Silicon Valley
TAX DIRECTORS GROUP

... for the implementation of sound, long-term tax policies that promote the global competitiveness of the U.S. high technology industry.

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Make Permanent and Further Enhance the Research Tax Credit (Section 41)

Section 41 currently provides a 20 percent credit for incremental increases in qualified research. In lieu of the regular research credit, taxpayers can elect to calculate the credit using the alternative simplified credit (ASC). The ASC equals 14 percent of qualified research expenses that exceed 50 percent of the preceding three-year average.

Technological development is an important component of economic growth. Decisions by companies about the location of R&D are critical to U.S. competitiveness. A number of countries, in addition to the United States, provide research tax incentives, and several foreign countries have expanded the scope of their research incentives in recent years.

The status of the U.S. research credit has become uncertain in recent years. For example, Congress allowed the research tax credit to expire at the end of 2007 because of a disagreement between Democrats and Republicans over whether a tax extender package should be offset by revenue-raising tax provisions. Congress in late 2008 enacted a retroactive extension of the research credit as part of the *Emergency Economic Stabilization Act of 2008 (P.L. 110-343).* Specifically, the legislation

- Extended the research credit retroactively from January 1, 2008, for two years;
- Modified the Alternative Simplified Credit ("ASC") by increasing the rate from 12% to 14% for taxable years ending in 2009 (taxable years ending in 2008 remained at 12%);
- Terminated the Alternative Incremental Research Credit ("AIRC") for taxable years beginning after December 31, 2008.

President Obama has proposed making the research credit permanent as part of the proposed federal budget for FY2010.

Legislation has been introduced this year to make the research credit permanent and also increase the ASC to 20%. Senate Finance Committee Chairman Max Baucus (D-MT) and Senator Orrin Hatch (R-UT) have sponsored S. 1203, which would extend the research credit permanently and eliminate the base-period credit after 2010 when the ASC reaches 20%. Similar legislation (H.R. 422) has been introduced by House Ways and Means Committee member Kendrick Meek (D-FL).

The House on December 9, 2009, passed the Tax Extenders Act of 2009 (H.R. 4213), which would extend the research credit for one year, through the end of 2010, but the Senate has not acted on this legislation. At this time, Congress once again is expected to consider a retroactive extension of the research credit at some point in 2010.

The SVTDG supports efforts to extend permanently and further improve the effectiveness of the Section 41 tax credit.

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Preserve the Deferral of U.S. Tax on Foreign Earnings

The United States (U.S.) imposes tax on companies based on their worldwide income (i.e., both foreign and domestic income). In general, a U.S. corporation does not pay income tax on the active earnings of its foreign subsidiaries until that income is paid to the U.S. parent, typically as a cash dividend. The "deferral" rule generally ensures that foreign subsidiaries of U.S.-based companies pay the same tax rate as their competitors in the country in which they are doing business, and do not pay a U.S. corporate tax rate that often times will be much higher. All of the U.S. trading partners (e.g., OECD countries) either provide deferral or they exempt the foreign earnings of their companies from taxation.

Deferring U.S. taxation of foreign subsidiary earnings until the money is repatriated allows U.S. companies to compete on a level playing field with foreign-owned companies in foreign markets. Deferral allows U.S. companies to increase sales in world markets, leading to more and better paying jobs for U.S. workers. Without deferral, U.S. companies would be disadvantaged because they would face higher tax costs than their foreign competitors.

Further restrictions on deferral would reduce the international competitiveness of U.S. companies and their workers relative to foreign competitors and — contrary to certain expressed views — would lead to a loss in U.S. jobs and reduce U.S. living standards. Maintaining deferral is important to ensuring the competitiveness of US multinational companies. Foreign operations of U.S. companies increase the demand for U.S. products and services, thereby leading to more exports from the U.S. and more jobs for its citizens.

The direct effect of further limitations on deferral would be to accelerate tax payments by U.S. companies on their affiliates' foreign operations. Because the U.S. corporate tax rate is among the highest in the world (in 2009, the combined U.S. federal, state and local rate was second highest among all OECD countries), U.S. companies would generally owe additional U.S. tax on their foreign earnings after netting foreign tax credits on the foreign income. U.S.-owned foreign subsidiaries would be significantly disadvantaged relative to their foreign competitors, because U.S. companies would be immediately subject to additional U.S. tax on their foreign income while their foreign-based international competitors could continue to defer or be exempt from additional home-country tax. The tax advantage available to foreign-based competitors would permit them to reinvest more and sell their products at a lower price than their U.S.-owned competitors.

