I. Introduction

The National Association of Manufacturers (NAM) welcomes the opportunity to comment on the Cost Recovery and Accounting Tax Reform Discussion Draft to reform current tax rules that determine when businesses can deduct the cost of investments and how they account for their income, released by Senate Finance Committee Chairman Max Baucus (D-MT) on November 21, 2013.

The NAM is the largest manufacturing association in the United States, representing small and large manufacturers 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 two-thirds of private-sector research and development.

The NAM knows first-hand that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. Because of manufacturing’s critical importance to our nation’s economy, any effort to rewrite the federal tax code should result in a balanced, fiscally responsible plan that allows manufacturers in the United States to prosper, grow and create jobs and also enhances their global competitiveness.

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 permanent 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&D) incentive and a strong capital cost-recovery system.

Capital investment is key to economic growth, job creation and competitiveness. Consequently, promoting investment should be a focus of any tax reform effort and an integral part of U.S. tax policy. 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.

While recognizing that the discussion draft plays an important role in the current tax reform debate, NAM members believe that a number of provisions in the discussion draft need to be modified—and in some instances, eliminated—to achieve a competitive, modern cost-recovery and tax accounting system. In fact, some of the changes in the proposal would move the U.S. system further away from the more competitive tax regimes in other nations, making it even more difficult for U.S. manufacturers to compete in markets both here at home and abroad.
II. Corporate Rate Reduction

As outlined in NAM’s “A Growth Agenda: Four Goals for a Manufacturing Resurgence in America,”¹ a key objective for the association is to create a national tax climate that promotes manufacturing in America and enhances the global competitiveness of U.S. manufacturers. An important step in achieving this goal is to adopt a corporate tax rate of 25 percent or lower to make U.S.-based companies more competitive with companies headquartered in countries with more competitive tax rules. The discussion draft takes the important step of proposing a most welcome reduction in the corporate income tax rate.

Unfortunately, the lack of a specific corporate tax rate, coupled with unspecified “base broadening,” makes it impossible for NAM to fully evaluate the effectiveness of the new system. Manufacturers understand that the non-specified lower corporate tax rate reduction will be “financed” by “broadening the corporate tax base.” While the corporate tax rate is a key piece of any tax reform plan and will influence our support for a specific proposal, any accompanying base broadening is equally important.

While NAM members recognize that broadening the income tax base will be part of the debate over lowering corporate 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. 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 $1.48 is added to the economy, 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.

III. 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 costs. 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. Moreover, increased investment leads to job creation. Cost recovery is not merely timing; manufacturers both large and small take into account the tax impact of cost recovery mechanisms on project cash flows in making investment decisions.

NAM members recognize that, given the cost of expensing and federal budget constraints however, expensing is a goal that can only be achieved over a period of time. In the meantime,

¹ Available at http://www.nam.org/
the enhanced Section 179 and bonus depreciation provisions enacted in recent years have moved us on a temporary basis towards an expensing system.

b. Expanded Section 179 Expensing

NAM members support the Section 179 provisions in the draft that would raise and make permanent the $1 million expensing threshold and $2 million phase-out level beginning in 2014, with both the threshold and the phase-out indexed for inflation. The expanded definition of qualifying property also would be helpful to many manufacturers.

The summary suggests that this change seeks to ease the tax burden on small businesses. While enactment of the proposal would be helpful to many small and medium-sized manufacturers, these companies, like their corporate peers, need thoughtful tax reform that includes a lower tax rate and a strong capital cost-recovery system. It is critical to note that since the draft does not address the individual marginal tax rate, it is difficult to fully gauge the impact of this change on the nearly 70 percent of manufacturers that are organized as flow-through entities/pass-through businesses. Any discussion about reforming the tax code must ensure that the tax reform plan does not disadvantage these manufacturers that play a critical role in the supply chain and broader economy.

c. Depreciation of Tangible Property

Because manufacturing is a capital intensive industry, 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 currently 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.

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. In contrast, the draft proposal would create four broad classes of assets with depreciation a fixed percentage of unrecovered costs, ignoring asset life and value. Although the needs of the various manufacturing sectors widely vary, manufacturing typically requires a significant investment in productive assets. By spreading depreciation deductions over a longer period of time, the proposal in the discussion draft could make investment in productive assets more expensive and discourage investment in some assets.

Manufacturers also are concerned that the discussion draft would include all existing capital equipment assets in the pools proposed in the draft. This shift, without any transition relief, will dramatically alter the assumptions made by manufacturers as to the cost of the equipment, potentially creating hardship for many manufacturers. This change could lead to slower future investment in additional equipment—and the job growth often associated with such investment—until anticipated tax savings are recouped.

