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August 1, 2014

The Honorable Ron Wyden
Chairman, Senate Finance Committee

The Honorable Orrin Hatch
Ranking Member, Senate Finance Committee

Dear Chairman Wyden and Ranking Member Hatch:

We want to thank you for holding this hearing and for continuing to seek input from tax experts and stakeholders on how to improve our international tax system "to help American businesses stay competitive in the global economy." The Silicon Valley Tax Directors Group is comprised of 78 representatives from leading high technology companies in the United States. A list of SVTDG members is attached for your information.

We are pleased to submit the following comments for the hearing record focused on tax reforms that will promote research and development (R&D) and job growth in the United States. Companies with intellectual property abroad face obstacles in the Internal Revenue Code that effectively preclude them from bringing their intellectual property home to the U.S. We propose that the tax code be amended to eliminate those obstacles.

We believe our current tax system impedes U.S. innovation and discourages retention of global IP in the United States. To enhance growth and ensure that U.S. companies remain highly competitive, changes should be made to our tax code that encourage the development, ownership and commercialization of IP in the United States. It is particularly important that Congress act quickly. If it does not, other developed countries may permanently capture for themselves the IP and related R&D development, as they have (or may put in place) more competitive tax policies.

The current U.S. international tax system is a hybrid—a worldwide tax system that can act like a territorial system because it generally defers U.S. tax until foreign active earnings are repatriated. This can be the worst of all worlds, particularly with respect to IP. The worldwide tax base places U.S. businesses at a competitive disadvantage to their foreign competitors based in jurisdictions that have territorial systems (i.e., exempt foreign income). Moreover, the U.S. tax deferral in the current system, combined with the high U.S. statutory rate, encourages foreign development and ownership of IP. As a result, to remain competitive, U.S. companies are economically compelled to maintain ownership of IP rights (and the attendant income) in lower-taxed jurisdictions, through R&D activities, cost sharing arrangements, and license agreements. Once IP rights are held abroad, even if the U.S. were to lower its rates, the high residual U.S. tax under the current system acts as a disincentive for domestic investment of foreign earnings (referred to as the "lock-out" effect). Together, the effect is that the current international tax system raises little revenue from the foreign activities of U.S. multinational corporations. Even reform proposals that would require a minimum tax would not necessarily raise revenue in the U.S., but simply would encourage foreign jurisdictions to raise their tax rates, with the acquiescence of U.S. multinationals.

In your opening statements to this hearing, each of you acknowledged that the current tax system is adversely affecting U.S. competitiveness. Chairman Wyden called the tax code "an anti-competitive mess," while Senator Hatch said "our primary goals should be to make the U.S. a better place to do business and to allow American companies to compete more effectively with their foreign counterparts in the world marketplace."

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Adoption of an IP Box

The adoption of a U.S. IP box for foreign market income would help make the U.S. tax system more competitive and rationalize the tax rate on IP income derived from serving foreign markets whether earned at home or abroad. In her testimony before the Committee, Professor Leslie Robinson suggested the need for such an approach to retain domestically created IP and enhance innovation:

> Options that reduce the effective tax rate on intangible income may be likely to keep R&D operations in the U.S. that are most likely to contribute to the U.S. economy. Chistof, Richter and Reidel (2013) find that reducing income tax rates on R&D output (as opposed to other incentives) attracts relatively more innovative projects with higher earnings potential. (pg. 8 of her written testimony).

Absent a relative balance between the tax rate on income earned by U.S. companies from the foreign IP they own and income from IP owned by CFCs, U.S. multinationals will continue to have an incentive to create, and maintain ownership of, IP abroad. This is particularly true in the current environment in which other countries are being increasingly aggressive in attracting IP creation and commercialization. In the past decade, at least nine countries have adopted IP or patent box regimes and others have expanded their R&D tax incentives. The OECD BEPS project may in fact serve to increase this trend as companies are faced with decisions on where to invest in response to changes in the current multilateral international tax framework, and countries adopt competitive policies to attract this investment.

Key Features of an IP Box

A properly designed IP box can promote the creation, ownership and commercialization of IP in the United States. The key features of an IP box are an internationally competitive tax rate on income attributed to IP and a tax-neutral mechanism for taxpayers to domesticate IP that is currently offshore.

To help determine gross income attributed to IP and properly allocate and apportion expenses, the proposal could require the creation of a special purpose corporation whose sole purpose is to hold and develop intangible property (an "IP SPV"). The use of an IP SPV is described more fully below. Alternatively, the IP would not be separate, but in connection with the provision of products or services abroad, an amount of the income could be simply allocated to IP exploitation (so called "embedded IP').

Eligible income would be limited to foreign source income (e.g., royalties) attributable to "intangible property."[1] This definition should include foreign source income attributable to patents, know-how, technology, copyrights, trademarks, marketing intangibles, and other IP. To the extent an item is in an existing qualified cost-sharing arrangement, it would generate eligible income. Ineligible income would be subject to ordinary U.S. corporate tax rates.

Domestication of IP

In designing an IP box, it will be critical to remove barriers to the domestication of existing IP by allowing the tax-free transfer to the United States of IP rights that are currently owned offshore by a foreign affiliate. Removing such barriers will encourage development, ownership and commercialization of IP in the United States, reduce business complexity, and strengthen IP and tax procedural protections for U.S. taxpayers, while at the same time increasing U.S. tax revenue on IP income derived from serving foreign markets. This tax-neutral domestication of IP can be made available permanently or for a limited amount of time.

