2013

Principles of Tax Reform

For the Independent Grocery Sector

NATIONAL GROCERS ASSOCIATION
Thirty years ago, the National Grocers Association (NGA) was born and has since been recognized as the representative of the independent retail and wholesale grocer. I’m pleased to report that the industry thrives due in large part to the entrepreneurial spirit that has spurred tremendous growth, even in these current challenging economic times. In fact, independent retail and wholesale grocers are responsible for over 945,000 direct quality jobs with wages exceeding $30 billion annually, while generating over $27 billion in state and federal taxes. We look forward to sharing more positive economic data at the end of April 2013 when NGA’s economic impact study of the independent supermarket industry is released.

While the independent grocery industry is strong, it is not without its challenges, especially during these economic times. According to the 2012 Independent Grocers Financial Survey, published by NGA and FMS, the average net profit for independent grocers before taxes was just 1.12%. The supermarket industry is hypercompetitive with many different operators and formats competing for the same consumer dollar, made even more challenging at a time when the economy remains weak. Independent retailers and wholesalers must continue to reinvest capital back into their businesses to keep stores fresh, to take advantage of new opportunities to expand their operations, and improve efficiency.

Many try to simplify tax reform into a one or two sentence talking point that often fails to reflect reality. It’s important for public policy makers to clearly understand the “faces” that operate behind the Internal Revenue Code and understand how tax provisions present challenges as well as opportunities for economic and job growth, especially for small and medium size businesses who are the cornerstone of thousands of communities across the nation.

In March 2013 NGA asked its members to provide their business insights into a number of specific categories regarding tax reform such as tax rates, capital investments, and other pro-growth tax provisions. Their candid responses have been summarized in this report and should be considered as Congress continues to address tax reform. Independent retail and wholesale grocers help drive America’s economy and are responsible for hundreds of thousands of local American jobs. It is our hope that the information provided in this report will provide valuable insights into those elements that are crucial to ensuring that businesses, such as independent retail and wholesale grocers, are able to continue investing their hard earned capital back into their businesses in an effort to spur economic growth and job creation.

We look forward to continuing to work together to reform the tax code in a manner that ensures America’s independent retail and wholesale grocers are able to continue growing and creating much needed jobs.

Sincerely,

Peter J. Larkin
President and CEO
**The Independent Supermarket Industry**

Independent retail and wholesale grocers are the true entrepreneurs of the grocery industry and are dedicated to their customers, associates, and communities. A vibrant independent sector promotes diversity in the marketplace and increases consumer choice in price, variety, quality, service and value.

The meaning of an independent retailer is more of a question of ownership and philosophy of operation, rather than a number of stores or type of format. An independent retailer is a privately owned or controlled food retail company operating a variety of formats. A few may be publically traded, but with controlling shares held by the family, and others are employee owned.

The independent grocery channel is a marketplace that is highly competitive, labor intensive, cash flow dependent, very sensitive to a broad range of tax provisions and low margin. In fact, according to the 2012 NGA / FMS Independent Grocers Financial Survey the average net profit before taxes for independent retail grocers was only 1.12%.

**Independent Grocers Drive Local Economies & Create Quality Jobs**

Independent grocers impact communities in virtually every community across the Nation, responsible for over 945,000 quality jobs with wages exceeding $30 billion. Annual sales of retail and wholesale grocers exceed $125 billion annually. The impact of the local supermarket is felt from the fields of America’s farmers to our family’s dinner table.

The importance of independent grocers is seen far beyond their direct employees. Over 147,000 people in the United States work in firms that supply the infrastructure and other services to the grocery industry including agriculture, physical infrastructure such as refrigeration equipment, technology, insurance, real estate services, and legal services. Additionally, over 422,000 people in the United States owe their jobs to the re-spending of the direct and indirect wages of the independent grocer industry. All told, independent retail and wholesale grocers and their employees generate over $27 billion in state and federal taxes.

**The National Grocers Association**

The National Grocers Association (NGA) is the national trade association representing the retail and wholesale grocers that compromise the independent sector of the food distribution industry. Also represented are affiliated associations, manufacturers, and service providers as well as other entrepreneurial companies that support NGA’s Mission and Philosophy.

NGA’s mission is to ensure independent, community-focused retailers and wholesalers the opportunity to succeed and better serve the consumer through its policies, advocacy, programs and services.
Executive Summary

Between March 4, 2013 and March 11, 2013 the National Grocers Association undertook a comprehensive tax survey of its member companies. The survey produced a number of key findings that NGA believes are critical elements in understanding how tax policy significantly affects the job creators in this key industry sector. Responses to the survey were diverse and reflective of NGA’s membership, ranging from a single store operator with just over $1 million in annual sales to a wholesaler with over $6.5 billion in annual sales.

