



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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About the American High-Tech Industry

The American high-technology industry employs over 5 million workers in the United States (U.S.), nearly a million of whom are concentrated in California. The U.S. is the leading market for technology products and services from software, semiconductors and computers to Internet technology, advanced electronics and telecommunications systems and services. Other nations buy more than \$189 billion worth of high technology products from the U.S. each year, making it the nation's largest export segment.

The U.S. is the undisputed world leader in technology usage. There were an estimated 159 million computers in use in the U.S. in 2000, compared to 135 million in the European Union and 116 million in all of Asia-Pacific. The U.S. also leads in Internet users, with 134 million compared to 79 million in the European Union and 51 million in Asia-Pacific.

A host of factors are integral to the success of America's high-tech industry. One reason the U.S. is the leading technology market is its large and affluent population of 270 million consumers. More difficult to quantify but equally important, the successful American system of entrepreneurial risk and reward, dynamic capital markets, and limited government intervention fuel America's high-technology sector.

California's high-tech industry

The American Electronic Association's Cyberstates 2002 report found that California remained the nation's leading cyberstate by industry employment, at 998,000 high-tech workers in 2001, adding 12,400 jobs since 2000. High tech growth in California slowed dramatically from 13 percent between 1999 and 2000 to 1 percent between 2000 and 2001. California's high-tech average wage was \$99,200 in 2000. This was more than three times the average private sector wage. In fact, California's high-tech average wage is the second highest nationally, exceeded by only Washington, D.C.

Cyberstates 2002 also examines 2001 electronics merchandise exports from each state. California was the leading high tech export state with \$56 billion in exports in 2001, up from \$51 billion in 1997.

An important factor driving California's technology industry is venture capital. California received \$56 billion in venture capital investments last year, the nation's top ranked state by this measure. Research and development is also an important factor for the technology industry. California ranked first in R&D expenditures at \$48 billion in 1998.

Nationally, Cyberstates 2002 shows that high-tech industry employment totalled 5.6 million in 2001, compared to 5.5 million in 2000.



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Introduction

The past year was one of great uncertainty for the technology industry. Well before the September 11, 2001 terrorist attacks, increasing job layoffs and job insecurity, coupled with dismal corporate earnings, contributed to the reduction in corporate investment in information technology ("IT"). Faced with decreased demand, stagnant or flat prices, and a shrinking market, all sectors in this industry, from personal computer ("PC") and semi-conductor manufacturers, to wireless equipment and software developers, continued to face significant challenges in 2002.

One of the most significant transformational challenges facing today's multinational technology company tax department stems from the increased pace of globalization, acceleration in business consolidations, and the burgeoning IT requirements fuelled by the evolving e-business environment.

Despite the failure of many Internet start-up companies, the Internet remains a burgeoning area that will continue to generate new business opportunities and create new jobs in the years ahead. In this regard, there are several positive trends worth mentioning.

Emergence of Wireless/Mobile Internet

The wireless or mobile Internet market continues to proliferate, as new wireless data technologies emerge, and bandwidth expansion and compression capabilities improve. Technology companies, faced with the increased commoditization of the PC, are seeking new ways to add value to their products, and wireless is seen as one way to differentiate their product. Mobile computing devices and mobile voice handsets, enjoying tremendous success in recent years, have developed into widely available platforms on which to deploy the mobile Internet.

Emergence of New Technologies

New technologies, such as electronic bill and presentation payment services, mobile field sales applications and services, and voice-over-IP phone systems, will continue to emerge, and the U.S. will play a key role in their development. New server technologies, web services, and web-based standards will facilitate better collaboration and integration of enterprise solutions.



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Introduction (continued)

Fundamental Hardware Trends

The continued truth of Moore's Law will result in a doubling of PC processing power every 18 months to two years. In addition, under Metcalfe's Law, the true value from multiple devices results from their ability to connect and interact with one another.

Despite lagging sales, reduced demand and lengthened lifecycles, the PC is well positioned to benefit from these trends. The PC itself will embrace new technologies such as voice enablement, broadband and network enablement.

Fundamental Software Trends

One of the key trends, a mobile Internet, requires a broad range of infrastructure software, such as embedded browsers, content transformation software, wireless application servers, enterprise and carrier gateways, middleware for integration with enterprise applications, and synchronization software.

This new framework requires moving beyond the single product (i.e., PC) focus, and embracing the numerous peripherals, services, and mechanisms necessary to achieve the full potential of these multiple devices.



