

COMMENT
TO THE WAYS AND MEANS COMMITTEE
TAX REFORM WORKING GROUP ON DEBT, EQUITY AND CAPITAL
BY
THE AMERICAN CHEMISTRY COUNCIL
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The American Chemistry Council is pleased to offer these comments to the Working Group on Debt, Equity and Capital of the Ways and Means Committee. We believe the Committee is to be commended for undertaking a review of the eleven topics identified in this survey. We agree with what we understand to be the overriding goal of the Committee, which is to arrive at a framework for tax reform that increases U.S. economic growth and strengthens the competitiveness of U.S. business taxpayers in the global economy.

The American Chemistry Council

The American Chemistry Council (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 an enterprise with sales of \$769 billion, and a key element of the nation's economy. Nearly 23% 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 780,000 Americans in high-paying, quality jobs and each of those jobs supports an additional 7.6 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 \$188 billion in exports in 2012, or more than 12 cents out of every export dollar.

This Comment

We understand that the goals of the working groups on tax reform are in large part to make each of the eleven subject areas more fully comprehensible to Members of the Committee as well as to all Members of the Congress and all concerned with U.S. tax and economic policy. On that basis, we will describe concisely the provisions of the Code and aspects of U.S. tax law with greatest effect on operation, management, and growth in the chemical industry, as well as upon other manufacturing businesses, almost all of which are customers of our industry. Considering the mission of the Working Group on Debt, Equity and

Capital, we focus on tax provisions affecting capital investment, capital retention, and economic growth.¹

This comment is a product of the ACC Tax Policy Committee, existing under the governing instruments of the association and for decades providing the ACC Board and Executive Committee with recommendations concerning tax policy issues. Most members of the Tax Policy Committee are chief tax officers or senior counsel for ACC member companies.²

Introduction

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 the increasingly competitive global economy.

As described below³, recent technological innovations make extraction of shale gas in superabundance economically feasible and give the United States a supply advantage in the global marketplace. The ethane component of shale gas is the primary feedstock for production of basic chemicals, the products of which appear in 96% of all manufactured goods produced in the U.S. Energy and chemical companies have committed enormous sums as necessary to exploit shale gas as both a fuel and feedstock. This makes the United States a highly attractive place for investment in chemical facilities and gas-transmission infrastructure that should spur very substantial economic growth, through creation of hundreds of thousands of new jobs in the manufacturing and energy sectors.

The capital necessary for shale gas development and the growth in manufacturing should come from both domestic sources as well as direct foreign investment in the U.S. But for the promise of a manufacturing renaissance driven by shale gas actually to occur, U.S. tax law must encourage, not impede, decisions to invest. Treatment of debt, equity and capital under the tax Code will prove a major determinant in this regard.

Debt, Equity and Capital Formation

Debt versus equity as vehicles for financing the corporation –

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

¹ In addition to these comments, the ACC also has filed comments with the Working Group on Manufacturing and the Working Group on International.

² A statement of principles for tax reform, written by the Tax Policy Committee and adopted by the ACC Board appears as Attachment 1. A concise and non-technical outline showing the basic operation of the corporate income tax appears as Attachment 3.

³ See, Attachment 2.

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.⁴ 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 chose 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.

⁴ 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.

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.⁵ Limiting deductibility of some or all of the interest expense 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.^{6 7} 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.⁸

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.

⁵ 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 $100 \times 35\% = \$35$.

⁶ We assume that the lower actual net earnings would be reported for financial statement purposes, thus distorting book-tax accounting.

⁷ 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.

⁸ 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. Calculation of net taxable income is described in somewhat greater detail in Attachment 3.

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.

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 plant 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"⁹ 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 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 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

⁹ 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.

would require lenders to raise interest rates to maintain profitability, with the consumer and homeowner bearing higher costs.

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.

