NATIONAL ASSOCIATION OF
Manufacturers

Dorothy Coleman

Vice President
Tax and Domestic Economic Policy

July 14, 2017

The Honorable Orrin Hatch
United States Senate
Committee on Finance
Dirksen Senate Office Building, SD-219
Washington, DC 20510-6200

Dear Chairman Hatch:

The National Association of Manufacturers (NAM)—the nation's largest industrial trade association and a voice for more than 12 million men and women who make things in America—thank you for the opportunity to provide input to the Committee on manufacturers' tax reform priorities.

NAM members have been leading the charge for comprehensive tax reform for more than a decade. While we have seen some positive changes, manufacturers and other businesses in the United States still struggle to compete against our international competitors under an outdated tax system that includes very high tax rates applied to both corporate and pass-through business income, arcane rules for taxing international income and a significant compliance burden.

Tax reform is a critical issue for all manufacturers. NAM members believe that we have the best chance in more than 30 years to advance permanent, fiscally responsible, pro-growth reform. It is imperative that we take full advantage of this opportunity to improve our global competitiveness, grow the economy and increase U.S. manufacturing jobs.

NAM members also are optimistic that Washington will deliver on tax reform this year. Recent NAM member surveys show that manufacturers' outlook for business is at an historic high. The rising confidence stems in part from the belief that Washington policymakers will act on pro-growth tax reform as well as much-needed regulatory relief and a significant infrastructure package. Indeed, business leaders are cautiously optimistic that pro-growth policies from Washington will allow the country to emerge from the sluggish expansion since the Great Recession.

An NAM study, A Missed Opportunity: The Economic Cost of Delaying Pro-Growth Tax Reform, looks at the potential impact of a tax reform plan that includes lower tax rates for all business income, a robust capital cost-recovery system, a strong research and development (R&D) incentive and a territorial tax system. The study concludes that this multipronged reform package would fuel the economy substantially and result in increased jobs and investment. Over a 10-year period, this plan would contribute more than $12 trillion in GDP, add more than 6.5 million jobs to the U.S. economy and increase investment by more than $3.3 trillion.

NAM's Tax Priorities

As outlined in more detail below,[1] NAM's top-line priorities for comprehensive tax reform include:

- A corporate tax rate of 15 percent;
- Comparable lower tax rates for pass-through business income;
- A modern international territorial tax system;
- Robust rules for capital cost recovery; and
- A permanent, strong R&D incentive.

In a May 2017 survey of NAM members, almost 88 percent of respondents indicated that a tax reform package that included these elements would address their concerns with the current tax system. Moreover, almost 70 percent of respondents said that this tax reform package would make them more likely to expand their businesses and increase capital spending, while almost 60 percent said they would be more likely to hire more workers.

Lower Tax Rates for Business Income

Since the last major overhaul of the U.S. tax code in 1986, manufacturers in the United States have innovated, expanded and evolved but the U.S. tax code has not kept pace. In fact, manufacturers in the United States now face higher tax rates on business income than their competitors in all relevant competitor nations.

With a combined (federal and state) top statutory corporate tax rate that can exceed 39 percent, manufacturers in the United States face the highest corporate statutory tax rate among the 35 industrialized nations of the Organisation for Economic Co-operation and Development (OECD), far higher than the average OECD statutory tax rate of 23.75 percent. Meanwhile, combined top statutory individual tax rates applied to manufacturing income from subchapter S corporations, partnerships and other pass-through entities are even higher, in many cases more than 40 percent.

A key NAM objective in tax reform is to create a national tax climate that enhances the global competitiveness of our nation's manufacturers and encourages investment and job creation in the United States. An important step to achieving this goal is to adopt a top federal statutory corporate tax rate of 15 percent, which would make our nation's manufacturers much more competitive in the global marketplace, encourage greater investment in the United States and promote U.S. job creation and overall economic growth.

Similarly, comparable lower tax rates for pass-through business income will allow these manufacturers to stay competitive, reinvest in their businesses at greater levels and retain and create jobs. For more than 60 years, many individuals and trusts with business operations, including manufacturing, have chosen to organize their business operations as S corporations or other pass-through entities in order to benefit from comprehensive liability protection and a single level of federal taxation. Today, pass-through companies are the most common business form in the United States and include many companies in the manufacturing supply chain.

[1] See also Competing to Win: Tax in Focus, NAM 2017

While NAM members recognize that broadening the income tax base will be part of the debate over lowering tax rates, policy makers also must consider the negative impact of expanding the tax base on economic growth and the competitiveness of capital-intensive industries like manufacturing. 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 $1.81 is added to the economy.[2] A new tax 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.

