Comments of

The National Association of Manufacturers

Submitted to the Senate Finance Committee

Business Tax Reform Working Group

April 15, 2015

I. Introduction

The National Association of Manufacturers (NAM) welcomes the opportunity to submit comments to the Senate Finance Committee Business Tax Reform Working Group.

The NAM is the largest manufacturing association in the United States, representing manufacturers of all sizes in every industrial sector and in all 50 states. Manufacturing employs nearly 12 million men and women, contributes more than $1.8 trillion to the U.S. economy annually, has the largest economic impact of any major sector and accounts for three-quarters of private-sector research and development.

NAM members know firsthand that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. As outlined in the NAM's A Growth Agenda: Four Goals for a Manufacturing Resurgence in America, a key objective for the association is to create a national tax climate that promotes manufacturing in America and enhances the global competitiveness of manufacturers in the United States. A pro-manufacturing tax policy must acknowledge that a high tax burden makes manufacturers in the United States less competitive.

To achieve these goals, we need a comprehensive tax reform plan that both reduces the corporate tax rate to 25 percent or lower and includes lower rates for the nearly two-thirds of manufacturers organized as flow-through entities. We also believe that comprehensive tax reform must include a shift from the current worldwide system of taxation to a modern and competitive international tax system, a permanent and strengthened research and experimentation (R&E) incentive and a strong capital cost-recovery system.

The NAM very much appreciates the current focus on improving our nation's tax system. Enactment of a pro-growth, pro-manufacturing tax reform plan will go a long way to strengthen our economy and ensure vibrant economic growth in the future. ***A Missed Opportunity: the Economic Cost of Delaying Pro-Business Tax Reform***, a study released by the NAM in January 2015, takes a close look at the economic impact of enacting a five-prong pro-business tax package similar to NAM's priorities and concludes that lack of action on pro-business tax reform is costing the U.S. economy in terms of slower growth in Gross Domestic Product (GDP), investment and employment. In contrast, the report finds that over a ten-year period, a pro-business tax plan would increase GDP over $12 trillion relative to CBO projections, increase investment by over $3.3 trillion and add over 6.5 million jobs to the U.S. economy.

The following comments reflect NAM Board-approved policy on tax reform and are based on the premise that any changes would be part of a comprehensive tax reform plan.[1]

II. Individual Tax Reform and Small and Medium Manufacturers

Manufacturers organized as flow-through entities—generally, small and medium-sized businesses—pay taxes at individual rates. Moving forward, any discussion about reforming the tax code must ensure that tax reform includes parallel changes for these manufacturers that play a critical role in the supply chain and broader economy.

For more than 60 years, manufacturers and other business owners have chosen to organize as S-corporations or other flow-through entities to benefit from comprehensive liability protection and a single level of federal taxation. According to IRS data, between 1980 and 2008, the total number of flow-through businesses more than tripled to nearly 31 million, employing an estimated 54 percent of the entire private-sector workforce.[2]

Manufacturing is a capital intensive industry and, in smaller companies, the capital to grow and expand operations, increase product lines and hire additional workers most often comes directly from the owners. Thus, the tax treatment of flow-through businesses impacts the decisions and the ability of small and medium-sized manufacturers to hire and retain workers and reinvest in their companies. Consequently, Congress must consider the unique impact that individual tax rates and specific types of base broadening could have on these smaller manufacturers and ensure that tax reform does not increase the tax burden on these companies to pay for other tax reform measures.

It also is important to point out that while many small and medium-sized manufacturers will benefit from the enhanced Section 179 proposal discussed below, pass-through companies, like their corporate peers, need thoughtful tax reform that includes both a lower tax rate and a strong capital cost-recovery system. It is essential to consider the impact of all the tax changes on the ability of these small and medium-sized manufacturers to compete, invest and grow.

III. Self-employment Payroll Taxes

Manufacturers have long been concerned with proposals to expand self-employment taxes. Unlike many other sectors of the economy, manufacturing requires significant—and continuing—investment in capital equipment. Thus, for many active business owners who are manufacturers, the share of income derived from their own labor is much less than the return on the capital investment they make in their own firms.

Moreover, for pass-through manufacturers, investment is largely driven by business owners reinvesting earnings back into the company. As the committee highlighted during the months leading up to the expiration of the 2001 – 2003 tax cuts, tax increases on pass-through manufacturers would harm the economy. In this instance, the tax increases are likely to come through the expansion of Self Employment Compensation Tax Act (SECA) taxes.