Additionally, under the draft proposal, assets are not assigned to a recovery period, but rather to a recovery rate and simple declining balance recovery method that, absent transactions involving the pool, could result in recovery periods that are significantly longer than an asset’s useful life. Also, the proposal does not provide any relief for abandoned assets or assets sold as scrap for less than the tax carrying value of the asset that could impair a taxpayer’s ability to acquire replacement property or make new investments.
d. The Tax Treatment of R&D Expenses

It is critical that any tax reform plan 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 over 30 years, but more and more countries have provided greater certainty for businesses in recent years by enacting permanent R&D incentives. One of the NAM’s priority goals 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, are critical to achieving this goal.

Under the discussion draft however, manufacturers would no longer be able to deduct research and experimentation expenses in the year incurred. Instead, taxpayers would be required to capitalize and amortize R&D expenditures over five years. This proposed change, coupled with the current lack of any R&D incentive, would make the United States even less competitive in the global race for R&D investment dollars.

Maintaining the current tax treatment of R&D expenses along with a strong and permanent R&D incentive will allow the United States to remain competitive in the global race for R&D investment dollars, particularly as manufacturers are courted by other countries with more generous and more stable R&D tax incentives and lower corporate tax rates. The certainty provided by a strengthened, permanent R&D incentive would enhance its incentive value and help ensure the United States’ leadership in global innovation.

e. Deducting Advertising Expenses

Advertising plays a critical role in the competitiveness of manufacturers and the success of their products and plays a central role in driving market growth and innovation, which benefits both the manufacturer and the consumer. In doing so, advertising also helps drive prices down by spurring competition.

The Internal Revenue Service has long recognized that advertising expenses represent a normal cost of doing business and are deductible. Thus, the proposal requiring capitalization of advertising expenditures is at odds with the IRS’s longstanding view that such costs constitute normal business expenses merit current deductibility under Section 162.

While NAM remains opposed to the proposed change in the current tax treatment of advertising expenses, in the event that taxpayers are required to capitalize a portion of their advertising expenses, the five year amortization period is too lengthy and should be reduced to a shorter period of two years.

f. Qualified Extraction Expenses

Current law allows operators or working interest owners to expense (in full or in part) intangible drilling costs (IDCs) relating to oil and gas investments. Under longstanding tax policy rules, energy companies can deduct these costs as ordinary and necessary business expenses, reducing the cost of exploring for and producing oil and gas.

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2 In Rev. Rul. 92-80, the IRS announced that “The [U.S. Supreme Court’s] Indepco decision does not affect the treatment of advertising costs as business expenses which are generally deductible under section 162 of the Code.” (Emphasis added.)
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.

Unfortunately, the discussion draft would require taxpayers to capitalize and amortize these costs over five years. This change would reduce levels of investment and production, since cash flow from operations would be significantly reduced and funds available for new investment would be proportionately limited. In addition, the proposal would prevent the full recovery of qualified expenditures after retiring, abandoning, or disposing of property and would instead require that such assets continue to be amortized over the remaining amortization period. In addition to discouraging capital formation and economic growth, the proposal would inject more complexity into the tax code and discriminate against businesses that have already made investments based on current law. Further, the proposed change could result in shut-ins, disposals or anticipatory abandonment of marginal wells.

g. Percentage Depletion

The NAM also opposes the proposed elimination of the percentage depletion deduction for “all mines, wells and natural deposits placed in service after Dec. 31, 2014.” This long-standing deduction is vitally important to U.S. companies producing natural resources including mineral, coal, aggregates, and independent oil and gas producers.

Percentage depletion 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. In contrast, the otherwise available cost depletion rules result in premature loss of important mineral resources.

It is important to note also that even with the percentage depletion tax deduction the U.S. tax burden on mining and other American resources operations puts them at a significant competitive disadvantage.

IV. Tax Accounting

a. LIFO

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

The NAM opposes the LIFO repeal proposal in the discussion draft, which would impact the hundreds of thousands of U.S. businesses of all sizes in all industry sectors that are currently using this accounting method. These companies would be subject to a one-time tax on their
LIFO reserves and would face higher future tax bills on the appreciation in value of their inventory. 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.

These additional costs and their impact on working capital will make it more difficult for manufacturers to expand the business and hire new workers. In some cases, the additional tax burden would exceed the company’s annual capital expenditure budgets and the cash outlay for the new taxes resulting could impair manufacturers’ borrowing ability.

