NATIONAL ASSOCIATION OF Manufacturers

Chris Netram

Vice President
Tax and Domestic Economic Policy

December 7, 2017

The Honorable Orrin Hatch
Chairman
Committee on Finance
104 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Hatch:

The National Association of Manufacturers (NAM) is the nation's largest industrial trade association and a voice for more than 12 million men and women who make things in America. As the House of Representatives and Senate work to reconcile their versions of the *Tax Cuts and Jobs Act*, we write to reiterate manufacturers' support for pro-growth tax reform and provide comments on the approaches taken by each Chamber.

We applaud your efforts in reforming our nation's outdated tax code. The NAM's Manufacturers' Outlook Survey for the third quarter of 2017 found that the promise of tax reform has led to the highest three-quarter average of manufacturer optimism ever recorded by the NAM. A strong majority of manufacturers who took part in the survey said a pro-growth tax reform package would make them more likely to expand their business (64.3 percent), hire more workers (57.3 percent) and increase employee wages and benefits (52.2 percent). Done right, tax reform will boost economic growth, spur hiring and make America a more attractive place to start and grow a business. This increased prosperity will provide greater economic security for hardworking families in the form of higher wages and more jobs.

The NAM's Tax Reform Priorities

Earlier this year, the NAM outlined its five priorities for tax reform: 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 interest expensing and a permanent, strong R&D incentive. We applaud the House and Senate for approving legislation that goes a long way towards meeting these criteria. However, there are a number of potential changes that conferees should consider as they reconcile the two bills. Our priorities and suggestions for conferees on these items are discussed in detail below.

1. **A corporate tax rate of 15 percent.**

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). To enhance global competitiveness of our nation's manufacturers and encourage investment and job creation in the United States, the NAM believes that the top federal statutory corporate tax rate should not exceed 15 percent. This rate would make our nation's manufacturers much

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more competitive in the global marketplace, encourage greater investment in the United States and promote U.S. job creation and overall economic growth.

By setting the corporate rate to 20 percent, both bills fail to meet this standard. Manufacturers would have significant concerns with proposals that would increase the corporate tax rate beyond 20 percent.

Manufacturers were pleased to see the House eliminate the corporate alternative minimum tax ("AMT"). The NAM has significant concerns with the Senate bill's reinstatement of the corporate AMT. The corporate AMT distorts business decisions and imposes needless complexities and administrative burdens on both taxpayers and the Internal Revenue Service (IRS). By definition, companies paying the AMT are paying higher taxes than they would otherwise pay under the regular corporate income tax system. Eliminating the corporate AMT would simplify some of the most complex compliance provisions of the tax code. We urge conferees to adopt the House position.

2. **Reduced tax rates for pass-through business income.**

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. Under current law, manufacturers organized as pass-through entities (e.g., S Corporations and LLCs) face top combined statutory tax rates that can exceed 40 percent.

Reducing the statutory rate of tax on business income earned by pass-through entities is a priority for the NAM. Both the House and Senate approaches present challenges for small and medium sized manufacturers. We urge conferees to adopt a position that ensures manufacturers organized as pass-through entities are provided a significant reduction in their tax burden in the least complex manner possible.

The House bill provides for a top rate of 25 percent on pass-through business income. The House approach recognizes the important role small manufacturers play in our economy by allowing a greater percentage of income earned by a capital-intensive pass-through to qualify for the 25 percent rate. However, small and medium-sized manufacturers are concerned about the complexity involved in complying with this provision's "guardrails." Moreover, the provision only allows for a portion of a pass-through owner's business income to be taxed at the 25 percent rate.

The Senate bill does not provide for a reduced rate for pass-through income. However, the NAM was pleased that the Senate increased the amount of the deduction for pass-through business income during floor consideration of the bill. We also note that the Senate approach is simpler to administer than the House approach, which is a key concern for many small and medium-sized manufacturers.

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3. **Adopt a modern territorial tax system.**

Global investment by American companies plays an important role in the U.S. economy. 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.[1] Manufacturers operate overseas for many reasons, including the need to be closer to their customers and reduce transportation costs. These operations 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.[2]

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. That is why the NAM was pleased to see the House and Senate both adopt a territorial tax system to level the playing field for global manufacturers.