---

[1] See also NAM Comments on Camp Discussion Draft, August 2014

[2] Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform,* April 2011.

Over the past several years, some proposals to increase the self-employment taxes have resulted from concerns about compliance problems and ongoing abuse of the current rules. For more than 35 years, manufacturers have been complying with the current rules that penalize business owners who pay themselves less than "reasonable compensation." In contrast, recent proposals to expand SECA taxes are based on the false assumption that pass-through owners have been sheltering earnings from SECA taxes by paying them as a distribution rather than as income. Any abuse should not be addressed with a "one-size-fits-all" policy that increases taxes on small and medium-sized manufacturers. Increasing taxes on these owners will reduce the amount of capital available to reinvest, grow and create jobs.

IV. The Corporate Tax Rate

For more than three years, the United States has had the highest corporate tax rate among developed economies. While the top U.S. corporate tax rate has remained at 35 percent for almost 25 years, other major developed countries have realized that lower corporate tax rates encourage economic growth and have significantly reduced their statutory tax rates. As a result, the United States is at a significant disadvantage in the global economy.

Manufacturers in particular feel the brunt of our high tax rates. Thus, a key objective for the NAM is to create a national tax climate that enhances the global competitiveness of manufacturers in the United States. An important step to achieving this goal is to adopt a federal statutory corporate tax rate of 25 percent or lower, which will put us more in line with our major competitors. A lower corporate tax rate will make it easier for manufacturers in the United States to compete in the global marketplace, encourage greater investment in the United States and promote U.S. job creation and overall growth.

In addition to recognizing the benefits of a lower, more competitive corporate tax rate, manufacturers also believe that the ideal tax system would eliminate the double tax on corporate income. Under current federal tax law, dividend income is taxed twice: once to the corporation and again to the individual recipient. This double tax burden creates a bias against corporate earnings. Absent elimination, keeping the tax rate on dividends as low as possible and maintaining the parity with capital gains will help dividend-paying public companies attract investors and allow them to finance investment and create jobs.

V. Capital Cost Recovery

a. Overview

In addition to lower tax rates for businesses of all sizes, one of the most effective ways to spur business investment—and make U.S. manufacturing more competitive—is through a strong capital-cost recovery system. An ideal system would allow companies to expense capital equipment in the tax year purchased.

The positive economic impact of expensing capital equipment is well recognized. A basic premise of economic theory is that investment is a positive function of an increase in demand and a negative function of cost. The cost of capital to a firm includes three components: the price of capital equipment, the cost of financing the equipment and the tax treatment of investment. Expensing lowers the after-tax cost of capital and increases the number of profitable projects a firm can undertake, helping spur the growth in business investment. The enhanced Section 179 and so-called "bonus depreciation" provisions enacted in recent years

have temporarily moved us toward an expensing system. Manufacturers believe that, where possible, these policies should be expanded and made a permanent part of any pro-growth tax reform.

Moreover, the fact that increased investment leads to job creation cannot be overemphasized. Indeed, cost recovery is not merely timing. Manufacturers of all sizes take into account the tax impact of cost recovery mechanisms on project cash flows in making investment decisions. For manufacturers large and small, cash flows are carefully managed to support key growth objectives and cash flow is critical when access to credit is difficult, especially for small and medium-sized manufacturers.

Thus, the NAM is concerned about the long-term impact of proposals that increase the cost of domestic investment. Recent data[3] released by the Bureau of Economic Analysis reinforces the role that a healthy manufacturing sector plays in the health of the nation's economy. Manufacturing in the United States is in the midst of a comeback, but for the nation to fully reap the benefit of this resurgence, manufacturers need tax policies that allow them to compete in today's global economy and do not tip the scales against investment.

Consequently, we urge policymakers to advance reforms that encourage investment and job creation in the United States rather than penalize companies struggling to compete in a global economy. To that end, it is critical that tax reform does not create a general limitation on interest expense, as it is important to maintain full deductibility for interest given the role it plays in funding new investments and business operations. Clearly, making the cost of capital more expensive will not serve to achieve these goals.

b. Alternative Depreciation System (ADS)

In the capital-intensive sector of manufacturing, an effective approach to cost-recovery beyond Section 179 is vital to ensuring that comprehensive tax reform allows manufacturers to remain globally competitive. Indeed, the tax treatment of tangible assets influences investment decisions by both small and large manufacturers. The accelerated depreciation regime in effect today promotes economic growth by stimulating investment, which has a multiplier effect throughout the economy.

