COMMITTEE ON PRIVATE COMPANY POLICY

July 6, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Brady:

On April 5, 2017 members of Financial Executives International's (FEI) Committee on Private Company Policy (CPC-P) met with members and staff of the Ways & Means Committee to discuss how business tax reform can enable private companies to become more competitive, fuel economic growth and create jobs. Barbara Angus of the Majority Staff asked that as a follow-up to our meetings, we provide some additional thoughts on certain aspects of the House Tax Reform Blueprint, including suggested transition rules to facilitate taxpayers' adjustment to major changes in the Internal Revenue Code that may result from enactment of tax reform. These thoughts are outlined below.

FEI is a professional association representing the interests of more than 10,000 chief financial officers, treasurers, controllers, chief tax officers, and other senior financial executives from over 8,000 major companies throughout the United States, Canada, and Japan. FEI represents both the providers and users of financial information. FEI's Committee on Private Company Policy formulates tax policy for FEI in line with the views of the membership. This letter represents the views of the Committee on Private Company Policy.

Tax Rates of Income Generated by Pass-Through Entities

Under the Blueprint, active business income earned by small businesses, sole proprietorships, and other pass-through businesses (including partnerships, limited liability companies, and S-corporations) would be taxed at a maximum rate of 25 percent. Pass-through entities play a critical role in the U.S. economy, serving as a key source of jobs, wages and tax revenue in the United States. We believe there should be parity between businesses that operate in corporate form and those that are formed as pass-through entities. We fully support the President's tax plan announced on April 26, which would include pass-through businesses in a reduction of corporate rates to 15%, and believe pass-throughs should be able to retain capital for growth and operating purposes, like larger corporations, without penalty.

Expensing of Capital Investments and Interest Expense Disallowance

The current House Blueprint will provide businesses with the benefit of fully and immediately expensing the cost of investments. This system of immediate cost recovery will apply to both investments in tangible and intangible property, except for land. To avoid a tax subsidy for debt-financed investment, the Blueprint would no longer allow businesses a deduction for net interest expense. Any net interest expense could be carried forward indefinitely and allowed as a deduction against net interest income in future years.

For businesses that do not make significant capital expenditures or do not have material interest income, a rate reduction will likely not fully offset the impact of the elimination of a deduction for net interest expense. We believe this would cause working capital and other issues for many businesses, especially in industries that are not capital intensive such as the service industry. Additionally, debt financing is an important component of most businesses capital structure. It allows most small business owners and private companies to retain ownership control, while providing an alternative and cheaper option to equity financing. As a result, transition rules are imperative for these changes to minimize disruption to our businesses.

A taxpayer should be able to choose one of the deductions and not be penalized for making capital investments. Thus, U.S. taxpayers may elect to expense capital investment and lose the deductibility of corporate interest expense and vice versa. We agree with the Trump Proposal, in which the immediate expensing of capital expenditures is not automatic, but rather elective. Thus, companies engaged in manufacturing in the United States could elect to immediately expense capital investments; however, such election would require the taxpayer to forego the deduction for interest expense. If the treatment of net interest and immediate expensing is not elective, smaller and mid-size companies could be hard hit as they utilize bank loans to finance growth and rely on the deductibility of interest costs.

We have identified reasonable transition solutions that would help minimize the impact of the issues stated above:

1) Grandfather existing debt and phase-out the net interest expense deduction over 5 years on any new or modified debt (beginning 1/1/18).
    - Immediate capital expenditure expensing in year 1
    - Existing debt would be grandfathered and not subject to net interest expense limitation rules
    - Existing assets would also be grandfathered and be depreciated under current rules
    - Net interest expense deduction would be phased-out over a 5 year period for any new or modified debt as follows:
        - Year 1, 80% deduction
        - Year 2, 60% deduction
        - Year 3, 40% deduction
        - Year 4, 20% deduction
        - Year 5 and beyond, no deduction of net interest expense would be allowed

