AMERICAN CHEMISTRY COUNCIL

WRITTEN COMMENTS AND RECOMMENDATIONS ON COMPREHENSIVE TAX REFORM

July 17, 2017

The American Chemistry Council (ACC) is pleased to offer these comments in response to Senate Finance Committee Chairman Hatch's June 16, 2017 letter requesting "advice and recommendations" from interested stakeholders regarding comprehensive tax reform. ACC commends the Chairman for undertaking this review. We urge Congress to take advantage of this once-in-a-generation opportunity and aim to have meaningful progression and hopefully passage of a bill on a tax reform proposal by the end of the year. We strongly agree with the overarching goals as stated in the Chairman's letter--"to create a simpler and fairer system that is more conducive to sustained economic growth in the 21st Century global marketplace." We look forward to providing any additional information or answering questions, and to being an active partner in Congressional efforts to comprehensively reform the Nation's outdated tax Code.

American Chemistry and Its Place in U.S. Manufacturing

ACC represents the leading companies engaged in the business of chemistry. ACC member companies apply the science of chemistry to create and manufacture innovative products that make people's lives better, healthier, and safer. The business of chemistry is a $797 Billion enterprise and a key element of the nation's economy. Over 26% of U.S. GDP is generated from industries that rely on chemistry, ranging from agriculture to oil and gas production, from semiconductors and electronics to textiles and vehicles, and from pharmaceuticals to residential and commercial energy efficiency products.

Our industry directly employs over 810,000 Americans in high-paying, quality jobs and each of those jobs supports an additional 6.3 American jobs in other manufacturing industries, meaning that nearly 6 million Americans are working in the industries that rely on chemistry to drive economic growth, innovation, and American competitiveness. Importantly, our industry is one of the nation's largest exporting sectors, with over $173 billion in exports in 2016, or more than ten cents out of every export dollar. The U.S. chemical industry is a leader in the amount of R&D performed, innovation delivered, and exports shipped, contributing enormously to the nation's economy.

As a result of the recent surge in the development and availability of domestic natural gas, which is a critical source of energy and feedstock for the production of chemical products, our industry is investing $185 billion in new facilities and expanded capacity in the U.S. This investment will help grow the U.S. economy, create jobs, and improve living standards. But fully realizing the shale gas opportunity will require reliable access to new capital. A significant concern for companies considering further investment is the continuation of tax provisions that underpin multi-billion dollar investments.

Manufacturing and the U.S. Economy

Manufacturing is the cornerstone industry in the U.S. economy. Manufacturing output supports other industries both directly and indirectly, and manufacturing businesses are long-lived, supplying good-paying jobs and weathering business cycles. Manufacturers are among the largest employers in the U.S. economy, providing the foundation that enables economic security and growth.

Manufacturers share certain key elements in their operations that enable them to create, maintain, and grow their businesses:

- Manufacturing is capital intensive, but at the same time requires skilled employees; start-up and expansion is both costly and slow to achieve full capacity, resulting in a deferred return on investment;
- In order to weather business cycles, manufacturers require financial tools to deal with inflation and market variations;
- In order to compete in a global economy, manufactures must create new technologies and products while operating with ever greater efficiency.

These and more are requirements for maintaining and growing a manufacturing business.

The essential role of manufacturing in the economy, along with the economic realities that manufacturers face, has strongly influenced tax policy since enactment of the corporate income tax. Although very few Code provisions affect manufacturers exclusively, much of the structure of the corporate income tax acknowledges the dynamics and necessities of manufacturing businesses.

The products of chemistry touch more than 96% of all U.S.-manufactured goods. As a leading segment within the manufacturing sector, ACC is keenly aware of larger tax policy issues affecting manufacturers. We are attuned to the impacts of tax policy on the chemistry industry as well as the many manufacturing companies that are our customers and suppliers. Together, we play an important role in driving innovation, and job creation and growth in the U.S. economy.

ACC's "Guiding Principles for Corporate Tax Reform"

To enable the United States to regain its competitive edge, our tax code should be reformed to drive investment, innovation and productivity to create American jobs. The focus of Chairman Hatch's letter is timely, and the decisions Congress makes will be critical to creating a strong and competitive U.S. manufacturing sector and chemical industry. ACC's Board of Directors has adopted the following "Guiding Principles for Corporate Tax Reform":

- *Tax reform should produce a fair, simpler, and internationally competitive tax system that promotes economic growth and job creation in America.*
- *Tax reform should recognize and reflect the important role of American manufacturing and the jobs it creates.*
  - *Manufacturing is a capital intensive activity, and therefore, tax treatment of capital cost recovery is of key importance.*
  - *Advanced manufacturing techniques and products rely on research, and therefore, incentives for research and development expenses also should be supported.*
- *ACC supports adoption of a competitive territorial system for the taxation of income earned outside the United States.*
- *ACC supports a substantial income tax rate reduction to reflect rates at least comparable to Organization for Economic Development and Cooperation (OECD) averages.*
- *Tax reform must produce a "level playing field concept" such that American companies investing abroad can compete equally with foreign investors, and American and foreign companies investing in the United States are treated equally.*
- *Tax reform should be enacted comprehensively, not piecemeal, and should include transitional rules that allow taxpayers to adjust to a new tax regime without financial dislocation, contraction, or reduction in employment.*

ACC regards the principles not as a menu of alternatives, but rather as a template for a reformed corporate tax system that achieves the paramount goal of economic growth. Our comments below reflect these principles.

Proposals for Business Tax Reform

Consistent with ACC's principles, we strongly recommend that business tax reform be "permanent", and produce a fair, simpler, and internationally competitive tax system that promotes economic growth and job creation in America. The measure of each decision and trade-off made in the tax reform process should be whether it advances these goals.