Deferral provides a level playing field for U.S. companies operating abroad with the local foreign competition in those countries. Commerce Department data show that 90% of what is produced abroad by U.S. companies is sold to foreign

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customers. As sales by U.S.-owned operations abroad increase, demand increases for products made by the U.S. operations of these companies to be exported as well.

In addition to jobs created through exports, foreign operations of U.S. companies increase employment in the U.S. for high-value jobs in research and development, engineering, logistics, finance, and marketing in support of the foreign operations.

If U.S. companies did not operate abroad, U.S. exports would decline — not increase and U.S. companies would reduce U.S. jobs accordingly. Deferral helps U.S. workers compete in the world economy.

President Obama has proposed reforming U.S. international tax rules to address provisions that "reward corporations that retain their earnings overseas" and that encourage companies to "ship jobs overseas." The Obama administration has submitted a proposed federal budget for FY2010 featuring provisions that would:

- Require a company generally to defer deductions for U.S. expenses (e.g., interest) "allocable" to foreign income until the deferred foreign income is repatriated. Notably, the Administration proposal includes an exception for research and experimentation expenses. This proposal is estimated to raise $51.5 billion.
- Impose new limitations on foreign tax credits. Specifically, the proposal would restrict foreign tax credits to the average rate of total foreign tax actually paid on total foreign earnings. The proposal also would address mismatches of foreign tax credits and the associated income in a manner similar to, but not the same as, August 2006 proposed regulations. These proposals are estimated to raise $45.5 billion.
- Revise the so-called "check-the-box" entity classification rules to require U.S. businesses that establish certain second-tier or lower foreign subsidiaries to treat them as separate corporations for U.S. tax purposes and not permit disregarded entity status. This proposal is estimated to raise $31 billion.

The SVTDG believes that it is essential to maintain current law tax rules that permit U.S. companies with active foreign earnings to reinvest these earnings in their foreign operations and defer paying U.S. tax until the earnings are paid to the U.S. parent companies, usually in the form of a dividend; to do otherwise would reduce the global competitiveness of U.S. multinational companies. The SVTDG believes that the Obama administration's proposals would result in an indirect loss of deferral of foreign earnings and could result in double taxation of such earnings, and as currently written would contribute to a further loss of competitiveness. Furthermore, the SVTDG believes that such changes should not be considered outside of a broader discussion of international tax policy and reform.

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Modernizing Subpart F to Increase Global Competitiveness of U.S. Multinational Corporations

The United States taxes U.S. based multinational companies on their worldwide income (i.e., both foreign and domestic income). In general, income earned by a U.S. company through a foreign subsidiary is subject to U.S. tax only when such earnings are repatriated to the United States. However, under the subpart F rules, certain types of income earned by foreign subsidiaries are immediately taxed in the United States regardless of whether the income is actually repatriated.

The subpart F rules were enacted in 1962, a different era of global competitiveness when U.S. companies were dominant globally. The rest of the world is catching up in terms of business competitiveness, while adopting more favorable tax regimes with respect to international business operations. Meanwhile, U.S. international tax rules generally are more complex and more far-reaching in terms of taxing global operations, making it harder for U.S. companies to compete globally. Recent guidance, such as the substantial assistance notice (Notice 2007-13) as well as the recently issued contract manufacturing regulations, generally acknowledge the complexity of the U.S tax system and the need to modernize subpart F in order to protect the competiveness of U.S. multinationals, and are reflective of efforts to import certainty and flexibility into the system. However, more transitional relief is needed in the implementation of the new guidance. For example, U.S. multinationals that may be adversely affected by the new contract manufacturing regulations may need to undertake costly and time-consuming restructuring (including potential changes to supply chain, HR, and/or IT) in order to comply with the new regulations without incurring significant U.S. taxes. However, the effective date provisions of these regulations in many cases would not provide sufficient time for these companies to complete the restructurings.

It should be noted that the IRS hopes to release regulations on substantial assistance "soon." In light of the above, these forthcoming regulations should provide better transitional relief by providing a more delayed effective date with an option to adopt at an earlier time (Notice 2007-13 indicates that forthcoming regulations would be effective for years beginning on or after January 1, 2007).

