November 15, 2011

Dave Camp
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Camp:

The National Small Business Association is pleased to provide these comments on the Ways and Means Discussion Draft released on October 26, 2011 primarily relating to international tax reform. We would like to commend you and the Committee for the process by which you are considering these matters. Providing a draft of proposed legislation well before mark-up and receiving comments from the public is the best way to ensure a thoughtful legislative process.

Aspects of this draft are highly constructive and would have a very positive impact on economic growth and job creation. We also, however, have a number of serious concerns regarding the proposal and corporate tax reform generally. We look forward to working with you and other members of the Committee to improve our badly broken tax system.

The National Small Business Association (NSBA) is America's oldest small-business advocacy organization, representing about 150,000 small businesses. The American small-business community is a large and diverse group of entrepreneurs and small-business owners. Census Bureau data show that small businesses employ half—59.7 million—of all private-sector workers. Collectively, there are around 70 million people in the U.S. either working for or running a small business. There are 27.3 million small businesses in the U.S., accounting for over 99 percent of all employer firms. In general, the term "small business" refers to a company with fewer than 500 employees. Since 1992, small business has created 64 percent of all net new jobs.

The NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

These comments specifically address the following 12 matters:

1. Promoting the international competitiveness of U.S. Businesses;
2. The small businesses perspective on corporate and international tax issues;

3. Reducing compliance costs and simplifying the tax system;
4. Placing foreign and domestic producers on an even footing and removing impediments to exporting;
5. Reducing marginal tax rates;
6. Providing for a neutral tax treatment of savings and investment;
7. Eliminating provisions in the tax law that provide artificial incentives to undertake particular kinds of economic activity;
8. Removing tax impediments to the free flow of capital and to repatriating profits earned abroad to the U.S.;
9. Moving to a territorial tax system and how to accomplish this result in a much simpler manner;
10. Consumption taxes;
11. The FairTax; and
12. Details regarding the October 26, 2011 Ways and Means Discussion Draft.

1. Promoting the International Competitiveness of U.S. Businesses

To promote the international competitiveness of U.S. businesses, we believe that tax reform, whether fundamental or incremental, should:

- reduce compliance costs and simply the tax system;
- place foreign and domestic manufacturers on an even footing and remove impediments to exporting;
- reduce marginal tax rates;
- provide for a neutral tax treatment of savings and investment;
- eliminate provisions in the tax law that provide artificial incentives to undertake particular kinds of economic activity; and
- remove tax impediments to the free flow of capital and to repatriating profits earned abroad to the U.S.

2. Small Businesses Perspective on Corporate and International Tax Issues

Most small businesses are sole proprietorships, subchapter S corporations or limited liability companies. Most of the remainder are partnerships (either limited or general). There are also some business trusts. All of these businesses are pass-through entities that are subject to individual tax rates not corporate tax rates.

A few small businesses are C corporations that are subject to the corporate income tax, but these constitute a relatively small percentage of small businesses. Moreover, in many cases a large portion of these companies' net income before compensating the owners' is usually consumed by paying the owners' salary. This salary is also subject to the individual tax rates.

Thus, the primary concern of the small business community is **not** the corporate tax rate but individual tax rates.

Very few small businesses have operations overseas. Thus, few are entangled in the morass that is subchapter N of the Internal Revenue Code. Small businesses, however, are significant exporters. Moreover, they must compete with imported goods and – increasingly – services from around the world. They thus have a keen interest in international economic matters and how the federal government enhances or impedes the competitiveness of U.S. based businesses. Moreover, in an increasingly globalized economy, international economic issues affect the overall economy in ways that are critical to the small business community.

The U.S. currently has the second highest corporate tax rate (39.2 percent including state corporate taxes) among the 34 developed countries in the Organization for Economic Cooperation and Development (OECD), second only to Japan. Reducing the corporate tax rate more towards the OECD norm of about 25 percent would be an economically constructive step, all other things being equal.

