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In this report, Brannon and Hanlon discuss a survey of Association of Equipment Manufacturers members regarding various aspects of tax reform.

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Everyone acknowledges that the tax code is broken and that the economy would be better served by a fundamental tax reform, but opinions vary greatly about precisely what that would entail.

There are multiple problems with how we tax businesses; the U.S. statutory tax rate on business income is among the highest in the world, and our treatment of income earned overseas by U.S. businesses comes close to being punitive. The tax code is generally unfavorable to investment, and many believe that it encourages corporations to excessively use debt to finance operations.

In 2016 the House GOP released a tax plan that addressed those problems and more.[1] It proposed a sharply lower tax rate on corporations and passthrough incomes, and it would allow businesses to immediately deduct capital investments instead of gradually doing so over the life of the investment. It would also move from the current worldwide-cum-deferral method of taxing foreign-sourced income to a territorial type tax regime.

While many businesses loudly applauded these proposals, many balked at the accompanying revenue raisers proposed in the plan to generate the revenue lost from these changes. Chief among these pay-fors was a border-adjustable tax that was estimated to bring in more than $1 trillion over the next decade. The plan also called for an end of the deductibility of interest for businesses.

As is invariably the case, the business community was torn on the revenue raisers: Those with business models that would be little affected by the revenue raisers supported (albeit quietly)

[1] Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

the reforms, while those who would bear the brunt of the costs complained loudly.

It appears that the House Ways and Means Committee has paid attention to these critiques, and there is some speculation that in the fall it will release a revised plan that scales back both the revenue raisers and the reforms that would cost revenue.

This begs an important question: How should these reforms be scaled back if it is politically imperative to do so?

We might have some data that would be useful in answering that question. Earlier this year we surveyed the members of the Association of Equipment Manufacturers (AEM) to obtain their perspective on tax reform. The respondents answered questions about the different facets of the "Better Way" plan. They also offered unfiltered opinions on the problems with the tax code as well as what they see as the most urgent reforms needed.

The message from our respondents is that a lowering of the high statutory tax rate on business is the most pressing change that businesses want to see made. While this result might be otherwise unsurprising, it is notable given that the industry is, generally, capital intensive and would presumably benefit from a move to full expensing — a key component of the Better Way plan — more than most others.

The survey cohort was also surprisingly ambivalent about the border-adjustable tax.

In general, the consensus from our survey respondents seems to be less in favor of a broad "reform" and more in support of the largest broad-based tax rate reduction that can be achieved. This observation does not necessarily make tax reform any easier — budget exigencies make a deficit-financed tax rate reduction complicated, if not all-but-impossible, which means Congress and the White House must still come up with a means to generate sufficient revenue to reduce business tax rates.

Our findings suggest a way to make this exercise easier.

I. The Survey

With the help of AEM, we surveyed a cross section of its members about their views regarding tax reform. We worked with the industry to derive the appropriate subpopulation of members. Our survey went out to about 250 member companies.

Fifty-six AEM member companies, constituting a representative mix of the association's membership, responded to the survey (at least in part) — an above-average response rate for such surveys. Seventy percent of respondents were C corporations, and the sample contained a mix of large and small companies that were representative of the broader membership. Roughly 50 percent were publicly traded. All but one respondent identified their company as an importer-exporter.

The average sales of the 29 respondents that answered the demographic questions are $2.4 billion, nearly one-fourth of which are outside the United States, and the average total assets are $2.8 billion, 18 percent of which are outside the United States. The sample companies have, on average, 8,600 employees worldwide and carry roughly $320 million in debt.

The survey posed 40 total questions about tax reform: It asked respondents several questions about their company and their current tax situation before querying their opinions on various proposed changes to the tax code.

II. The Responses

Naturally, the respondents were keen on all changes that reduced the taxes they paid and disliked the reforms that would raise revenue to pay for the other changes. But within the two reform groups, some patterns emerged.

A. It's the Statutory Tax Rate

We asked respondents to rate their enthusiasm for various proposed changes to the tax code on a scale of 1 to 5, with a score of 5 indicating enthusiastic support and 1 indicating complete opposition to a proposal.

Several responses in this section are worth highlighting. First and most notably, AEM members rated the importance of a lower business tax rate at 4.5, and most respondents identified it as the most important priority for their company in tax reform.