We recognize the need for robust base erosion provisions in a territorial tax system. However, manufacturers have significant concerns with Section 4303 of the House bill, which imposes an excise tax on foreign affiliate payments. In effect, the provision would require global companies to treat affiliate income as effectively connected income ("ECI"). It also creates an incentive to move manufacturing offshore, which would ultimately reduce American manufacturing jobs – certainly not a result intended by Congress.

4. **Encouraging investment through cost recovery and interest deductibility.**

Manufacturers are pleased that both bills provide for 100 percent expensing for five years and substantially increase the limits under Section 179. We note that capital investment drives long-term economic growth, and urge Congress to consider making these provisions permanent.

However, the NAM is concerned about the treatment of interest expense. Manufacturers borrow money for a variety of reasons, including to finance capital equipment purchases. We urge the conferees to carefully consider the House and Senate limitations on the ability to deduct interest expense, especially with respect to debt incurred under existing law and with the expectation that such payments would be deductible.

Both bills would fundamentally alter the tax treatment of interest expense by imposing two new limitations on the ability to deduct interest expense. First, it would limit the amount of deductible interest expense to 30 percent of a company's adjusted taxable earnings. Significantly, the House and Senate differ on the base upon which this limitation is calculated. We have significant concerns with the Senate approach, which would base the limitation on earnings before interest and taxes ("EBIT"), and support the House approach, which employs an EBIDTA standard. Manufacturers invest in depreciable equipment to produce goods. Limiting the base

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

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for the 30 percent calculation to EBIT would harm manufacturers by failing to account for the depreciation that is associated with capital equipment purchases.

Both bills would also require a U.S. company that is a member of a worldwide group to calculate a second interest limitation. In the Senate bill, this limitation is 110 percent of the global debt to equity ratio. In the House bill, this limitation is 110 percent of the ratio of global interest expense to EBITDA. We believe that the 110 percent limit should be eliminated. As designed, it will function in a manner that is inconsistent with international norms. Both bills would limit a company's interest deduction to the lesser of the two limitations. However, the OECD has noted that the group ratio rule should function as an escape clause, not as a further limitation.[3]

Should conferees choose to keep a version of the worldwide limitation, we urge you to consider exempting interest on existing debt from the provision. Global companies' capital structures reflect years of planning and long-term commitments based on the understanding of current law. These structures can be costly to unwind. The cost of modifying existing agreements may cause manufacturers that compete globally to re-evaluate their investment in the United States. As a corollary, we urge you to also consider exempting interest on debt that will be incurred in connection with a transaction that has already been publicly announced and awaiting regulatory approval. Implicit in many of these agreed-to transactions are financing assumptions that were made under current law.

5. **Maintain a permanent, strong R&D incentive.**

We are pleased that both bills retain the R&D tax credit. However, as discussed above, the Senate's inclusion of a corporate AMT at the same rate as the regular corporate income tax, would make the AMT the default rate for some manufacturers. This would essentially eliminate the R&D credit for these businesses. We reiterate our opposition to the Senate's inclusion of the corporate AMT, and urge conferees to adopt the House position.

Moreover, manufacturers are concerned that both bills would eliminate the ability of businesses to deduct R&D expenses, and instead amortize these costs. While this change would not take effect for years, we urge the conferees to indicate their support for the current treatment of research and development expenses.

Other items

Effective date of the corporate rate

We urge the conferees to implement the 20 percent corporate rate in 2018. The Senate bill would eliminate or curtail a variety of tax incentives for businesses in 2018, but have the corporate rate reduction take effect in 2019. The Senate's approach would dramatically increase the tax burden on U.S. manufacturers for 2018.

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[3] Organisation for Economic Co-Operation and Development, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4- 2015 Final,* at ¶24.

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Pass-through assets used to determine manufacturing income eligible for a reduced rate

As discussed above, the House bill would allow pass-through businesses in capital-intensive industries, such as manufacturing, to increase the amount of income that is eligible for the 25 percent rate. We note for many manufacturers in the innovation economy, workforce-in-place and long term, non-cash investments are key assets. We ask that conferees consider including the value of these assets as additional items that would increase the amount of manufacturing income eligible for the lower rate.