When it comes to corporate tax reform, however, we have two primary concerns. First, it would be unfair to reduce corporate tax rates without also reducing the individual tax rates that apply to small firms. Moreover, a large disparity in the corporate tax rate and individual tax rates is likely to lead to various forms of tax gimmickry. Second, we are deeply concerned that reducing corporate tax rates may be funded by economically counterproductive "base broadeners" that also apply to non-corporate businesses. It is highly unlikely that repeal of various provisions such as so-called accelerated capital cost recovery allowances, LIFO and other provisions would apply only to corporations. Therefore, "corporate" tax reform could easily end up substantially increasing the tax burden on unincorporated businesses and S corporations. It would increase the cost of capital to small firms. This would be both unfair and very counterproductive economically. It would be likely to eliminate the pro-growth and job creating aspects of C corporation tax reform.

On October 27, 2011, the Joint Committee on Taxation staff provided to ranking minority member Sander Levin, a series of revenue estimates that are illustrative of this concern. Three fifths of the revenue from the proposed base broadeners comes from two provisions that are not tax expenditures properly understood and are not loopholes by any reasonable definition: (1) reasonable capital cost recovery allowances and (2) Last-In First-Out (LIFO) inventory accounting.[1] Returning to pre-1981 capital cost recovery allowances would dramatically increases the cost of capital, reduce investment and the capital stock, reduce productivity gains, reduce the international competitiveness of U.S. businesses and reduce real wages. Eliminating LIFO inventory accounting will mean that businesses have to pay tax on phantom inflation-induced gains.

It is not entirely clear how the Committee intends to proceed. Section 401 of the Discussion Draft is blank. However, a corporate tax reform funded by returning to the dramatically inadequate capital cost recovery allowance of the 1970s and taxing phantom inflationary gains is likely to have an adverse rather than positive economic effect.

[1] Most of the remaining revenue would come from repeal of the research and experimentation credit and the domestic production activities deduction.

Moreover, it would constitute an unacceptable shift of the tax burden from large businesses to small businesses. We caution the Committee against proceeding down that road.

3. Reducing Compliance Costs and Simplifying the Tax System

Compliance costs are the costs that businesses incur complying with the tax system. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out IRS forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. In general, small business compliance costs relative to income or revenues are disproportionately high.

There will always be some compliance costs in any tax system. But today these costs are very high. And if there is one thing the NSBA membership is almost universally agreed on, it is that current tax compliance costs are too high and that the tax system needs to be simplified.

Estimates by economists vary as to the magnitude of compliance costs. In general, compliance costs seem to be in the neighborhood of 9 to 14 percent of the revenues raised. They are disproportionately higher for small firms. These high costs do nothing to further a societal interest. We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

These costs also represent a significant drag on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress. Furthermore, there is strong reason to believe that U.S. costs are substantially higher than those of most other developed nations.

The Discussion Draft does not address these issues for domestic companies but may reduce complexity to a very moderate degree for U.S. multinationals. As discussed in section 12, there are much simpler ways to move towards a territorial system than the method employed by the Discussion Draft.

4. Placing Foreign and Domestic Producers on an Even Footing and Removing Impediments to Exporting

An origin principle tax system taxes goods and services based on where they were produced or originated rather than where they were purchased or consumed. In an origin principle tax system, the production of goods and services in the taxing country is taxed no matter where the goods and services are sold, used or consumed. In a destination

principle consumption tax, goods consumed in the taxing country are taxed whether the goods or services were produced domestically or abroad. Exported goods are not taxed.

The individual and corporate income tax combined with payroll taxes raise well over 90 percent of the revenue collected by the federal government. These taxes are origin principle taxes. Most consumption taxes (including sales taxes[2], European style credit-invoice type value added taxes, Canadian and Australian goods and services taxes[3] and proposed business transfer taxes[4]) are destination principle taxes. The Flat Tax[5] and various proposed consumed income taxes[6] are, however, origin principle systems.

It is a common fallacy that having a destination principle tax like a VAT or a GST helps domestic exporters and hurts foreigners importing goods into the taxing country. This is not the case because both domestic and foreign goods are subject to the same tax when consumed domestically. This is why VATs and GSTs are legal under World Trade Organization (WTO) rules.

