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Submission to

Ways and Means

Tax Reform Working Groups

on behalf of
The National Retail Federation

April 11, 2013

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The National Retail Federation (NRF) strongly supports the efforts of Chairman Camp and the Ways and Means Committee to develop comprehensive proposals for reform of the federal income tax by lowering tax rates and broadening the tax base. We appreciate the Chairman's open process for examining difficult issues presented by tax reform through the issuance of discussion drafts and the formation of bipartisan working groups. Tax reform is vitally important to the U.S. economy and to retailers specifically, as retail sales constitute more than two-thirds of the U.S. economy. The U.S. economy cannot thrive when we have the highest corporate tax rate in the industrialized world.

As the world's largest retail trade association and the voice of retail worldwide, NRF represents retailers of all types and sizes, including chain restaurants and industry partners, from the United States and more than 45 countries abroad. Retailers operate more than 3.6 million U.S. establishments that support one in four U.S. jobs – 42 million working Americans. Contributing $2.5 trillion to annual GDP, retail is a daily barometer for the nation's economy. NRF's Retail Means Jobs campaign emphasizes the economic importance of retail and encourages policymakers to support a Jobs, Innovation and Consumer Value Agenda aimed at boosting economic growth and job creation (www.nrf.com).

Summary of Comments

NRF believes that the most important aspect of any tax reform measure is its impact on the economy, jobs, and the consumer. The U.S. economy is coming out of the worst recession since the Great Depression, but economists predict that economic growth may continue to be slow, which will also continue to depress consumer spending. Tax reform can provide much needed stimulus to the economy and should be enacted as expeditiously as possible.

We believe that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency to the federal tax system. These changes will lead to greater investment, more jobs and greater economic growth. In making these reforms, it is important that the tax code not place different tax burdens on taxpayers in similar economic circumstances. For this reason, tax reform must be applicable to all businesses, not just "C corporations." A reformed income tax code should not include tax preferences based on form of legal entity (e.g. C corporations vs. pass-through entities), how property is owned (e.g. leased stores vs. owned stores), and distribution channel (e.g. brick and mortar sales vs. remote sales).

Exchanging so-called "tax expenditures" for lower tax rates will not only result in greater economic efficiency, it will also eliminate some of the major complications in the current Internal Revenue Code, which cause businesses to spend tens of thousands of man-hours each year on tax compliance issues that do not assist the company with its business objectives. Reduction in complexity would also eliminate a lot of controversy with the IRS, making the government's tax collection process far more efficient.

Finally, one of the most harmful things that could be done to our economy at this time would be to place a direct federal tax on consumption. A recent study performed for the NRF by Ernst & Young and Tax Policy Advisors found that if a VAT were adopted in addition to the income tax, economic growth would decline for several years. It would cause a loss of 850,000 jobs in the first year and 700,000 fewer jobs over the longer term. The study also found that most Americans alive today would be worse off under a VAT. An earlier study conducted for the NRF by PricewaterhouseCoopers found that if a consumption tax were adopted to replace the current income tax system, the transitional impact would cause harmful economic results for a period of three to eight years, with employment dropping for a period of four to five years.

At its most recent meeting, the NRF's Board of Directors adopted a resolution encouraging Congress to enact comprehensive tax reform in 2013 that includes the following principles:

1. Tax reform should eliminate tax credits and incentives that favor some industries over others, and should replace these "tax expenditures" with substantially lower tax rates, freeing businesses to make the most economically-prudent investment decisions rather than having the tax code drive decision-making.

2. Tax reform should be neutral among different types of businesses, so that businesses are not favored based on their form of legal entity (e.g. C corporation vs. pass-through), how they own their property (e.g. leased stores vs. owned stores) or distribution channel (e.g. brick and mortar sale vs. remote sale).

3. Tax reform should be limited to income tax reform and should not include a consumption tax.

4. Tax reform should eliminate temporary tax provisions and provide certainty.

5. Tax reform should provide adequate transition rules, so that businesses do not face large tax burdens based on investment decision made in years prior to the enactment of tax reform.

