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ORDER OF BUSINESS

Nothing like campaign season panic. Does the economy need another stimulus? If you offset stimulus with revenue increases elsewhere, is it really a stimulus? If you believe in deficit reduction, can you do stimulus activity at the same time? Is compromise a four letter word?

The first order of business in the Senate is supposed to be votes on the pending small business lending assistance and tax relief bill. The bill would establish a \$30 billion Small Business Lending Fund (SBLF). Under the proposal, the SBLF would support lending among community banks and other lenders with assets under \$10 billion.

On the tax relief side of the bill, the bill would increase temporarily the direct expensing allowance. Currently, businesses may write off up to \$250,000 of capital expenditures subject to a phase-out once those capital expenditures exceed \$800,000. The bill would increase the thresholds to \$500,000 and \$2,000,000 for the taxable years beginning in 2010 and 2011. At the end of 2011, the amounts would revert to \$25,000 and \$200,000, respectively.

The bill would also restore a temporary 50 percent depreciation bonus, eliminate temporarily the capital gains tax on a special type of small business stock, reduce the penalties for small businesses that inadvertently use a tax structure known as a "listed transaction," increase temporarily the amount of deductible start up costs of a business, temporarily allow the self employed to deduct their health care premiums from the self employment tax, and eliminate the paperwork burden for documenting business use of cellular telephones and similar devices.

If the Senate does pass this bill, the House must still act on it as the House has passed most of the elements of the bill but not in a single legislative vehicle. If you had asked me before the recess, I would have told you that I think the House will take up the bill "as is" and pass it so the majority can wave it around during the October campaign season.

Now the President comes along and proposes some additional stimulus items. One – allowing for a temporarily 100 percent tax write off of capital asset purchases – arguably is a modification of the elements of the pending bill. If you

are the Senate majority, you are probably asking yourself "can we add those to the Senate bill?" They are in a rather tight procedural box at the end of the process plus there is the risk of messing up the 60 vote majority that they have cobbled together. Another option is to have the Senate pass the pending bill and let the House modify it. If you do that, you can probably get it through the House easy enough, but then you are back in the Senate with a fresh bill and fresh filibuster problems.

Bottom line: I am of the school a small business lending assistance and tax relief bill is passed and signed into law. Small tweaks maybe.

The next question is what about all those other expiring or expired tax provisions? Do you do anything about those now before the campaign season shifts into overdrive?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The

regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. Other items, including a child care credit, family and education expenses deductions, and marriage rate penalty relief, will also expire at the end of the year. The top marginal rate has been the big concern for small business.

The reduced capital gains rate and the reduced dividends tax rate expire at the end of the year.

Until the end of this year, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. Starting next year, the maximum rate of tax on the adjusted net capital gain of an individual will be 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate will be taxed at a 10-percent rate.

Until the end of this year, an individual's qualified dividend income is taxed at the same rates that apply to net capital gain. Thus, an individual's qualified dividend income is taxed at rates of zero and 15 percent. For taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income tax rates. (Hello, if you are old money you probably have some of dividend paying stocks in the portfolio and that is going to be a pretty big jump, especially if the top marginal rate goes up.) While there are small C Corporations, SBLC has never considered the dividends rate to be a top small business priority.

There will be floor action on some sort of bill dealing with these items in the Senate. There are a lot of variations on the theme possible, ranging from dealing with extending the cuts for "middle class" incomes and below to a short term extension across the board. The problem is finding 60 votes for any variation. The House will not act unless the Senate does, and the Blue Dogs are not eager to vote.

Bottom line: Conventional wisdom would say given the partisan label (the Bush tax cuts), the magnitude and scope of the cuts, the pending election and the short time window before the campaign recess, there is no way this could happen. But timing is everything, and this just does not feel like the time for leaving the question of pending significant tax increases that affect all income levels begging. If anything falls in place, I would think it would be to extend the parts of cuts for under \$250K incomes. Wish they would consider up to \$1 million in income so as to extend the relief well beyond small business' pain threshold.