What will help U.S. producers and impose a greater effective tax burden on foreigners importing goods into the U.S. would be to replace the current origin principle taxes with a destination principle consumption tax. There are two reasons for this. First, exports will no longer bear a U.S. tax burden and imports, for the first time, will bear the same tax burden as U.S. goods. Second, as discussed below, a consumption tax reduces the U.S. user cost of capital and will increase the U.S. capital stock and hence the productivity of U.S. businesses.

The current tax system taxes U.S. producers whether they are selling in the U.S. or in foreign markets and imposes no appreciable tax on foreign producers selling goods (or services) into the U.S. market. It, therefore, places U.S. producers at a considerable disadvantage.[7] Were the U.S. to replace the current tax system with a destination principle consumption tax (such as the FairTax) then, for the first time in nearly a century, the U.S. government through its tax system would no longer be according a major advantage to those who produce goods abroad over those that produce goods in the U.S. We believe this effect would reduce the advantage that foreign producers are given

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[2] Including U.S. state sales taxes and proposed national sales tax such as the FairTax.

[3] Goods and Services Tax (GST) is essentially just another name for credit-invoice type VAT.

[4] These are subtraction method value added taxes.

[5] By which is meant a Hall-Rabushka-Army-Forbes type flat tax. David Bradford's "X-Tax," which used the Hall-Rabushka base but applied graduated rates, is also a origin principle tax. President Bush's President's Advisory Panel on Federal Tax Reform proposed border adjusting a Hall-Rabushk type tax, which would make it a destination principle tax and, given its administrative structure, may or may not be WTO legal.

[6] A consumed income tax is sometimes called an expenditure tax (Kaldor), cash flow tax (Aaron-Galper) or inflow-outflow tax (Ture) depending on the author or analyst. The only significant difference among the various proposals is the inclusion (or not) of the proceeds from debt in the tax base and the deduction from the tax base of principal payments.

[7] There is an argument sometimes made that exchange rates will adjust to compensate for this effect. It is beyond the scope of this letter to address that subject. Suffice it to say that the tax system alters costs, relative prices and rates of return and therefore alters behavior in this case just like other better understood cases.

by the current tax system over domestic producers by something on the order of 20 percent.

The Discussion Draft does not address this important international tax issue.

5. Reducing Marginal Tax Rates

The tax base should be broadened and marginal tax rates on business reduced. However, the tax base should only be broadened to the extent that can be accomplished without imposing multiple levels of taxation on savings and investment. High marginal tax rates discourage work, savings and investment. Conversely, reducing marginal tax rates encourages work, savings and investment. Reducing marginal tax rates also increases entrepreneurial risk-taking because less of the potential reward from a successful outcome will be taken by government. Furthermore, lower marginal tax rates reduce the cost of capital and increase productivity increasing investment.

The economic loss associated with the tax system increases with the square of the tax rate increase.[8] Thus, doubling the tax rate will result in a four-fold increase in the adverse economic effect of the tax system. This effect is equally true in reverse. Lowering marginal tax rates has a disproportionately positive impact on the economy.

The U.S. currently has the second highest statutory corporate tax rates in the developed world. This is mitigated to some degree by U.S. capital cost recovery allowances that are somewhat more rapid than in many countries.

Small businesses are, however, overwhelmingly pass-through entities and pay at the individual tax rates which are also higher than business tax rates in most countries. Small businesses also create most of the new jobs created in the U.S. economy. Reducing the corporate tax rate without also reducing the top tax rates on small businesses by reducing individual tax rates would limit the positive impact of rate reduction considerably, be unfair and lead to tax gimmickry. Moreover, if the corporate tax rates are "purchased" at the price of raising small business taxes by repealing adequate capital cost recovery allowance and LIFO inventory accounting, then the proposal would be both unfair and economically counterproductive.