Principle #1: Tax Reform Must be Fair & Equitable for all Business Entities.

It’s clear from responses that tax rates have the most direct impact on a business owner’s ability to reinvest capital back into the business. Respondents indicated 57% operate as pass-through entities while 37% operated as a C-Corporation, highlighting the importance of tax reform addressing both individual rates and corporate rates. Any tax reform effort must simultaneously include relief for both pass-through entities and C-corps and must include parity. When tax rates rise, such as the increase in individual tax rates to 39.5%, there is less cash for investment. As one respondent noted, lenders are requiring large sums of cash to qualify for loans, further highlighting the importance of cash flow. In an industry with the average net profit before taxes is only 1.12% every penny counts.

Additionally, 88% of respondents cited the Death Tax as important to their business continuity. NGA’s members are family-owned and / or privately controlled businesses so the death tax is a real threat to their ability to pass the business onto the next generation. The Death Tax impacts independent grocers particularly hard as well over half of the assets of a typical supermarket are not liquid, meaning the surviving heirs are often faced with securing an expensive loan to selling part or all of the business to pay the tax. While the current Death Tax exemption provided a level of certainty and some relief to NGA’s members NGA’s ultimate goal remains to see this onerous tax repealed.

Accounting Method Last In, First Out is Widely Used

Nearly 60% of respondents indicated that the accounting method Last In, First Out (LIFO) was important to their business. Many retailers and wholesalers have been on LIFO accounting for many years, including one respondent who has relied on LIFO for 66 years. LIFO has been a widely accepted accounting practice since 1939 and should be preserved as an accepted accounting method under tax reform. It’s clear from the survey responses that repeal of LIFO would have a devastating impact on many in the industry.
**Principle #2: Tax Provisions That Encourage Capital Investment in Businesses Should be Retained to Continue Creating Jobs and Growing the Economy**

Bonus Depreciation was rated by 93% of respondents as important, while 89% rated section 179 expensing as important. Comments from survey respondents specifically cited their ability to use these provisions to provide cash flow to replace old fixtures, build new stores, remodel stores, and invest in energy saving equipment. The 15 Year Straight-Line Cost Recovery for Qualified Leasehold Improvements was rated by 82% of respondents as important for store upgrades. These investments have a positive impact on local economies and jobs through product procurement and installation, while often leading to increased sales allowing retailers to hire more workers.

**Principle #3: Incentives to Expand Employment Opportunities and Business Investment in Underserved Communities Should be Maintained**

*Work Opportunity Tax Credit and New Markets Tax Credit*

The Work Opportunity Tax Credit (WOTC) was cited by 60% of respondents as important and was valuable in hiring workers who often face barriers to employment, while 37% of respondents indicated the New Markets Tax Credit (NMTC) was important. NMTC are becoming more important to independent grocers as more retailers work to address the issue of food deserts.
Tax Structures
Respondents represent a diverse range of business tax structures with S-Corporations being the dominate response at 48% followed by C-Corporations at 37%. A growing segment of respondents and our members are electing to become ESOPs.

Survey Respondent Tax Structure Breakdown:
- C-Corporation: 37%
- S-Corporation: 48%
- ESOP: 1%
- LLC / Partnership: 8%
- Other: 3%
- No Response: 3%

Individual & Corporate Tax Rates
Respondents were asked to rate the importance of tax rates to their business. Overwhelmingly, both C-Corps and S-Corps and other pass-through respondents cited a direct correlation between higher taxes and the adverse effect on their ability to service debt, reinvest in stores, distribution centers, equipment, and people without going deeper into debt. The current disparity between individual tax rates for pass-through entities and C-Corps results in unfair and inequitable taxation of business income. One S-Corp ESOP respondent specifically cited the detrimental impact taxing passive entities with certain revenue thresholds as C-Corps and would have a direct, negative impact on our employee owners.

Rate the importance of tax rates and any impact, if any, they have on your business.
- Very Important: 67%
- Important: 12%
- Somewhat Important: 9%
- Not Important: 1%
- Not Applicable: 10%

Comments:
“Taxes are the most significant cost that we incur.”

“There is a direct correlation between the amount of taxes we pay and the amount of funds we have for capital investment.”