We interpret this to mean that for most businesses, a reduction in their tax rate gives them the most bang for their buck in terms of alleviating the government burden on what they do and that they would much rather have a stripped-down, simplified tax code that eschews encouraging some activities while discouraging others and instead simply, in the words of the French philosopher Jean-Baptiste Colbert, plucks the most feathers from the goose with the least hissing.

What's more, the history of tax reform in the United States suggests that reducing the corporate tax rate is as permanent a tax change as there is. The top marginal tax rate on individuals and small businesses was increased in 1990 and again in 1993 before being cut in 2001, with that last cut being undone in 2013. Nearly every facet of the 1986 tax reform — especially the dramatic reduction in exemptions and deductions — has been undone.

B. Rate Reductions and Simplification Above All

We asked respondents to list their top priorities for any tax reform legislation that might be enacted this Congress. The most common response given as one of the top two priorities was the need for a lower rate, with more than 80 percent of both passthroughs and C corporations giving that response.

The second most common response regarding the top two priorities for fixing the tax code — and one that surprised us — was to simplify it. Figure 1 shows that lower rates and simplification were by far the most desired changes among respondents. There is almost no difference between passthroughs and C corporations in their preference for lower tax rates, with more than 80 percent of each cohort expressing this as a top issue.

We suspect simplification is not nearly as salient for C corporations because the reality is that it is nearly impossible to truly reform the tax code for these businesses in a way that significantly reduces their compliance costs.

Some publicly traded C corporations expressed a strong preference for moving toward a territorial tax system, with several listing it as one of their top two priorities for tax reform. Privately held businesses, on the other hand, listed estate tax reform as an important priority. We discuss each in more detail below.

C. Full Expensing Versus Interest Deductibility

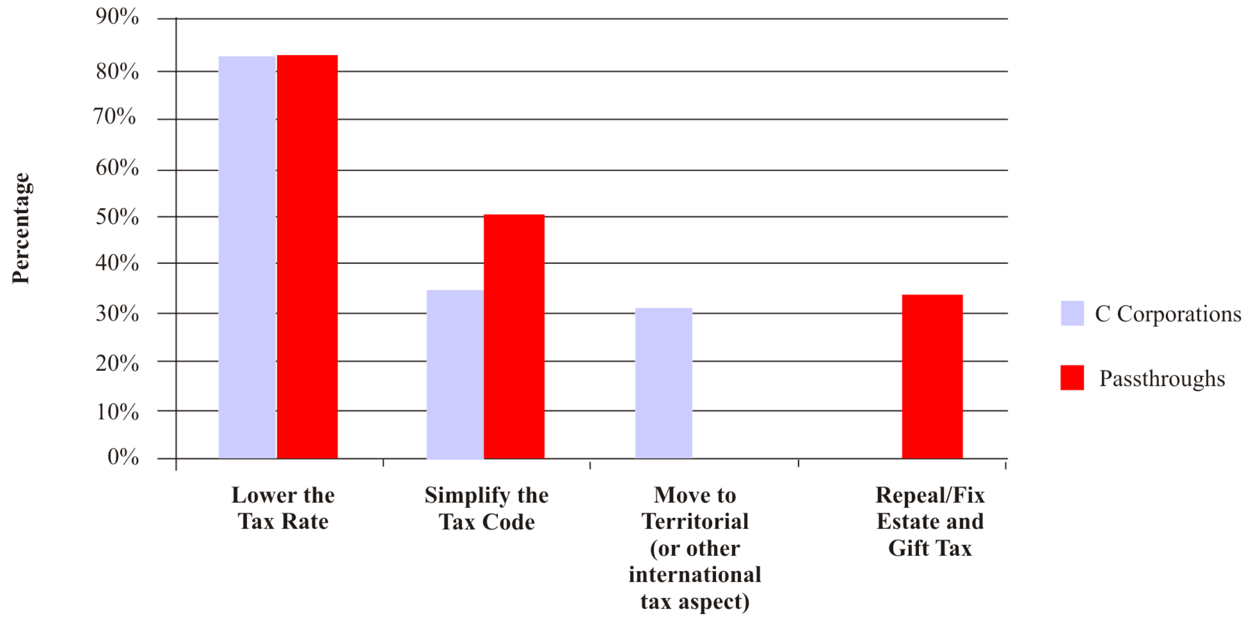
The companies in our sample do not appear to value full expensing as highly as they do a lower tax rate. Indeed, when asked to consider the importance of full expensing, ignoring all else, the average importance rating was 4. When asked to consider the importance of full expensing combined with the elimination of the deductibility of interest (as described under the Better Way plan) the importance rating was even lower, at 3.6. This is especially significant given that the equipment manufacturing sector has more capital investment than most other sectors.