<u>Comprehensive Income Tax Reform is Needed to Boost the U.S. Economy</u>

Income tax reform that lowers tax rates and broadens the tax base will provide an important and much needed boost to the U.S. economy. As the rest of the industrialized world reduces its corporate tax rate, leaving the United States with the highest corporate tax rate in the industrialized world, U.S. GDP declines, real wages in the United States decline, and consumer spending in the United States declines.

Because the United States has the highest corporate tax rate in the industrialized world, U.S. businesses move more operations out of the United States in search of a lower tax burden, and foreign businesses are less inclined to do business in the United States because of the higher tax burden. A recent study by Ernst & Young and Tax Policy Advisors, performed for the RATE Coalition,[1] found that in 2013 U.S. GDP is estimated to be between 1.2% and 2.0%

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[1] Carroll, Robert J., John W. Diamond, and George R. Zodrow, 2013. *Macroeconomic Effects of Lower Corporate Income Tax Rates Recently Enacted Abroad*, Ernst & Young LLP, Washington, DC.

smaller because of the high level of corporate income taxes. In the longer term, GDP is expected to be between 1.5% and 2.6% lower if current differences in corporate income taxes remain.

The retail industry is particularly concerned with the impact of lower U.S. GDP on real wages and consumer spending in the United States. The RATE study found that the high U.S. corporate income tax rate in the face of declining foreign corporate income tax rates results in a decline in real wages in the United States by 0.1 percent to 0.3 percent in 2013 and 1.0 percent to 1.2 percent in the long run. Consumer spending declines by 1.7 percent to 2.3 percent in 2013 and 2.3 percent to 3.3 percent in the long term.

The retail industry has the highest *federal* effective tax rate of any industry, typically between 34 and 35 percent. With state and foreign taxes included, our industry's corporate effective tax rate is even higher. Business tax reform would most likely lower the effective tax rate of the retail industry. The NRF believes that most of that tax rate reduction will be passed forward to the consumer through lower prices. Because our industry is so competitive, once one retailer reduces prices, others are forced to follow if they want to maintain their sales. As a result of this price cut to consumers, retailers will have the ability to sell greater volume, which will create the need for more employees in stores and distribution centers. In addition, retailers will purchase more inventory, which will increase investment and jobs throughout the supply chain.

Lower tax rates will create more business investment. Many of our members avoid debt-financing their capital expenditures. As a result, lower tax rates will allow more cash to make improvements to stores, build new stores and new distribution centers and make improvements to internal systems. NRF members, like most companies, evaluate investments based on metrics such as "return on investment" (ROI). If the corporate tax rate is lowered, investment proposals will be more likely to achieve the needed hurdle rate and a decision to invest is more likely to be made. These types of investments lead to higher employment both within and outside of the retail industry.

Finally, a consumption tax should not be added to comprehensive tax reform because it would have a chilling effect on our already weak economy. In 2010, Ernst & Young and Tax Policy Advisors conducted a study for NRF on the Macroeconomic Effects of an Add-on VAT enacted for deficit reduction[2]. The study found that following the enactment of a VAT, the economy would lose 850,000 jobs, GDP would decline and retail spending would decline. By contrast, the study found that following the enactment of comparable deficit reduction through a reduction in government spending, the economy would add 250,000 jobs, GDP would increase and there would be a much smaller drop in retail spending. A copy of the NRF study can be found at www.nrf.com/VAT.

