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Testimony

of

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on behalf of

The National Retail Federation

Hearing on How Business Tax Reform Can Encourage Job Creation

before the

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Chairman Camp, Ranking Member Levin, and Members of the Committee, my name is Jim Misplon. I am Vice President of Tax for Sears Holdings Corporation, parent company of Sears, Roebuck and Co; Kmart and Lands' End, headquartered in Hoffman Estates, Illinois. Sears Holdings has 280,000 employees and over 3500 stores in the United States. Like most retailers, we have partnerships with multinational suppliers and we have some employees outside of the US including those at Sears Canada, a 92% owned subsidiary, however, the vast majority of our operations are domestic. I am the Chair of the National Retail Federation's Taxation Committee, and am testifying today on behalf of the National Retail Federation (NRF).

As the world's largest retail trade association, the NRFs'global membership includes retailers of all sizes, formats and channels of distribution as well as chain restaurants and industry partners from the U.S. and more than 45 countries abroad. In the U.S., NRF represents the breadth and diversity of an industry with more than 1.6 million American companies that employ nearly 25 million workers and generated 2010 sales of $2.4 trillion.

<u>Summary of Comments</u>

Sears Holdings and other members of NRF believe that the most important aspect of any tax reform measure is its impact on the economy and jobs. 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 because of high unemployment, which will also continue to depress consumer spending. It is vitally important that any tax reform measure do no harm to our economy, which is likely to remain fragile for several years to come.

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."

Reforms of the income tax could be designed to eliminate some of the major complications in the current Internal Revenue Code, which cause companies like Sears Holdings 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, there would be harmful economic results for a period of three to eight years, with employment dropping for a period of four to five years.

Impact of Tax Reform on Business

Sears Holdings and other members of the NRF support income tax reform that would broaden the income tax base and lower the income tax rates. The elimination of many special deductions and credits in exchange for lower rates will bring about a more economically efficient tax system that is simpler for taxpayers and will ease enforcement.

Most importantly, we believe that business tax reform will result in greater economic growth. The retail industry may have the highest *federal* effective tax rate of any industry, typically between 33 and 35%. 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. 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. For our member companies, some of the types of investment that would be typically considered are improvements to stores, building new distribution centers, and improvements to internal systems. These types of investments lead to higher employment both within and outside of the retail industry.

In addition, lower tax rates 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.

Finally, in a global economy, high U.S. corporate tax rates serve as a disincentive for investment in the United States and make U.S. companies less competitive in the global marketplace.

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, the new tax system also should not burden investments by extending the tax write-off of an asset beyond its economic life. These rules must be applied fairly so that similarly situated taxpayers are not treated differently. Thus, any new system should eliminate the current tax law bias that provides more favorable depreciation rules for taxpayers that lease their property than for taxpayers in the same industry that own their property.

Tracking inventories can be extremely difficult. If current law rules are to be changed, we urge that every effort be made to keep the new systems as simple as possible.

For both depreciation and inventory accounting, reform must include necessary transition rules to mitigate the economic disruptions of moving to a new tax system. We recognize that the specifics of inventory reform or depreciation reform are not the subject of today's hearing; however, 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.

Problems with Complexity, Uncertainty and Biases in the Current Tax System

The complexity of the tax code creates a huge and unnecessary burden for both businesses and the IRS. NRF members spend tens of thousands of man hours per year on tax compliance issues. The complexity of tax issues relating to inventories and depreciation account for a lot of these compliance hours. In addition, members of the industry typically spend hundreds of thousands of dollars each year on outside tax consultants to assist with the complexity in the code and the additional compliance burdens that it creates.

The complexity as well as the temporary nature of many provisions in the tax code also present difficulties in making investment decisions. Earlier in the testimony, I discussed the ROI metric that many companies use. However, because there is so much uncertainty with respect to the interpretation of certain tax provisions or whether certain expiring tax provisions will be extended for the time period for which the investment is planned, many alternative scenarios may need to be evaluated. This is very frustrating when management is trying to make an investment decision. At times, these tax uncertainties could either delay an investment or cause the investment not to be made. Replacing targeted provisions within the tax code and all of the associated complexities, as

well as the temporary nature of many of these provisions, with a permanent lower corporate tax rate will greatly improve this process and should result in more investment.

