



**Letter to Congress, December 12, 2002 supporting international tax reform**

To:

The Honorable Max Baucus  
Chairman

The Honorable William Thomas  
Chairman

The Honorable Charles Grassley  
Ranking Member  
Committee On Finance  
U.S. Senate  
Washington, DC 20510

The Honorable Charles Rangel  
Ranking Member  
Committee on Ways and Means  
U.S. House of Representatives  
Washington, DC 20515

Regarding: The American Competitiveness Act of 2002, Input to the Bipartisan, Bicameral ETI Working Group, and to the Senate Finance Committee's International Tax Working Group

Dear ETI Working Group Leaders:

The members of the Silicon Valley Tax Directors' Group (SVTDG), and the companies that we represent, recognize that the American Competitiveness Act of 2002 (H.R. 5095) was an important effort toward achieving international tax simplification. We commend House Ways and Means Chairman Bill Thomas for his leadership in developing this bill. The companies that we represent are encouraged by the bill's simplification provisions as they address important areas, including the repeal of the Subpart F base company sales and services provisions; an extension of the foreign tax credit carryforward period and repeal of the alternative minimum tax foreign tax credit limitation.

The subpart F sales and services rules were enacted forty years ago, and U.S. multinationals compete in a very different world in 2002. Other jurisdictions generally restrict their taxation of international income to passive income, rather than active business income, such as sales and services income. Reform of these rules has long been needed, and would be greatly welcomed by companies in Silicon Valley that must compete in intensely competitive global markets.

The foreign tax credit changes also are much needed, as they will better allow companies to avoid international double taxation, which is the very purpose of the foreign tax credit.

The bill also would have repealed the exclusion for extraterritorial income (ETI). Taxpayers that benefit from the ETI exclusion have to-date been companies that manufacture or develop products in the United States, and export their products overseas. Companies impacted by a repeal of ETI are those that manufacture or perform research in the United States. If ETI is repealed, the loss of ETI benefits for such U.S. companies represents a significant impediment to the retention of their competitiveness, and, in fact, could result in U.S. multinationals being made less so through our own tax policy. Although ETI is considered to be no longer sustainable following the WTO decisions, the underlying purpose of ETI remains – the maintenance of at least some level of competitive balance in U.S. tax policy relative to our foreign competitors, who enjoy no or low income taxes on exports and/or border adjusted VAT exemptions.

Published December 8, 2004

Visit the Silicon Valley Tax Directors Group Web site at [www.svtdg.org](http://www.svtdg.org)



## Letter to Congress, December 12, 2002 supporting international tax reform

### Ideas To Address A Repeal Of The Extraterritorial Income Exclusion

The United States must either repeal, or significantly modify, ETI to satisfy its WTO obligations. The SVTDG believes this can be accomplished in a manner in which lost ETI benefits can be substantially recovered through other tax measures, that covers a broad segment of U.S. companies and is WTO-compatible.

#### *Exclusion of Income Earned Offshore Attributable to U.S. Manufactured or Developed Product*

The WTO ETI decision permits tax law provisions that avoid double taxation of foreign-source income. As such, income earned offshore which is "susceptible" to foreign taxation and excluded from U.S. taxation would not be violative of WTO trade agreements. Accordingly, an elective exclusion from U.S. taxation for income earned offshore, from an active trade or business, by foreign sales or distribution subsidiaries and attributable to U.S. manufactured or developed products, would not violate WTO trade agreements. Making the exclusion an elective provision would provide taxpayers with a choice to either claim a foreign tax credit or exclude the foreign income. This proposal is different from earlier income exclusion ideas in that it would only apply to income earned offshore by related foreign corporations under arm's-length transfer pricing principles. Earlier proposals would have "deemed" marketing intangibles to have been transferred offshore, and this is not part of this proposal. The activities to which this proposal would apply are performed in a foreign jurisdiction and clearly susceptible to taxation there.