An earlier study,[3] prepared for the NRF Foundation by PricewaterhouseCoopers, examined the impacts of *replacing* the income tax with a consumption tax (either an NRST or a

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[2] Carroll, Robert J., Robert J. Cline, John W. Diamond, Thomas S. Neubig, and George R. Zodrow, 2010. *The Macroeconomic Effects of an Add-On Value-Added Tax*. Ernst & Young LLP, Washington, DC.
[3] PricewaterhouseCoopers LLP, *Fundamental Tax Reform: Implications for Retailers, Consumers, and the Economy*, April 2000. A copy of the study can be found at: http://nrf.com/modules.php?name=Documents&op=viewlive&sp_id=3965

Flat Tax). The study concluded that although replacing the income tax with a consumption tax *might* bring *long-term* economic growth, there could be very harmful short-term and mid-term economic results.[4] The study also found that the economic growth that occurred during the ten-year modeling period was relatively modest compared to the disruptions to the economy during the transition years. Specifically, the study found that following the enactment of an NRST, the economy would decline for three years, employment would decline for four years and consumer spending would decline for eight years. The study found that following the enactment of a Flat Tax, the economy would decline for six years, employment would decline for five years and consumer spending would decline for six years. Given the fragile state of the current economy, the United States cannot afford to see further declines in consumer spending for several more years.

In addition to the overall impact of consumption taxes on the economy, retailers are particularly concerned with the impact of consumption taxes on our customers. Consumption taxes are highly regressive and will raise the tax burden on lower and middle-income Americans. This occurs because lower-income households tend to spend a higher portion of their incomes, so they will pay a higher tax relative to income level under a consumption tax than will upper income households.

The Tax System Should Not Pick Winners and Losers

Tax Expenditures Should be Eliminated in Exchange for Lower Tax Rates

The myriad of complex, interfacing business tax provisions in the Internal Revenue Code has spawned an industry of tax professionals focused on structuring business transactions to fit within the narrow confines of particular interacting tax code provisions. These efforts expend inordinate amounts of man-hours and consulting fees that could be more productively invested by businesses. These tax expenditures also favor certain types of businesses or industries over others. At times, these tax code provisions even discriminate between businesses in the same industry. Lower tax rates will reduce the incentives for entering into tax motivated business strategies. Lower rates combined with the elimination of various tax preferences will cause businesses to structure transactions to their most productive use, rather than spending inordinate amounts of resources on tax planning. This will also eliminate a lot of complexity from the business tax system and reduce controversy between taxpayers and the IRS.

Tax Reforms Should Apply to Both Small and Large Businesses

The vast majority of retailers are small businesses. In fact, 96% of all retailers have only one location. The policy of eliminating tax expenditures in exchange for lower tax rates is important for both large and small businesses because it will lead to a more productive employment of capital and more economic growth. Retailers, both small and large, are high effective taxpayers and prefer the simplicity of a tax system that exchanges complex tax

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[4] The PwC model was developed specifically to analyze tax reform plans. It combined microsimulation models for individual and corporate income taxes with a macro-economic forecasting model, which allowed it to provide short-term transition results on an annual basis. Id at p. 119.

expenditures for lower rates, allowing businesses to make economic decisions for their enterprises that are based on the best business result, rather than tax motivations. Because most small business owners report taxes as individuals, generally as S corporations or partnerships, there are some additional considerations to this reform that may not be present in the debate of corporate tax reform.

The NRF commends Chairman Camp for issuing a discussion draft for reforming small business tax rules. The options included in the draft recognize that tax reform must be comprehensive with respect to all businesses, whether C corporations or "pass-throughs." The draft includes some alternative approaches for addressing this tax reform. Although we may have some technical comments with respect to implementation of some of these approaches, we believe they achieve small retailers' ultimate goal of exchanging tax expenditures for lower rates, thereby achieving both economic efficiency and simplicity.