Legislation has been enacted to mitigate the negative impact of U.S. subpart F rules on the competitiveness of U.S. multinationals. Recent reforms have sought to narrow the scope of U.S. anti-deferral rules so as not to apply to certain types of active business income. However, the United States continues to impose current taxation on certain active foreign business income. The most important example is the subpart F foreign base company sales and services income rules (active financial service income has been addressed on a temporary basis).

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Congress in 2008 enacted the *Emergency Economic Stabilization Act of 2008 (P.L. 110-343),* which extends through the end of 2009 both the subpart F exception for active financing income and the "look-through" rule for payments between related CFCs. President Obama has proposed to extend these two provisions through the end of 2010 as part of the Administration's federal budget for FY2010. The House on December 9, 2009, passed the Tax Extenders Act of 2009 (H.R. 4213), which would extend these provisions for one year, through the end of 2010, but the Senate has not acted on this legislation. At this time, Congress is expected to consider a retroactive extension of the subpart F exception for active financing income and the "look-through" rule for payments between related CFCs at some point in 2010.

The SVTDG recommends that the foreign base company sales and foreign base company services income rules of subpart F be repealed in their entirety.

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Proposed Change to a Territorial Based Income Tax System

The United States taxes U.S. based multinational companies on their worldwide income, with tax on foreign earnings deferred until repatriated to the U.S. An alternative to this worldwide taxation is a territorial tax system. Under the type of territorial tax system used by many U.S. trading partners, some or all active overseas earnings of their businesses are exempt from taxation in the home country.

In 2005, the President's Advisory Panel on Federal Tax Reform released its final report. The report's recommendations include two options: (1) a Simplified Income Tax (SIT) Plan, and (2) a Growth and Investment Tax Plan. The SIT plans includes adoption of a territorial tax system that generally would exempt from U.S. tax the dividends paid from active earnings of a foreign subsidiary to its U.S. parent corporation.

The panel recommended a territorial tax system to remove tax barriers for U.S. multinationals that hinder the repatriation of foreign earnings to the United States, and to improve the competitiveness of U.S. corporations in their foreign operations. However, the panel's proposal includes certain potentially negative features that could increase the tax burden on U.S. multinationals, such as disallowing deductions for expenses allocable to the exempt dividends and a potential tax increase on certain foreign royalty and export income.

In December 2007, the Treasury Department issued a report on U.S. business taxation and global competitiveness that discusses an approach for reforming the U.S. international tax system by moving to a territorial tax system. According to the Treasury report, the current tax disincentive to repatriating foreign earnings could be addressed by moving to a territorial tax system.

In June 2008, the Senate Finance Committee held a hearing on international tax reform options, including proposals for a territorial tax system. Congress in 2010 may consider international tax changes during expected debate on general reform of U.S. individual and business tax provisions.

While the territorial tax proposal under the Simplified Income Tax Plan would allow simplification of the foreign tax credit rules, it would increase pressure on other rules, including sourcing, transfer pricing, and anti-deferral rules.

The SVTDG believes that the proposal would result in unfavorable tax results to U.S. taxpayers compared to present law and urges that the proposal not be enacted in its current form. Any consideration of a territorial tax system should be done in the context of an overall examination of tax reform options that would ensure the global competiveness of U.S. taxpayers as well as U.S. economic growth. The SVTDG would look forward to actively participating in any dialogue on a broad overhaul of the U.S. tax system.

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Corporate Income Tax Rate Reduction

The Tax Reform Act of 1986 lowered the top corporate income tax rate from 46 percent to 34 percent, in the belief that lower rates would promote economic growth. In the succeeding 20 years, corporate income tax rate reductions have swept the world but today's top U.S. rate is 35 percent. Once competitive, the combined federal, state, and local corporate tax rate (39.3 percent) is second highest (after Japan) among the 30 OECD countries, and 13.4 percentage points greater than the OECD average.

High corporate tax rates have a negative effect on economic growth. Research shows that countries with lower corporate income tax rates have over time achieved both higher real wage levels and economic growth rates. Corporate tax rates also affect the ability to attract business investment. High corporate tax rates make domestic investment less attractive and create an incentive for companies to shift high-profit activities abroad.

In October 2007, House Ways and Means Committee Chairman Charles Rangel (D-NY) introduced a bill (H.R. 3970, the Tax Reduction and Reform Act) to reform the individual and corporate income tax. The bill included a revenue-neutral proposal to reduce the federal corporate tax rate from 35 percent to 30.5 percent and broaden the corporate tax base. Chairman Rangel plans to introduce a new version of this bill in the 111th Congress.