2) Full or partial limitation of net interest expense on all debt immediately but transitioned over a 10 year period (beginning 1/1/18).
    - Immediate capital expenditure expensing in year 1
    - All debt would be subject to net interest expense limitation rules
    - Existing assets would be grandfathered and be depreciated under current rules
    - Net interest expense deduction would be phased-out over a 10 year period
        - Net interest expense deduction would be reduced by 0.833% every month for 10 years; <u>or</u>
        - Net interest expense deduction would be reduced by 10% every year for 10 years.
3) Full limitation of net interest expense on all debt, leases or similar financing instruments immediately for debt issued by U.S. issuers to non-U.S. lenders deemed to create base erosion.
    - All base erosion debt would be subject to net interest expense limitation rules beginning 1/1/17.
    - All base erosion debt would be subject to net interest expense limitation rules similar to rules outlined in Regulation Section 385 and be recast as an equity instrument.

Overall, we believe that existing debt should be grandfathered and only the net interest expense deduction limitations apply to new or modified debt. If existing debt is not grandfathered, we believe that the transition rules be extended over a significant period of time.

<u>Border Adjustment</u>

Under the current House Blueprint, corporate income from exported goods would not be taxable. However, U.S. companies that source goods from foreign suppliers or affiliates would no longer be allowed to deduct those purchases, effectively implementing a new tax on a multitude of products at the corporate rate, which under the plan would be 20%. In addition, transactions that are made to avoid or divert profits that are sourced from the U.S. will be recast and subject to the Border Adjustment corporate tax rate. The intent of the diverted profits adjustment is to capture direct sales or transactions into the U.S. under an economic nexus rule to avoid tax base erosion.

Certain economists and other supporters argue that border adjustments would have little long-term effect on the balance of trade because of offsetting changes in real price levels occurring through changes in exchange rates. These same supporters suggest that, once international price levels fully adjust, businesses' real after-tax incomes would be unaffected by border adjustments. However, it is highly unlikely to fully adjust and the exact outcome is too unpredictable. Additionally, economists assume that businesses are fully able to pass the incremental cost of the border adjustments on to consumers. This is not true for many U.S. businesses, including those that may be subject to contractual obstacles, regulatory controls, or other barriers that prevent passing along the incremental costs of border adjustments to consumers.

If the border adjustment provision does move forward as part of tax reform, it should also include a transition rule and be phased in over time. This would allow businesses to successfully develop and execute plans to transition offshore facilities and the procurement of goods in the U.S. without considerably disrupting operations. Transition rules are imperative to avoid major disruption of

business operations and to smoothly shift manufacturing to the U.S. A corporate rate reduction phase-in over time could follow this approach (e.g. a 25% border adjustment resulting in a 5% U.S. corporate rate reduction each year over the next four years).

- Territorial Tax System Access/Deemed Repatriation Transition: Broadly, tax reform legislation should create a territorial system that puts all U.S. businesses on an even footing with their US and foreign competition, removing disincentives for capital mobility and earnings repatriation from overseas, aligning U.S. tax policy with other developed countries, eliminating complexity in organization structure driven by the current foreign tax credit regime, and providing consistent tax treatment for all US businesses.
    - Current territorial tax proposals are limited to C-Corps. Congress should grant pass-throughs access to any new territorial tax regime.
    - Pass-throughs have very complex international structures because they don't qualify for the Section 902 indirect credits even though they have exposure to Subpart F income. Some have CFCs for offshore deferral, but most use a combination of check the box and hybrid entities to manage tax exposure. A territorial system could reduce the need for this complexity.
    - Transition to a territorial system by providing a toll charge applicable to prior period accumulated untaxed foreign earnings that would be payable 50% in year 1 and the balance over a period of 5 to 8 years. The toll charge applicable to prior period accumulated untaxed foreign earnings would be assessed at an effective date of 1/1/2017.

The Committee on Private Company Policy appreciates your efforts on tax reform and looks forward to working with you to advance tax reform legislation that advances our goals. We welcome the opportunity to discuss these issues further with you and your staff.

Also, we would be pleased to discuss other related topics such as tax simplification, financial reporting consequences of tax reform, including deemed toll charges, or any other topics you desire.

Thank you for your consideration of our views.

Sincerely,

Committee on Private Company Policy
Financial Executives International

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