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Senator Rob Portman
Co-Chair, International Tax
Senate Finance Committee

Senator Charles E. Schumer
Co-Chair, International Tax
Senate Finance Committee

Senator John Thune
Co-Chair, Business Income Tax
Senate Finance Committee

Senator Ben Cardin
Co-Chair, Business Income Tax
Senate Finance Committee

Dear Senators:

We want to thank you and your staffs for your efforts to improve our business tax system and for seeking input from interested stakeholders on how best to reform our system to ensure the U.S. remains competitive in a global marketplace. Actions taken by the OECD and foreign governments create an immediate need for U.S. international tax reform before companies have to make decisions (to mitigate the impact of such international tax changes) that could adversely impact U.S. jobs and investment.

The Silicon Valley Tax Directors Group is composed of 81 high technology companies with operations in Silicon Valley. Since our inception, our purpose has been to help promote long-term tax policies that encourage innovation and growth in the U.S. high technology industry. Accordingly, our comments will focus on tax reforms that are important to maintain competitiveness for American companies, promote research and development ("R&D") and job growth in the United States, and help to preserve and increase the tax revenue base for the Federal Government.

The high U.S. corporate statutory rate combined with our hybrid worldwide tax system causes U.S.-based companies to be less competitive, encourages foreign development and ownership of intellectual property ("IP"), and traps cash outside the United States that could be used for domestic investment. This combination also hinders U.S. companies when bidding for foreign acquisitions, and makes them more susceptible to foreign takeovers.

To address these concerns, we believe that meaningful U.S. federal income tax reform should feature a reduced corporate statutory tax rate consistent with OECD norms and a competitive dividend exemption regime with appropriate base-erosion provisions and transition rules to allow companies to access foreign earnings. These changes will help level the competitive playing field for U.S. companies and will generate significant economic and job growth in the United States. Council of Economic Advisors former Chair Dr. Laura Tyson recently testified before the Finance Committee that she and her colleagues at Berkeley "estimate that under a territorial system, U.S. companies would repatriate an additional $100 billion a year from future earnings, adding about 150,000 U.S. jobs a year on a sustained basis."[1]

Need for a competitive corporate tax system and transition

We believe the U.S. corporate tax rate should be lowered to an internationally competitive rate—for example, to 25% (consistent with the G7 average, taking sub-national taxes into account).

Foreign countries—in recognition of the importance of R&D to their economies and job growth—have implemented permanent R&D tax incentives and IP box regimes. We believe the U.S. should implement an IP box regime (discussed below) and make permanent and enhance the R&D tax credit (e.g., a 20% alternative simplified credit).

We recommend the U.S. adopt a 95% dividend exemption system (consistent with other major OECD countries), with a reasonable transition tax (e.g., equivalent to an 85% dividends-received deduction) for pre-enactment foreign subsidiary earnings.

A lower U.S. statutory corporate tax rate, coupled with an IP box regime (discussed below), would dramatically increase incentives for U.S. IP development, ownership, and commercialization, thereby substantially addressing U.S. base erosion concerns. We understand, however, that Congress may additionally address base erosion by revising subpart F of the tax code. The main features of such an approach are the applicable tax rate and the foreign subsidiary income to which it is applied. One could apply a uniform rate to a broad base of income, or apply different rates to target categories of income (e.g., IP income). As a policy matter, applying a uniform tax rate (e.g., 10–15%) to a broad base of foreign subsidiary income (e.g., not just IP income) applied at the controlled foreign corporation level, with the current check-the-box regulatory rules intact, would be more administrable.

Need for an IP Box

In addition to the general structural changes suggested above, we believe it is important for the United States to adopt an IP box as soon as practicable. Otherwise, as described more fully below, the United States risks losing R&D and other high-skilled

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[1] Testimony of Dr. Laura D'Andrea Tyson, Hearing on "Tax Reform, Growth and Efficiency," Senate Finance Committee (February 24, 2015), p. 8. She also testified that a transition rule taxing current unrepatriated foreign earnings, similar to Chairman Camp's tax reform bill (H.R. 1), would result in $1 trillion of repatriated earnings, increase U.S. GDP by $ 200 billion, and add 1.5 million jobs in the first few years following enactment.

jobs, IP ownership, and the associated revenue to other developed countries with low tax rates and/or IP boxes.