The estate tax is currently repealed. It returns in 2011 with a top marginal rate of 55 percent and an individual exemption of \$1 million. Nobody has been able to get 60 votes for any relief option. No one is blinking yet. I am still holding out a glimmer of hope that the Senate might cobble together a package of "must pass" tax extenders (like the R&D credit and some energy credits) and include some estate tax relief. For small business it is all about the exemption.

Bottom line: With each passing day, odds are increasing it will revert back to old law in 2011.

Had enough? How about one more? The temporary increases in the income thresholds at which the Alternative Minimum Tax (AMT) is applied have already expired, and if Congress does not act, the AMT will apply at lower starting income levels for the *current* tax year.

Bottom line: I can see this getting fixed in a lame duck regardless of the outcome of the election.

Will Congress pass another stimulus bill? This one remains somewhat unlikely in my view. If things progress poorly for the current majority's candidates in September, it might be a last panic effort at the end of the month. But seems to me extending some of the individual tax cuts would be more popular.

FORM 1099

The pending small business lending assistance and tax relief bill will also be the battleground for dueling amendments regarding a new information reporting requirement included in the recently enacted health care reform law. The new provision requires businesses to issue an information reporting form, known as Form 1099, to all of its vendors of goods and services to which it paid more than \$600 annually. Before the new law, Form 1099s were issued to individuals who provided services to a business.

The Republicans, led by Senator Mike Johanns (R-NE), have proposed an amendment to repeal the requirements created by the new law. The Democrats have also proposed an amendment to "fix" the new law. The Democratic amendment exempts businesses with fewer than 25 employees at any time during the year from the

requirement to file information returns on payments for goods and property. For businesses with more than 25 employees, the alternative also raises the threshold for reporting purchases of goods and property from \$600 to \$5,000. The proposal also exempts all purchases made with a credit card from information reporting.

The Democratic version gives Treasury the authority to exempt payments with minimal compliance risk from the reporting requirements. Examples of such payments might include payments for office supplies, airline tickets, and restaurant meals. (Put your left foot in, put your left foot out, and do the hokey-pokey. Nothing like making something even more complicated in the name of helping us from something they should not have done in the first place?!).

I am not sure what to say yet about the outlook. I am optimistic the momentum is there for repeal. I think we will have a better idea tomorrow after the Senators meet in their Tuesday luncheon caucuses. My thought is there are going to a number of Democratic Senators that are going to be saying "I am tired of hearing about it in town meetings, and I don't want to talk about it in October, let's just get it off the table." Countering that is the face-saving problem because it was in the health care bill and no one in the majority wants to reopen that discussion. The other problem is that the Republican offset is one that is not the best spending decrease to choose – it would eliminate funding for a new preventative health care program.

LAME DUCK

At the moment, two lame duck sessions have been scheduled. The plan is to come back for a week immediately after the election and then for a number of weeks after Thanksgiving.

Congress will not fund the government on time for the fiscal year that begins on October 1st. There will be a series of "continuing resolutions" to fund the government for short periods of time. The lengths of those CRs will dictate some of the lame duck schedule.

Ostensibly, Congress is coming back to deal with other items. If the President's deficit reduction commission can come up with recommendations, the congressional leadership promised to at least give passage a shot.

The back story is that some folks believe the lame duck will be used to force through some legislation if the composition of the next Congress changes dramatically (see Congressional Outlook story). I am skeptical that anything major could be rammed through. My caveat to my observation is whether Democrats could convince moderate Republicans in the Senate including Senator George Voinovich (R-OH), who is retiring, that it is their "last, best opportunity" to move some controversial items.

KABUKI

There is a good chance that we will see some traditional campaign season theater in Washington this month. At a minimum, the tone of the floor speeches will change. But if they follow the tradition, the leadership will call up some bills

that they know will not pass. The bills will fail but the speeches and points will have been made. I suppose the classic would be the "Card Check" union organizing bill.