The current system, which includes 189 specific categories, attempts to match productive lives to asset type and the high productivity in early years of asset ownership with the higher costs of operating equipment in later years. Some policymakers have in recent years instead proposed a shift to straight line depreciation under the Alternative Depreciation System (ADS). For many manufacturers, this shift would greatly increase the time for a company to write off the cost of the investment. Further, for some capital assets, this shift will require calculating a useful life for a piece of equipment that does not reflect the actual useful life for the company due to the rapid pace of technological advancement in 21st century manufacturing. In short, useful life does not always equal optimal productive life in modern manufacturing.

Indeed, policymakers considering tax reform must recognize that, for some manufacturers, even a delayed shift to ADS away from accelerated depreciation would impact cash flow and alter the fundamentals of long-term investment decisions.[4] Additionally, the inflation factor is a variable

[3] Bureau of Economic Analysis, U.S. Department of Commerce, April 25, 2014.

[4] See Fiscal Fact No. 413, Trading Longer Asset Lives for Lower Corporate Tax Rates in the United Kingdom By Kyle Pomerleau, Tax Foundation, January 2014. "Although the United Kingdom has lowered its corporate tax rate by more than 25 percentage points

that may be difficult to predict. It would add a level of uncertainty to the projections and could be cumbersome, especially for small and medium-sized businesses.

The manufacturing sector typically requires a significant investment in productive assets. Proposals that spread depreciation deductions over a longer period of time could make investment in productive assets more expensive, leading to slower future investment in additional equipment—and the job growth often associated with such investment.

c. Natural Resources

As noted in our comments to the Infrastructure and Community Development Working Group, providing the energy needed to support manufacturers and the broader U.S. economy requires large capital investments by the private sector. Promoting investment should be an integral part of comprehensive tax reform, particularly as it relates to investments in developing our nation's energy supplies.

In particular, finding and producing domestic oil and natural gas requires large and continuing capital investments. Drilling oil and gas wells involves a number of costs, including labor, repairs, fuel, chemicals, supplies and other expenses that have no salvage value. Under longstanding tax policy rules, energy companies can deduct these costs—known as intangible drilling costs (IDCs)—as ordinary and necessary business expenses, reducing the cost of exploring for and producing oil and gas.

For manufacturers and other energy consumers, the development of shale natural gas in the United States has been a "game-changer" in terms of reduced energy costs, increased access to secure energy supplies and availability of a low-cost raw material. The chemistry industry alone has generated billions of dollars of new investment thanks to this innovation. IDCs cover about 70 to 80 percent of the cost of a shale gas well.

Preserving U.S. energy companies' access to global natural resources is also critical to U.S. energy security. Unlike their competitors, U.S. energy companies with overseas exploration and production operations—so-called "dual-capacity" taxpayers—pay both U.S. and foreign taxes. Current tax rules for dual-capacity taxpayers—already stricter than rules for other taxpayers—reduce the potential of double taxation of income in the U.S. worldwide tax system and limit foreign tax credits to payments that are truly in the nature of income taxes. Existing rules specifically deny foreign tax credits for some payments, such as royalties paid to access a natural resource.

Unfortunately, some policymakers support provisions that will deny foreign tax credits even for income taxes paid by dual-capacity taxpayers. These proposals will unfairly and retroactively overturn well-established and longstanding rules, subjecting American energy companies to harmful double taxation on new and existing investments. These increased costs will make it even more difficult for U.S. energy companies to compete for and develop new properties outside the United States.

---

over the past thirty years, it has also lengthened its depreciation schedules. As a result, the United Kingdom did not experience the expected benefits from a lower corporate tax rate. In fact, levels of investment declined in the country and were the lowest in the OECD in 2012. This decline also likely disproportionately affected the United Kingdom's manufacturing industry and its manufacturing-centered northern regions."

Additionally, percentage depletion, which is not available to smaller producers, allows taxpayers producing from mines, wells and other natural deposits to claim a deduction for a percentage of the gross income from these properties, recognizing the unique nature of these investments, which require significant financial commitments to long-term projects to deliver a competitive product at a low margin.

The percentage depletion provision also reflects the large risk inherent in these activities and the fact that the value of a mine or well declines as production progresses. Congress created percentage depletion because the otherwise available cost depletion rules resulted in a cost of capital too high to permit producing from important mineral resources. It is important to note also that even with percentage depletion, the U.S. tax burden on mining and other American resources operations puts them at a significant competitive disadvantage.