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Globalization

Globalization continues to be one of the most visible trends in the technology industry. As the industry continues to mature, companies are seeking fuller participation in major regional markets around the world. Indeed, some might argue that globalization has historically meant Americanization, and that, as U.S. companies continue to expand overseas, more and more foreign companies are adopting American business practices.

Competing effectively in the international marketplace is more critical for U.S. technology firms than ever before. Foreign companies continue to close the productivity gap, and U.S. technology companies must implement the necessary organizational change to secure their long-term growth and survival. A global marketplace requires assessment of contracting relationships, location of manufacturing activities, and compensation issues for a global workforce.

To achieve growth, U.S. technology companies are continuously focusing on global management strategies. Partnerships, joint ventures, and alignments with overseas partners, designed to access the growing pool of non-U.S. talent, are being considered more and more in the development of emerging intellectual properties. Efficiencies are also driving the process. Cost sharing arrangements remain a predominant mechanism among intellectual property developers, and outsourcing of non-core functions (such as manufacturing) represents a key strategy employed by many companies to facilitate rapid international expansion, without the corresponding need for high investment in back-office infrastructure, or diminishing a needed focus on core business activities.

U.S. technology multinational companies are among the nation's largest and most successful exporters. In 2001, high tech exports were \$189 billion, which represents 26 percent of all exports (down from a high of \$223 billion in 2000, or 29 percent of all exports). Despite this decline, the U.S. high technology industry remained the nation's leading exporter in 2002. However, U.S. tax policy does not recognize the disparate treatment accorded our treaty partners under their own domestic laws, as compared with their U.S. counterparts. The foreign taxing policies of our treaty partners are designed to protect and promote their own interests, which adds a level of flexibility to operate efficiently in the international marketplace that is not currently enjoyed by U.S. companies. As a result, U.S. multinational technology companies operate at a competitive disadvantage. In light of the World Trade Organization's ruling that the U.S. tax law extraterritorial income regime constitutes an "export subsidy," current efforts to eliminate the disparate treatment of U.S. technology multinational companies fall short of the mark.



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Globalization (continued)

U.S. companies that continue to expand their overseas operations also must deal with a growing volume of foreign country examinations, controversy resolutions, advance pricing agreements, and competent authority procedures, and the continually changing team of government officials carrying out such measures. As technologies, competitive pressures and global markets create borderless organizations, companies need to create appropriate tax and legal structures to reflect new operating configurations and realign tax profiles to reflect this restructured value chain. This leads to a growing prevalence of transfer pricing audits among technology companies. While there are a growing number of IRS issue resolution mechanisms to resolve potential tax disputes, there remains a critical need for accelerated resolution and answers to questions as quickly as possible. Uncertainty as to disposition of an issue is an enemy to good business decision-making.



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R&D

Research and development ("R&D") remains a cornerstone of technological innovation, which in turn fuels long-term economic growth in the technology industry. With today's rapid pace of innovation, it is critical for companies to increase efficiencies, and reduce the time within which an idea is transformed into a finished product and taken to market.

The primary objective of the research tax credit under the Internal Revenue Code is to stimulate increased corporate research spending by lowering the cost of capital of the firms actually conducting the research. Since 1981, when a federal R&D tax credit was introduced into law, the credit has been repeatedly extended (most recently to June 30, 2004). The temporary nature of the credit acts as a disincentive to significant U.S.-based R&D investment over the long term, and more and more U.S. companies will look to foreign markets to conduct R&D activities, where competition for such work is fierce.

While the U.S. high technology industry increased its R&D expenditures by 38 percent between 1997 and 2000 (\$58 billion in 2000), many technology companies reduced R&D spending in 2001 and 2002, primarily as a result of the weakened economy and diminishing corporate earnings. The September 11, 2001 terrorist attacks, and the government's shifting priorities, have added additional uncertainty. Ultimately, corporate R&D spending will be largely dependent upon an economic recovery.

Technology companies cannot afford to ignore R&D -- new ideas and products are fundamental to their success. Emerging markets in the mobile computer device and Internet appliance areas will be heavily research focused as the demand for new technologies continues. Low cost PCs and broadband access will enable a new generation of devices, applications, and wireless services. In addition, research activities will play a large role in developing new functionalities in e-commerce and customer relationship software packages, as existing business-to-business and business-to-consumer models mature.