Attachment 1

American Chemistry Council

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 comparable to Organisation 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.*

Attachment 2

Shale Gas and the “Manufacturing Renaissance”

The chemical industry has announced tentative budgeting of \$71 billion for plants to separate chemical “feedstock from shale gas”. Feedstock provides basic materials used in manufacturing 96% of all U.S. manufactured products. This new source of lower-cost feedstock can mean a significant cost advantage for U.S. manufacturers and a “manufacturing renaissance”. However, construction of the new chemical plants depends upon continuation of tax provisions critical to manufacturers.

Only a few years ago, customers of ACC member companies asked how long a domestic chemical industry in the U.S. could survive. Customer concern reflected the run-up in costs of natural gas, the primary feedstock with which chemical manufacturers produce the basic materials the customers use in their own production processes. A historical price advantage enjoyed by U.S. manufacturers because of relatively inexpensive natural gas had disappeared, as U.S. natural gas supply declined. Availability of a domestic source of basic and specialty chemicals is obviously important to U.S. manufacturers, given volatility of global markets, transportation issues, and uncertainties of world output and availability.

However, declining prospects for the domestic chemical industry and, by extension, its manufacturing customers, dramatically changed with recent technology that allows access to massive shale-gas underlying much of the Northeast, Midwest, and Southwest. If these resources are developed to potential, U.S. manufacturers will achieve a world price advantage for chemical-product inputs. New job growth, exports, and inbound foreign-capital are among the more obvious factors that will contribute to a renaissance in U.S. manufacturing, led by inexpensive chemical feedstocks and low cost energy.

But exploitation of the shale gas resource requires capital investment commensurate with the enormous growth potential for the U.S. economy. A significant concern for those considering investment in the extraction and “cracking” facilities (to separate wet ethane from dry gas used as fuel) is continuation of tax provisions such as accelerated cost recovery.

Attachment 3

A Brief Description of the Corporate Income Tax

The category of corporations subject to the rules discussed below are “C” Corporations, that under the tax Code are taxable entities subject to rules in most ways consistent with those for taxation of individuals.¹⁰ Virtually all large corporations and the great majority of publicly-traded entities are C corporations.¹¹

Although complex, the rules for taxing the income of corporations are based on a statutory structure, the most significant elements of which are common to the corporate tax as first enacted in 1913. At most basic, the corporate tax is a levy imposed on business earnings, net of the expenses incurred in order to produce the earnings.¹²

The footnotes are not technical, but explain certain aspects of the corporate tax more completely (and to avoid clutter in the seven paragraphs below).

- (1) Taxpayers compute tax liability on the basis of a “taxable year”, almost always an accounting period of twelve months, although not necessarily a calendar year. The constant of an annual accounting period is fundamental to operation of the tax.
- (2) For the taxable year, determine the amount of “gross income”, which is the total of sales, receipts, gains¹³, rents, royalties, refund of earlier taxes paid, refunds from customers, release of liability, found money – any economic increase enjoyed by the taxpayer.¹⁴
- (3) Then, calculate “deductions” from gross income, which are the “ordinary and necessary” expenses of operating the business, to include employee compensation, interest expense, cost of supplies and materials¹⁵, costs of utilities, simple maintenance of property, plant and equipment, etc.¹⁶; plus, a portion of certain

¹⁰ Not dealt with below are “S” corporations, entities with corporate form under state law that are not subject to income tax, with shareholders taxed directly upon earnings of the business. *See*, n. 7.

¹¹ Some partnerships, real estate investment trusts, and limited liability companies are also publicly traded, and subject to rules similar to those for “S” corporations, noted above.

¹² A convenient consequence is that the taxpayer has the money with which to pay the tax.

¹³ Treatment of capital gains and losses is of limited concern to corporate taxpayers.

¹⁴ Under the rules of the Code, this is an amount “realized” -- received – or a current economic benefit quantifiable in dollars. Tax law defines gross income as broadly as possible, and deductions as narrowly as possible.

¹⁵ Manufacturers and some other categories of taxpayers are required to calculate the costs of supplies and materials by maintaining inventories. The inventory rules were designed by the Congress to prevent mismatching of income and expense and so as to best reflect taxable income. The most common inventory methods are FIFO and LIFO.