When asked why full expensing was less important, we got few responses. However, six respondents wrote that full expensing lacked value because the company would not get financial statement benefits in terms of its recorded tax expense and effective tax rate (because the timing benefits of full expensing would be accrued as a deferred tax liability). Also, one respondent said that their company already had tax losses, and one company responded that equipment is depreciated quickly anyway.

There are a few other interesting aspects of our responses to the questions on full expensing. Nineteen of 31 respondents (61 percent) said that their company would increase investment because of full expensing (ignoring interest deductibility limits). Also, of the seller-dealers in our sample, 15 out of 21 respondents (71 percent) said that full expensing would lead them to increase sales projections. However, when asked about combined rules of full expensing and the proposed changes to interest deductibility under the Better Way plan, only five of the 21 seller-dealer respondents (24 percent) said they would increase sales projections.

In terms of the importance of the limitations on interest deductibility in the Better Way plan (all else constant), 48 percent said the provision would be harmful or very harmful to them, 22 percent stated that it would result in their company having lower debt levels. Somewhat surprisingly, 41 percent responded with a rating of 3 on a scale of 1 to 5, indicating some level of ambivalence.

Figure 1. Top Preferences for Tax Reform



III. Respondents Are Wary of the BAT

The most controversial part of the Better Way plan is its border-adjustable tax, which would impose a 15 percent tax on imported goods. The rationale is that because nearly all countries with a VAT do not impose it on exports, goods imported into the United States have a tax advantage over goods produced here.

At the same time the border adjustment part of the Better Way plan would rebate the corporate income taxes attributable to goods exported from the United States to put them on an even playing field in foreign markets. The border-adjustable tax would create about $1 trillion in revenue over the next decade, which is the main source of revenue the plan uses to reduce corporate tax rates and still maintain revenue neutrality.

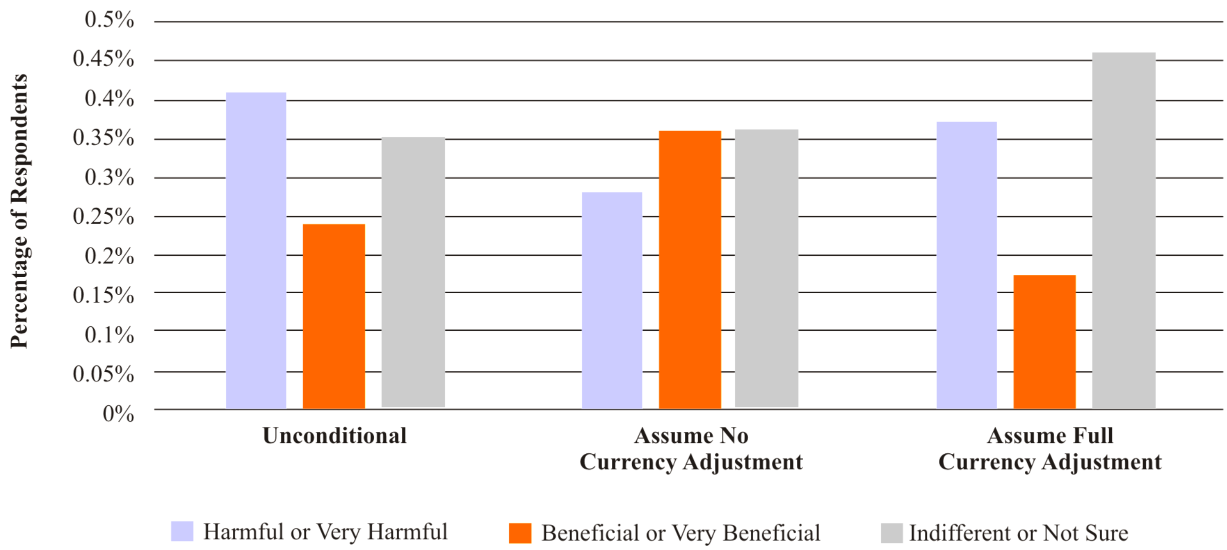
On July 27 the "Big Six" members of the administration and Congress released a joint statement about tax reform that appeared to sound the death knell for any border-adjustable tax.[2]

We first asked companies to rate the importance of the border adjustment part of the Better Way plan (on a scale of 1 to 5, where 5 is very important), which we described simply as a tax regime whereby imports are not deductible and exports are not taxable. Second, we asked them to what extent border adjustment would be harmful or beneficial to their companies.