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[1] Eligible income would also include gains from the disposition of IP that would have given rise to foreign source income.

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Under this proposal, a U.S. corporation could elect to treat a distribution of qualifying IP from a CFC as a dividend eligible for a 100% dividends received deduction. The recipient domestic corporation would have a carryover basis in the IP, and in the case of an IP SPV, would step into the shoes of an existing foreign cost-sharing participant for purposes of future cost-sharing payments. The transfer of qualifying IP would not trigger gain at the CFC level, would not affect the CFC's E&P, and would not result in taxable income or a basis step-up to the U.S. corporation.

Use of an IP SPV

As described above, if an IP box is adopted, requiring use of a separate U.S. IP SPV may simplify tax administration and improve compliance by providing a mechanism for attributing income and allocating and apportioning expenses to IP. In such a case, the IP SPV would file a return separate from that of its U.S. parent corporation's consolidated return.

An IP SPV would step into the shoes of an existing foreign cost-sharing participant, and companies would be able to roll their existing cost-sharing arrangement[2] into the IP SPV tax-free and without a basis step up (e.g., in a distribution). Thus, a transfer of currently cost-shared IP to an entity subject to this regime would be tax-neutral for U.S. tax purposes, even though the transfer is from a foreign entity to a U.S. entity. The transferring CFC's E&P would be unaffected.

Payments that are currently included in a cost share arrangement would be similarly cost shared with the IP SPV (and deductible only by it to the extent of its share). For other expenses, existing expense allocation and apportionment rules under section 861 could be used, as could approaches adopted on this issue in sections 199, 936, 1352 (the "tonnage tax"), the FSC regime, etc.

Foreign tax credits and other tax attributes would be calculated separately for an IP SPV. Dividends from an IP SPV to a domestic corporation would be eligible for a 100% dividends-received deduction under section 243. Thus, there would no longer be a lockout effect with respect to IP income from foreign sources.

WTO Compliant

A U.S. IP box that applies to all IP income would clearly not implicate WTO issues regarding export subsidies. Adoption of a U.S. IP box that applies only to income from serving foreign markets, however can also be structured in a manner that complies with the WTO agreements and the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") in particular. The World Trade Organization, through the General Agreement on Tariffs and Trade (GATT) and the SCM Agreement, only disciplines and restricts subsidies provided to the trading of goods.[3] The WTO does not have subsidies obligations related to the trading of services or the trading of intellectual property (e.g., the direct sale or licensing of patents, copyrights, and trademarks). Therefore, a special tax rate under an IP box that is applied only to foreign-sourced intangible income would be WTO compliant.

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[2] If an existing cost sharing arrangement was entered into prior to January 5, 2009, it would continue to be governed by the prior cost sharing regulations after the transfer of IP to the IP SPV.

[3] Specifically, Annex 1 of the Marrakesh Agreement Establishing the World Trade Organization is divided into three sub-categories. Under "Annex 1A: Multilateral Agreements on Trade in Goods," subsidy obligations are set forth in the General Agreement on Tariffs and Trade and the Agreement on Subsidies and Countervailing Measures. However, such obligations are explicitly excluded from "Annex 1B: General Agreement on Trade in Services," and simply do not exist in "Annex 1C: Agreement on Trade-Related Aspects of Intellectual Property Rights."

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U.S. Revenue Benefit

Somewhat paradoxically, adoption of an IP box and removing current law barriers to domestication of currently offshore IP is likely to increase substantially the amount of U.S. taxable income from foreign exploitation of IP. Under current law, U.S. companies are encouraged to locate IP serving foreign markets overseas and the lockout effect means that the U.S. Treasury is unlikely to see much, if any, revenue from such foreign source IP income. An IP box would reduce current incentives to shift IP development and ownership overseas, while imposing an immediate U.S. tax at a low, competitive rate on foreign source IP income. For example, providing for tax-neutral domestication would help to attract IP back onshore and make it more likely that any income tax imposed on the associated income would be payable fully to the U.S. rather than a foreign government.

Countries have already taken steps to adopt more competitive tax policies to attract investment and IP, and more are likely to do so in response to the OECD BEPS project. Current U.S. tax policy does not provide a competitive response. As a result, the United States risks missing out on the opportunity to attract investment and tax revenue the longer it takes to act on tax reform that includes a low, competitive tax rate on IP income and a mechanism for tax-neutral domestication of offshore IP.

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We very much appreciate the opportunity to submit these comments regarding international tax reform and the long-term benefits to U.S. competitiveness of adopting an IP box. We believe enactment of a U.S. IP box with provisions allowing tax-free domestication of IP will encourage innovation and job growth by U.S. companies, while at the same time increasing revenue for the Federal Government. U.S. companies will also enjoy less complexity by consolidating worldwide IP and greater IP and tax procedural protections by being able to bring IP home. Please do not hesitate to contact Jon Talisman at (202) 289-8700 if you have any questions or comments regarding this submission.

Sincerely yours,

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Co-Chair, Silicon Valley Tax Directors Group

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Co-Chair, Silicon Valley Tax Directors Group

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