We note that business tax reform is generally proposed within a framework of revenue neutrality, under which the reformed system of business income taxes would produce the same amount of tax revenue as the current system, but at the lower tax rate—requiring repeal of a broad range of so-called "tax expenditures."

We respectfully suggest that Congress consider satisfying this objective by taking into account the increased revenue that would result from modifying the Code to generate far greater economic growth. In contrast, we caution against embarking on a complex and difficult tax reform process that achieves revenue neutrality on a "static basis," which would simply create winners and losers in a zero-sum game. Moreover, if the reforms are not "permanent" but rather are only guaranteed for a relatively short period of time, it will fall short of meeting the goal of being "conducive to sustained economic growth in the 21st Century global marketplace." Capital-intensive heavy manufacturing industries such as the chemical industry cannot make huge, long-term investments based upon short-lived tax provisions. We need the clarity and certainty that comes with permanent reform.

A number of the so-called tax expenditures often suggested for repeal, such as accelerated depreciation, are vital to the manufacturing sector. Consequently, manufacturers would be disproportionately and adversely affected by such an approach to tax reform. The sector would find it even more difficult to compete in U.S. and global markets, and would be likely to experience reduced growth or even contraction, with a corresponding reduction in its workforce. Spill-over effects would harm suppliers and service-providers that depend upon manufacturing customers. We seriously question whether there is pro-growth tax "reform" if the existing business tax burden is simply rearranged among business sectors, with the capital-intensive manufacturing sector being disproportionately hurt.

Manufacturing Renaissance

Just a few years ago, the future of America's chemical industry was in doubt. Domestic natural gas supplies had declined, and U.S. natural gas prices were among the highest in the world. These challenges jeopardized domestic supplies of basic and specialty chemicals – a significant problem for a U.S. manufacturing sector that faced volatility in global markets, transportation issues, and the uncertainties of world output and availability.

But in recent years, the U.S. chemical industry has undergone a dramatic reversal. . The availability of lower-cost energy and feedstock has created a significant cost advantage for U.S. chemical manufacturers and started a manufacturing renaissance. Since 2010, the industry has announced $185 billion worth of new and expanded facilities to take advantage of ethane feedstock from domestic shale gas. About half of the investment is completed or underway, while half is in the planning phaseConstruction and operation of the new projects will rely on the continuation of tax provisions critical to manufacturers.

Accelerated Cost Recovery

Manufacturers regard accelerated cost recovery of capital assets ("ACR") as a fundamental tax provision. As a practical matter, ACR makes capital investment possible because of the leveraging effect on investment return and cash flow. Moreover, ACR is central to determining the "hurdle rate"[1] for an acceptable return on investment, i.e., the rate of return that governs the binary decision to invest/not invest.

Historically, "depreciation" meant capital cost recovery, but the term was largely made obsolete by tax law changes in the early 1980's that de-linked cost recovery from assumed "useful lives" of given assets. ACR describes the current system that features simplified formulas for recovery of costs over a stated period of years. An additional advantage is that ACR avoids contentious determination of useful lives that burdened the tax law for decades.

ACR allows recovery of the cost of capital investment more quickly for tax purposes than under financial accounting rules for the benefit of shareholders and creditors that amortize asset value over asset lives assumed by such rules.

> *Example:* Investment of $1000 in production machinery with a deemed useful life of ten years. Financial accounting rules specify depreciation on a "straight-line" basis over the ten-year period, reducing book income and balance sheet value by $100 annually. The same $1000 is recovered under ACR, but deductions are front-loaded in a yearly sequence such as $150, $300, $250, $150, $100, $50. Cost is recovered over six years rather than ten, under an accelerated method, meaning that the discounted value of deductions under ACR is substantially greater than under a straight-line method, with greater return as a consequence. Note the obvious fact that taxpayers get no greater total deductions under ACR, but that write-off is accelerated.[2]

ACR represents Congressional policy responsive to issues of up-front capital costs, deferred investment return, and business cycles, noted above as common to all manufacturers. In this regard, accelerated cost-recovery compensates for the risk of investing massive capital in relatively lower-profit enterprises, typically with longer start-up for bringing new assets on line and longer pay-out times in order to achieve return commensurate with the investment. The

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[1] Achieving an after-tax return on capital invested in a project is the essential element in the determination of whether the return on the capital is sufficient to justify the risk of making the investment. Calculation of the hurdle rate is by reference to projected annual cash outflows and inflows over the project life, including tax effects and other factors. Failure to achieve an adequate rate of return, often spoken of as the hurdle rate, will generally mean that particular investment will not be made.

[2] ACR is distinguishable from "bonus depreciation", the stimulus vehicle enacted temporarily in recent years. For a variety of reasons, including, most importantly, its *ad hoc* implementation, bonus depreciation has been of little consequence to the chemical industry and other large manufacturers in promoting new investment. However, the economic effect of encouraging capital investment is common to bonus depreciation and ACR – and permanent enactment of bonus depreciation would be much more meaningful.

concept that ACR incentivizes new capital investment is recognized in the Joint Committee of Taxation's report published on July 17th, 2012, which states:

> "A formulaic system of depreciation can serve to provide a tax incentive for capital investment to the extent the depreciation deductions are faster than the economic or financial statement depreciation of the property. For example, temporary rules providing for additional first-year depreciation (also known as bonus depreciation) were enacted several times in recent legislation with the purpose of providing economic stimulus during times of economic downturn." [3]

Longer cost recovery periods harm economic growth. To this effect, a 2007 Treasury Department study found that:

> ". . . repealing these provisions reduces the incentive to undertake new investments. This reduced incentive to invest can hurt labor productivity, which is central to higher living standards for workers in the long run. Thus, in evaluating the base broadening (through repeal of ACR among others special tax benefits) it is important to recognize that the repeal of several provisions would discourage investment and have a detrimental effect on economic growth. Indeed, the Treasury Department estimates that the combined policy of base broadening and lower(ed) . . . business tax rate to 28 percent might well have little or no effect on the level or real output in the long run because the economic gain from the lower corporate rate may well be largely offset by the cost of eliminating accelerated depreciation. . . If accelerated depreciation provisions were retained (to allow) the federal tax rate to be lowered to only 31 percent . . . the Treasury Department estimates that this approach would contribute somewhat more substantially to the growth of the economy."[4]

Because ACR is unusually significant to manufacturing and other capital-intensive businesses, repeal would have a disproportionate adverse effect on the industry. Some tax reform proposals have included expensing in lieu of ACR. As noted above, ACR *leverages* the value of capital investment in productive assets separate and apart from the tax rate, and expensing could enhance that value. In this regard, even a lower statutory rate under a reformed business tax system may not fully compensate for loss of ACR.

This is not to deprecate a lower statutory corporate tax rate. On the contrary, reduced rates are among the critical goals of tax reform and are highly prominent among the "Guiding Principles for Corporate Tax Reform" adopted by the ACC Board. However, to the extent that

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[3] JCT Report, July 17, 2012, pp. 13-14.

[4] *Approaches to Improve the Competitiveness of the U.S. Tax System for the 21st Century,* p. 69, published by the Treasury Department in 2007.

tax reform seeks greater economic growth through greater capital investment, ACR provides a "great bang for the buck" identified as such by the Treasury study.[5]

We respectfully question whether "reform" and the progress the term implies, actually would occur if changes in the tax law meant a significant disadvantage for new capital investment, with less growth, and erosion of the national economic base that the manufacturing sector represents.

Rate Reduction

ACC supports and strongly encourages the adoption of a substantial and permanent corporate or business tax rate reduction at least comparable to our OECD trading partners' averages to make the U.S. the most competitive place to do business, and to achieve greater investment, economic growth and job creation. Ideally, tax reform would make a substantially lower rate effective immediately, but the rate might be phased in over a number of years in order to satisfy revenue constraints.

Incentives for Research and Development (R&D)

Other countries offer increasingly generous tax and other financial benefits for research activities because of universal recognition that R&D creates advantage in the global marketplace and constitutes a job-creating engine for scientific professionals and support staff. The U.S. has fallen out of the top ranks globally when measuring government incentives for private sector R&D, , and risks losing these key jobs to other more competitive jurisdictions.

U.S. economic growth largely depends on continued R&D, providing manufactured products that are innovative, of higher quality and greater variety, and produced more efficiently. The chemical industry's R&D supports other manufacturing industries, as virtually all U.S.-manufactured products include chemical components that enhance value and help make U.S. goods more competitive in world markets.

The chemical industry is among the largest creators and users of technology. The U.S. chemical industry spends approximately $12 billion annually (separate from pharmaceuticals), with a significant majority of expenditures supporting research conducted in the United States. R&D incentives have encouraged the chemical industry to conduct research domestically, thereby maintaining high-paying jobs and technological leadership. Robust R&D is among key

[5] *See,* Study cited above, at pages 31-32.

factors in retaining a domestic chemical industry that can compete globally. The tax reform debate should consider the continuing role of incentives for creation of U.S. technology, while addressing the mobile nature of capital and intellectual property. Congress should examine the current R&D credit in the context of global incentives for research and development, and whether the credit or other devices would prove most valuable to U.S.-based manufacturers.

Tax reform should reestablish U.S. global competitiveness for R&D incentives. Incentives for conduct of domestic R&D are less competitive vis-à-vis the tax regimes of our trading partners, and the U.S. risks forfeiting R&D to countries with greater incentives. When the R&D Credit was first created in 1981, the U.S. provided the most generous tax treatment for research among all Organisation for Economic Development and Cooperation (OECD) nations. Today, Canada, China, India, Japan and other global competitors offer better R&D incentives, to include innovations such as "patent boxes" that reward both the conduct of R&D and retention of Intellectual Property (IP) domestically.

Tax provisions that promote research across all sectors of the economy are industry and taxpayer neutral, and thus consistent with sound tax policy principles, and would be an appropriate response to competitive challenges from other jurisdictions. Elimination of incentives for domestic R&D – which is to say, increasing R&D cost – would impair global competitiveness of U.S. businesses and technology. Retaining domestic R&D will provide an effective means of enhancing economic growth and global competitiveness, as the history of R&D incentives bears out.

Continued deduction of R&D expenses currently, an updated tax credit for R&D expenditures reflecting global markets and economics, and patent boxes are but three among a variety of provisions for promotion of domestic R&D. Favorable tax treatment for IP income, separate from or in addition to deductions and credits are among ideas for consideration in addressing declining U.S. incentives for domestic research.

LIFO

Short for “last-in-first-out”, LIFO is typically adopted by taxpayers that anticipate inflation in the costs of merchandise and other types of inventory items. For these taxpayers, LIFO measures taxable income most accurately. Taxpayers not choosing LIFO typically adopt the FIFO inventory method (“first-in-first-out). As a general matter, FIFO taxpayers anticipate level or declining inventory costs, and for such taxpayers FIFO measures taxable income most accurately.

This being the case, any discussion of LIFO should recognize that as a practical matter and as anticipated by the Code:

LIFO and FIFO methods are alike in providing taxpayers under each method a calculation of taxable income based on deducting higher costs of inventory acquired during the year.