CONGRESSIONAL OUTLOOK

SBLC is non partisan. We do not have a PAC. From time to time, we have said good things about individual candidates, Republican and Democratic, who have performed above and beyond the call of duty for small business (e.g. former Senator David Pryor (D-AR) and soon to be former Senator Kit Bond (R-MO)). My "take" on elections consists of observations about the likely impact on small business. Having said that...

I have been asked numerous times whether this is a one-term presidency. Here are my rules of thumb. Number one: It is all about the economy. I have been here for both President Carter and President Bush 41's one-term presidencies. Number two: If the economy is good, folks will forget about other stuff. Cases in point: President Clinton and President Bush 43's re-elections. Number three: Somebody has to take the short-term blame. For the House Democrats, it looks like they are the short term collateral damage for the current state of the economy and controversial policy actions.

Bottom line: I recall getting the "vibes" in the third year of the Carter and Bush 41 presidencies that they were on their way to one-term presidencies. So check back with me in the late spring.

Early this year I did not think the Senate majority would be "in play." I am not sure at the end of the day it will be, but nevertheless it is now.

IF the majorities in both Chambers switch, the President obviously would have to change his legislative style to makes some deals or wait it out, hoping the economy rights itself soon enough, because history suggests the public will forget a lot in two years if the economy is good.

A switch would allow us to move off defense on the Hill and find some ground to play offense. Not on big ticket items but on the small stuff like fixing the home office deduction or the self employment deduction for health care.

Even with a switched majority, the pace and direction of health care reform will not change unless the courts decide to do it. It is awfully hard to imagine the election would produced veto-override 2/3's majorities in both chambers.

We are already experiencing a shift to more regulatory activity and a switch would most likely accelerate the trend. See the next stories for a peek into that crystal ball. And with that comes an effort to attach riders to appropriations bills by the new majority to stop that activity by de-funding it.

Early this summer, I was saying I thought Indiana would be a bellwether for the Democrats in the Senate. Senator Evan Bayh (D-IN) is retiring. They picked an unknown, Representative Brad Ellsworth (D-IN) to run against former Senator Dan Coats (R-IN), someone who had not been on the Indiana scene for awhile. Indiana is always one of the too close to call states. Back in the early summer my thinking it would be a bellwether for whether the Senate Democrats would lose more than a couple of seats.

Now, that bellwether may have come and gone as Ellsworth does not appear to be gaining traction, (Arguably, Indiana could still be a bellwether. If Ellsworth improves his numbers between now and October, that would suggest they have stemmed the tide) but Wisconsin may be the more accurate bellwether as to whether they lose their majority. Senator Russ Feingold (D-WI) is running for re-election and apparently struggling. However, he does have his own formidable campaign structure - one of the differences between his situation and Indiana.

If the Democrats are not going to turn themselves into the minority party, it is going to take individual senators and representatives turning on personal efforts to overcome what appears to be the national trend. Hence the bellwether appellation for Wisconsin.

Bottom line: I think the Democrats may hold on to a slim Senate majority. Republicans will have enough leverage that we may be able to produce some positive small business results if Congress can rise above the partisan junk.

HOURS OF SERVICE

In response to a petition from the Public Citizen (a national, nonprofit consumer advocacy organization), the Federal Motor Carrier Safety Administration (FMCSA) is preparing a proposed rule to revise the Hours of Service limitations on commercial truck drivers. A draft of the rule has been sent by FMCSA to the Office of Management and Budget for review. If it clears the review, it will then be published in the Federal Register for comment from the public later this year with a final rule target of mid-year 2011.

The government started a rulemaking in 2000 and issued a final rule in 2003. Then there was a series of lawsuits and rule changes (or some safety advocates would say a lack thereof). There are rumors that FMCSA may propose further limitations on the Hours of Service for local delivery drivers.

CADMIUM

While not many small businesses have cadmium lying around, here is another example of the regulatory trend.

Four environmental advocacy groups petitioned the Environmental Protection Agency (EPA) to use its authority under the Toxic Substances Control Act (TSCA) to review the use of cadmium in children's products and possibly limit the amount of cadmium in children's products.