Modernizing International Tax Rules

Global investment by American companies plays an important role in the growth and vitality of the U.S. economy and manufacturers have a strong interest in our nation's international tax regime. Almost half of American worldwide companies are manufacturers and 57 percent of all manufacturing employees in the United States are employed by U.S. companies with operations overseas.[3]

U.S. global manufacturers operate in foreign countries to be near their customers and foreign operations help American companies market products effectively to foreign consumers, cut transportation costs, avoid tariff barriers, meet local content requirements and provide services locally. These foreign operations do not shrink the U.S. tax base or U.S. operations. Rather, they generate additional jobs both at U.S. headquarters, in the U.S. supply chain and at U.S. facilities that manufacture for the export market.[4]

Despite the economic benefits of having American companies expand beyond our shores, U.S. tax laws make it difficult to compete globally. The U.S. tax system, including high tax rates on business income and highly taxed exports, increases the cost of doing business for U.S. companies with global operations. In addition, the U.S. system taxes income even when it is earned outside of the United States. As a result, American businesses with customers around the world generally have a higher tax burden than their competitors, a significant disadvantage for companies competing in a global economy.

If American companies cannot compete abroad, where 95 percent of the world's consumers are located, the U.S. economy suffers from the loss of both foreign markets and domestic jobs that support foreign operations. Territorial systems are now the international norm. The vast majority of our trading partners have territorial systems that tax income earned within their borders but do not tax the foreign profits repatriated to their own economies. Adopting a territorial system is critical to the ability of manufacturers in the United States to compete in the global marketplace.

NAM members believe that a territorial system should not discriminate against any manufacturer. The tax code should allow for the free flow of capital back to the United States from foreign operations for reinvestment in the domestic economy. The current high federal tax rates on business income often result in a high U.S. tax charge on earnings repatriated from foreign operations, even though the tax charge is partially offset by foreign tax credits. This additional residual tax causes what is often referred to as a "lockout" of earnings from foreign operations, preventing these earnings from being brought back to the United States.

---

[2] http://www.nam.org/Newsroom/Facts-About-Manufacturing/

[3] See American Companies and Global Supply Networks, Matthew J. Slaughter January 2013

[4] Ibid.

Enactment of a well-crafted, competitive territorial system also would simplify U.S. tax law by eliminating several complex tax rules. For example, a territorial system could significantly reduce the importance of the foreign tax credit. The rules for allocating and apportioning interest expense have long been criticized for over-allocating interest expense to foreign source income, resulting in double taxation of foreign source income. Limiting the importance of the foreign tax credit rules would minimize double taxation and other inequities in the rules.

Transition rules will be important for all areas of tax reform, particularly in the international arena. As noted above, the additional tax faced by U.S. companies with worldwide operations makes it difficult for these companies to repatriate these earnings back to the United States. Thus, the NAM supports a two-rate approach for taxing accumulated deferred foreign earnings.

Specifically, the NAM supports the bifurcated approach in the House tax reform blueprint that would apply an 8.75 percent tax to accumulated foreign earnings held in cash and cash equivalents and a 3.5 percent tax to accumulated foreign earnings invested in other assets including buildings, equipment, etc. The lower tax rate on fixed assets is of particular importance to many NAM member companies that have invested in "hard assets" outside the United States to address the needs of a global marketplace. We also support a provision in the blueprint that would allow companies to pay this tax liability over eight years with no interest charge.

The NAM also supports transition rules that would allow taxpayers to net deficits in earnings and profits on CFCs with positive earnings and profits from other CFCs. It makes no sense for a U.S. taxpayer without any net foreign earnings to pay a toll charge for the benefits of a territorial system. In addition, taxpayers should be able to use foreign tax credit carryovers against the transition tax, and loss carryovers against the income on which it is imposed. Finally, any transition tax should not have a retroactive effect that would undo repatriations that occur prior to the date of enactment. Companies must be able to rely on current law, at least until they are put on notice that a specific retroactive effective date would apply.

The NAM understands that there are some concerns about the possible erosion of the U.S. tax base under a territorial tax system. While NAM members do not think that moving to a territorial system necessarily poses an increased threat of eroding the U.S. tax base, the NAM agrees that a properly designed anti-base erosion provision to prevent artificial income shifting to low tax jurisdictions is needed. In addition, we agree that the current subpart F income rules need to be modernized because they were developed in an era when business models and the United States' role in the global economy were quite different. In particular, policymakers need to focus on the impact of the subpart F income rules on U.S. manufacturers operating abroad and their ability to compete with their foreign counterparts that often have a lighter tax burden on their foreign operations.

A well-designed territorial regime should both protect the U.S. tax base and exempt active foreign business income. From a competitiveness perspective, it is critical that policymakers avoid broadening the scope of foreign income subject to immediate U.S. tax in a way that essentially makes it a full inclusion system for a significant portion of a U.S. multinational's active foreign earnings. In addition, any anti-base erosion rules must not be overly broad, unfairly target any particular industry or type of active income or unfairly penalize suppliers solely on the fact that their component is in a final product that would trigger an anti-base erosion rule.

Businesses headquartered outside the United States and foreign individuals that invest in our nation also play an important role in the growth and vitality of the U.S. economy. Like their domestic counterparts, they provide high-paying jobs for millions of Americans and are an important source of U.S. exports. As a result of the importance of foreign direct investment to the U.S. economy, it is critical that policymakers avoid imposing discriminatory taxes on foreign-owned companies and foreign individuals that invest in our country. Congress should focus on tax policies that attract and maintain more capital investment, rather than discourage it.