“Trying to manage the tax rate doesn’t allow us to grow our business effectively and create new opportunities for our associates and create more jobs.”

“Being an S corporation, the profits from our company are reflected as personal income to us; however, we do not actually earn this as personal income (does not go into our pockets). The Company’s retained earnings go into growth; plant renovations and personnel benefits.”

“I try on average to reinvest 20% of my income in plant and equipment improvement each year. With state and federal taxes approaching 50% I am not left with much to invest in additional business opportunities.”
“As an LLC it is a challenge to pay high taxes in light of the constant necessity to accumulate resources to use when purchasing equipment or paying for a remodel in a store. The loan to value rates require large sums of cash to qualify for lending, 50% for inventory, 30% for equipment, 30% for buildings. When taxes have taken up cash capital projects are directly impacted.”

**The Death Tax**

The Death Tax remains an important issue for independent retail and wholesale grocers with 88% of survey respondents identifying the issue as important. NGA’s members are family-owned and / or privately controlled businesses, many having served their local communities for decades. Well over half of the assets of a typical supermarket—the highest of any other industry sector—are not liquid, so the death of an owner creates a serious obstacle to continuation of the business. Because the estate tax of up to 40% is assessed on the value of a business at the owner’s death, it often forces families to borrow funds to pay the tax, and hampers a family-owned businesses’ ability to pass the company to the next generation. As a result it reduces the ability to invest and grow the business, or forces the sale of the business. Additionally, the Death Tax is a reality that independent grocers must face in which their publicly traded competitors never face.

The current Death Tax exemption of $5.25 million ($10.5 million per couple), indexed to inflation with stepped up basis, provides some relief to family-owned retailers and wholesalers, while also providing much needed certainty. NGA’s ultimate goal remains to see this onerous tax with a top rate of 40% repealed.

*Please rate the importance of death taxes on your business. Background: Death Tax top rate increased 5% to 40% in 2013, with an exemption of $5.25m / $10.5 couples indexed to inflation, portability of any unused portion to surviving spouse, and stepped up basis.*

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**Comments:**

“As a family-owned business we spend a lot of money on tax planning and life insurance to mitigate the impact of this tax instead of using these dollars to drive associate and customer satisfaction”

“Our family-owned business started from nothing and now because we have been successful we will be forced to sell or refinance to pay the taxes when our father passes.”

“We are a small 4th generation family-owned business. We have spent substantial resources on lawyers, accountants, and planners to try and set-up a structure that can deal with estate taxes. We are very concerned that we may have to sell our business just to pay the taxes and end a 68 year old company.”
**Capital Gains / Dividends**

In today's economy investment in a supermarket requires substantial capital costs in buildings, equipment and real estate. Capital gains tax rates that are lower than ordinary income tax rates promote capital investment in businesses in order to encourage long term businesses and economic growth. A differential between capital gains and ordinary income tax rates was rated as important by 88% of survey respondents to their ability to grow their businesses.

**Please rate the impact Capital Gains and Dividend Taxes have on your business. Background:** Capital Gains / Dividends rates below $400,000 / $450,000 (couple) currently are 15% while increasing to 20% above the $400,000 / $450,000 threshold. On January 1, 2013 an additional 3.8% tax went into effect for individuals with incomes above $200,000 / $250,000 couples. This also pertains to "passive" investment income from flow-thru entities.

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**Comments:**

“The increase in capital gains from 15 to 20% will be a deterring factor in my decision to invest in my business. With the additional 3.8% tax on top of the income tax increases, the prospects for growth in my company are quite poor. Raises for my employees have been greatly impacted by these recent (tax) increases.”

“The capital gains tax is a penalty for running a profitable business as it, along with the dividend taxation, ends up being a double tax.”

**Capital Investments**

Independent retail and wholesale grocers require significant capital in order to reinvest in and grow their businesses. Equipment for a typical supermarket requires a substantial capital investment that can quickly grow into six figures, even for a small store, and easily exceeds $1 million for many larger stores and wholesale distribution facilities. Capital investments include replacement or upgrades to refrigeration cases, shelving, fork lifts, and technology to operate front end cash registers as well as backend systems to manage inventory and cash flow. Wholesale distribution facilities require millions of dollars of capital in equipment, racking systems, trucks and trailers, and sophisticated technology to manage logistics and inventory control. Importantly, capital investment in our member’s facilities has a positive impact on the local economy. Capital investment by independent retailers and wholesalers has a multiplier effect as equipment and services are often secured from local providers, helping to grow the local economy and create jobs.