Tax Reform Should Eliminate Tax Code Biases Favoring Leased Stores over Owned Stores

The current tax system also includes biases that may discriminate between taxpayers in the same industry and cause competitive disadvantages. Because of the haphazard approach that Congress has taken to depreciation, improvements to stores that are owned by a retailer are treated worse than improvements made to stores that are leased by a retailer. This is primarily because the definition of qualified retail improvement property does not match the definition of qualified leasehold improvement property.[5]

Buildings generally have a 39-year straight line recovery period. In 2004, Congress recognized that improvements to buildings do not have a 39-year economic life and provided a 15 year life for "qualified leasehold and restaurant improvements."[6] In 2008, Congress recognized that these rules discriminated between retailers that lease their buildings and those that own their buildings, and they extended the 15 year life for "qualified retail improvements." However, because of revenue concerns, Congress limited the definition of "qualified retail improvements" to space that is "open to the general public."[7] As a result, a shorter depreciable life is applied to improvements to all leased space, whether storefront or warehouse, but if a retailer owns its buildings, improvements to non-public space (i.e. backroom or warehousing) have a longer depreciable life. Because the Section 179 expensing provision for small businesses applies to current tax code definitions of qualified leasehold, retail and restaurant improvements, the disparate treatment between leased and owned retail improvements is continued by denying Section 179 expensing to non-public space of a retailer that owns its stores. Because many Main Street retailers own their buildings, this is an important small business issue. Finally, bonus depreciation is only offered to leasehold improvements, again

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[5] Retail improvement provisions were added to the Internal Revenue Code after the leasehold improvement provisions were enacted in order to address the major aspect of the disparate treatment between leased and owned stores – improvements to retail space open to the public. However, the narrower definition of retail improvement property still leaves disparate treatment between leased and owned stores in three significant areas: (1) treatment of "non-public" and warehousing space; (2) application of Section 179 small business expensing; (3) eligibility for bonus depreciation.

[6] Report to Congress on Depreciation Recovery Periods and Methods, Department of Treasury, July 2000, p. 2.

[7] Sec. 168(e)(8)(A).

placing retailers that own their stores at a disadvantage compared to retailers that lease their stores.

In the context of tax reform, cost recovery rules should not owner-occupied property worse than leased property.

Tax Reform Should Eliminate Biases Favoring Remote Sales over Local Sales

Another way in which the current tax system discriminates against taxpayers in the same industry is through the tax treatment of internet sales. Local retail stores, be they small independent businesses or national chains, must collect sales tax on items sold in their stores that are taxable. If the same item is sold to a customer in that state by an electronic retailer that has no store in the state, the item is still taxable but the "e-tailer" does not have an obligation to collect tax on the sale (instead the tax burden is borne by the consumer). This issue creates a competitive disadvantage to the retailers that are actually providing jobs and paying local taxes. Although this tax discrimination does not arise out of the Internal Revenue Code, it can be resolved through federal legislation. [8] H.R. 684, The Marketplace Fairness Act, would resolve the current tax discriminatory treatment on goods sold in local retail stores.

Transition

In the context of business income tax reform that lowers the rates and broadens the base, a new tax system will still need to include provisions that provide recovery of costs for capital assets and inventories. We recognize and support the tax reform goal of substituting lower tax rates for tax incentives. However, in moving to a more economically neutral system for recovering costs, Congress should provide adequate transition rules for investments made in years prior to enactment of tax reform that take into account taxpayer expectations of the after-tax cost of the investment at the time the investment was made. These rules must be applied fairly so that similarly situated taxpayers are not treated differently.

In addition to tax costs associated with changes to cost recovery and inventory taxation, there will be a need for accounting system changes. We urge the Committee to adopt approaches to reform that are simple and minimize changes to current accounting/inventory tracking systems.

Because inventory accounting represents such a large issue for the retail industry, we respectfully request the opportunity to offer our views on this issue when the Committee considers it in more detail.

[8] *Quill Corp. v. North Dakota,* 504 U.S. 298, 318 (1992) clarifying that Congress has the power to resolve this issue and is better qualified than the courts to resolve this issue. "Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with the duty to collect use taxes."

Conclusion

The NRF supports income tax reform that will lower tax rates and broaden the tax base. We believe this type of income tax reform will be good for the retail industry and good for the economy as a whole. The NRF urges the Committee to pass tax reform legislation this year, and we offer whatever assistance we may provide in meeting this goal. Income tax reform will encourage investment, create jobs and simplify administration of the tax system.