LIFO repeal is an issue affecting manufacturers of all sizes. In fact, small- and medium-sized manufacturers would face the greatest harm from the imposition of this retroactive tax obligation since they are likely to be the least able to absorb a large tax increase. Many of these businesses are structured as pass-through entities and have often been in business for many years and have built up significant LIFO reserves.

b. Repeal of the Like-Kind Exchange Rules

The NAM also opposes the proposed repeal of the like kind exchange (LKE) rules that allow taxpayers to replace property with like property, without recognizing gain. Historically, Congress has recognized the fact that, from an economic perspective, taxpayers are in the same position after the property exchange and recognition of gain is unnecessary. A number of manufacturers have captive finance arms to facilitate and support sales and leasing transactions with their customers, and in some cases, to enable sales where financing might otherwise be difficult to obtain. These captive finance arms use LKEs to reduce tax gains and thus, financing costs, enabling them to provide competitive financing for customers. The program provides dual benefits to both the lessor and the lessee. It benefits the lessor by lowering the cost of capital and the lessee with a lower lease payment. LKE helps ensure leasing is a viable, affordable option for customers. The proposed repeal of LKE would decrease cash flows and increase lending costs, which in turn decreases the ability to compete for sales and jobs in U.S. manufacturing.

V. Other Issues

a. Section 199 Domestic Manufacturing Deduction (DMD)

The Domestic Manufacturing Deduction (DMD), which effectively reduces the federal tax rate on income from domestic manufacturing activities, 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 over-arching goal of lower tax rates.

b. Repeal of Corporate AMT

NAM members also believe that any serious proposal to reduce the corporate tax burden must include a provision to repeal the corporate alternative minimum tax (AMT) and allow companies
with AMT credit carryovers to utilize those credits, immediately. The NAM has led the business community for many years in advocating for repeal of the corporate AMT, a tax that distorts business decisions and imposes needless complexities and administrative burdens on both taxpayers and the IRS. In fact, eliminating the corporate AMT would simplify some of the most complex compliance provisions of the tax code.

By definition, companies paying the AMT are paying higher taxes than they would otherwise pay under the regular corporate income tax system. Because the AMT represents a prepayment of tax liabilities, any AMT repeal legislation must also address the problem of accumulated and unused AMT credits that are currently estimated to total more than $26 billion.

Companies with unused AMT credits essentially are making interest-free loans to the federal government that will be repaid only when the company has sufficient regular income tax liability in the future. Congress intended for the AMT to serve only as a prepayment of tax, not as a permanent tax increase, which effectively becomes the case if taxpayers cannot use AMT credits. Consequently, it is critical that legislation that repeals the corporate AMT also allows taxpayers to utilize existing AMT credits on an expedited basis.

Moreover, even if the corporate AMT is not repealed immediately, companies with AMT credit carryovers should be allowed to realize those credits, without delay, through accelerated utilization, refunds, etc.

c. Transition Rules

As mentioned above, transition rules will be critical to the success of any tax reform effort. A new system must include broad transition rules that provide fair and equitable treatment for taxpayers that have generated substantial attributes based on current law. For example, it is important for transition rules to allow future timely utilization of tax attributes, including net operating losses, alternative minimum tax credits, foreign tax credits and depreciation.

Another example of a change proposed in the draft that would require transition relief is the proposed elimination of the completed contract method of accounting. Without further clarification, it is not clear whether options executed post effective date under contracts that were executed pre-effective date still be subject to the 40/60 rule under current law.

Indeed, without transition relief many long term investments and long term contracts could be negatively affected by many of the proposals in the draft because these changes would significantly alter the fundamental tax treatment and economic assumptions underlying the original investment decisions. Manufacturers will want to provide additional input to the Committee during this process to minimize these negative impacts.

VI. Conclusion

As outlined above, NAM members have concerns with some of the provisions in the November 21st discussion draft. Indeed, the proposal, taken as a whole, is out of step with tax systems in competitor nations and could make it more difficult for U.S. manufacturers to compete in a highly competitive global economy, as well as for the United States to attract investment and jobs.

The NAM recognizes the need to attract high-value jobs and investment to the United States, improve competitiveness and the important role a favorable tax climate plays in achieving these
goals. Consequently, we urge policy makers to advance reforms that encourage investment and job creation in the United States rather than penalize companies struggling to compete in a global economy. Indeed, making the cost of capital more expensive will not serve to achieve these goals.

In addition, any changes to the cost-recovery and tax accounting rules should be addressed in the broader context of comprehensive tax reform. Given that all the components of a comprehensive tax reform package have yet to be determined, the comments above are based on the premise that any changes to our cost-recovery and tax accounting rules would be part of a comprehensive tax reform plan. Furthermore, the NAM supports revenue-neutral, comprehensive tax reform. Thus, we have concerns with language in the draft that indicates that the plan is “revenue-neutral in the long-term,” and the potential that this could result in immediate tax increases for U.S. manufacturers.

As essential as comprehensive tax reform is to the long term competitiveness of our nation, a new system must not result in a net increase in manufacturers’ tax burden—a change that would derail efforts to enhance U.S. economic growth, investment, competitiveness and jobs.