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Work Force

Employment in the technology industry remains at the forefront of the economy. High technology industry employment represents 5 percent of the U.S. private sector workforce, and its payroll represents over 10 percent of the private sector payroll. However, after years of strong growth in the high technology industry, there was a considerable slowdown in job growth in 2001. The U.S. high technology industry grew just 1 percent in 2001, adding 80,000 jobs to the U.S. economy. This is a significant decline from the 441,000 jobs created between 1999 and 2000. One of the hardest sectors hit was high tech manufacturing, which saw its second drop in employment in the past seven years. The communications services and software and computer-related services sectors, at the heart of the "information revolution," continues to grow albeit at a slower pace. The rate of unemployment for 2002 remains uncertain, as staff reductions continue as a result of the recent economic slowdown.

Despite the continuing uncertainty, there are several positive trends emerging. Late in 2001, there were record lows in the number of layoffs announced by Internet companies. In addition, despite the failure of many Internet startup companies and resulting proliferation of the pool of qualified employees, there still remains a shortage of, and consequently a substantial demand for, skilled IT workers, at least with respect to more established companies. Skilled professionals, such as technical support specialists, programming and software engineers, will continue to see opportunities, as companies become more selective in their hiring practices.

Although well-educated foreign workers would obviously address the shortage issue, it is unclear whether H-1B visas will increase in the future. According to some, the issue is not the impact of foreign workers, but rather, the lack of adequately trained Americans in the workforce.

In this connection, training and improvements in education at both a national and state level is another key issue for the technology industry, since a fundamental requirement of progress is to ensure a skilled workforce in the future. A report released by the American Electronics Association focuses on the efforts of the country and individual states in preparing students to succeed in the 21st century. The report highlights progress that has been made in recent years, and notes several obstacles that must be overcome, particularly in the areas of math and science education.



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Work Force (continued)

Recruiting and retaining skilled personnel from around the world will remain a critical challenge facing technology companies. Turnover will continue to be an issue, and creative equity techniques will permeate the industry. The continued use of profit sharing and stock compensation arrangements (incentive stock options, employee stock purchase plans) to retain skilled workers will be of paramount importance. U.S. technology companies are among the pioneers in this regard. Current legislative initiatives which would inhibit the effectiveness of these initiatives (e.g., by limiting the tax benefits) could jeopardize the ability to retain and promote a skilled workforce.



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Capital Investment

With the overall retraction of the economy in 2000, companies reassessed their overall IT expenditures. Across the board, spending on IT hardware and software was cut sharply, with IT budgets rising only slightly in 2001.

Technology companies also had to address the significant overspending from prior years (due, in part, to Y2K concerns and the dot.com proliferation). Thinning markets and increased obsolescence (through reduced product life cycles) also presented challenges to technology companies. Many companies now outsource manufacturing activities so that they can concentrate on core activities and reduce some of these risks. As a result, contract manufacturing has become a growth business for many companies in the technology industry, as well as for some current manufacturers (for at least a portion of their manufacturing activity).

In 2002, technology budgets were expected to rise somewhat, but this has taken longer than anticipated to materialize. According to several studies, the sector will post much weaker growth than previously forecasted for 2002, due in part to a delay in the expected rise in demand, and rigid budget controls.

Companies will continue to experience spending shifts within their IT budgets, with a significant portion of IT spending likely to relate to the ongoing buildout of the Internet infrastructure and integration of previously acquired technologies. Interest in tele-communicating and tele-conferencing capabilities will continue to increase, particularly in light of the September 11, 2001 terrorist attacks. The main drivers for investing in e-business initiatives will be cost reduction and savings, enhanced customer support, and customer retention.



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Conclusion

The focus of U.S. technology companies in 2002 will be on investing to create value. Revenue maximization, cost containment, and the ability to meet and exceed shareholder expectations will dictate corporate IT investment decisions. Build out of Internet infrastructure will also be a priority, as will data storage and warehousing capabilities. Opportunities for global expansion will remain, particularly in the Asia Pacific region, and technology companies will adopt organizational changes to align themselves for the future. There will be moderate increases in research spending, and retention of skilled professionals will be critical. New revenue sources, such as portal access fees and changing business models, such as application service providers, will pose questions as to how to properly tax revenue streams under current regimes.

With the maturation of the technology industry, consolidation, joint venturing, and partnering will proliferate in the next year as companies seek out additional market share. Restructuring will also be fuelled by the need to expand service territories, increase brand awareness, and share the cost of technology upgrades. Less established firms might become targets for acquisition by cash-rich competitors attempting to expand beyond core business operations. Outsourcing will play a key role, as there will be an increased willingness to form joint venture relationships with external service providers.

In all events, the U.S. technology industry will remain a dominant force in the global marketplace, and will play a key role in shaping the policies and practices that will lead to the long-term growth of the U.S. economy.