Statement of

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Chairman Huelskamp, Ranking Member Chu, and Members of the Subcommittee,

I am grateful for the opportunity to speak to you today. Small business needs tax reform, and simplifying compliance and administration for small businesses should be part of that tax reform. ,This subcommittee's concern and interest in exploring the subject is to be applauded.

The complexity and costs of calculating many tax incentives makes it difficult for small businesses to properly take advantage of them. It is my firm's experience that because of this, many small businesses simply ignore them. This not only prevents these incentive provisions from accomplishing their intended purpose, but also results in small businesses being placed at a disadvantage compared to their larger competitors who are better positioned to incur the costs of calculation.

More importantly, it leads many small businesses to believe that they have been left out, that the incentives in the Code are intended to only be available to larger business, and that the system is simply not fair.

Grant Thornton urges Congress to pursue tax reform that would lower the tax rates applicable to all businesses, regardless of the form in which they conduct business. Small businesses are among the businesses most likely to organize as pass-throughs and it is essential that pass-throughs such as partnerships and S corporations be included in any reduction in tax rates.

We recognize the immense difficulty, however, in enacting fundamental tax reform. If for whatever reason such tax reform is not possible, or is only possible in the future, we believe that the ability of small businesses to share in the incentives provided by the Internal Revenue Code[1] could be increased by better focusing on those methods that are easier to compute and the use of safe harbors specific to small businesses that would simplify calculations.

I will focus the remainder of my testimony on the challenges faced by the small business community in taking advantage of two important Federal tax incentives, the research credit and the domestic production activities deduction.

Research Credits

The credit for increasing research is one of the most effective incentives in the Code. Studies have shown that additional research contributes a multiple of its cost in increased economic activity. Under current law, there are two methods are available for calculating the research credit: The traditional method and the alternative simplified method.

The traditional method provides a credit equal to 20 percent of the amount that current qualified research expenditures exceed a base amount that is determined by multiplying the business' average annual gross receipts for the prior four years by a historical ratio of research expenses to

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[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated under the Code.

average gross receipts that may be determined by years as early as 1984.[2] An alternative simplified method is available that provides a credit equal to 14 percent of the amount that qualified research expenditures for the current year exceed 50 percent of the qualified research expenditures for the preceding three years.[3]

It is my firm's experience that virtually no small- or medium-sized businesses uses the traditional method. In recent years, there have been numerous proposals to abandon the traditional calculation method and increase the credit percentage allowed for the alternative simplified method. Congress could provide a significant benefit to smaller taxpayers and enhance the use of the research credit by raising the alternative simplified rate. Regardless of the method chosen, the taxpayer is required to determine which of its expenditures satisfy detailed rules and regulations to be treated as qualified research expenses. Where the research is performed by the taxpayer, such expenses include wages paid to employees (or self-employment income of an owner) for engaging in qualified research or the direct supervision of qualified research, supplies (not including land, improvements to land, or property of a character subject to the allowance for depreciation), and amounts paid for the use of computers in the conduct of qualified research.

Small businesses would significantly benefit from the implementation of safe harbors that would simplify the process of determining which expenses qualify and the modification of existing safe harbors to facilitate their use by small businesses.

An example of an existing safe harbor that may serve larger taxpayers but does not fully satisfy the need of small businesses relates to the treatment of wages paid to employees with multiple responsibilities, only some of which are research related. The general rule applicable to such employees is that, in the absence of another method that the taxpayer can demonstrate to be more appropriate, the wages must be separated into qualified and nonqualified portions based on the number of hours worked on qualified and nonqualified activities.[4] Treasury regulations provide that an employee devoting 80 percent of his or her time to qualified research activities may be considered to have devoted all of his or her time to such activities.[5]

For large businesses with significant research staffs, it is generally possible to judge whether an employee spends substantially all of his or her time performing or directly supervising qualified research. In such cases, the 80 percent rule provides a cushion and may allow for the full inclusion of the employee's wages as qualified research expenses without further examination.

Small business employees, however, typically have a wider range of responsibilities than employees of larger organizations. Employees that are primarily employed for the purpose of doing research may also have a range of administrative and other duties that do not qualify as research under the Code and regulations. The likelihood that these other duties might exceed 20 percent requires smaller businesses to go through the process of examining time sheets or other records. Reducing the safe harbor percentage to 50 percent for small businesses would allow

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[2] IRC §41(a)
[3] IRC §41(c)(5).
[4] Treas. Reg. §1.41-2(d)(1).
[5] Treas. Reg. §1.41-2(d)(2).

such businesses the type of cushion that would simplify their determination of which costs are qualified.

Domestic Production Activities Deduction

Subject to certain limitations, the domestic production activities deduction of section 199 provides a deduction equal to 9 percent (6 percent in the case of production of oil and gas) of the net profits from producing property (including software), providing certain utility services, or providing services in the areas of construction, architecture and engineering provided such property is produced or services provided in the United States.[6] Other types of service income, income from the resale of items not produced by the taxpayer, and most types of investment income, do not qualify. For corporations paying tax at a 35% marginal rate, the deduction is the equivalent of a 3 point reduction in the corporate tax rate.

Although relatively simple in concept, the domestic production activities deduction can be very difficult to determine in practice. In some instances, only a portion of the net income earned in an activity or even a single transaction may qualify for the deduction. Given the difficulty in determining the amount of eligible income, and the limited benefit to be derived from identifying that income, many small businesses have decided that the deduction is not worth the effort required to calculate it.

The Treasury has provided several safe harbors to assist taxpayers in the calculation of the domestic production activities deduction. One of these is the rule that allows all of a taxpayer's gross receipts to be treated as qualified if 95 percent of its gross receipts are qualified. [7] This allows taxpayers with only minimal amounts of nonqualified income to simply treat nine percent of their taxable income as their domestic production activities deduction.

However, taxpayers who are not comfortably within the 95 percent test must still go through the process of segregating their income into qualified and nonqualified portions, if only to determine whether or not they satisfy the 95 percent test. For those taxpayers, the 95 percent safe harbor may produce a small tax savings, but it does nothing to simply the calculation and make the benefit worth the effort required to obtain it.

The existing 95 percent safe harbor could be modified in several ways to make it more practical for small businesses, making it feasible for them to benefit from the provision in the same manner as their larger competitors. The percentage could be lowered, making it more likely that a small business could satisfy the safe harbor and claim the benefit of the domestic production activities deduction without having to carefully segregate its income into qualified and nonqualified portions. Alternatively, the safe harbor could be modified to allow it to be applied solely to the active portion of a small businesses' income by first excluding identifiable investment income as nonqualified, and then applying the safe harbor to the remaining taxable income. While this might result in a reduced benefit in certain cases, it could significantly

[6] IRC Section 199
[7] Treas. Regs. §1.199-1(d)(3).

simplify the process of calculating the domestic production activities deduction, bringing its benefits within the reach of small as well as larger businesses.

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