

*Principles for a Business Income Tax – Questions to Consider*

- Does the U.S. business income tax system encourage and sustain job growth in the United States?

All businesses, large and small, domestic and worldwide, create and provide the jobs necessary for sustainable economic growth. As members of the Tax Council, we recognize the importance of job creation in the small business sector as well as among larger worldwide businesses. Indeed, a very large number of small business enterprises are our valued suppliers and customers. These smaller business enterprises contribute to and benefit from our ability to compete successfully in the world marketplace. Thus, job creation and retention requires both small and large businesses being able to thrive and grow. One without the other will simply not achieve acceptable growth levels.

A tax system that is intended to foster meaningful job growth in the U.S. should consistently recognize the need for investment in the U.S. and the need to ensure the strength and vitality of all U.S. employers, whether they operate solely in the U.S. or around the world. Tax policy should recognize that a tax system that is competitive with our trading partners' systems will enhance the long-term strength of both domestic and worldwide American businesses and will maximize opportunities to promote our national standard of living. Thus, to the extent that reform of the tax code results in (i) a competitive tax rate, (ii) a tax system that reflects the pressures of an increasingly competitive world marketplace, and (iii) a sustainable, fair source of revenue over the long term, such reform will enhance economic growth and job creation.

- Does the U.S. business income tax system effectively recognize the importance of innovation and capital investment in the U.S.?

Competitive and pro-growth innovation and capital cost recovery systems for domestic investment and a competitive U.S. corporate business tax rate would enhance the attractiveness of the U.S. as a location for investment by domestic and international businesses, thereby contributing to increased jobs and economic growth and resulting in a higher standard of living in the U.S.

There are direct correlations between innovation, investment and jobs. Innovation contributes to productivity growth, strong economic performance, and ultimately to higher standards of living. It also leads to job creation because workers are needed to undertake the research and development required for advances in new technology, new processes and new products. Competitive tax provisions are critical to ensuring that innovation and research and development work will be conducted in the U.S. Nevertheless, the U.S. research and development tax incentive currently ranks 23<sup>rd</sup> out of 38 trading partners according to a recent OECD study, and this ranking will only slip further as these trading partners and other jurisdictions continue to adopt new incentives.

The U.S. tax system should reverse this trend and instead foster and encourage long term investment in innovation and research through a system of competitive and permanent policies.

Similarly, a robust and expanding U.S. manufacturing and industrial sector is often cited as necessary to long-term job growth. Expansion of this sector requires consistent additional capital investment in the existing capital infrastructure. The return on such investments is a determining factor in investment decisions, and that return is assessed on an after-tax basis. Thus, a tax system that encourages capital investment in the U.S. is a critical component of any plan to expand the manufacturing footprint in the U.S. Therefore, the capital cost recovery rules for investment should be designed so that the U.S. attracts such investment. A capital cost recovery system can encourage such investment by permitting businesses to rapidly recover the costs of its investments through expensing or through rapid depreciation.

- Does the U.S. business income tax system properly reflect the importance of the ability of U.S. taxpayers to engage successfully in the world marketplace?

Policy makers should review carefully why and how most of the industrialized world has moved away from worldwide taxation and consider whether the global environment warrants adoption by the U.S. of measures to improve the competitiveness of American businesses. We note that two areas in which the U.S. significantly diverges from global standards are (i) the lack of a competitive territorial tax system and (ii) the high corporate income tax rate.

This point bears emphasis as U.S. based companies that conduct business on a worldwide basis operate in two arenas. The first arena is the U.S. market, where worldwide American businesses compete with both domestic based as well as foreign based businesses. The second arena is the area outside the U.S., where worldwide American businesses must compete with foreign based businesses (as well as with other worldwide American businesses).

With respect to the U.S. market, it is fair to conclude that domestic companies, worldwide American companies, and foreign based companies should each be subject to equivalent U.S. effective tax rates on profits earned in the U.S. With respect to non-U.S. activities, it is equally fair to conclude that worldwide American companies and foreign based companies should be subject to equivalent effective tax rates on profits earned outside the U.S. The goal of fairness and consistency in tax policy should hold that companies doing business in the same jurisdiction should receive equivalent tax treatment. To conclude otherwise would mean adopting policies that are non-competitive to one or another of these business groups.

The U.S. tax rate should be competitive with the rate of our major trading partners on a sustainable basis. A competitive tax rate eliminates a disincentive to investment (domestic or foreign) in the U.S.

- Additionally, the following general aspects of tax policy should be considered:
  - a. Stability and Equity. A stable, reliable and equitable tax system is crucial to long term growth and investment confidence. The certainty granted by such a system encourages long term investment commitments. The goals of equity and fairness will not be well served if the rules unfairly discriminate against any one sector or industry, or against certain taxpayers within particular sectors or industries.
  - b. Taxable Base. The U.S. should maintain a definition of taxable base that is competitive with those of our major trading partners. Taxable base issues include the definition of taxable income and deductible expenses and the timing of the recognition of such income and expenses.
  - c. Active & Passive Income. If policy makers pursue a territorial system that exempts active foreign income, income that is truly passive under internationally accepted norms should not be exempt. The definition of active income should reflect business realities, such as the significant role of intellectual property and knowledge in both the domestic and world economy and the financing of active business operations.
  - d. Transfer Pricing. Internationally accepted arm's-length transfer pricing should remain the foundation for transfer pricing in any tax reform system. Properly applied and enforced, the arm's-length standard most appropriately reflects the underlying economics of business transactions.
  - e. Interest. The tax treatment of interest expense is critical to the competitiveness of taxpayers in a global economy. Measures that would depart from longstanding principles would be detrimental to American businesses.

If these basic principles are followed, income tax on business will do the least harm to competitiveness and job growth and still be a sustainable source of revenue for the government. An income tax is most likely to produce a steady stream of revenue when it follows the patterns of business operations over the long term, and does not constrain decision-making regarding investment, organization, and planning.