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 because the owners of stores are denied the opportunity to elect bonus depreciation for their improvements, but lessees are permitted to have bonus depreciation. This not only hurts the NRF's larger member companies like Sears Holdings, which own a significant portion of our stores, but it also hurts the traditional small Main Street retailer that tends to own its retail store building. Another depreciation bias impacting retailers is the fact that a shorter depreciable life is applied to improvements to all leased space, whether storefront or warehouse. If a retailer owns its buildings, improvements to non-public space (i.e. backroom or warehousing) have a longer depreciable life. In the context of business tax reform, we believe the tax base needs to be defined more comprehensively, so that taxpayers within the same industry are not treated differently.

Another way in which the current tax system discriminates against taxpayers in the same industry is through the tax treatment of internet sales. Because Sears Holdings and other national retailers have stores in most, if not all 50 states, when we sell an item into any state that has a sales tax, either through a store located in that state or over the Internet, we must collect sales tax on the sale. If the same item is sold to a customer in that state by an e-retailer that has no store in the state, they do not have to collect sales tax. This issue creates a competitive disadvantage to the retailers that are actually providing jobs and paying taxes in your states, and, again, applies to the larger companies like Sears Holdings, as well as the traditional Main Street retailers. Although this tax discrimination does not arise out of the Internal Revenue Code, it can be resolved through federal legislation. [1]

Consumption Taxes

Whenever fundamental tax reform is considered, policy debates generally turn to whether the United States should move from its current income-based tax system to a consumption-based tax system or to a hybrid tax system, which would impose a value added tax (VAT) in addition to the income tax, similar to the European model. NRF opposes the adoption of a consumption tax because it would have a chilling effect on our already weak economy.

[1] *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."

Consumption taxes can be imposed in various ways including a National Retail Sales Tax (NRST), Value Added Tax (VAT), Flat Tax, and consumed income tax. Economists generally agree that the economic impact of various forms of consumption taxes is similar, although the application of the taxes may differ.

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

Consumption taxes also impose an unfair tax increase on senior citizens, who are living on fixed incomes. Senior citizens generally live off of previously-taxed earnings that they have saved

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[2]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

[3] 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.

from their working years. They now are at a stage where they consume far more than they earn. An increase in the tax burden on consumption would be extremely difficult for seniors.

A consumption tax, whether as a replacement to the current income tax system or as an addition to the income tax system, will not meet President Obama's goal to not impose higher taxes on Americans with less than $250,000 a year of income. The E&Y/Tax Policy Advisors study showed that enactment of a VAT would mean that most Americans alive at the time the VAT was enacted would have a lower standard of living for their entire lifetime. Even if exemptions were provided to alleviate the impact of a VAT on lower income households, most families with household income over $40,000 a year would have a lower standard of living if a VAT were enacted.

A federal consumption tax will also wreak havoc with state budgets. Forty-five out of fifty states depend on sales taxes as a major source of revenue. In fact, much of the current short fall in state budgets is as a result of the sharp decline in consumer spending, and hence sales tax collections, during this weak economic period. If a consumption tax is added at the federal level, it will be far more difficult for the states to increase sales taxes to address budget short falls.

Enforcement issues are likely to increase if the federal government adopts a consumption tax either in addition to the current income tax or as a replacement to the current income tax. When the rate of tax on consumption exceeds certain levels, tax evasion grows.[4] The level of tax on consumption that would be imposed if a federal tax were added to state and local sales taxes would probably exceed these levels. They certainly would be exceeded if a federal consumption tax were to replace the income tax.

Adding a bureaucracy within the Internal Revenue Service to enforce a federal consumption tax will necessitate large start up costs, as well as additional ongoing costs to operate.

Adding a federal consumption tax to the income tax will also greatly increase the overall level of complexity of our tax system. A World Bank Study found that the hours needed to comply with a VAT exceeded the hours needed to comply with the corporate income tax by 26%.[5] Complications will result because of the differences between the federal sales tax base and state and local tax bases. The dual tax system may be particularly burdensome for small businesses, which have enough trouble meeting the burdens of collecting and remitting payroll and income tax withholdings.

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[4] President's Advisory Panel on Federal Tax Reform, *Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System.* November, 2005.
[5] World Bank, *Paying Taxes2010* (November 2009). The compliance hours are presented in Appendix 1.3.

Conclusion

The NRF supports business tax reform that will lower corporate 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 move forward with corporate income tax reform, and we offer whatever assistance we may provide in meeting this goal. Corporate income tax reform will encourage investment, create jobs and simplify administration of the tax system without shifting the burden to those that can least afford to pay.