The Manufacturing Council

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Subcommittee on U.S. Competitiveness
Focus: Corporate Tax Burden

Subcommittee Report

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Corporate Tax Burden

As members of the Manufacturing Council's Subcommittee on Competitiveness, we are very concerned about the competitive challenges facing U.S. manufacturers. The global competition we face is at an all time high as we struggle to contain ever increasing costs. Unfortunately, the tax structures of our country and its states contribute to this cost burden through arbitrary restrictions on the use of legitimate losses, deductions, and credits.

There are several areas where Congressional action would really make a difference in helping U.S. manufacturers remain competitive. We are suggesting reforms to:

1. The Corporate Alternative Minimum Tax System
2. Loss and Credit Carryover Limitations
3. The Research and Development Credit
4. The Subpart F Active Financing Exception
5. State Tax Credits
6. The Personal Property Tax imposed at the State and Local Level

1. The Counter-cyclical Nature of the Corporate Alternative Minimum Tax: The corporate Alternative Minimum Tax ("AMT") ensures that corporations pay tax at a time when they can least afford it. When times are tough and income is depressed, the AMT frequently applies to force a company to make tax payments it would not have had to make under regular tax law. Accordingly, the AMT unfairly punishes companies like U.S. manufacturers that are experiencing difficult times or that are cyclical. The AMT should be repealed. However, short of repeal, the AMT could be modified to eliminate elements that disproportionately burden manufacturers.

To incentivize capital expenditures, Federal tax law allows for accelerated depreciation deductions; however, the AMT does not permit accelerated depreciation. Accordingly, for those taxpayers subject to AMT, the incentive effect of accelerated depreciation is reduced or eliminated. Moreover, AMT taxpayers are disadvantaged in comparison to competitors, frequently foreign owned, that are not subject to AMT. In the aftermath of the attacks on our country of September 11, 2001, Congress enacted tax legislation that temporarily eliminated (September 10, 2001 – December 31, 2004) the prohibition on use of accelerated depreciation for AMT. For many sectors of our economy the economic crisis following the September 11 attacks has receded. For domestic manufacturing, however, the crisis largely continues. AMT accelerated depreciation should be allowed for all future investment.

In addition, R&D credits may not be used to offset a taxpayer's tentative minimum tax liability. This AMT restriction has forced companies to accumulate large tax credits during periods of economic difficulty. The inability to utilize credits to reduce a taxpayer's AMT liability undermines U.S. R&D spending and contributes to an already struggling company's problems by impeding new investments and spending when they are most needed. The AMT should be modified to allow R&D credits to offset a taxpayer's tentative minimum tax liability.

2. Reforms to Mitigate the Tax Code's Impact on Manufacturers: Economic losses are a reality of business life for manufacturers. They are reflected in share prices, job numbers, profits, investments, and future business strategies; however, they are often not appropriately reflected in the tax code. While gains are immediately taxed, the tax code adds complexity and erects barriers to the use of losses. Manufacturers are at an unfair economic disadvantage under the tax code because of restrictions on the use of losses and credits that are unduly rigid and limited. For example, capital losses and charitable contributions only have a five year carryover period. Companies have actually incurred the loss or deduction; there is no policy rationale for unduly restricting them from receiving associated tax benefits. To ameliorate this unfairness, carryover limitations on all losses and credits should be eliminated or at least commonized with the net operating loss carryover period of twenty years.

Alternatively, Congress could consider allowing taxpayers more flexibility to use elections to slow down deductions. For example, it would be helpful if IRC Section 59(e) or depreciation elections could be retroactive so that they could be made to defer deductions for an earlier year after a company has had some time to determine that carryovers from the earlier year are in danger of expiring unused.

3. Research and Development Credit: The R&D tax credit provides an important incentive to undertake inherently risky research and experimentation in the United States. It was enacted in 1981. Since enactment the credit has been temporarily extended 11 times. In July 1995, the R&D credit lapsed for a period of twelve months. The importance of the R&D credit is validated by its extension so many times by so many different Congresses. However, the need for continual extension belies the credit's intent. The greater the certainty of realizing some benefit, the more likely businesses are to spend money on R&D. Since most R&D projects are long-term, not knowing if the credit will be available in following years seriously undermines the credit's incentive effect. To alleviate this uncertainty, the already-existing R&D credit should be made permanent.

4. Active Financing Exception: The U.S. tax code has not kept pace with an increasingly competitive global environment. The Subpart F rules, in particular, put a U.S. company competing in a foreign country at a competitive disadvantage to a foreign company competing in the same foreign country. The U.S. company's foreign country operations are subject to current U.S. taxation under Subpart F, but the foreign company's operations are not. In recent years, some of the harshest effects of Subpart F have been ameliorated by the Subpart F active financing exception. This exception enables a U.S. manufacturer to avoid current Subpart F inclusions for income earned by its captive foreign finance company. A U.S.-based manufacturer's foreign captive finance operations are typically integrated with its foreign manufacturing operations; the captive finances buyers/lessees of the manufactured products. Congress has extended the active financing exception three times since 1997 but it is now scheduled to expire at the end of 2006. Congress should make the Subpart F active financing exception permanent.

5. State Tax Credits: A recent U.S. 6th Circuit case, commonly known as the *Cuno* case, held that certain state tax credits are unconstitutional because they discriminate against interstate commerce. Congress alone has the power to regulate commerce among the states and the courts are forced to step in only when Congress' guidance on a particular issue is not clear.

There is legislation already pending in Congress (the Economic Development Act) that would clarify that states have the right to offer tax credits if they so choose and that those credits are not viewed by Congress as being an inappropriate burden on interstate commerce. Until Congress speaks on this issue, there will continue to be great uncertainty and litigation. As a result, companies will be forced to discount the value of state incentives when making decisions whether to invest and keep jobs in the U.S. which will place the U.S. at a competitive disadvantage.

6. Personal Property Tax: A majority of states and localities impose a tax on machinery and equipment and other personal property. This type of tax disproportionately burdens manufacturers and serves as a disincentive to making investment. The tax burden should be more equally distributed among various industries and impediments to making investment in the U.S. should be eliminated. States should update their tax structures to provide less emphasis on the personal property tax either by eliminating the tax on machinery and equipment (which several states have already done) or by providing a state level refundable credit for personal property taxes paid.

In a world environment that daily becomes more competitive, it is incumbent on Congress that it looks for ways to maintain jobs and economic growth at home by increasing our global competitiveness. Too often America's workers and businesses are undercut globally by a domestic tax system that has not changed with the 21st Century's business climate. The results are fewer jobs, lower wages and profits, greater costs, more complexity, and tax-motivated transactions that undermine our economic as well as domestic policy priorities.

We look forward to working with the Administration and Congress to make improvements to the existing tax structure that will remove barriers to making U.S. manufacturers more competitive.