failed to deliver on its promises. Bonus depreciation and expensing were a step in the direction of good economic policy, but a leap was needed in light of the economic circumstances. Governments cannot spend themselves out of recessions, but should establish a framework so that businesses can recover.

Small businesses often spearhead economic recoveries. Policies that benefit small businesses by lowering capital or startup costs are vital. Ensuring that the tax rates on capital gains and marginal tax rates on personal income do not increase over the next few years is important to encourage entrepreneurial activity.

It is also important that no harm is done to make it more difficult for successful small businesses to grow even during this downturn and future recovery. The upcoming minimum wage hike will increase labor costs during a time period that wages have not been rising. This will reduce employment opportunities and make it more difficult for small businesses to grow and expand. This increase should be postponed till after the recovery is underway so as to not further add to the already dire unemployment situation.

Thank you again for allowing me this opportunity and I look forward to any questions.

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[6]Joseph Sabia "The Effect of Minimum Wage Increases on Retail and Small Business Employment", Employment Policies Institute, May 2006, at http://www.epionline.org/study_detail.cfm?sid=98 (July 14, 2009).

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Statement of

The Associated General Contractors of America

submitted to the

Committee on Small Business
U.S. House of Representatives

on the topic of

Economic Recovery: Tax Stimulus Items that Benefitted
Small Business with a Look Ahead

July 15, 2009

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7,500 of America's leading general contractors, and over 12,500 specialty-contracting firms. More than 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. Visit the AGC Web site at www.agc.org.

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
2300 Wilson Boulevard, Suite 400 • Arlington, VA 22201 • Phone: (703) 548-3118 • FAX: (703) 837-5407

The Associated General Contractors of America (AGC) is pleased to submit these comments for the record of the July 15, 2009 hearing of the House Small Business Committee entitled "Economic Recovery: Tax Stimulus Items that Benefitted Small Business with a Look Ahead."

Introduction

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7,500 of America's leading general contractors, and over 12,500 specialty-contracting firms. Over 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, site preparation/utilities installation for housing development, and more.

The American Reinvestment and Recovery Act

Continuing the momentum of economic recovery aided by the enactment of the American Reinvestment and Recovery Act (P.L. 111-5) ("Recovery Act"), which contains nearly $350 billion in construction stimulus spending and tax relief, is particularly important for the construction industry. AGC studied the economic impact of infrastructure investment on job creation. AGC's analysis, in partnership with George Mason University, showed that investment in nonresidential construction adds significantly to jobs, personal income, and GDP—far beyond the hiring that takes place in the construction industry itself. AGC found that $1 billion in nonresidential construction spending would add about $2.6 billion to the state's Gross Domestic Product (GDP), about $780 million to personal earnings and create or sustain 22,000 jobs.

The Recovery Act is already going a long way towards creating or saving jobs. However, national construction unemployment is still at 17.4 percent (not seasonally adjusted), compared with the total private unemployment rate of 9.7 percent. The industry is in a critical, vulnerable stage in economic recovery, maintaining program continuity is key to "staying the course" set by the infrastructure investment and tax provisions in the Recovery Act. This is particularly true for small businesses.

During consideration of the Recovery Act, AGC urged Congress to enact economic stimulus activities that would have an immediate positive impact on economic activity. AGC's recommendations included both stimulus spending and targeted tax provisions to stimulate public and private investment in infrastructure and building construction, and to leverage stimulus funding by incentivizing capital investment. AGC continues to believe that targeted tax relief is an important component of the economic recovery package and makes the following observations regarding the impact of the tax provisions enacted in the Recovery Act, and additional recommendations for future tax relief.

Depreciation Bonus and Section 179 Expensing Levels

The Recovery Act extended a temporary benefit for businesses to recover the costs of capital expenditures made in 2008 faster than the ordinary depreciation schedule would allow by permitting these businesses to immediately write-off 50 percent of the cost of depreciable property (e.g.,

equipment). The Recovery Act extended this benefit for capital expenditures made in 2009. The Recovery Act also allows small business taxpayers to write-off up to $250,000 of capital expenditures subject to a phase-out once capital expenditures exceed $800,000 until the end of 2010.

AGC member construction companies are taking advantage of these provisions. In particular, smaller construction companies are making investment decisions (i.e., making purchases of equipment sooner rather than later) due to the enhanced Section 179 expensing. These results are consistent with a survey of contractors conducting in summer 2008 that found that approximately one-third of survey respondents said that they purchased equipment in the first half of 2008 to take advantage of the depreciation bonus and/or increased Section 179 expensing levels enacted in the Economic Stimulus Act of 2008 (P.L. 110-185). The survey also found that more than three-quarters of contractors would be more likely to buy additional equipment in 2009 if the depreciation bonus and the increased Section 179 expensing levels were extended. The reason cited most often by the survey respondents for why their companies had not take advantage of the incentives was that the economic slowdown had led to a considerable drop in construction work (and, therefore, the need for additional equipment). This concern continues and will likely remain until a six-year reauthorization of transportation programs is enacted.