Accordingly, elimination of LIFO would surely create "losers" and "winners" under tax reform, benefitting those businesses best served by adopting FIFO.[6]

Loss of LIFO inventory accounting would mean that some manufacturers operating under the LIFO method for many years would experience a major retroactive tax increase through "LIFO recapture" discussed below. The result could prove crippling, and in fact could cause business termination. The retroactive tax is in addition to higher annual tax cost going forward.

Prime among benefits to manufacturers is that LIFO allows greater reinvestment of earnings in the business, thereby providing greater capacity to weather business cycles, and to expand, particularly when inflation is an issue. A substantial portion of manufacturers chose LIFO, along with a majority of taxpayers, both large and small, from wholesale and retail industries for which inventory costs have a particularly close correlation with net earnings.

Since 1939, Congress, the Internal Revenue Service (IRS), and the Securities and Exchange Commission (SEC) have recognized LIFO as the most accurate manner of calculating business income, for tax as well as financial accounting, by certain categories of businesses. To this effect, inventory accounting methods allowed under the Code and IRS regulations exist so as to measure taxable income by preventing mismatching of income and deductions. LIFO is one of the two most common inventory accounting conventions, not a device or "loophole" for avoiding tax, but an essential element in the structure of a business income tax. Historically, tax economists have not regarded LIFO as a tax expenditure, but rather, an alternative and appropriate means of keeping business books and calculating tax liability, not unlike cash as opposed to accrual accounting.

[6] The triggering event and reserve recapture are not evidence of any preference in GAAP accounting or under the Code for FIFO, nor do they imply that FIFO is somehow the "correct" inventory method. LIFO is designed to help finance increased investment in inventory caused by inflation and the resulting higher cost of inventory replacement. LIFO defers tax on this artificial inventory gain, and is essentially a loan by the company to itself that must be repaid when the business ultimately is sold, or when the company goes off the LIFO method. The LIFO reserve represents this loan on the books of the company, with reserve recapture an accounting "true up". FIFO taxpayers are less concerned with the problem of renewing inventory at inflated cost, choose not to make a "loan", and accordingly have no such reserve on the books. FIFO is not an accounting method preferred by financial and tax accounting; rather, it is a different method for a different category of businesses and under accounting principles requires no reserve.)

It should be noted that the Treasury does not regard LIFO as a tax expenditure. However, the Joint Tax Committee added LIFO to its list of tax expenditures in 2008. The changed position by the Joint Committee was without comment or explanation, notwithstanding its longstanding position to the contrary, which was consistent with the Treasury position. However, re-characterization corresponded with an initiative for early repeal of LIFO in light of an assumption that the method would become obsolete, along with U.S. Generally Accepted Accounting Principles (GAAP) financial accounting rules in general. In this regard, the U.S. appeared certain to "converge" the GAAP rules with the International Financial Reporting Standards (IFRS) system promulgated by European nations. IFRS does not recognize LIFO, so it was assumed that convergence would eliminate LIFO for the U.S. If repeal preceded IFRS, the revenue score would represent a very significant windfall for the government. However, the assumption of IFRS adoption proved unfounded.

In the first instance, the SEC carefully considered the convergence issue over a number of years, and in mid-2012 reported that adoption of IFRS is on indefinite hold, citing LIFO among the reasons. Moreover, the report noted that even if the U.S. ultimately were to adopt some form of IFRS, LIFO is among provisions likely to be an exception from convergence requirements, in the same category as certain accounting rules allowed to continue at the discretion of certain nations that adopted IFRS.

Repeal of LIFO would create a dual detriment to LIFO taxpayers, while providing a dual benefit to the federal treasury. First, repeal would mean higher annual tax liability, by limiting deduction of more expensive inventory (while deduction of higher inventory costs would continue for FIFO taxpayers). Second, and as noted above, repeal of LIFO triggers "recapture" of LIFO reserves – the difference between inventory costs accrued under LIFO and the lesser amount taxpayers would have accrued if accounting for inventories under FIFO.

In this regard, note that such an arbitrary levy on income earned in prior years must be paid currently, but from cash not produced by current sales – the retroactive element. The earlier earnings were reinvested in the business (for growth or to guard against business cycles). The business must find the cash somewhere else. Even if the financial posture of a taxpayer forced off LIFO were sufficient to survive the retroactive tax, the business has reduced assets, requires additional borrowing, or foregoes capital expenditures.

These consequences are inconsistent with tax reform goals of stability, economic and job growth and increased investment.

Deduction of Interest Expense

In the case of a long-term project that requires large up front outlays, like the building of a new plant, investment dollars are tied up for a period of years before the completion of construction and onset of production at a profit. During this period, the interest on company debt compounds. Accordingly, long-term, capital intensive projects are especially sensitive to changes in the cost of capital. Repealing or limiting the corporate debt interest deduction as part of comprehensive tax reform, without other reforms that act to offset the effects of such a policy, would have a direct and negative impact on the capital formation process, and reduce investment in large-scale manufacturing projects.

Interest paid on debt is recognized as a cost of doing business and virtually every business relies on debt at some level to finance its operations. Investing activity targeted for growth is based upon achieving certain rates of return over and above their cost of capital. Reducing or eliminating the interest deduction would immediately increase the cost of capital, thereby increasing hurdle rates companies use to evaluate investment opportunities.[7] This will lead to reduced investment and capital spending activity with the potential for companies to reevaluate capital decisions that have already been made or are under consideration.

Companies need flexibility in raising capital for their operations, whether through debt or equity. They use a range of factors in striking the right balance: cash flow, capital costs, types of projects to be financed, risk profile, and desired financial profitability. We appreciate the concern with companies that are too heavily in debt and are over-leveraged, but the market is a very efficient mechanism for sorting this out. Companies with too much debt will see their cost of capital increase in the market, which would probably move them toward a more balanced mix of debt and equity that will keep their capital costs more in line with their competition. There is no need to legislate what the market already manages efficiently and effectively.