¹⁶ Dividends (paid on earnings) are not deductible by the corporate taxpayer, resulting in double-taxation of earnings: first at the corporate level and then by the shareholder recipient. The Congress enacted the rules for S Corporations so as to eliminate double taxation in the case of closely-held businesses operating in corporate form.

expenses incurred currently or in an earlier taxable year, but subject to ratable deduction over a stated number of years, the most significant of which is recovery of costs of property, plant, and equipment put into service.¹⁷

- (4) The result is “taxable income”, which is the net of gross income minus deductions, equaling economic increase subject to income tax.¹⁸
- (5) To taxable income, apply a “statutory tax rate” – the percentage tax rate specified under the Code for corporations -- typically 35%¹⁹, resulting in tax liability before credits against tax, if any.
- (6) From tax liability, subtract “credits against tax”. Credits are a portion (or in some cases, all) of a particular category of expense incurred by the corporation during the taxable year. The Code has two kinds of tax credits. The first is for expenditures that the Congress wishes to encourage, because of economic policy or larger objectives, *e.g.*, the credit for increasing research and development. The second is a credit to prevent double taxation, in this regard, the “foreign tax credit” that reduces U.S. tax liability by the amount of tax paid *on the same items of taxable income* to a foreign jurisdiction. Although simple in concept, few aspects of U.S. corporate tax law are as contentious and misunderstood as the foreign tax credit.²⁰

¹⁷ Cost recovery is sometimes referred to generally as “depreciation”. However, “depreciation” is a term actually made obsolete by changes to the rules for cost recovery enacted in the early 1980’s that de-linked deductions for recovery of costs of depreciable assets from schedules that sought to equate actual useful life of assets to depreciation allowances under the Code. A body of economic analysis holds that depreciable assets should enjoy first-year expensing under the Code, thus avoiding what is actually imposition of income tax directly on invested capital.

¹⁸ A tax on gross income would simply apply the tax rate without deducting expenses. Although having the virtue of simplicity, a gross income tax is obviously unfair because different taxpayers have different levels of expense in the ordinary course of operating their particular businesses. And, as a practical matter, the taxpayer might not have the money with which to pay the tax.

¹⁹ If deductions exceed gross income, the taxpayer, obviously, has a loss for the taxable year and no income to which tax can apply. Losses in a given year, to a limited extent, can become “net operating loss” constituting deductions allowable in another taxable year, a prime example of a tax provision designed to help taxpayers weather economic volatility.

²⁰ Under the U.S. system of “worldwide” taxation, the same item of income may be subject to both to U.S. tax as well as the tax of a foreign country. This, of course, is for income of a U.S. taxpayer, subject to the worldwide rule of inclusion, but also subject to the tax of the foreign jurisdiction in which the income item is earned. Thus, the foreign tax credit is designed to reduce U.S. tax by the amount of the foreign tax paid. A common misunderstanding is that the foreign tax credit can offset U.S. tax on income earned in the U.S. However, the foreign tax credit operates so as to eliminate this possibility. Also not fully understood is that the amount of the credit cannot exceed the amount of U.S. tax paid on the same item of income, *i.e.*, foreign tax paid on income at a 40% rate can offset U.S. tax only to the extent of the 35% U.S. rate on the same item of income. The foreign tax credit rules are among the most complex in U.S. tax law, and as a practical matter, the amount of foreign tax credit allowed to a taxpayer is frequently less than the foreign tax paid (separate and apart from the limitation of the credit to operation of the 35% rate).

(7) The amount of tax payable is after adjustment for such credits. Corporations file estimated returns throughout the year, with a true-up when the full-year return is filed. All large corporations are subject to a continuing auditing process by the Internal Revenue Service. Typically, three or more taxable years are combined in a single “audit cycle”. In recent years, the IRS has instituted programs designed to ease the manpower burden on itself as well as taxpayers with respect to tax audits.