House Committee on Ways and Means
December 1, 2015, Hearing on BEPS
Testimony of Gary D. Sprague
On Behalf of the Software Coalition

1. Opening

Chairman Boustany, Ranking Member Neal and members of the Committee, thank you for inviting me to appear here today on behalf of the Software Coalition, and to provide testimony on the impact of the OECD/G20 BEPS project on U.S. software companies, and in particular how the changes to the international tax rules as developed under BEPS will significantly reduce the U.S. tax base and create disincentives for U.S. multinational corporations (MNCs) to create R&D jobs in the United States.

The Software Coalition is the leading software industry group dealing with U.S. domestic and international tax policy matters.[1] Software Coalition members account for more than $400 billion per year in total gross revenue and $50 billion per year in total R&D spend. Member companies employ over 1.1 million individuals around the globe. The Coalition member companies are listed in our written submission.[2]

2. Impact of BEPS on the U.S. Software Industry

Our comments today will focus on those BEPS developments of greatest significance to the U.S. software industry, including corporate income tax nexus in countries into which our companies sell goods and services (which I will refer to as "market states"), transfer pricing, R&D employment incentives, and the unraveling of consensus among countries on international tax norms. While my comments are being

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[1] The Software Coalition was formed in 1990 and now comprises 23 U.S. companies which operate in the software and e-commerce sectors. The Software Coalition has been actively involved in the work of the OECD/G20 BEPS project, including participating as a business representative in a number of BEPS consultations, and submitting written comments on a number of the BEPS discussion drafts.
[2] The Software Coalition's current membership comprises the following companies: Adobe Systems Inc.; Amazon.com, Inc.; Attachmate Corporation; Autodesk, Inc.; BMC Software, Inc.; CA, Inc.; Cisco Systems, Inc.; Citrix Systems, Inc.; Electronic Arts, Inc.; EMC Corporation; Facebook, Inc.; IBM Corporation; Mentor Graphics Corporation; Microsoft Corporation; Nuance Communications, Inc.; Oracle Corporation; PTC Inc.; Pivotal Software, Inc.; Salesforce.com Inc.; SAP America, Inc.; Symantec Corporation; Synopsys, Inc.; and VMWare, Inc.

delivered on behalf of the U.S. software industry, U.S. MNCs in other high-tech industries are similarly impacted.

The net effect of most, if not all, of the BEPS measures will be to increase the amount of foreign tax that U.S.-based software companies with foreign operations must pay, and to increase considerably their foreign compliance burdens. The income that foreign countries are seeking to tax is ultimately part of the U.S. tax base, and increased foreign taxes will in most cases be borne by the U.S. fisc through the foreign tax credit, thereby reducing U.S. tax receipts.

Several elements of the BEPS rules create incentives for U.S. multinationals to increase high-value employment outside of the United States. These new rules place an increased emphasis on people functions over tangible and intangible assets in determining where income should be taxed. This disadvantages U.S. high-tech MNCs since those MNCs earn their income in large part from their intangible assets. The BEPS project also sets minimum standards for R&D employment incentive regimes, which create powerful incentives for MNCs to locate R&D employment outside the U.S. in order to take advantage of those regimes.

a. BEPS Action 7 – Permanent Establishments

We will comment first on the proposed changes to the technical tax treaty rules that establish when a company is subject to income tax in the country into which it sells its goods or services, which is referred to in our tax treaties as the "permanent establishment" standard. A key focus of the BEPS work was a push by market countries to obtain greater taxing rights over non-resident companies which make sales into their countries. To that end, BEPS Action 7 significantly reduces the threshold for income tax nexus, so that a member company of an MNC group may have to file tax returns and pay taxes in a market country, even if that separate entity does not have operations in the country. This significantly affects the U.S. software industry because U.S. software companies by and large have created cost-efficient centralized sales structures that do not rely on large sales and marketing operations in every market country, which was more common in the past. It can reasonably be expected that this lowering of the

income tax nexus threshold will result in greater income taxation in market countries on sales into such countries, above and beyond the taxable income already being reported for the sales functions actually performed in those countries. Foreign politicians have argued that U.S.-based multinationals must pay their "fair share" of tax based on "where value is created". They argue that value is created in the market country by the act of consumption. We believe that value is created by innovation and production, not by consumption. Higher foreign income taxes imposed on U.S.-based multinationals ultimately will be subsidized by the U.S. fisc through foreign tax credits, resulting in lower U.S. income tax receipts, even if the U.S. itself never adopts the lower nexus threshold in our own tax treaties.