To build on the Recovery Act investments and spur capital expenditures, AGC recommends extending the bonus depreciation and increased Section 179 expensing levels for capital expenditures made in 2010.

5-Year Carryback of Net Operating Losses for Small Business

Under current law, net operating losses ("NOLs") may be carried back for the two taxable years before the year that the loss arises (the "NOL carryback period") and carried forward to each of the succeeding 20 taxable years after the year that the loss arises. For 2008, the Recovery Act extends the maximum NOL carryback period from two years to five years for small businesses with gross receipts of $15 million or less.

Few construction companies have taken advantage of the new NOL carryback provisions, since they generally remained profitable in 2008. However, their profitability may be in doubt for 2009 and 2010 based on industry projections for the construction market in the short term. Moreover, the majority of construction companies—while small businesses—have gross receipts greater than $15 million and cannot take advantage of the NOL carryback provisions.

Because capital to run operations (meet payroll, etc) continues to be very tight, if available at all, the need to convert a future tax benefit into cash today is critical to maintain cash-strapped but otherwise viable businesses. Such critical NOL relief would help construction companies, as well as businesses in other industries, to save jobs, make critical investments, and in some cases, stay open for business.

AGC recommends extending the five-year carryback provisions for NOLs incurred in 2008, 2009, and 2010 for all businesses regardless of size. AGC supports legislation introduced by Representatives Richard Neal and Patrick Tiberi, H.R. 2452, which would allow such relief for all businesses in 2008 and 2009.

Three Percent Withholding

Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) mandates that federal, state, and local governments with total annual expenditures of $100 million or more withhold 3 percent from all payments for goods and services, including payments made to contractors for public works repair or construction. AGC strongly believes that this requirement should be repealed. If the 3 percent withholding law is not repealed, it will require a significant overwithholding of payments to construction companies that will cause an adverse impact on their cash flow and will likely increase the price government entities pay for construction services. According to the Construction Financial Management Association's (CFMA) 2007 Construction Industry Annual Financial Survey, construction companies averaged 2.7 percent income before taxes on contracts. That means under Section 511 the government is withholding a percentage of taxes that is greater than the industry's average income before taxes.

Moreover, while the 3 percent withholding requirement is not set to go into effect until January 1, 2012, thanks to a one-year delay enacted in the Recovery Act, construction companies, as well as state, federal, and local governments, are expending funds starting to prepare for implementation now. These are needless preparation expenses, particularly during rough economic times. And, with construction companies facing narrower profit margins, the prospect of additional tax withholding diverts available resources away from business expansion activities, including workforce investment and equipment purchases.

AGC recommends an immediate and full repeal of the 3 percent withholding law. AGC supports H.R. 275, introduced by Representatives Kendrick Meek and Wally Herger, which would repeal the 3 percent withholding law.

Multiemployer Pension Plans

The drop in the value of pension plan assets coupled with the current credit crunch has placed defined benefit plan sponsors in an untenable position. At a time when companies desperately need cash to keep their businesses afloat, the new defined benefit plan funding rules require huge, countercyclical contributions to their pension plans. Consequently, many companies will divert cash needed for current job retention, job creation, and needed business investments and instead contribute the cash to their pension plans to fund long-term obligations.

Many AGC members—large and small—contribute to multiemployer defined benefit plans. AGC urges Congress to enact relief to moderate the effects of the aggressive funding targets contained in the Pension Protection Act. Such relief is necessary to avert devastating burdens and job loses arising from massive contribution increases and unavoidable benefit reductions that would be required to comply with those rules.

AGC recommends the following:

1) providing additional time for plans that are financially challenged, but fundamentally sound
2) providing new financing approaches to help employers meet the increased contribution requirements for plans in critical or seriously endangered condition

3) strengthening the PBGC so that is has sufficient resources, direction, and authority to achieve its stated mission of promoting defined benefit plans and the security of participants' retirement income

AGC recommends that multiemployer pension plan funding relief be enacted to allow contributing employers to remain economically viable and to employ covered participants. Contributions attributable to such employment are critical to the long-term survival of those plans.

Construction Contract Accounting

The Tax Reform Act of 1986 revised the long-term contract accounting rules for contractors. These rules—contained in Section 460 of the Internal Revenue Code—place unfair burdens on construction contractors and should be modified in two ways: 1) to account for inflation grown since 1986; and 2) to provide relief from the onerous "lookback" accounting requirement.