Pass-through income earned by trusts

Manufacturers have concerns with both bills' treatment of pass-through entities that are structured with trusts holding S corporation shares or partnership interests.

It is not clear in the House bill that either a complex trust, an estate or an electing small business trust with qualifying business income would be eligible for the 25 percent rate. The Senate bill specifically excludes trusts and estates holding S corporation shares or partnership interests from claiming the 23 percent deduction. This would preclude otherwise eligible individual taxpayers who report qualifying trade or business income from partnerships or S corporations held by grantor trusts or qualifying subchapter S trusts from claiming the 23 percent deduction, as well as complex trusts, estates and electing small business trusts that have similar income.

Many family businesses have some form of trust ownership, and these business owners would be at a significant disadvantage relative to their competitors if they were denied access to the final bill's pass-through provisions simply because of their ownership structure. Accordingly, we urge the conferees to clarify that complex trusts, estates, and electing small business trusts may utilize the pass-through provisions adopted in the conference report and that individual taxpayers are not subject to restrictions on their ability to benefit from the pass-through provisions simply because they hold ownership interests through grantor trusts or qualified subchapter S trusts.

Repatriation

As part of the transition to a territorial system, both bills provide that foreign earnings and profits ("E&P") that have not been previously subject to U.S. tax will be included in income and subject to a transition tax. Manufacturers are pleased that both bills adopt a bifurcated rate structure for this transition tax, in which foreign earnings invested in property, plant and equipment are subject to a lower rate than foreign earnings simply held in cash accounts. However, we are concerned that the rate of this tax far exceeds the rates that were developed by former Ways and Means Chairman Dave Camp (R-MI). It is critical that these rates be held as low as possible. Moreover, we urge conferees to apply the higher cash rate only to items that are truly cash or cash equivalents.

In addition, we note that both bills provide that E&P subject to the transition tax is determined as of November 2, 2017 (House), November 9, 2017 (Senate) or December 31, 2017, whichever is

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higher. There is potential uncertainty for taxpayers in 2017 regarding the treatment of dividend distributions from foreign subsidiaries whose tax years end between the testing dates. We urge the conferees to provide clarity on the treatment of such distributions.

Effective date of CFC attribution rules

Both bills would modify stock attribution rules used to determine controlled foreign corporation ("CFC") status. However, the Senate version (Section 14214) has an effective date would make the provision retroactive. We believe such changes to CFC status should be prospective.

Base erosion

While we understand that the final bill is likely to include anti-base erosion measures, we urge the conferees to be mindful that this may be a significant impediment to business investment throughout the U.S. and to be mindful that other countries do not impose broad minimum taxes on their companies. To allow U.S. companies to be competitive in global markets, the new tax on active foreign business income should be held as low as possible. The current proposals apply the new tax if the foreign tax paid is less than 12.5 percent, although the Senate bill is higher in 2018 and raises after 2025. Keeping this rate at or below 12.5 percent will be important to allowing U.S. companies to compete in the global marketplace.

Lease financing

The NAM has concerns regarding the treatment of lease financing under the bills. Some manufacturers finance their product sales by leasing rather than lending. Under both bills, such companies would be disadvantaged relative to businesses that finance customer purchases because they allow netting of interest expense against interest income, but not leasing income. We note that these financing methods play virtually the same role, and that conferees should consider allowing taxpayers to offset lease income with interest expense.

Settlements

We urge conferees to remove Section 13306 of the Senate bill. Under current tax law, governmental settlements are generally deductible. Section 13306 would reverse this long-standing policy, and increase the financial burden on manufacturers. We also note that this provision creates a disparity between the treatment of private party and governmental settlements. Moreover, the provision is overly broad, in that no proof of wrongdoing is required for this increase in tax liability to apply.

Puerto Rico

We also note that manufacturing is a significant part of the economy of Puerto Rico, an American territory, and federal tax policy has long recognized the unique relationship of Puerto Rico to the United States. We urge conferees to consider fully the impact of tax reform proposals on the Puerto Rican economy and job base.

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Thank you for your consideration of these comments. We appreciate the opportunity to work with your office on this matter.

Sincerely,

Chris Netram

CC: Members of the Senate Finance Committee
Members of the House Ways and Means Committee