6. Providing for a Neutral Tax Treatment of Savings and Investment

The current tax system is quite biased against savings and investment. Corporate income and corporate capital gains are taxed. Dividends paid from after-tax income are taxed again.[9] Individual capital gains are taxed but capital gains are simply increases in

[8] Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation," in the Handbook of Public Economics, Alan Auerbach and Martin Feldstein, Editors, 1985; Harry Watson, "Excess Burden," Encyclopedia of Taxation and Tax Policy, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, Editors, 2005; John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper 3/29, December 2003.

[9] Even Henry Simons, one the fathers of the modern income tax thought double taxing corporations was wrong. In his 1938 book *Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy*

the present value of future income stream that will be taxed. What is left over and not spent is also taxed by the unified estate and gift tax. Moreover, there are numerous places in the code that force businesses to delay deducting costs incurred now. This raises their costs and reduces their cash flow. Examples include the amortization of start-up expenses and the inventory capitalization requirements of section 263A. But the most important example is the requirement that purchases of equipment and structures be deducted over a period of many years rather than be expensed.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace.[10] It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If returns to investing in the U.S. fall substantially, firms will relocate their operations overseas. If, of course, they fall far enough behind, the firms will simply fail.

Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensives industries. It should be retained or expanded. For now, section 179 eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. For 2011, up to $500,000 of investment purchases may be deducted. In 2012, the figure falls to $125,000. Thereafter, unless Congress acts, the amount deductible will fall to $25,000. This latter limitation will dramatically limit the number of firms that can appreciably benefit and dramatically reduces the positive economic effect of the provision. Retaining the current $500,000 threshold should be high on the Congressional agenda.

7. Eliminating Provisions in the Tax Law that Provide Artificial Incentives to Undertake Particular Kinds of Economic Activity

The economy will grow most rapidly and society's scarce resources be used most effectively if the tax code's many provision rewarding or punishing particular types of investment or other economic behavior are eliminated. Business decisions should be made for sound business reasons not because of the tax treatment or tax subsidy accorded certain activities.

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he proposed integrating the personal and corporate income tax to prevent double taxation. In an integrated system, all corporate income would be taxed but only once.

[10] Expensing is always the correct answer in a consumption tax where either (i) interest is neither taxable nor deductible or (ii) debt proceeds are includible in the taxable base and principle and interest are deductible. In a hybrid system, such as the current U.S. system, some limits on debt financed investment in expensed property may be appropriate. As a practical matter, this will only be important in the case of large enterprises with large borrowing capacity.

The FairTax and other consumption taxes eliminate the large differential returns caused by the current income tax and would channel business investment to the most economically efficient investments. This, along with reducing the user cost of capital and lowering marginal tax rates, would have a pronounced positive impact on the economy.

As shown by the JCT submission to Ranking Minority Member Levin, there are dozens of provisions designed to channel economic activity in the tax code. But the true tax expenditures of major economic significance are not on the business side but on the personal taxation side of the equation.

8. Removing Tax Impediments to the Free Flow of Capital and to Repatriating Profits Earned Abroad to the U.S.

Having adequate capital in the U.S. is important to U.S. businesses. Small businesses, in particular, have difficulty obtaining adequate capital for their businesses. Eliminating barriers to the repatriation of capital to the U.S. will help small businesses in two ways. First, by increasing the amount of capital on deposit with U.S. financial institutions, it will improve the likelihood of U.S. small businesses obtaining capital and reduce the cost of obtaining capital.[11] Second, money invested in the U.S. instead of abroad will have positive effects because employment and investment would occurr here. That, in turn, will increase small businesses opportunities.

There is reportedly at least $1.5 trillion "trapped" or "locked-in" off shore because repatriating those funds would trigger a large tax whereas keeping those funds invested abroad will not. It is time to bring these funds home.