In 1986, Congress enacted changes to the Internal Revenue Code (Section 460) requiring contractors to use the percentage of completion (PCM) accounting method for reporting taxable income from long-term contracts. Long-term contracts are contracts are contracts that are not completed within the tax year in which they are entered into. PCM requires contractors to calculate what percentage of the contract is complete in a tax year and then pay taxes on that percentage. Congress created an exception to Section 460 for smaller contractors. Those contractors whose contracts will be completed within two years of the contract commencement date, and whose average annual gross receipts for the preceding three tax years do not exceed $10 million are exempt. Unfortunately, the $10 million threshold was not indexed for inflation. Today, more and more small contractors are crossing the threshold and are being forced into the burdensome and costly percentage of completion method.

AGC recommends that the $10 million exemption be updated to $25 million to account for inflation since 1986.

In addition, the 1986 Tax Act enacted a provision mandating the use of the lookback method for all long-term contracts accounted for on the percentage of completion method of accounting. The lookback method requires a construction contractor to file amended tax returns for every prior year in which a currently completed contract was in progress. The difference between the theoretical taxes that would have been due if all the facts were known in the year the contract was entered into, and the taxes actually paid in prior years, is calculated. Interest is then calculated on this change in prior-year tax liabilities. Lookback does not result in a change of a contractor's tax; it does not require contractors to pay more, or less, in taxes. It does, however, require a contractor to pay or receive interest, and to spend thousands of dollars on tax practitioners to make the interest calculations.

The lookback method is exceedingly complex, and imposes compliance and administrative burdens on construction contractors, which diverts valuable time, labor, and resources of construction financial and accounting professionals from worthwhile functions. The lookback method poses special problems for smaller contractors that have to hire outside accounting experts to calculate lookback.

The Taxpayer Relief Act of 1997 attempted to address this issue by providing an election to forego application of the lookback method if the estimated gross profit recognized in each contract falls

within 10 percent of the retroactively determined gross profit for year the contract was in progress. However, this provision provides no relief from the paperwork burden. That is because election to apply this provision requires most of the above calculations, as well as additional calculations in order to determine whether each contract falls within this 10 percent variance in each prior year.

AGC recommends that Section 460 be modified to exempt construction contracts of 36 months or less in duration from the lookback filing requirement.

Diesel Retrofit

AGC members are making efforts to reduce the impact of off-road diesel-powered construction equipment on the environment. One way is by retrofitting their equipment. However, for the construction industry, the costs of retrofitting equipment are prohibitive without financial assistance. AGC urges Congress to provide financial and technical assistance to construction equipment owners and operators to encourage these firms to install emissions control technologies on their diesel engines or, in some cases, to offset the cost of a replacement engine or an entirely new piece of equipment. Congress can provide this assistance by fully funding EPA's Diesel Emissions Reduction Program and by enacting provisions in the surface transportation reauthorization bill that would provide federal funding to contractors engaged in federal-aid highway and transit projects for diesel retrofit activities.

In addition to grant funding, AGC recommends a 30 percent investment tax credit to construction equipment owners, as well as manufacturers, to spur investment in cleaner, more fuel efficient off-road diesel-powered construction equipment.

Conclusion

AGC members are ready to build, to create and sustain jobs throughout the country. Construction has always been an engine of economic stimulus and can play that role once again. While increases in infrastructure investment do have a direct impact on the economy, at the same time, AGC members, most of which are small businesses, have benefited from the tax provisions enacted in the Recovery Act. However, these benefits are limited. That is why AGC makes recommendations to extend tax incentives to purchase new (and cleaner) equipment, allow NOL relief to all businesses through 2010, and provide some relief from pension plan obligations, 3 percent withholding taxes, and burdensome construction contract accounting rules.

Thank you for this opportunity to comment.

"Economic Recovery:

Tax Stimulus Items that Benefitted Small Business with a Look Ahead"

U.S. House of Representatives, House Committee on Small Business

Wednesday, July 15, 2009

Dear Chairwoman Velázquez, Ranking Member Graves, and Members of the Committee:

On behalf of the Computing Technology Industry Association (CompTIA), we thank you for your ongoing interest in the effects of our tax system on small businesses and appreciate the opportunity to submit the following views. In short, CompTIA supports tax provisions that assist small businesses – especially small information technology businesses – in this time of economic difficulty; therefore, we are both pleased and supportive of a number of provisions contained within the American Recovery and Reinvestment Act of 2009 (ARRA), enacted on

February 17, 2009, Public Law No. 111-5. These provisions help to sustain our small businesses which employ over half of the private sector workforce. We must ensure the viability of the small business community, without which, our national economy cannot improve.