Moreover, imposing a limit or reducing interest expense deductibility, once again absent other reforms that act to offset the effects of such a dramatic policy change, would have an immediate and sustained impact on capital costs. The resulting decrease in corporate investment activities would threaten the already low economic growth experienced in the U.S. over the last several years.

A Competitive Territorial Tax System is Essential for Future U.S. Prosperity

The modern economic realities of business operations and government tax policy in a global economy require a fresh approach to international taxation in the U.S. With 95% of the world's population outside the U.S., the U.S. tax system must enable, not impede, the

[7] For a description of "hurdle rates" and the effect on investment decisions, *see* n. 4, above.

competitiveness of U.S. companies. The best approach to international tax reform is to review carefully the international tax policy developments in the rest of the industrialized world with a view to emulating the best practices of other nations.

The clear trend over the last 20 years is that almost all Organisation for Economic Development and Cooperation (OECD) countries, even those that traditionally had worldwide tax systems, have determined the preferred—and hence now the competitive-- system for taxing income earned outside their home country borders is a territorial system, i.e., a tax system that essentially exempts active foreign business income from "home" country taxation. The lone significant outlier is the U.S. We would also note that such countries have significantly reduced their corporate income tax rates as well.

The U.S. International Tax Code is Non-Competitive

Under current law, worldwide American companies' earnings from foreign operations are effectively "locked out" of the U.S. American companies competing with foreign-based companies in foreign markets pay income tax rates in foreign jurisdictions that are lower than the U.S. rate of 35%, which is the highest in the industrialized world. The American company must pay the difference between the low foreign rate and the high U.S. rate when bringing foreign earnings home. The foreign competitor with a home in a "territorial" tax regime pays no such additional tax on its foreign earnings when distributed to the home country of the parent company—even in the frequent circumstance that the foreign taxes in any year are less than the parent company's home country tax. Thus, the U.S.-based company is at a distinct disadvantage in competitive foreign markets for two reasons—first, an additional layer of home country (U.S.) tax is imposed, unlike our trading partners, and second, that additional layer is based on an uncompetitive tax rate of 35%. U.S. enactment of a competitive territorial system of taxation would put American companies on a level playing field with foreign-based competition, particularly if coupled with a lower tax rate and/or features that provide exemption or reduced rates for activities directly associated with earning active foreign business income.

The present U.S. system, imposing an additional home country tax when lower-taxed foreign earnings are repatriated, encourages U.S. companies to keep cash abroad. Removing this "lock-out effect" would encourage movement to the U.S. of very significant amounts of cash presently sitting in foreign bank accounts of foreign subsidiaries of U.S. multinationals. Movement of this cash to U.S. parent companies could cause an increase in investment in U.S. capital equipment, creation of new jobs in the U.S. and payout of dividends to U.S. shareholders, who in turn invest in other American businesses.

It is clear that the high U.S. tax rate combined with an outdated international system of taxation puts U.S. companies at a competitive disadvantage to foreign-owned companies competing in the global marketplace. The additional layer of U.S. tax on foreign earnings limits

expansion opportunities, employment and investment, both at home and abroad. As U.S. companies expand globally, they increase U.S. employment -- in engineering, R&D and administration and supervisory support roles. Moreover, a territorial system eliminating disadvantages of the current system to U.S. companies engaged in global markets also would enhance the growth of virtually all the domestic companies that support global reach through the U.S. supply chain of goods and services.

Furthermore, recent studies have found that within global production networks, when some tasks are relocated to foreign affiliates in different parts of the world, the coordination to make the finished product tends to create new jobs in the U.S. parent company as well. And growth of global supply chain networks of U.S. multinational corporations (MNCs) also results in growth of other intermediate suppliers of goods and services, many of which are small and medium-sized American companies.

U.K. and Japan Adoption of a Territorial Tax System

Relatively recently, two countries with long-standing "worldwide" tax systems, the United Kingdom and Japan, have independently determined that it is better to move to a territorial system that exempts foreign income. Like the current international tax regime in the U.S., these "worldwide" systems of U.K. and Japanese tax laws had imposed a home country tax when lower-taxed foreign earnings were repatriated to the parent company as dividends. U.K. and Japan determined that worldwide taxation was stifling their resident multinational companies in the highly competitive global economy and limiting domestic employment and investment while failing to add any significant amount of revenue to government coffers. The U.S. is under similar competitive pressures, and without comprehensive tax reform, faces a future with fewer job opportunities.

Anti-Base Erosion Provisions of a Territorial System

We offer the following considerations in developing approaches to prevent inappropriate erosion of the U.S. tax base:

- Focus on erosion of the U.S. tax base, not the erosion of tax bases in foreign countries. It should not be the role of the U.S. tax law to punish U.S. companies that operate successfully in jurisdictions that impose a substantially lower income tax burden than the U.S. does. Increasingly, countries are determining that income taxes, and particularly corporate income taxes, are among the most harmful ways to generate tax revenues. As more countries develop alternatives to high income taxes, U.S. companies should not be disadvantaged based on the type of revenue raising choices a particular foreign country

makes. It would be ironic for a foreign nation to choose a less harmful revenue raising approach, only to have its choice undercut by the United States, with the result that U.S. based companies are prevented from participating in that country's development.

- Debt-financing is an important source of funding for capital investment, and it is appropriate for businesses to be able to deduct interest expense related to borrowing. In the context of a competitive international tax system, any efforts to limit interest expense under the auspices of base erosion must:

    1. Be carefully, and narrowly, drawn so that they do not impede U.S. economic development by limiting the deductibility of interest on debt used to finance U.S. business activities where the borrowing reflects an efficient manner of obtaining financing and is at levels that are in fact commercial and arm's length;

    2. Not impose a new complex framework of administratively burdensome, inflexible rules;

    3. Be market based and avoid arbitrary constraints on debt financing that fail to recognize the cyclical nature of capital intensive industries or the sound business reasons for companies to vary their debt levels based on their particular business model, financial profile and risk diversification strategy.