The primary way to eliminate this "lock-in" effect is to eliminate deferral of tax on foreign source income allowed by the law relating to Controlled Foreign Corporations (CFCs).[12] This may be accomplished by a territorial system combined with a zero percent or very low tax on repatriated income. This is the approach employed in the Discussion Draft. A second approach, tried in 2004, is to apply a substantially lower tax rate on repatriations made during a specified window of time. A significant disadvantage of this approach is that it is a temporary solution.[13] A third approach is to eliminate deferral and in general tax foreign source income earned by U.S. businesses currently. Any of these approaches would eliminate the lock-in effect and increase repatriations. It is probable that the latter approach would harm U.S. businesses in other ways. For example, it is thought that U.S. owned subsidiaries are disproportionately likely to buy from the U.S. Thus, by making U.S. owned foreign manufacturing subsidiaries less attractive, it may be that U.S. exports are harmed. The latter approach would also make it very unattractive to

[11] Financial intermediation will direct this capital far beyond just banks.

[12] Subchapter N, Part III, Subpart F of the Internal Revenue Code. In principle, the Passive Foreign Investment Company rules would need amended as well. These are much less important than the CFC rules.

[13] A permanently reduced rate on repatriations would reduce the lock-in effect to the extent the rate was reduced but would not accelerate the tax revenue gain as much as a short-term reduction to the extent firms believed the change was permanent.

headquarter a business in the U.S. and make U.S. firms the likely targets of foreign takeovers. This third approach would also raise taxes on multinational business.

The key point is that the repatriation of foreign profits to the U.S. should not be subject to a major tax burden.

An entirely different means of solving the problem is to move to a destination principle consumption tax such as the FairTax. Under the FairTax, repatriation of foreign source income would not be a taxable event. Neither foreign source nor U.S. source income would be taxed. Instead, domestic consumption would be taxed.

9. Moving to a Territorial Tax System

The Joint Committee on Taxation staff has previously estimated that with the appropriate rules regarding intangibles, a move to a territorial system could actually increase tax revenues. It is remarkable that imposing a zero tax on foreign source income could raise tax revenue. It is also a reminder of how broken the current system is.

The Discussion Draft would move the U.S. from its current world-wide taxing system (with some tax deferral) to a territorial system income tax system (with a minor 1 ¼ percent toll charge on repatriation).[14]

A territorial income tax system may put tremendous, potentially fatal, pressure on the section 482 inter-company pricing rules. Pushing those rules hard is one of the central reasons that the current tax system raises so little revenue from taxing the overseas operations of U.S. multinationals. There is a small industry of lawyers, accountants and economists devoted to helping large corporations defend aggressive intercompany pricing. Those rules will only be pushed that much harder if the U.S. adopts a territorial income tax system. Since there is no single "correct" transfer price, there will be a huge incentive to manipulate intercompany prices to transfer income outside of the U.S. if the tax rate on U.S. source income is 35 percent and the tax rate on foreign source income is zero (or 1 ¼ percent).

U.S. parents will tend to sell domestic goods cheaply to their foreign subsidiaries so their foreign subsidiaries will show the profits.[15] U.S. corporations will tend to transfer ownership of their intellectual property (IP)[16] (a form of intangible property) to their foreign subsidiaries so the income from licensing that IP will be "foreign source." Options A and C in the Discussion Draft are meant to address this issue.[17] Of course, if the Treasury gets too aggressive in policing such transfers, multinationals will simply start conducting the research overseas or purchasing it from trusted foreign strategic

[14] This is a function of only five percent of dividends from CFCs being included in taxable income (after the 95 percent deduction afforded by the Discussion Draft) and the proposed 25 percent corporate tax rate. 25 percent of 5 percent is 1 ¼ percent.

[15] Since, contrary to popular belief, profits are a small percentage of gross revenues, it does not take much of a change in the price to shift all or most of the profits.

[16] Including patents, trademarks, copyrights and, to a lesser extent, unpatented trade secrets.

[17] See the discussion in section 12 for more detail.

partners subject to appropriate licensing and disclosure agreements. This would be economically counterproductive. There are also games that can be played to allocate interest expense disproportionately to the U.S., although there are currently rules in the Internal Revenue Code designed to address this issue.[18] Thus, a lot of U.S. source income will end up be scored as foreign source income not subject to tax.