The NAM also supports retaining the current tax treatment of master limited partnerships (MLPs) in a comprehensive tax reform plan. MLPs are the primary builders of midstream energy infrastructure in the United States and MLP assets include over 300,000 miles of pipelines linking energy producing regions and end use consumers and manufacturers.

d. Last-in, First-out (LIFO) Method

For more than 70 years, companies have been using the last-in first-out (LIFO) accounting method to determine financial statement earnings and tax liability. It allows taxpayers to match current sales revenues with current inventory replacement costs. By taking into account the greater cost of replacing inventory, LIFO results in a more conservative measure of the financial condition of the business and the economic income subject to tax. The LIFO method is the predominant method of accounting for industries that carry inventories of goods, including manufacturing, mining and energy production.

The NAM has long opposed LIFO repeal, which would impact hundreds of thousands of U.S. businesses of all sizes in all industry sectors. Under many proposals, companies currently using the LIFO method would be subject to a one-time tax on their LIFO reserves <u>and</u> higher future tax bills on the appreciation in value of their inventory.

Particularly challenging for manufacturers are LIFO repeal proposals that would be retroactive in impact. The retroactive nature of this tax, coupled with the inability to use the LIFO method prospectively, would cost manufacturers billions of dollars in immediate and future taxes. For some LIFO companies, this burden would not necessarily match up with a revenue-generating event to provide the cash to pay the tax bill. For companies that do have cash on hand, this retroactive tax would take capital away from other growth priorities and put these companies at a competitive disadvantage vis-à-vis peer firms, foreign or domestic, that do not face this additional tax burden.

These additional costs and their impact on working capital will make it more difficult for manufacturers to expand their businesses and hire new workers. In some cases, the additional tax burden would exceed the company's annual capital expenditure budgets, impairing manufacturers' borrowing ability.

VI. Other Business Deductions and Exclusions

a. Overview

While NAM members recognize that broadening the income tax base will be part of the debate over lowering tax rates, policy makers must also consider the negative impact of expanding the tax base on economic growth and the competitiveness of capital-intensive industries like manufacturing.

Indeed, some current tax rules are key to a strong manufacturing sector, and the benefits of these provisions should be maintained in a new system. For every $1.00 spent in manufacturing, another $1.37 is added to the economy[5], the highest multiplier effect of any economic sector. A new system should not result in a net increase in manufacturers' U.S. tax burden—a change that would undoubtedly derail efforts to enhance U.S. economic growth, investment and jobs.

b. Net Operating Losses

NAM members believe that a new tax system also should provide fair and equitable treatment for taxpayers that have generated substantial attributes based on current law. For example, manufacturing is a cyclical industry and manufacturers of all sizes and in all industry sectors fall into a net operating loss (NOL) position when expenses exceed income. The U.S. tax code has long recognized that business cycles include natural fluctuations in a company's loss and profits from year to year.

Thus, the NAM is concerned about changes to current rules on net operating losses (NOLs), in particular a "haircut" on NOL carryovers and carrybacks. This limitation unfairly burdens companies already in a loss position that are most in need of additional cash and sets a dangerous precedent for limiting existing tax attributes. Manufacturers believe that a new tax plan should allow future timely utilization of tax attributes, like NOLs, that have been generated but not yet utilized under the current tax code.

c. The Domestic Manufacturing Deduction

Section 199—or the Domestic Manufacturing Deduction (DMD) — effectively reduces the federal tax rate on income from domestic manufacturing activities and helps mitigate the tax burden for all domestic manufacturers. By reducing the tax burden on income from U.S. manufacturing activities, the DMD encourages more manufacturing in this country and helps attract needed capital to spur new investment.

This deduction creates a financial incentive to keep production in the United States and influences decisions on where corporations build new production facilities. Since the DMD is directly linked to domestic production, the loss of the DMD would result in higher effective tax rates for many domestic manufacturers, which could outweigh the overarching goal of lower tax rates.

---

[5] http://www.bea.gov/iTable/index_industry_io.cfm

d. Like-kind Exchange Rules

The NAM has supported existing like-kind exchange (LKE) rules that allow taxpayers to replace property with like property, without immediately recognizing gain. Historically, Congress has recognized the fact that, from an economic perspective, taxpayers are in essentially the same position after the property exchange, making the recognition of gain inappropriate. Moreover, the taxpayer is not taking any profit from this type of transaction but rather investing it back into the business.