President Obama has expressed an interest in discussing with the business community revenue-neutral options for a corporate rate reduction. However, the Administration's budget for FY2010 does not propose a corporate rate reduction and instead uses for general deficit reduction two key components of the business tax reform legislation introduced by Ways and Means Chairman Rangel in 2007.

The SVTDG would like to promote a dialogue with policy leaders regarding the need for corporate rate reduction and reform. While significant efforts by the Treasury Department and the IRS have been made to minimize much of the complexity associated with our tax system, there is still much more to be done to further this objective. One possible scenario could entail a true reduction in the effective corporate tax rate, thus minimizing many of the issues set forth above, and enabling the federal government to concentrate its efforts on identifying and penalizing tax offenders. The rate reduction would also work toward advancing global competitiveness. The SVTDG would look forward to actively participating in any such dialogue, including discussions addressing specificity about the rate, as well as other areas of the Internal Revenue Code.

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Codify the "Economic Substance" Judicial Doctrine

President Obama has proposed codification of the economic substance doctrine as part of the Administration's federal budget for FY2010.

Both the House and Senate in recent years have passed competing versions of legislation to codify the economic substance judicial doctrine.

The most recent Senate version was included in a 2008 farm reauthorization bill (H.R. 2419) as revenue offset for an agriculture tax incentives package, but this provision was later dropped from the final farm bill. Under the Senate provision, in any case in which a court determines that the economic substance doctrine is relevant to a transaction, the economic substance doctrine would be satisfied only if (1) the transaction changes in a meaningful way (apart from federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-federal tax purposes for entering into such transaction. The provision imposes a strict-liability, 30 percent penalty on any understatement of income attributable to a non-economic substance transaction (unless the transaction was disclosed, in which case the penalty is 20 percent). Because it is calculated based on an *understatement* of income, the penalty is due even if there is no understatement of tax (e.g., due to net operating losses). Public entities required to pay the penalty are required to disclose the penalty in SEC filings. The proposal is effective for transactions entered into after the date of enactment. The Senate provision was estimated to raise approximately $10 billion over 10 years.

The most recent House version has been included in health care reform legislation (H.R. 3962) approved on November 7, 2009. Although similar to the Senate provision, the House version would impose a 40 percent penalty on *underpayments* attributable to a transaction lacking economic substance (unless the transaction was disclosed, in which case the penalty is 20 percent). The House provision also would increase the threshold for avoiding the substantial understatement penalty to "more-likely-than-not" for larger corporations, with no reasonable cause or disclosure exception. The House provision was estimated to raise $5.7 billion over 10 years, and is being considered as one of several revenue-offsets being considered as part of broad health care reform legislation. Note that the House version is extremely similar to an economic substance codification provision included in the Tax Reduction and Reform Act of 2007 (H.R. 3970), introduced by Ways and Means committee chairman Charles Rangel in late 2007

The courts have long established, through judicial doctrine, the principle of economic substance. Previous Treasury and IRS officials have said codification could aid planning by aggressive taxpayers while discouraging legitimate business transactions by less aggressive taxpayers.

The SVTDG believes that codification of the doctrine should be rejected.

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Qualified Cost Sharing Arrangements - Inclusion of Stock Option Expenses

The IRS position, as articulated in 2003 final regulations (T.D. 9088) and restated in 2009 temporary cost sharing regulations (T.D. 9441), is that the "cost" or "value" of compensatory employee stock options are intangible development expenses and therefore, must be included in the pool of costs to be shared or charged out pursuant to taxpayers' cost sharing arrangements (CSAs) under Treas. Reg. Sec. 1.482. According to the IRS, requiring stock-based compensation to be taken into account for purposes of CSAs is consistent with the legislative intent underlying Section 482 and with the arm's length standard.

The inclusion of compensatory stock options in the cost sharing pool was the remaining issue in the Xilinx litigation. In this regard, the Tax Court, in August 2005, held that Xilinx's cost sharing agreement, which did not include any sharing of cost for stock option expenses, met the arm's length standard and that unrelated parties would not share the spread or grant date value of stock options. The Tax Court decision addressed years prior to 2003, but nonetheless raises the question of the viability of the final Treasury regulations.