**Bonus Depreciation**

In tough economic times pro-growth tax provisions such as bonus depreciation have helped independent retailers and wholesalers continue to purchase new equipment and reinvest in their businesses by being able to write off the investment at a faster rate. **Bonus depreciation was identified by 93% of respondents as important to their ability to reinvest in and grow their businesses.** Many survey respondents also cited the positive impact provisions, such as Bonus Depreciation, had on cash flow for use in capital investments.
Please rate the importance of Bonus Depreciation on your ability as a retailer or wholesaler to reinvest and grow your business.

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Comments:
“We remodeled one of our stores and took advantage of this (provision). We also spent a million dollars last year on new equipment.”

“We have used this incentive to replace old equipment and help to grow our business. Small companies need this to help stretch our limited budgets in hard times. The more we invest in equipment and remodels the more Americans have jobs.”

“This program has allowed us to modernize our aging stores and better compete with the large chains. We need Bonus Depreciation to invest in new technology and energy saving equipment.”

“We have depended on Bonus Depreciation to make approximately $300,000 of capital improvements over the past year. We have replaced technology, installed new refrigeration cases, equipment, and various machinery.”

“We have upgraded our facilities over the past few years and believe that none of it would have been possible if normal depreciation rules were applied. A lot of capital that we used would have gone to pay taxes. It has made our company strong and should help us stay viable for many years.”

“We were able to build a brand new store in 2008 using Bonus Depreciation. We have continued to purchase new equipment to help production and improve safety at our facility.”

“Helps small business reinvest in their stores at a time when our economy needs to be spurred on.”

Section 179 Expensing
Similar to bonus depreciation, 89% of survey respondents also rated Section 179 expensing for qualified purchases as a very important tax provision given the positive impact it has had on independent retailers and wholesalers’ ability to reinvest in their businesses and grow.

Section 179 expensing is essential to providing many retailers with increased cash flow for capital investments. While some wholesales noted that the provision was not applicable to them give the threshold phase-out, but it was very important to their retail customers who were able to reinvest and grow their businesses, thereby having a positive net effect on the wholesaler as well. A number of respondents urged that the maximum threshold of $500,000 for qualified purchased be increased to encourage further investment. Lowering the threshold would likely lead to decreased investment.
Rate the importance of the section 179 deduction for qualified purchases up to a maximum of $500,000 and a phase-out threshold to $2 million in 2012-2013. Taxpayers may also expense up to $250,000 of the cost of qualified leasehold improvement.

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Comments:
“I have added equipment each year because of this!”

“We need to know what is going to happen before it’s too late to react like last year’s tax package. It was too late to spend money when we found out the tax package was going to go through. Fear caused us to hold back.”

“Need more qualified purchases.”

“Would like to see maximum raised.”

“Deduction has allowed us to make needed improvements in a tight economy.”

*Note: Many respondents cited many of the same reasons given under the Bonus Depreciation question.

Credit: Grocery Headquarters Magazine
15 Year Straight-Line Cost Recovery for Qualified Leasehold Improvements

The 15 Year straight-line cost recovery for qualified leasehold improvements was cited as an important provision by 82% of survey respondents for independent grocers remodeling and reinvesting in their facilities. Specifically the provision is important to independent grocers from a cash flow perspective; however a number of respondents noted that 15 years is still long and a shorter period would be more advantageous.

Please rate the impact on your business of the 15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements. Note: provision is extended through 2013 and includes the 15 year cost recovery period for qualified leasehold, restaurant, and retail improvements / new buildings established prior to January 1, 2014.

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Comments:
“Makes upgrading my stores easier”

“Have used this a lot, a shorter period would be better”

“This is very important to our retail owners”

“From a cash-flow perspective it is very important”

“Having to go 39 years is awful, this makes more sense”

Acceptable Accounting Method

Last In, First Out (LIFO)

Proposals by President Obama and some in Congress would repeal the accounting method Last In, First Out, commonly referred to as LIFO. Contrary to what some have characterized as a “gimmick” LIFO is a widely accepted accounting practice recognized by the Internal Revenue Service since 1939.

Historically, in time of high food price inflation many independent retail and wholesale grocers chose the Last In, First Out (LIFO) accounting method to more accurately valuate their inventory replacement cost. Over the years many independent retailers and the wholesalers that serve them have built up considerable LIFO reserves, which are neither cash nor assets and by no means are liquid. Repealing LIFO and taxing a company’s reserves would have a devastating impact on most respondents.