- Avoid incentives for foreign subsidiaries of U.S. MNCs to pay more foreign tax, and for foreign governments to raise their taxes at the expense of the U.S. Treasury.

- Take into account that many U.S. (as well as foreign) MNCs are managed on a regional or global basis, not by maintaining a full-service operation in each individual country. Services must be shared across a number of countries and subsidiaries to be efficient. Do not assume a free-standing supply chain in each country.

- Avoid distortive "cliff effects," e.g., where one U.S. tax treatment follows if a certain effective foreign tax rate is paid by a subsidiary of a U.S. MNC, but a totally different U.S. tax treatment applies if the foreign tax rate is just slightly higher or lower.

- Consider the anti-base erosion provisions in the territorial tax systems of other developed countries. To impose much more onerous terms on U.S. MNCs operating globally would be inconsistent with the purposes of adopting a territorial tax system.

- Understand that global expansion by U.S. companies is essential for U.S. companies to prosper, grow and capture new markets. Such expansion adds to the U.S. economy and creates jobs in the U.S. To be competitive globally, U.S. companies must consider cost savings from operating closer to foreign customers and raw material suppliers, availability and costs of labor, logistics costs and many other factors.

Repatriated Earnings/Transitional Tax on Pre-Enactment Earnings

Outside of comprehensive tax reform and absent recognition of the unique circumstances of the chemical manufacturing sector's operations abroad, ACC strongly opposes proposals to tax historical foreign earnings.

In previous years, proposals under consideration for raising tax revenue to pay for highway and infrastructure projects included a device referred to as "deemed repatriation" or "mandatory repatriation" to U.S. parent corporations of foreign earnings accumulated by foreign subsidiary corporations and permanently reinvested abroad. Use of the term "repatriation" in these contexts is inaccurate and misleading because the proposals do not require nor anticipate any actual return of cash. The proposals mandate U.S. tax on foreign earnings as though the earnings *were* distributed to U.S. parent corporations as dividends. In the case of the chemical industry and other manufacturers, the distinction between actual and deemed dividends is very real and has very serious consequences.

With the exception of relatively small amounts of working capital to pay receivables and meet other current expenses, foreign subsidiaries of U.S. parent chemical companies typically keep only incidental cash funds offshore. Earnings from manufacturing operations of the foreign subsidiaries are reinvested in plant and equipment in order to serve foreign markets and compete internationally. As a consequence, only a relatively small amount of earnings is represented as cash and cash equivalents and available for actual repatriation, and therefore parent companies would need to borrow money in order to pay the U.S. tax with respect to deemed transfers of deemed cash.

Absent comprehensive tax reform that includes significant corporate rate reductions, adoption of a territorial tax system, and sufficiently lengthy transition periods, the tax on reinvested earnings would simply reduce amounts and availability of capital in the U.S. This would also lead to weakened balance sheets, lowered share prices, limited investment in new plant and equipment, stifled growth, and eroded payroll and job creation. As noted above, the chemical industry is among the largest U.S. exporters, with an outsized share of export dollars, with many jobs in the industry supporting exports as well as foreign operations.

Within the context of comprehensive tax reform, there also continues to be serious consideration of imposing a tax on pre-enactment earnings of foreign subsidiaries of U.S. MNCs at the time of transition to a territorial system. We appreciate that the terms of such a provision

are to some extent driven by the need for revenue-neutrality and therefore would not necessarily resemble features of the transition to a territorial tax system adopted in other countries. Still, we offer the following recommendations:

- In the interests of simplicity and the ability to administer the law, consider the difficulty of accurately computing historical accumulated earnings and profits for subsidiaries of U.S. MNCs that have been in business for many decades.
- Understand that financial statement accumulated earnings do not equate to cash on hand that can be repatriated at the time of transition to a territorial system. In many cases, foreign subsidiaries have reinvested much of their accumulated earnings in capital assets, and therefore do not have cash available to repatriate. Consider whether the transition tax should treat differently the cash or equivalents on hand in foreign subsidiaries versus accumulated earnings represented by plant and equipment.
- Consider whether the transition tax should take into account that some foreign subsidiaries in a group may have positive accumulated earnings, while others have accumulated deficits. Rather than ignoring the deficits and taxing the positive earnings at transition, netting of positive and negative earnings of group members should be allowed.
- If Congress includes deemed repatriation in its comprehensive tax reform package, it must either exempt earnings that have been reinvested in plant and equipment, or at least recognize the difference between such reinvested capital and simple reserves of cash and cash equivalents by enacting a bifurcated rate—taxing reinvested earnings at a substantially lower rate than cash/cash equivalents.

Dynamics of the Global Economy Require Reform

While the U.S. GDP is large relative to that of many other countries, it does not follow that the U.S. or its resident companies are materially different from their competitors or immune to global competitive forces. Foreign companies pursue the advantages of investing in the U.S. economy on an essentially equal basis without facing uncompetitive international tax rules either in their home jurisdictions or here in the U.S.

Congress should look at the historic trend line for the U.S. economy and the likely direction of that line in the future. In recent years, the U.S. GDP as a percentage of worldwide GDP has been shrinking. Similarly, the number of U.S. companies that are among the largest 100 companies in the world has been declining steadily. These trends are likely to continue, even with robust economic growth at home and abroad. This is not necessarily bad news. New markets have developed over the past twenty years in countries that before 1990 had closed

economies. This trend implies that we should recognize the importance of being connected and competitive with the rest of the world.