About CompTIA. The Computing Technology Industry Association (CompTIA) is the voice of the world's $3 trillion information technology industry. CompTIA membership extends into more than 100 countries and includes companies at the forefront of innovation; including, the channel partners and solution providers they rely on to bring their products to market, and the professionals responsible for maximizing the benefits organizations receive from their technology investments. The promotion of policies that enhance growth and competition within the computing world is central to CompTIA's core functions. Further, CompTIA's mission is to facilitate the development of vendor-neutral standards in e-commerce, customer service, workforce development, and ICT (Information and Communications Technology) workforce certification.

CompTIA's members include thousands of small computer services businesses called Value Added Resellers ("VARs"), as well as nearly every major computer hardware manufacturer, software publisher and services provider. Our membership also includes thousands of individuals who are members of our "IT Pro" and our "TechVoice" groups. Further, we are proud to represent a wide array of entities including those that are highly innovative and

entrepreneurial, develop software and hold patents. Likewise we are proud to represent the American IT worker whom relies on this technology to enhance the lives and productivity of our nation. Based upon a recent CompTIA survey, we estimate that one in twelve, or about 12 million American adults, consider themselves to be IT workers. This is larger than the number of American adults classified by the Bureau of Labor Statistics ("BLS") as employed in farming, mining, and construction combined. This is also close to the number of adults classified by BLS as working in manufacturing or transportation. CompTIA has concluded that the IT workforce is now one of the largest and most important parts of the American political community.

Small Business Expensing. We are especially pleased that ARRA extended the $250,000 limitation for small business expensing through 2009, and we call for legislation that would make this higher limitation a permanent part of the tax code.

As the general rule, a business must depreciate the cost of equipment purchased over a period of years. However, section 179 of the Internal Revenue Code (IRC §179) provides an exception for small businesses. Under IRC §179, a small business is allowed to expense certain acquisitions in the year of purchase; the business would be required to depreciate any excess purchases over the stated limitation. While the current limitation of $250,000 applies for tax years 2008 and 2009, without legislation, this limit will decrease to $125,000 beginning in 2010 and will further decrease to $25,000 beginning in 2011.

The IRC §179 equipment expensing provision is an incredibly valuable incentive, enabling small businesses to invest in technologies that improve both productivity and the quality of goods and services. CompTIA's small business members realize a double benefit from this provision through purchases of needed equipment for their own businesses and through increased demand for technology equipment and systems that our members provide. This higher expensing limitation has certainly increased the ability of our small business members both to purchase equipment for their own businesses and it also has increased the demand for our members' technology products by other small businesses.

Accordingly, we point to the $250,000 IRC §179 limitation as a great benefit to all small businesses, and we encourage this committee to support passage of legislation that would permanently extend this limitation, as adjusted for inflation.

Net Operating Loss Carryback. Prior to ARRA, the tax code allowed a net operating loss (NOL) to be carried back to the two preceding taxable years; any excess would then be carried forward over the following 20 years. ARRA provided needed relief for small businesses hit by the current economic recession by extending the carry back period to the five preceding years (as opposed to the preceding two). This provision was specifically tailored for small businesses,

as it limited its application to businesses which have no more than $15,000,000 in gross receipts.

CompTIA believes it is important to continue this extended carry back period for small businesses, and we ask for support in making this provision a permanent part of the tax code. Small businesses that have consistently paid their federal income taxes during period of economic boom should be allowed access to taxes paid when there is an economic downturn. While we pay taxes in yearly cycles, the extended NOL carry back recognizes that in some **situations, the real measurement of a business' income (and thus tax liability) must be viewed** over a period of years; to look at taxable income in discrete annual periods can in some situations result in an unfair tax situation.

Accordingly, we encourage this committee to support passage of legislation that would permanently extend the NOL carry back period to five years.

Bonus Depreciation. For 2008, business were allowed to write off an additional 50% bonus depreciation for qualifying assets (including most computer software) purchased and placed into use during 2008. ARRA extended this provision to new qualifying assets purchased in 2009.

While this provision is not limited to small businesses, we do believe it is an important incentive, combined with the §179 provision, for all small businesses, especially during the current economic situation. Our members support this provision, and we call upon this committee to support legislation that would extend this depreciation bonus at least until the business economy has sufficiently improved. We also call upon this committee to support a permanent extension of this provision for small businesses.

Conclusion. ARRA contained a number of important tax provisions for small businesses, and CompTIA believes those provisions have helped to blunt the impact of the current recession. Therefore, we call upon this committee to support making these provisions a permanent part of the tax code for small businesses. Small businesses are the back bone of the American economy and the greatest engine of job creation. It is vital that we continue these important incentives for this most important part of the America economy – especially during these trying economic times.

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