LKE rules are a powerful economic engine that promote capital investment, improve business productivity and create jobs. Indeed, tax-deferred exchanges are one of the few incentives available to, and used by, taxpayers of all sizes in all sectors of the economy, including manufacturers. For example, by deferring the tax consequences associated with replacing outdated equipment, LKE helps businesses invest in newer, more efficient and more environmentally friendly machinery.

Proposals to repeal the LKE rules will affect a wide array of taxpayers. Even with a lower corporate rate, there still will be a significant lock-in effect as manufacturers consider upgrading equipment. The effect will also apply to customers considering replacing worn equipment, vehicles, etc., potentially causing delays or even elimination of new investments.

Repeal would also harm manufacturers with captive finance arms that facilitate and support sales and leasing transactions with their customers and, in some cases, enable sales where financing might otherwise be difficult to obtain.

Since the LKE rules also apply to real property, repeal could make upgrading facilities more costly for manufacturers, impacting real estate prices and restricting manufacturers' growth. Repeal of LKEs could also make it more difficult for companies to better align real properties to current business needs.

e. Research and Development Incentive

The NAM believes it is critical for any tax reform plan to recognize the important role of research and technology investment in the growth of U.S. jobs and innovation. The United States has been a leader in promoting R&D for more than 30 years, but more and more countries have provided greater certainty for businesses in recent years by enacting permanent R&D incentives. A top priority of NAM members is to ensure that manufacturers in the United States are the world's leading innovators. The tax treatment of R&D, including the current deduction for R&D expenses and a strengthened and permanent R&D incentive, is critical to achieving this goal. In addition, the NAM also is open to the idea of a preferential rate for IP income earned by U.S. companies resulting from R&D developed or owned in the United States.

First enacted more than 30 years ago, the now-expired R&D tax credit is a proven incentive for spurring private-sector investment in R&D and creating domestic, high-wage jobs. The R&D credit is a true U.S. jobs credit with 70 percent of credit dollars going toward the salaries of high-skilled domestic R&D workers. Thus strengthening the R&D incentive and making it permanent would significantly increase employment. To that end, the NAM has supported increasing the alternative simplified credit (ASC) formula from 14 to 20 percent, making it easier for companies of all sizes to use the R&D credit.

Proposals to eliminate the current year deduction of R&D expenses or to remove supplies and computer software from qualifying for the credit would weaken the R&D incentive and move the U.S. backward as it competes for global research dollars. In contrast, a stronger, permanent R&D incentive would restore U.S. leadership in global innovation. The United States was once the leader among developed countries in providing the best R&D incentives, but according to a recent Organisation for Economic Co-operation and Development (OECD) study, the United States now ranks at 22nd among industrialized countries, as many have created more robust and permanent R&D incentives[6].

Manufacturers account for the lion's share of R&D in the United States, and its tax treatment plays an important role in their ability to perform R&D. NAM urges the Committee to consider a permanent R&D incentive that retains the current tax treatment of R&D expenses while also strengthening the R&D tax credit and making the credit permanent.

VII. Conclusion

There is no doubt that the U.S. tax code is a drag on economic growth and competitiveness. While the NAM is a strong advocate for comprehensive reform of our current tax code, we also believe it is critically important to keep our current tax system in place until policymakers agree on a final, comprehensive reform plan.

Piece-meal changes or repeal of long-standing rules, like the current expiration of the R&D credit, will inject more uncertainty into business planning and make companies in the United States less competitive, threatening economic growth and U.S. jobs. Moreover, using "one-off" tax increases to pay for unrelated policy changes will make it even more difficult to achieve pro-growth tax reform.

Manufacturers want the United States to be the best place in the world to manufacture and attract foreign direct investment. The NAM very much appreciates the diligent efforts of Chairman Hatch, Ranking Member Wyden and the other members of the Senate Finance Committee to reform the U.S. tax system. Comprehensive tax reform should not be a far-off goal but a near-term priority for the Congress and such reform should address the fundamental flaws in our existing system.

Thank you for the opportunity to share our thoughts and concerns with you. We look forward to further discussing these issues and working with the Business Tax Reform Working Group and the rest of the Committee to achieve a pro-growth, pro-competitiveness and pro-manufacturing tax system.

[6] Organisation for Economic Co-operation and Development, *Science, Technology and Industry Scoreboard*, December 2013, p. 107.