The EPA has granted their petition. Said the EPA, "EPA believes your petition raises an important issue about the risks of cadmium in metal toy jewelry and that some action should be taken to address the risk. Therefore, without determining whether your petition contains sufficient information and analysis to compel EPA to grant it, EPA believes action is appropriate, and is choosing to grant your petition."

The EPA has a wide range of "tools" under TSCA. In its letter, the EPA indicated it will proceed with two steps, one of which is to initiate a rulemaking to require reporting by producers, importers, and processors of cadmium and cadmium compounds that are reasonably likely to be incorporated into consumer products, and the other is to require submission of copies of ongoing and completed

unpublished health and safety studies relevant to the determination on whether a potential hazard exists and whether a product may be a banned hazardous substance as outlined in Consumer Product Safety Commission (CPSC) guidelines.

The EPA can take other steps under TSCA and can regulate the use of the cadmium. It is not too hard to read between the lines that the petition and the EPA response put pressure on the CPSC to act. Said the EPA in its letter: "Though it is EPA's understanding that CPSC is currently developing exposure limits for cadmium in certain children's products, if CPSC does not act, EPA will initiate a rulemaking under TSCA section 6 as your petition requests."

R&D CREDIT

One item raised by the President is to make permanent the R&D Credit. For the record, there is no such thing as an R&D or Research and Development Credit. Trick answer you say, since the credit was temporary and it expired at the end of 2009. No, it does not exist. You will find the term "research credit" and the term "research and experimentation" but no R&D. Somewhere along the line, the popular phrase simply stuck in the vernacular when talking about the credit. I won't fight the tide, so I call it the R&D Credit.

Second, there are (or were) actually three credits, the basic credit, the alternative incremental credit and the alternative simplified credit. Along the way, the alternative incremental credit has been abandoned as less workable and only the other two are in play for renewal, Third, "simplified" is an

overstatement. It still takes a lot of work to claim the alternative simplified credit. The simplified has to do with calculating the baseline from which additional research expenses are considered qualified. The R&D credit rewards incremental increases in research expenses.

Generally speaking, the R&D credit is not small business friendly. About 80 percent of the credit claimed goes to companies with more than \$50 million in assets.

From a theoretical standpoint, many small businesses are not likely to make the incremental increases in research. They are more likely to make a sustained steady investment in R&D. Second, the recordkeeping necessary to track expenses is not easy. The good news is small business' use of the R&D credit has grown and it is partly because a cottage industry of accounting bounty hunters have been able to create a pricing structure that makes it worthwhile for small businesses to engage them to claim the credit. Third, there are some restrictions on claiming the practical but narrow applied research that many small businesses do for their customers.

Not to say the R&D Credit is bad. A truly simplified, flat credit would be better, but something is better than nothing.

Here are few details about how the R&D Credit works. Internal Revenue Code (IRC) Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research tax credit applies only to the extent that the

taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of 3 percent. In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current year qualified research expenses.

The Tax Relief and Health Care Act of 2006 created an alternative simplified credit effective January 1, 2007 for qualified research expenses. The alternative simplified research is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

For the purposes of the credits, qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid

or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses). Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

The research also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic or seasonal design factors. In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.

Under Section 174, taxpayers currently may elect to DEDUCT the amount of certain research or

experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under Section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under Section 41 in lieu of reducing deductions otherwise allowed.

CHIEF COUNSEL FOR ADVOCACY

While Congress was in recess President Obama exercised his executive privilege to make a "recess" appointment for the Chief Counsel for Advocacy over at the Small Business Administration.

Dr. Winslow Sargeant's nomination had been held up in the Senate for many months by various Senators under their veiled "hold" tradition. A recess appointment means he can serve until the next session of Congress ends, which means he will be in place through 2011.

Most recently, he served as managing director of Venture Investors, LLC, in Madison, Wisconsin. The firm provided seed and early-stage money to high-potential health care and IT companies. There, he specialized in computer software, hardware, and materials, and worked with technology transfer offices.

From 2001 to 2005, he was program manager in electronics for the National Science Foundation's