Actions are taking place overseas, in the context of the OECD Base Erosion and Profits Shifting (BEPS) project and otherwise, that will exacerbate these concerns. Other countries are being increasingly aggressive by using BEPS concepts to support unilateral law changes and audits that will increase foreign taxes on U.S. multinationals (using tax policy as a 'stick'). They are also "using tax policy as a 'carrot' to attract the income and operations of U.S. companies with significant intangible assets and the positive externalities associated with them — including spillover effects boosting innovation, productivity and wages."[2] These include reductions in their corporate statutory rates, as well as adoption of IP boxes. For companies to take advantage of these incentives, the BEPS project will require a strong link between economic activity and location of IP income by imposing "nexus" requirements for IP boxes and more stringent transfer pricing rules premised on activity and control. These overseas actions are unprecedented and are a fundamental shift in the international tax landscape. To adapt, U.S. companies will be forced to make decisions relating to the location of R&D operations and IP ownership.

Without immediate U.S. international tax reform, adoption of these policies overseas is likely to cause greater migration of IP ownership and R&D jobs from the U.S. to other developed countries. The combination of these carrot and stick actions by other governments is likely to shrink U.S. tax revenues by both diminishing the tax base attributable to IP development and commercialization, and causing greater U.S. foreign tax credits for foreign taxes paid.

The U.S. still has a window of opportunity to respond, but <u>must act quickly</u>. Changes should be made to our tax code to encourage the development, ownership, and commercialization of IP in the United States. Adoption of an IP box would help maintain U.S. competitiveness and ensure the U.S. is "first in line" to tax IP income, rather than ceding that right to other developed countries that have lowered their tax rates and/or implemented IP box regimes. The adoption of an IP box would help make the U.S. more competitive so that we attract and retain the high value jobs and spillover benefits associated with innovation and development. In her testimony before the Committee last year, 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. Christof, Richter and Reidel (2013) find that

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[2] See *id.*, p. 9. In the past decade, at least twelve EU countries have adopted IP or patent box regimes and others have expanded their R&D tax incentives. See Testimony of The Honorable Pamela Olson, Hearing on "Building a Competitive US International Tax System," Senate Finance Committee (March 17, 2015), p. 10.

> reducing income tax rates on R&D output (as opposed to other incentives [such as R&D credits]) attracts relatively more innovative projects with higher earnings potential.[3]

If no action is taken, the incentives for U.S. multinational companies to create and own IP abroad will likely be even greater in the future than it is now. The nexus/activity requirements underlying the OECD BEPS project and unilateral law changes in other countries influenced by BEPS are already forcing companies to rethink decisions regarding where to locate R&D investment and ownership of IP. Once decisions are made to shift existing and/or locate new R&D jobs and investment overseas, they will be difficult to reverse. As a result, the U.S. could lose (or not gain) significant high-paying jobs as well as the revenue base associated with the IP. This loss would be felt on a long-term or permanent basis, making it more difficult in the future to achieve revenue neutral reform. We are hopeful that the Congress will act quickly to adopt a competitive tax policy that encourages innovative companies to maintain and grow jobs in the U.S.

<u>Key Features of an IP Box</u>

We believe there are several important features of a properly designed IP box that will help to promote the creation, ownership, and commercialization of IP in the United States. These include:

- An internationally competitive tax rate on income earned by U.S. companies from IP;
- Eligibility that covers all forms of innovation IP;
- Adoption of a nexus standard that is appropriate and administrable, to maintain and enhance the U.S. position as an attractive location for research; and
- A tax-free mechanism for taxpayers to domesticate IP that is currently offshore.

First, for an IP box to be successful in attracting and retaining IP development in the United States, it should provide a rate on qualifying income that is comparable to the rates being offered by other countries. Because many companies would prefer to have development and ownership of IP in the United States, the U.S. rate for the IP box need not be the lowest, but it must be competitive. We note that the U.K. has an IP box regime that will have a 10% tax rate when fully phased in by 2017. The qualifying income could be defined to be any (worldwide) income earned from qualifying innovation IP (all non-marketing IP, as discussed below), or it could be any IP income from foreign customers.[4] The former approach is consistent with that taken by IP boxes

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3 Testimony of Dr. Leslie Robinson, Hearing on "International Corporate Taxation," Senate Finance Committee (July 22, 2014), p. 8.