#### *Subpart F Exclusion for Software Royalties Received From Unrelated Parties*

H.R. 5095 contained an important provision to exclude from subpart F rents and royalties received by a controlled foreign corporation from related parties that are engaged in an active trade or business. H.R. 5095 also contained provisions important to the high technology industry that would have repealed the base company sales and service income rules for U.S. corporations engaged in traditional manufacturing and service activities and royalties from related parties. These are highly desirable changes.

Although the repeal of these subpart F provisions is a welcome advance from a competitive position, H.R. 5095 modifications to subpart F did not address an important competitiveness problem for the software industry. H.R. 5095 did not address situations where royalties are received from unrelated parties when the controlled foreign corporation is engaged in the development, production, marketing or technical support of software developed by either the controlled foreign corporation or a related party. Modifying subpart F to also except rents and royalties received by a controlled foreign corporation engaged in a software business represents an attractive offset to lost ETI benefits for software companies if ETI is repealed. An active software royalty exception to subpart F would reduce the current incentive for U.S. software companies to relocate software development and other activities offshore.

#### *Improved R&D Tax Policy Would Reduce The Impact of ETI Repeal*

As discussed above, many companies impacted by ETI repeal perform the bulk of their R&D in the United States. Profits from future sales of U.S. developed or manufactured products are taxed in the United States and, if the resulting products are exported, the profits are eligible for ETI benefit. ETI benefit aligns closely with U.S.-incurred R&D.

Accordingly, another suggestion would be to increase the tax deduction for U.S.-incurred R&D, which would follow a similar approach in the United Kingdom. The U.K. R&D incentive is simply a deduction equal to 125 percent of qualified R&D expenditures. A 125 percent deduction for U.S.-incurred R&D would help offset a portion of the loss of ETI for U.S. multinationals.



## Letter to Congress, December 12, 2002 supporting international tax reform

As an addition or alternative to an enhanced R&D deduction, other deductions relating to U.S. activity that benefited from ETI could be increased. For example, tax deductions for payroll or capital expenditures could be increased in computing U.S. taxable income.

Another indirect means of enhancing the after-tax return on U.S.-incurred R&D would be to eliminate the apportionment of U.S.-incurred R&D to foreign source income, now required when computing the foreign tax credit. Currently, the maximum amount of U.S.-incurred R&D directly allocated to domestic source income is limited to 50 percent. The 100 percent allocation of U.S.-incurred R&D to domestic source income is not without precedent. Congress permitted, and in fact mandated, a 100 percent allocation in the past, largely on the basis that foreign countries do not permit a corresponding deduction for the allocated R&D and, to the extent the foreign tax credit is limited, the cost of U.S. R&D is increased, creating a risk that U.S. multinationals move R&D functions offshore. Perhaps the best economic argument for 100 percent domestic allocation is that, under transfer pricing principles, the economic profit from U.S.-deducted research is taxed in the United States. Therefore, deductions directly associated with the U.S.-taxed profit should not be limited through the foreign tax credit.

### Conclusion

The ETI Working Group and the Senate Finance Committee International Tax Working Group are important complementary efforts to the H.R. 5095 initiative. These initiatives take on added significance because negotiations between the United States and European Union may not otherwise resolve the ETI issue in a timely or acceptable manner, avoiding highly detrimental trade retaliation.

H.R. 5095 included important simplification measures and provisions addressing U.S. competitiveness. The Silicon Valley Tax Directors' Group believes that the passage of an international reform bill is possible with H.R. 5095 as a starting point, further enhancing it with provisions that more effectively and completely address the loss of ETI tax benefits. While not necessarily providing a full offset for the loss of ETI nor uniformly doing so, a package that includes provisions regarding U.S.-incurred R&D, an exclusion for distribution income earned offshore from sales of U.S. manufactured or developed products, and an exclusion from subpart of software royalties, will closely align future benefits with U.S. activities that currently generate ETI benefit – U.S. R&D, U.S. manufacturing, and U.S. software development. The SVTDG would support a bill similar to H.R. 5095 that includes this package of proposed additions.

Sincerely,

Silicon Valley Tax Directors' Group

CC:

Ms. Pamela Olson  
Deputy Assistant Secretary  
Tax Policy

Ms. Barbara Angus  
International Tax Counsel  
Department of Treasury