Benefits of Adopting a Competitive International Tax System

The U.S. should adopt a territorial system of international taxation that will enable the U.S. to tax business income earned in America, without stifling the opportunity for American companies to participate in the growth of the global economy. International tax reform should include innovative ways to apply traditional guidelines to modern business enterprises that enable income tax laws to raise the necessary revenue in each jurisdiction consistent with the arms-length principle of transfer pricing. This approach, properly crafted, would recognize and rely on the underlying economics of business conducted in global markets. By combining this approach with a competitive territorial structure, American companies will be better able to compete globally. The result would be more quality and quantity of job opportunities in the U.S. and a higher U.S. standard of living.

Debt, Equity and Capital Formation

Debt versus equity as vehicles for financing the corporation –

As discussed briefly earlier, the treatment of debt, equity and capital formation under the tax Code has a direct impact on capital formation in the U.S. It can encourage investment, attracting more capital to the U.S., or it can put the U.S. at a disadvantage in an increasingly competitive global economy. In making decisions about how to structure the capital of an enterprise or to fund business expansion, a principal consideration is the distinction between the form of returns on equity – dividends that the corporate payor may not deduct – and interest payments on borrowings and debt instruments – that the corporation may deduct as ordinary and necessary business expenses. Deduction of such business expenses is a fundamental principle under the U.S. corporate income tax imposed on the earnings of businesses *net* of expenditures necessary to produce such earnings.

In this regard, deduction of interest expense is an essential element in determination by corporate management of how to finance formation and operation of the enterprise. Deductibility of interest expense does not foreclose use of equity – common or preferred stock – that may provide management with greater flexibility than debt. Regardless, raising necessary capital, either upon corporate formation or to fund operations and expansion, is an essential tool for growth of the corporate enterprise. Use of debt is common to all companies, of whatever size or complexity without respect to industry segment, and whether publicly-traded in the U.S. or a

subsidiary of a foreign parent company. For all, debt constitutes a basic tool for attracting necessary capital.

The tax law treats interest expense paid to borrow money differently from returns on equity through dividend distributions because debt is fundamentally different than equity. As noted, interest is an "expense" of the business; dividends are not. Whether to meet payroll, purchase inventory, meet working capital needs, or to finance large long-term projects, businesses need to borrow money, the cost of which is interest.

Equity financing is not always available or suitable as a means to supply the funds needed. Further, equity holders, who assume greater risk than lenders, demand higher returns than the interest charged by creditors. Like any other ordinary and necessary business expense, interest must be paid, according to a schedule, and regardless of profitability. Dividends are paid at the discretion of the corporate board, and can be paid *only* from net earnings.[8] Moreover, a business may employ debt financing for part of its capital in order to obtain the leverage necessary to provide return on investment to equity holders at a level that is competitive within the market for investments.

There are multiple business reasons for corporate borrowing, some unique to individual companies, but in any event, necessary for the enterprise to provide the products or services from which its earnings are derived. To this effect, interest is payable at a rate and according to a schedule agreeable to the lender (whether a bank or holders of publicly-issued debt instruments). Interest payments (unlike dividends) are not at the discretion of the business, and are in the same category of ordinary and necessary expenses as wages, salaries, utilities, rent, and maintenance costs, all payable regardless of current profitability. Only if business revenues are sufficient to cover such expenses – to include interest – can the business earn a profit, and then choose whether or not to pay dividends.

Because interest is a necessary expense of running a business, and because its payment is not discretionary or conditional, the interest expense of a business is fully deductible.

Limitation of the interest deduction as taxing "phantom income" –

As noted, the corporate income tax applies to the earnings of the business, net of those expenditures necessary to produce the earnings. Interest payable is very much an expense necessary to operate the business.[9] Limiting deductibility of some or all of the interest expense

[8] As a matter of corporate law, unless a corporation has current or accumulated earnings it may not pay dividends. This is highly significant, legally and as a practical matter, and is among the primary factors that distinguish equity financing from use of debt.

[9] It is doubtful that any legitimate business ever borrowed money and agreed to pay interest merely because the interest could be deducted: The cost of the interest would necessarily exceed the value of the deduction. To this effect, the value of a tax deduction is equal to the amount of the underlying expense, over the tax rate imposed on earnings, *e.g.,* if the business that is subject to a 35% tax rate incurs a deductible expense of $100, the value of the deduction as a positive number, or "tax benefit", is 100 X 35% = $35.

would mean that interest paid would "cost" more than other business expenses that were fully deductible. Very simply, that would make the cost of borrowed capital higher, because the deduction would not fully cover the cost of the expense. The tax on net income would be calculated incorrectly, applying with respect to more net income than the business actually produced.

In this regard, consider the example of a business with gross income (*i.e.,* "sales") of $100 and incurring expenses of $80, of which interest is $40. If, say, 30% of the interest were disallowed as a deduction, then the taxable income of the business would be $12 higher than the actual net earnings, with the disallowed interest creating, in a sense, "phantom" income. [10] [11] If not phantom income, then the result might be characterized as a *de facto* tax rate greater than that appearing on the face of the Code, a result, one assumes, that is contrary to a goal of transparency in reform of the tax law. [12]

Deductibility of interest, cost of capital, and investment decisions –

The deductibility of interest directly impacts investment decisions because it directly affects the cost of capital. Major investment decisions, such as whether to build a new chemical plant or invest in new technology, are based on estimated revenue and expenses projected over a period of years. In these projections, the time value of money is taken into account. This is to say, will the proposed investment prove sufficiently profitable to pay the after-tax interest expense charged by creditors and the investment returns expected by equity holders, over the life of the investment.