As supporters of the FairTax, the NSBA has no problem with eliminating the corporate income tax. We do not believe, however, that the right way to go about that is to make the corporate income tax largely optional for multinationals while corporations and pass-through entities operating solely in the U.S. must pay significant income taxes. It is imperative that whatever tax system is adopted adequately police intercompany pricing, intangibles and interest allocation. Otherwise, the only businesses that will be paying tax will be small, U.S. based companies.

It is true that the current U.S. tax system makes headquartering a company in the U.S. unattractive compared to most developed countries.[19] Most developed countries have some form of territorial tax system. Thus, a company headquartered there can take advantage of tax rates lower than those in the home country. A U.S. company cannot since the U.S. world-wide system taxes companies on their income throughout the world, allowing a foreign tax credit for foreign taxes paid.[20] Deferral, as presently structured, does not address this problem. It is in the interest of small businesses and workers to have large corporations headquartered in the U.S. due to business and employment they generate.

There is among many analysts a concern, not entirely unfounded, that a territorial income tax system will provide an incentive for U.S. firms to locate their manufacturing operations in low tax foreign jurisdictions rather than the U.S. The counter argument is that if U.S. owned firms do not do so, then European and Asians firms will and, once again, U.S. firms are rendered less competitive by the current tax system.

There is a solution to these problems. Do not move to a territorial income tax system. Instead, move to a territorial consumption tax system. In a consumption tax, like the FairTax, intercompany pricing, interest expense allocation, research and development expense allocation and the situs of IP ownership are irrelevant to the U.S. tax result and there is no tax incentive to place manufacturing operations abroad. This is because such

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[18] See Part I of Subchapter N of the Internal Revenue Code generally, Internal Revenue Code §163(j) and Treasury Regs. §1.861-9 through §1.861-13T. See also, Internal Revenue Code §871(h) for the portfolio interest exception.

[19] For example, taxes were the primary reason that when Mercedes merged with Chrysler, the parent was in Germany rather than the U.S. There was a dramatic increase in so-called inversions (where after the transaction, the parent was a foreign corporation) in the late 1990s and early 2000s. Internal Revenue Code §7874 enacted as part of the American Jobs Creation Act of 2004 substantially reduced the attractiveness of such transactions by effectively treating the new foreign parent as if it were a U.S. corporation.

[20] Subject, in general, to a limit equal the U.S. tax rate times foreign source income. In reality, the foreign tax credit system is much more complex because of the separate baskets that income is separated into for purposes of the limitation.

a tax does not tax production anywhere. Both U.S. and foreign operations of U.S. firms would be free of tax. Headquartering a company in the U.S. would make perfect tax sense. Goods consumed in the U.S. would be taxed, whether they were made here or abroad and goods shipped abroad would not be subject to any tax. Therefore, the tax bias against U.S. producers would be eliminated.

10. Consumption Taxes

Most real world consumption taxes in the world today are sales taxes or credit invoice method value added taxes (aka goods and services taxes). They are border adjusted because exports are excluded from the tax base and imports are subject to tax upon entry (a VAT) or because of their nature (a retail sales tax). They are territorial. No tax is imposed on foreign operations, income or consumption. They are neutral toward savings (all savings is effectively accorded Roth IRA tax treatment due to the nature of the tax) and investment (all investment is either expensed (VAT) or not subject to tax (national sales tax)).[21]

11. The FairTax

Obviously there are a lot of ways to improve the tax system. To be better than the current system doesn't take a lot. But NSBA regards the FairTax as the best fundamental tax reform proposal. In an international context, it would have a dramatic positive impact on the competitiveness of U.S. businesses. A summary of why:

1. It would be simple and dramatically reduce compliance costs that place U.S. firms at a substantial disadvantage. Neither intercompany pricing rules, nor interest expense allocation rules, nor research and development expense allocation rules would be necessary and the situs of IP ownership would be irrelevant to the tax system.
2. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods and the FairTax would eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).
3. It would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity and innovation would increase.
4. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.
5. The U.S. would attract capital from throughout the planet. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the largest tax haven in the world. The "giant sucking sound" you would hear, to paraphrase Ross Perot's memorable metaphor, would be the U.S.