The average rating for the importance of border adjustment is 3.6 in our sample and the average response is 2.7 when asked whether it is harmful (1) or beneficial (5). In other words, the respondents were markedly unenthusiastic about it — even though nearly all respondents are exporters. One note of caution is that while 56 percent responded that border adjustment is important or very important, 23 percent were indifferent (rating of 3) or responded that they were not sure. Similarly, 41 percent of the respondents replied that a border

[2]Treasury Secretary Steven Mnuchin; National Economic Council Director Gary Cohn; House Speaker Paul D. Ryan, R-Wis.; Senate Majority Leader Mitch McConnell, R-Ky.; Senate Finance Committee Chair Orrin G. Hatch, R-Utah; and Ways and Means Committee Chair Kevin Brady, R-Texas; "Joint Statement on Tax Reform" (July 27, 2017).

Figure 2. Rating of the Impact of the BAT



adjustment would be harmful or very harmful to their company, and 35 percent responded that they were indifferent (rating of 3) or not sure about the effects on their company. Thus, there seems to be some degree of uncertainty about the effect of border adjustability.

We then asked respondents about border adjustability, assuming there is no currency adjustment, and then assuming there is full currency adjustment.

We summarize the responses to the scenarios in Figure 2. The respondents reported that they would be more supportive of the border-adjustable tax if they knew that exchange rates would *not* adjust and least supportive if the exchange rates were to fully adjust. That response makes sense for exporters: If the tax break from the border-adjustable tax is completely offset by a change in the exchange rate, it would not change their competitiveness in foreign markets. However, if they get a tax break without a completely offsetting exchange rate increase, the border-adjustable tax will make them more competitive abroad. Again, it is important to note that the responses indicate a somewhat high degree of uncertainty about the border-adjustable tax.

IV. The Estate and Gift Tax

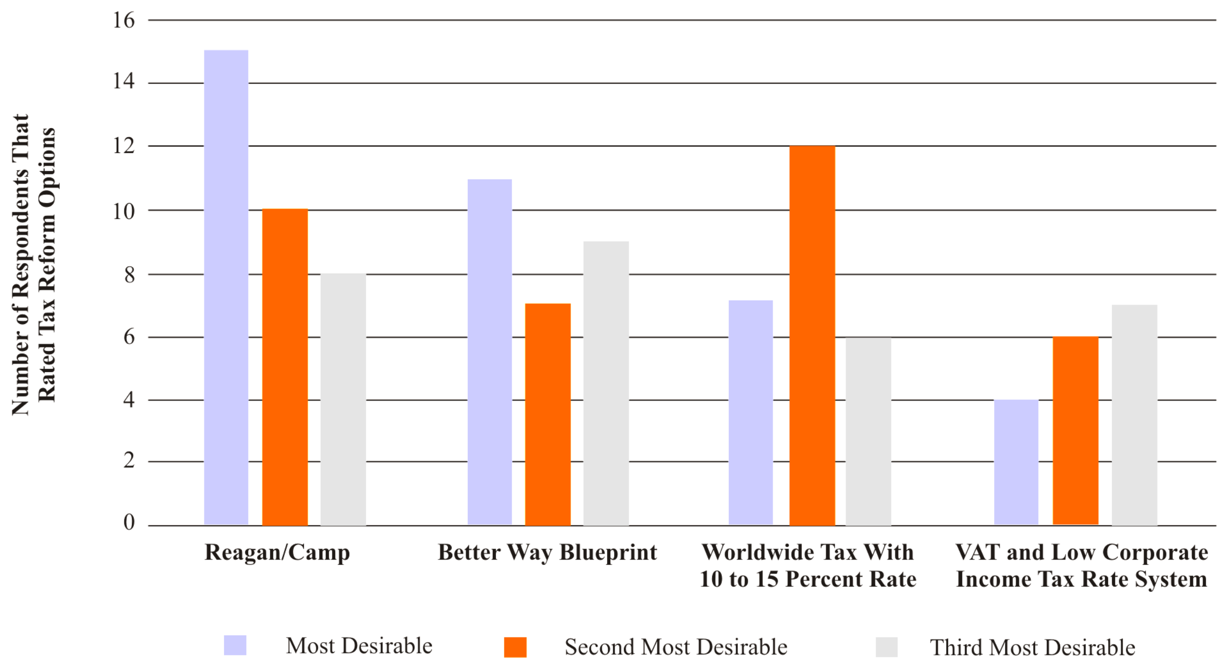
The Better Way plan would repeal the estate and gift tax while eliminating the step-up in basis for inherited assets. We asked two specific questions about this change, taking care to explicitly link the two provisions in our questions. First, we asked how important the estate tax repeal/step-up in basis is, and then we asked how harmful or beneficial to their company that change would be.