In May of 2009, the Ninth Circuit Court of Appeals, in a 2-1 decision, reversed the Tax Court in Xilinx, holding that the cost sharing regulations in effect for Xilinx's 1997-1999 tax years require that related companies developing intangibles under a CSA must share all costs associated with the intangible development activity, regardless of what an analysis pursuant to the arm's length standard demonstrates. Specifically, the court found that the "cost" of stock option compensation must be shared, even though it was established that these costs are not shared in arm's length arrangements. Xilinx has petitioned the Ninth Circuit Court of Appeals for a rehearing en banc.

While the Xilinx case was pending, the IRS tried to advance its position on stock option expenses, despite the lower Xilinx decision, in the 2006 proposed services regulations, which require, among other things, that stock-based compensation be included in the cost of providing services when utilizing a transfer pricing method based on cost. In final services regulations published August 4, 2009 (T.D. 9456), the IRS continued to state that total services costs include all costs in cash or in kind (including stock-based compensation) that are directly identified with or reasonably allocated to the services.

In March 2008, the IRS Large and Mid-Size Business division (LMSB) released a coordinated issue paper (CIP) as to their approach on stock-based compensation should they lose their appeal of the Xilinx case. The CIP, which in essence presents nothing new, considers a situation in which a

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taxpayer, a U.S. corporation, is the parent of an affiliated group of domestic and foreign corporations (USP). USP enters into a CSA with a foreign subsidiary pursuant to Reg. Sec. 1.482-7. The CSA provides that the parties will share all costs related to intangible development of the covered intangibles, including but not limited to, salaries, bonuses, and other payroll costs and benefits. The taxpayer includes all forms of compensation in the cost pool except those costs related to stock-based compensation (SBC). The CIP concludes that the IRS should continue to follow the audit approach set forth in the January 2004 Industry Director Directive that reinforces the IRS's alleged long-standing position of including SBC in the pool of costs to be shared. In Xilinx the IRS sought to include only non-statutory options, while as the CIP notes, the "clarifying regulation" requires the inclusion of statutory equity compensation as well.

The SVTDG recommends, despite the result reached by the Ninth Court of Appeals in Xilinx, that the IRS no longer require U.S. taxpayers to include the cost or value of stock options in the cost pool. The government's attempt to redefine the well-established "arm's length" standard is a dangerous road to go down and will impact our relationships with treaty partners.

Cost sharing is under continual attack by the IRS. Cost sharing permits U.S. companies to perform important research and development activities in the U.S. while sharing the financial risks and burdens of such research and development with foreign subsidiaries. Cost sharing keeps important jobs in the U.S. and allows partial funding of those jobs from subsidiaries outside the U.S.

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Tax Treaty Override Legislation

House Ways and Means Committee Chairman Charles Rangel (D-NY) on October 25, 2007, introduced the Tax Reduction and Reform Act of 2007 (H.R. 3970), which included a provision that would override treaty benefits for deductible payments made by US subsidiaries of foreign-based companies if the payment is made to an intermediate foreign affiliate that is located in a treaty country. The provision would override the reduced rate of U.S. withholding accorded by the treaty and require a higher withholding rate to be imposed if the foreign parent is incorporated in a tax haven jurisdiction and would have been subject to a higher withholding tax rate had the payment been made directly from the U.S. subsidiary to the foreign parent company. The provision was modified from a previous version passed by the House as part of a farm reauthorization bill (H.R. 2419) to ensure that foreign multinational corporations incorporated in treaty partner countries will not be affected. The Senate Finance Committee opposed the version in the House farm bill, and this provision was dropped from the farm bill as enacted in 2008.

The House in June 2008 passed individual AMT relief legislation (H.R. 6275) that included a similar tax treaty override provision. The provision was estimated to raise approximately $7 billion over 10 years. On September 24 2008, however, the House passed stand-alone individual AMT relief legislation (H.R. 7005) that did not include a tax treaty override provision or any other revenue offsets. The Senate-passed extenders bill (H.R. 6049) included similar AMT relief but like the House bill did not include a tax treaty override provision.

The House on November 7, 2009, renewed efforts to enact the proposed tax treaty override provision as part of health care reform legislation (H.R. 3962).

The SVTDG believes that such tax treaty override legislation is bad tax policy because it constitutes a breach of our obligations to our treaty partners as well as of international law.