[21] The FairTax and the Schaefer-Tauzin national retail sales tax excluded all business to business transactions from to prevent cascading. Unfortunately, U.S. state sales taxes collect a substantial portion of their revenue from taxing business inputs.

attracting capital from throughout the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.

6. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.[22]

12. The October 26, 2011 Ways and Means Discussion Draft

The Discussion Draft keeps the current international tax structure but effectively achieves a territorial tax result by means of a 95 percent deduction for dividends received from CFCs by domestic corporations that are 10-percent U.S. shareholders of those CFCs with respect to dividends attributable to the foreign source income of the CFC. Thus much of the complexity associated with the current international tax system remains, including the various deferral and anti-deferral provisions (supart F, CFCs, PFICS, foreign personal holding companies, etc.) and the foreign tax credit. The proposal does eliminate the separate baskets for the foreign tax credit, which is a major simplification.

If the goal is to adopt a territorial tax system, it would be much simpler to simple junk the current international tax rules regarding the foreign tax credit, CFCs, PFICS and the like and simply not tax foreign source income. This would reduce administrative costs considerably. Obviously, income sourcing and expense allocation rules and intercompany pricing rules would need to be retained. Rules regarding intercompany pricing and income generated by intangible property would need to be robust but no more so than under the rules proposed by the Discussion Draft.

The Obama Administration proposal (Option A) relating to excess income from intangibles appears to make sense in the context of a territorial system and would impede abusive attempts to avoid taxation by moving the ownership of intangibles offshore. One part of Option B appears to make sense and the other rests on much shakier policy foundations. It makes sense to limit the 1 ¼ percent tax rate to income derived from the conduct of an active trade or business in the home country of the CFC. It does not make sense to per se punish operations in countries that have corporate tax rates below 10 percent by including "low-taxed cross-border income" in subpart F income. Were the FairTax in place, for example, the U.S. would not meet that test. Moreover, it would make it impossible for U.S. companies to take advantage of tax sparing arrangements (usually in developing countries) while European and Asians companies could.

Option C would treat foreign intangible income as supart F income but allow an arbitrary 40 percent deduction which effectively reduces the tax rate on foreign intangible income by 40 percent (i.e. to 15 percent from 25 percent). This proposal is better than not addressing the issue but still retains a large incentive to move ownership of intangibles abroad for tax reasons

[22] The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

We believe that section 332 of the Discussion Draft denying the deduction for interest expense of U.S. shareholders which are members of worldwide affiliated groups with excess domestic indebtedness is vital to prevent erosion of the U.S. tax base.

13. Summary and Conclusion

The primary concern of the small business community is **not** the corporate tax rate but individual tax rates. Any reduction in the corporate tax rate should be accompanied by corresponding reductions in the tax rate on small business. We are deeply concerned that reducing corporate tax rates may be funded by economically counterproductive "base broadeners" that also apply to non-corporate businesses. It is highly unlikely that repeal of various provisions such as so-called accelerated capital cost recovery allowances, LIFO and other provisions would apply only to corporations. Therefore, "corporate" tax reform could easily end up substantially increasing the tax burden on unincorporated businesses and S corporations.

Because it largely retains the current tax system, the Discussion Draft does not achieve nearly the simplification and compliance cost reduction that a move to a territorial system should.

The best way to move toward a territorial tax system is to move toward a territorial, border-adjusted tax system like the FairTax that places U.S. producers and foreign producers on a level playing field. The Discussion Draft does not address this issue. If the goal is to adopt a territorial income tax system, it would be much simpler to simple junk the current international tax rules regarding the foreign tax credit, CFCs, PFICS and the like and simply not tax foreign source income.

Reducing impediments to repatriation of capital to the U.S. is good policy and the Discussion Draft would largely achieve this goal.

Robust intercompany pricing, interest allocation and intangible income rules are vital if corporate taxes are not to become entirely optional for multinational corporations.

We look forward to working with the committee on these issues.

Sincerely,

Todd McCracken
President

cc: Members of the Ways and Means Committee