Privately held passthrough entities rated its importance at 3.7 and how beneficial such a change would be at 4.3. No publicly traded entities expressed interest in the provision because the estate tax is important primarily for private, closely held businesses (formed as either C corporations or passthroughs).

While our results would indicate that the estate tax is not as important to our sample as lower rates, we are not certain that is truly the case. When we presented our results to several tax officers of companies that are members of AEM, they expressed a belief that the results did not reflect the level of importance of this issue for their privately held members.

The data indicate a degree of uncertainty about the provision: 36 percent of respondents reported that they are "not sure" about whether the repeal of the estate tax coupled with the elimination of the step-up in basis would be harmful or beneficial. This is likely because it is difficult to assess which is more harmful for many family businesses — the estate tax or eliminating the step-up in basis.

Figure 3. Ranking of Tax Reform Options



Another issue that might have affected the reliability of the answers to this survey question is that for family businesses for which the estate tax is so important, it may not have been a family member responding to the survey.

Several respondents indicated in open responses that they thought that the estate tax issue should be dealt with separately and not as part of overall reform because of its complexity and so that it does not delay the remaining tax reform provisions.

A. The Camp Plan Survives

The survey asked respondents to rank their top three preferences regarding five different versions of fundamental tax reform: (1) a Reagan/Camp[3] style reform (lower statutory tax rate and broader tax base); (2) the Better Way plan; (3) tax reform that amounted to a simple and steep rate reduction and the elimination of deferral for foreign earnings (worldwide tax but with a very low rate); (4) a European-style tax code with a border-adjustable VAT paying for a rate reduction to 15 percent; and (5) no change.

Our results, displayed in Figure 3, show that the Camp plan won this "beauty contest" by a fair margin, which we attribute to the lack of enthusiasm the respondents have for a border-adjustable tax. The Better Way plan is more popular than a low-rate, worldwide tax regime (with no deferral) is interesting: At a rate of 10 percent to 15 percent, the U.S. statutory rate would be below nearly all of our country's trading partners, thus rendering the impact of our worldwide tax regime irrelevant: If the foreign country has a higher rate than the United States, that money will not be taxed again when it is repatriated to the United States. To us this suggests that respondents are keen on a change to our international tax regime and that they value other facets of the Better Way plan. The current tax regime garnered only ratings of 3 (untabulated); no respondent listed it as the most desirable or even second most desirable tax regime.

V. What Manufacturers Want From Tax Reform

Extrapolating from a relatively modest survey such as ours that solely examines the machine

[3]Dave Camp, former chair of the Ways and Means Committee, put forth a tax reform plan titled "The Tax Reform Act of 2014," H.R. 1, 113th Cong., 2d Sess. (Feb. 21, 2014).

equipment industry and positing broad lessons about the perception of tax reform is to some degree a fool's game. However, the fact that the major reforms being discussed — namely, the border-adjustable tax, the elimination of interest deductibility, and the move to full expensing — significantly affect this industry makes it to some degree a bellwether for corporate tax reform writ large.

The survey results suggest that the equipment manufacturing industry (and, we infer, other capital-intensive industries) prioritizes a lower business tax rate above all other tax changes and that stakeholders would be inclined to trade the deductibility of interest payments and expensing of capital investment if that revenue were used to significantly lower the corporate and business income tax rates.

Our survey respondents indicated ambivalence and uncertainty about the border-adjustable tax.

Achieving anything approaching fundamental tax reform will require various trade-offs by Congress, and it is likely that the scope of what has been deemed a "fundamental" tax reform will eventually be narrowed as the concerted opposition hardens to most proposed methods of increasing tax revenue to pay for proposed reforms.

Should that occur, there will be little we can do to the corporate tax code. Whatever we can afford to do should be designed to reduce the statutory corporate tax rate. ■