Federal tax policy also has traditionally recognized the unique relationship of Puerto Rico to the United States and has helped foster a strong manufacturing sector in the territory. Indeed, the manufacturing industry currently is the leading employer in the private sector and represents almost one-half of Puerto Rico's economy. In light of the important role that U.S. tax policy has played in the economy of Puerto Rico, we urge the Committee to consider fully the impact of tax reform proposals on the Puerto Rican economy and job base.

Encouraging Investment through Cost Recovery and Interest Deductibility

It is also critical that any tax reform plan encourages the capital investment needed to ensure durable economic growth and job creation and promote U.S. productivity and competitiveness. The most effective way to spur business investment and make manufacturing in the United States more competitive is through a strong capital cost-recovery system and a full deduction for interest expense.

Recent data from the Bureau of Economic Analysis reinforces the role that a healthy manufacturing sector plays in strengthening the nation's economy. Manufacturing in the United States is in the midst of a recovery and for the nation to benefit fully from this resurgence, manufacturers need tax policies that allow them to make the investments necessary to grow and compete in a global economy.

Indeed, a robust capital cost-recovery system—similar to the bonus depreciation system in effect today—reduces the after-tax cost of investment and promotes economic growth by stimulating investment, which has a multiplier effect throughout the economy. Also, expanding the use of accelerated depreciation to building components and equipment would spur jobs and construction and free-up capital within the building sector for other local investments.

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 the investment. Accelerated depreciation lowers the after-tax cost of capital and increases the number of profitable projects a firm can undertake, helping to spur investment, productivity and growth.

Manufacturers of all sizes take into account the tax impact of cost-recovery mechanisms on projected cash flows in making investment decisions. For manufacturers large and small, cash flows are managed carefully to support key growth objectives and cash flow is critical when access to credit is difficult, especially for small and medium-sized manufacturers. Comprehensive business tax reform that includes pro-investment provisions will help drive the increased growth our economy needs.

A favorable tax climate plays an important role in attracting high-value jobs and investment to the United States and improving competitiveness. In addition to a strong cost recovery system, it also is important to maintain full deductibility of interest expense given the role it plays in funding new investments and business operations.

NAM members have significant concerns with proposals that would deny a deduction or impose an arbitrary limit on deducting interest expense, deny a deduction based upon a formulaic allocation of interest or create an unreasonable low threshold of deductible interest expense relative to earnings.

In addition, the NAM is concerned about proposals to either deny or further limit interest deductions for U.S. subsidiaries of foreign–headquartered corporations and eliminating their ability to carry forward excess interest expense to future tax years. Proposals like these disregard the important role that foreign direct investment plays in the U.S. economy and discriminates against non-U.S.-headquartered companies that play an important role in the U.S. economy and U.S. communities. Indeed, one out of five U.S. manufacturing employees is employed by a U.S. subsidiary. The ability to deduct interest expense is a critical factor in a company's decision to invest and create jobs in the United States.

A Strong and Permanent R&D Incentive

Manufacturers know firsthand how important it is that any tax code overhaul maintains a strong R&D incentive to allow the United States to remain a leader in global innovation. Manufacturers account for more than three-quarters of all private-sector R&D in the United States. The United States has been a leader in promoting R&D for more than 30 years but has slipped behind in recent years as more and more countries have provided lower tax rates, territorial tax systems and more robust R&D and royalty income incentives. A top NAM priority is to ensure that manufacturers in the United States are the world's leading innovators.

The favorable tax treatment of royalty income and R&D, including the current deduction for R&D expenses and a strengthened R&D credit, is critical to achieving this goal. Indeed, a strong R&D incentive is the only way to keep the United States competitive in the global race for R&D investment dollars. First enacted more than 30 years ago, the current R&D credit is a proven incentive for spurring private sector investment in R&D and creating domestic, high-wage jobs. R&D fuels innovation that translates into new product development and increased productivity—two key factors necessary for growth in manufacturing.

Conclusion

Manufacturers want the United States to be the best place in the world to manufacture and attract foreign direct investment. There is no doubt that the U.S. tax code is a significant negative drag on economic growth and competitiveness. Comprehensive, permanent business tax reform that reduces the corporate tax rate to 15 percent, provides comparable lower rates for business income from pass-through entities, moves to a modern territorial international tax system that does not discriminate against any particular industry or type of income, maintains a strong R&D incentive, and includes a robust capital cost-recovery system will go a long way to attract this investment and economic growth and our country's competitiveness.

The NAM appreciates the magnitude of effort required to reform the U.S. tax code and we are committed to working with you and your staff to advance much-needed permanent reform before the end of 2017. Making comprehensive business tax reform a near-term top priority will promote investment in America, create U.S. jobs, enhance the global competitiveness of U.S. manufacturers and other businesses in the United States and ensure durable economic growth well into the future.

Sincerely,

Dorothy Coleman