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OECD Initiatives on Attribution of Business Profits to a Permanent Establishment

A fundamental part of every comprehensive U.S. income tax treaty is the concept that a resident of one of the contracting states will not be subject to income taxation in the other contracting state on the enterprise's business profits arising within the other contracting state unless that enterprise has a permanent establishment (PE) in the source country and the profits are attributable to the PE. The purpose of the PE limitation is to promote bilateral trade and investment between residents of the two treaty partners by establishing a relatively objective and substantial threshold of presence in the source country before a resident of the other country is subjected to net income taxation by the source country. The PE principle is also a fundamental part of the model income tax convention developed by the Organization for Economic Cooperation and Development (OECD), an organization of which the United States is a member. The OECD model convention and guidelines established thereunder serve as a model for the formulation of treaty policy by most developed countries. The OECD is engaged in ongoing efforts to review and refine the principles guiding the determination of whether a business enterprise's activities in a host country (i.e., the country that has taxing jurisdiction by reason of economic nexus of the income) rises to the level of a permanent establishment and, if so, the appropriate methodology for attributing profits to that PE.

In recent years, some tax authorities have taken an expansive view of what constitutes a PE and what profits are attributable to a PE. The issues have been complicated by the issuance of draft guidelines by working parties of the OECD that are proposing new, untried and controversial principles both for the determination of whether a PE exists and, if so, what profits are attributable to the PE. On March 15, 2005, the Committee on Fiscal Affairs of the OECD issued proposed revisions to its commentaries on the model convention that would make clear that when a company's own activities at a given location may provide an economic benefit to the business of another company, it does not mean that the latter company has a PE as a result.

With the growth of global business and particularly with the rapid development of electronic commerce, the need for certainty, consistency, and clear thresholds before source country taxation is asserted is greater than ever.

The release of Parts I - III of the OECD Report on Attribution of Income to PEs clarifies a few points. First, it is very clear in indicating that the report is not intended to broaden or change in any way the definition of PE in the model treaty. It is limited to Article 7 issues related to how to determine how much income is attributed to a PE once it is established that a PE exists. Second, the Report makes it very clear that if a dependent agent

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PE exists, it is likely that additional income should be allocated to it based on the methodologies in the Report. These include attributing (i) risks to the geographic locations where the people in the business assuming and managing a particular risk reside; (ii) allocating intangible assets on the basis of the location of risk; and (iii) allocating income on the basis of the location of assets and risks.

On August 22, 2007, the OECD released a revised discussion draft of Part IV (Insurance) of the Report on the Attribution of Profiles to Permanent Establishments. This version replaced a June 2005 draft and made substantial revisions to the reinsurance section, and amended the definition of "key entrepreneurial risk-taking" functions in the earlier draft.

On September 19, 2008, the OECD released its discussion draft on business restructuring. The Discussion Draft addressed several important transfer pricing aspects of the taxation of internal business restructurings. These include:

- the treatment of allocation and transfer of risk among related parties;
- the question of whether and when internal business restructuring transactions require arm's length compensation or indemnification;
- the question of how transfer pricing rules should be applied to the parties to a business restructuring transaction following the restructuring; and
- the question of whether and when governments have the ability to disregard a taxpayer's restructuring transaction for purposes of applying transfer pricing rules.

While the Discussion Draft reflected consensus among OECD member countries across many issues, the Draft acknowledged differences of opinion between governments on some critical issues, a lack of consensus the OECD now seeks to narrow or resolve through its continuing deliberations.

The Discussion Draft generated tremendous interest in the business community, as evidenced by more than 400 pages of written comments provided to the OECD. The comments, while generally complimentary, also reflect significant disquiet over some key issues.

The SVTDG welcomes efforts by the OECD and its membership to provide greater clarity and certainty to the definition of a permanent establishment and the attribution of profits thereto and encourages further steps to discourage the assertion of taxing jurisdiction based on inappropriately low levels of activity of a taxpayer in a source country. The SVTDG encourages the U.S. government, as a member of the OECD, to actively promote the goals of certainty and consistency between countries in future OECD guidelines and to serve as a leader in combating inappropriate assertion of taxing jurisdiction by source countries.

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Executive Compensation

President Obama during his presidential campaign talked about "closing the CEO pay deductibility loophole" but has not yet offered a specific proposal on executive compensation. In 2007, the Senate passed legislation to impose new restrictions on executive compensation. None of these legislatives proposals were enacted in the last Congress, but such provisions could be revived in 2009.