4 In either case, only income in excess of a defined routine return would be treated as qualifying income.

adopted by other major developed countries, and by the OECD BEPS project guidance on countering harmful tax practices; the latter approach has been taken in recent U.S. tax reform proposals (e.g., H.R. 1). In either case, qualifying income should include income from any and all forms of monetization—e.g., from product sales, services, leasing, IP licensing and dispositions, data centers, etc. Scoring considerations may influence which approach is taken, but the chosen approach must provide an internationally competitive rate on qualifying income to attract and retain IP development in the U.S.

Second, because the underlying purpose of an IP box applies to most forms of intangible property, we believe that qualifying IP should be broadly defined to include all innovation IP—i.e., all IP other than marketing IP. Like patents, the research, development, and commercialization of copyrights, know-how, and other innovation IP generates significant high-value jobs, economic activity, and tax revenue. Moreover, ownership and development of these forms of IP are just as mobile and responsive to other countries' incentives as they are for patents. Consequently, we believe the definition of qualifying IP should be broadly defined to include all types of innovation IP, including patents, know-how, trade secrets, copyrights, and other non-marketing innovation IP. For instance, software innovations are driving a significant portion of the technology changes across all markets, and software developers rely primarily on <u>non</u>–patentable IP for their products. These types of innovation IP should qualify for an IP box regime.

Third, to ensure the IP box encourages R&D in the United States, an appropriate and administrable nexus standard should be adopted that would tie eligibility to the level of such activities conducted in the United States. To be administrable, the nexus standard should not be based on any particular IP asset or product (as has been proposed in the BEPS project). The tracking and tracing of expenses to each IP asset or product does not reflect the way IP is developed or used to develop products. Innovations are interconnected and often carry over across product lines. To provide proper incentives and be administrable, a nexus standard should be based on the overall direct IP expenditures incurred in the United States (related to developing and enhancing all innovation IP assets) compared to the amount of such direct IP expenditures incurred outside the United States. The tracking and tracing requirements should be flexible enough to accommodate any reasonable way of tracking IP expenditures to IP income, and permit use of tracking based on what may be commonly used for other purposes (e.g., on a product family or service family basis, or on a Business Unit basis) or on a country basis (i.e., aggregate U.S. IP expenditures over worldwide IP expenditures of the consolidated group). The nexus standard could be based on either a threshold test (i.e., a U.S. IP expenditure threshold that, once met, would result in all qualifying income being eligible for benefits) or a percentage eligibility test (based on the ratio of U.S. to worldwide IP expenditures). In any event, the test should not include the cost of acquiring IP assets, or a business owning such assets, in determining IP expenditures, but should allow a qualifying taxpayer to step into the shoes of the target by inheriting the target's qualifying IP expenditures.

Finally, for an IP box to be fully successful, 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.[5] To encourage such transfers, domesticated IP developed under an existing qualified cost sharing arrangement with a CFC should be deemed eligible under the nexus standard. Only post-domestication expenditures should be taken into account in determining eligibility in subsequent years. Removing such barriers will encourage development, ownership, and commercialization of IP in the United States, will reduce business complexity, and will strengthen IP and tax procedural protections for U.S. taxpayers. At the same time, these rules will increase the U.S. tax revenue on IP income derived from serving foreign markets. This tax-free domestication of IP can be made available permanently or for a limited time.

U.S. Revenue Benefit

We believe adoption of an IP box and removal of current-law barriers to domestication of offshore IP is likely to increase substantially the amount of U.S. taxable income from 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 with appropriate nexus standards would counteract incentives to shift IP development and ownership overseas, while imposing an immediate U.S. tax at a low, competitive rate on IP income. Providing for tax-free 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 until it adopts tax reform that includes a low, competitive tax rate on IP income and a mechanism for tax-free 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

[5] To be tax-free, the transfer of qualifying IP from a CFC to the U.S. parent (or affiliate) would not (i) be a taxable event, (ii) provide a step-up in basis to the recipient domestic corporation, and (iii) affect the CFC's E&P. Any carryover basis would be recovered pursuant to I.R.C. Sec. 197.

also enjoy greater IP and tax procedural protections, as well as less complexity through consolidation of IP, by being able to bring IP home. Please do not hesitate to contact me at (925) 699-7188 if you have any questions or comments regarding this submission.

Sincerely yours,

Jeffrey K. Bergmann
Co-Chair, Silicon Valley Tax Directors Group

cc:
Chairman Orrin Hatch
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