While a number of independent retailers use LIFO, so too a large number of wholesalers use LIFO and have considerable reserves. In the case of those wholesalers who are cooperatives, the impact of repeal and taxing their LIFO reserves would be felt by their independent retail grocer owners,
thereby causing a trickle effect by effectively reducing the equity position of those retailers. NGA strongly supports maintaining the LIFO accounting method.

*Please rate the importance of the accounting method, Last In, First Out (LIFO). If you do not use LIFO please select “Not Applicable”. Background: President Obama has repeatedly called for LIFO to be repealed, forcing companies to “write up” their LIFO reserves.*

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Respondents were asked to provide their current LIFO reserves. Responses ranged from a low of $40,000 to a high of $6.7 million. A large number of responses listed reserves in excess of $1 million. In terms of years on LIFO the responses ranged from a low of 4 years to a high of 66, with most responses in the 20 - 30 year range.

**Comments:**

“"I am not sure how we would pay for that. We do not have those kinds of (cash) reserves. We would have to evaluate a loan and if that could not be done we may be forced to sell one or two of our stores.”

“"If this happens there would be a fire sale on this business.”

“"The impact on our company would be huge.”

“"We would mail our keys to the IRS”

“"We operate as a cooperative (wholesaler). This would trigger very high taxes paid should we have to recognize our valuation allowance.”

“"Would possibly be forced to sell the company.”

“"Very important for our wholesaler. We are not using LIFO, but our member owned wholesaler is and it is very important for our co-op.”
Miscellaneous Pro-Growth Tax Provisions

Work Opportunity Tax Credit (WOTC)
Over 60% of survey respondents cited the Work Opportunity Tax Credit (WOTC) as important to their business. Predictably, respondents are reflective of the businesses particular geographic location and how their operations function. Additionally, larger operations seemed more inclined to utilize the credit given the administrative burdens required to administer the program, which may be more than a smaller operator is able or willing to undertake, given the threat of penalties for errors. Other respondents were not familiar with the credit. One respondent located in the Gulf region cited the important role WOTC played in the aftermath of Hurricanes Katrina and Rita; however it has become less important due to lack of qualified employee candidates. NGA has long supported WOTC and is a member of the WOTC Coalition.

Please rate the importance of the Work Opportunity Tax Credit (WOTC) to your business. Background: the WOTC is extended through 2013 allow business to claim a tax credit equal to 40% of the first $6,000 of wages paid to new hires in certain targeted groups.

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Comments:
“We have been able to put many at-risk individuals or persons who otherwise might not have an opportunity to work.”

“Haven’t used WOTC, as it’s difficult to find qualified folks in targeted groups in my rural community.”

“The penalty for mistakes is not worth the trouble”

“Would like to see this program extended”

“We’ve hired about 10 people through this program”

“We have hired 4 employees over the last 10 years on this program. Two have been here for 10 years! Would never have taken a second look had it not been for this program, and they turned out to be excellent employees.”

“Have hired an estimated 25 people”

“We definitely use this program and it has allowed us to continue to operate in an area that we may have had to review profitability more closely.”
New Markets Tax Credit (NMTC)

As more of NGA members are investing in communities located in food deserts the New Markets Tax Credit (NMTC) has become a key tool that has enabled numerous urban projects. Independent grocers in Pennsylvania, New York, California, Illinois, the City of New Orleans, and Mississippi are participating in efforts to bring supermarkets and economic development to areas that have lacked access, in addition to new store projects that are ongoing in numerous communities across the country due, in part, to NMTC resources.

The NMTC program is relatively new to many independent grocers, which may explain the large number of respondents who rated the program as either “not important” or “not applicable”.

If you have utilized the New Markets Tax Credit (NMTC) please rate the importance to your business. The NMTC program is extended through 2013 enabling businesses and individuals that make private investments in low income communities a 39% tax credit spread over 7 years.

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Comments:

“Good program, just not an issue in our marketplace”

“Working on a project now that will use NMTC, the project is in a tough area and the business model would not work financially if this program and county resources were not available. I would like to see money geared toward smaller businesses.”

“Have not used this, but have investigated and will use if still available in 2014.”

“This credit has been utilized by several of our owners and assisted in the development of new independent grocery stores. As a company we have not utilized the Federal New Markets Tax Credit, but our sales have benefited through retail use of the credit.”

“We purchased a store from a developer who was able to use this (NMTC) to finance the development.”

“We are currently looking at this program for a possible expansion in 2014.”
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