This return needed for a company to pay interest on its debt and returns to equity holders is termed the company's "cost of capital." A company's cost of capital is calculated based on a weighted average of the *after-tax* cost of the company's debt (that is, the *after-tax interest rate*) and the demands and expectations of its equity investors. Unless an investment project will be profitable enough to meet the company's cost of capital, it will not be undertaken.

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[10] We assume that the lower actual net earnings would be reported for financial statement purposes, thus distorting book-tax accounting.

[11] More to this effect, tax paid on income that doesn't exist is a tax upon the capital of the business. It is as though income tax were assessed against a business that otherwise had an operating loss for the year. The business could satisfy the tax only by reducing its capital.

[12] We assume that reform of the business income tax would not change the fundamental design of the tax as a levy against earnings *net* of expenses. But if certain expenses were not allowed as deductions in full, the character of the tax would change, with any exceptions representing a shift toward a levy against gross income. Such a tax, departing in whole or in part from the conceptual framework of a business tax on net income, almost certainly would prove inequitable simply because different businesses require different kinds and levels of expenses in order to produce profit. We respectfully suggest that the Committee not alter the fundamental design of the business net income tax without extensive consideration that full or partial disallowance of deductions for expenses incurred as necessary to operate businesses would produce very significant economic distortions throughout the economy. The few existing Code provisions that disallow deduction of expenses look to whether the expenses incurred were "necessary" in fact, or whether allowance of the deductions would tend to frustrate some purpose or policy elsewhere in the law.

In the case of a long-term project that requires large up front outlays, like the building of a new plant, investment dollars will be tied up for many years before profitability is expected. During this period, the interest on company debt and the investment returns demanded by equity holders will compound each year. Accordingly, long-term, capital intensive projects are especially sensitive to changes in the cost of capital. *Limiting or eliminating the deductibility of interest would directly increase the cost of capital and would have a dramatic effect on investment decisions.*

A new facility that had been projected to meet or exceed its cost of capital, taking into account the deductibility of interest expense, may no longer satisfy the minimum investment return or "hurdle rate"[13] if deductibility is eliminated or limited. If the cost of capital increases, some plants will not be built; others will be scaled down.

In short, the deduction for interest expense reduces the cost of capital for US investments, making investment in the United States more attractive. The higher the cost of capital, the lower the amount of investment a firm can profitably undertake. *Tax-law changes that increase the cost of capital (absent other reforms that act to offset the effects of such a policy on those same parties) will reduce domestic investment, thus, foregoing positive impacts on economic and job growth.*

Potential effects on bond markets and the broader US economy –

Commentary suggests that partial or complete disallowance of interest deductions would create negative effects to the broader U.S. economy. In addition to reducing returns on investment, raising the cost of capital, and incentivizing capital flight, there are significant effects on the public bond markets. Companies issue publicly traded debt with the expectation that the interest remains deductible. If the rules change, then the debt would become more expensive, and would cost more to redeem, thereby introducing great price volatility into the debt markets.

Changes in bond price volatility would have collateral and potentially systemic negative effects on the public equity markets. Moreover, a reduction in U.S. investment through shrinkage of the bond markets would negatively impact the balance of trade, with corresponding impacts to U.S. currency. Of particular concern, is that home mortgage, consumer credit, and commercial lending is funded in part by debt itself. Thus, the change in interest deductibility would require lenders to raise interest rates to maintain profitability, with the consumer and homeowner bearing higher costs.

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[13] More to this effect, achieving an after-tax return on capital invested in a project is the essential element in the determination of whether the return on the capital is sufficient to justify the risk of making the investment. Failure to achieve an adequate rate of return, often spoken of as the hurdle rate, will generally mean that particular investment will not be made.

In summary, there are valid business reasons for funding investments with debt, including intercompany debt. Thus, any changes to the existing rules that would make them more burdensome would only increase the cost of capital for U.S. investments, driving investment away from the U.S. and into other countries. In the chemical industry in particular, capital investment decisions are not short-term financial investments, but rather long-term investments that generate jobs and economic activity (both directly and indirectly) for extended periods. Moreover, given the bright future for U.S. chemical investments because of shale gas, there is little policy justification in changing the tax rules so as to discourage companies from investing in U.S. chemical facilities.

Overall Summary: "Level the Playing Field"

As reflected in ACC's "Guiding Principles for Corporate Tax Reform" and as an overall principle to guide policymakers, ACC believes that U.S. tax reform must provide for a "level playing field" where U.S. companies investing abroad can compete equally with foreign investors, and where U.S. subsidiaries of foreign investors which invest in the U.S. and U.S. parented companies are treated equally. Further, we believe that tax reform should not create winners and losers among industries or among types of businesses, but should attract investment and enhance job creation throughout U.S. business enterprises and foreign enterprises investing in the United States. In summary:

- The U.S. should adopt U.S. tax rules that will enable, rather than impede, U.S. companies to compete on a level playing field with regard to their foreign business operations. ACC supports the adoption of a territorial system (which is comparable to those of our major trading partners) for the taxation of foreign business income, that would permit competitive treatment for U.S. companies.
- U.S. companies operating in the U.S.—whether U.S. owned or foreign owned-- should be subject to comparable rules, and thus taxed on a level playing field with regard to U.S. business operations. ACC supports U.S. tax rules which would provide parity between U.S.-owned companies and foreign-owned companies.
- Changes that would place the burden of U.S. tax reform on one or more particular industries would not result in a level playing field. For example, when looking at potential base broadeners, the manufacturing industry (including the chemical industry) should not be disproportionately impacted, unfairly so, vis-à-vis other industries. Otherwise, this would have a significant negative impact on U.S. manufacturing, economic growth, new investment and jobs.