In February 2007, the Senate passed H.R. 2, the Small Business and Work Opportunity Act of 2007, to increase the federal minimum wage and provide small business tax relief. The cost was offset by several revenue-raising tax provisions, including provisions to further limit nonqualified deferred compensation and expand the scope of the $1 million cap on deductible compensation under section 162(m).

The Senate provision on nonqualified deferred compensation would amend section 409A to impose a dollar cap on the aggregate annual amount of compensation that may be deferred by an individual. The cap would be equal to the lesser of $1 million or the individual's average annual compensation over the previous five years. If there are any deferrals in excess of this limit, then all deferrals would be subject to current income taxation, interest at the underpayment rate plus one percent, and a 20 percent penalty. The provision generally would be effective for amounts deferred after 2006.

The Senate provision on section 162(m) would expand the definition of "covered employee" to include: (1) any individual who was the CEO of the company at any time during the taxable year (not just the CEO as of the last day of the tax year); (2) the four highest compensated officers for the year; and (3) any individual who previously was a covered employee with respect to the company (or a beneficiary of such person).

The Senate provisions were not included in the conference agreement on the final bill (H.R. 2206). The House Ways and Means Committee held a March 14, 2007 hearing on the Senate revenue-raising tax provisions. Several Democratic and Republican Ways and Means members raised concerns about the Senate provision to limit deferral under nonqualified deferred compensation plans.

In April 2008, Senate Majority Leader Reid, on behalf of Senator Clinton, introduced an executive compensation bill (S. 2866) that includes a provision to impose a $1 million annual limit on nonqualified deferred compensation. S. 2886 does not include the "lesser of" language regarding the 5-year average of an employee's compensation. The bill also includes

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several non-tax provisions regarding shareholder votes on executive compensation and new disclosure requirements. It is not clear yet whether this bill may be considered as a possible revenue raiser at some point. The bill was referred to the Senate Finance Committee. The Finance Committee has taken no action on this bill.

In October, 2008, Senator Kerry introduced S. 3675, (the "Compensation Fairness Act of 2008") which in general would tighten the rules for the amount of compensation that is deductible as an ordinary and necessary business expense. Among other things, S. 3675 would repeal the exceptions for commission and performance-based pay under current law.

The nonqualified deferred compensation rules could be modified to address several concerns. Possible modifications include eliminating the average of the previous five years to provide a flat $1 million annual cap on deferrals, excluding investment returns up to a market rate of return, excluding mirror plans, and adding a correction mechanism. In addition, the proposed legislation could hit middle managers with defined benefit supplemental retirement arrangements and/or excess section 401(k) deferral arrangements where the benefits provided under the nonqualified plan merely mirrored the qualified plan except that statutory limits on the amount of compensation taken into account for qualified plan purposes are ignored.

In December the IRS issued long-awaited proposed regulations providing guidance on calculating the amount of deferred compensation includible in income and subject to penalty on a violation of section 409A; a notice providing an expanded voluntary correction program for the correction of inadvertent operational failures in a nonqualified deferred compensation plan under section 409A; and another notice providing interim guidance to employers and payers on their reporting and wage withholding requirements with respect to amounts includible in gross income under section 409A and on their reporting requirements with respect to all deferrals of compensation under section 409A.

In July 2009, Senators Carl Levin (D-MI) and John McCain (R-AZ) introduced a bill (S. 1491) intended to align book and tax treatment for stock options by allowing a federal tax deduction only equal to the book deduction for the year. To accomplish this, the bill would end the current section 83 deduction for stock options, under which a company may deduct an amount equal to the income recognized by the individual when the

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option is exercised, and would amend section 162 to provide the new rule. This change generally would apply to stock options exercised after the date of enactment, subject to certain transition rules.

In addition, the bill would modify the treatment of stock option expenses under the section 41 research credit to conform to the bill's new deduction. Incentive stock options under section 421 would not be affected by this bill.

The bill also would subject stock option expensing to the $1 million cap that applies to certain compensation under section 162(m), effective for stock options exercised or granted after the date of enactment.

The SVTDG believes that Congress should refrain from imposing any new limitations on nonqualified deferred compensation plans until the IRS has had time to fully implement Section 409A. In addition, Congress should hold hearings on proposals to impose new limits on deferred compensation, modify section 162(m), or change the tax treatment of stock option costs before adopting specific proposals.