b. BEPS Actions 8-10 – Transfer Pricing

Second we will comment on changes under Actions 8 - 10 to the OECD Transfer Pricing Guidelines. These Guidelines set out the rules which allocate the income of a group between its constituent legal entities, and thus determine how much of a group's income is subject to tax in a particular country where that group operates. In many countries, these Guidelines become operative automatically upon their approval by the OECD. The principal effect of these transfer pricing changes will be to decrease the returns allocated to intangible property and other assets, in favor of returns to people functions. This potentially will disadvantage U.S. software companies, as it will increase tax collections by countries where U.S. software companies do not hold those assets. It also will create strong incentives for U.S. MNCs to locate high-value, innovative jobs relating to the creation and enhancement of their intellectual property, like software development, in countries with lower tax rates.

c. BEPS Action 5 – R&D Employment Incentives

Third we will comment on the BEPS work under Action 5 regarding incentive tax regimes for R&D employment. The BEPS work recognizes that countries may set their national tax rate at any level. Most OECD member states have significantly reduced their rates of corporate income tax in recent years.[3]

[3] Consequently, the U.S. now has the highest corporate tax rate of any major country. The U.S. 35% federal income tax rate when combined with the average U.S. state tax rate results in a combined corporate income tax rate for the U.S. over 39%. The average statutory tax rate (including sub-national taxes) of the OECD countries other than the United States is 24.8%. Accordingly, the U.S. tax rate is over 57% higher than the OECD average tax rate.

While the BEPS project is expected to increase the amount of foreign taxes paid by U.S. software companies, and also increase their administrative burdens, it is also clear that foreign corporate tax rates will remain considerably lower than the U.S. rate. The high U.S. corporate tax rate is a significant disincentive for U.S. investment in intangible property and jobs.

At the same time, the BEPS work also resulted in guidelines for targeted R&D employment regimes. Several European and other countries that compete with the United States for technology investments have enacted so-called "IP Box" regimes that provide an even lower incentive tax rate for income derived from intellectual property developed in their country. The BEPS project links the amount of the allowable incentive to the percentage of locally performed R&D, and countries are adapting their regimes to that standard. This creates a strong incentive for U.S. multinationals to locate R&D functions in those countries.

d. Lack of Consensus and Resulting Unilateral Action

Finally we would like to comment on a particularly unfortunate side effect of the current political and administrative environment relating to international tax. In my view, the BEPS process has encouraged, or at least tacitly permitted, some countries to circumvent the normal consensus building process at the OECD and to act unilaterally. This stands in stark contrast to much good work that the OECD has done over the years to develop an international tax consensus. The BEPS Action 1 final report on the digital economy, which as a practical matter principally addressed U.S. multinational business models since our companies are the global leaders in the digital economy, refrained from recommending specific changes to increase tax on companies operating in the digital economy, but specified that some countries could unilaterally introduce those changes in their domestic law, provided they respect treaty obligations. These developments have emboldened, and will continue to embolden, other tax administrations to bend established international tax principles, with a resulting increase in double taxation, international tax disputes, and greater uncertainty for U.S. multinationals.

3. Implications for U.S. International Tax Policy

The U.S. corporate tax system needs to be more competitive with current international standards. The U.S. now has the highest corporate tax rate of any major country. We believe the Congress should enact comprehensive international tax reform, which would include reducing the corporate tax rate to an internationally competitive rate – for example, to 25% or even 20%, as has been suggested recently. As part of such comprehensive reform, we favor a territorial system, such as a 95% or 100% dividend exemption system, consistent with other major OECD countries, and a transition rule that allows a tax-favored repatriation of earnings. Furthermore, the U.S. should enact a "best-in-class" IP Box regime that provides an effective incentive to protect and create R&D jobs in the U.S. Please see our letter of September 14th to Chairman Boustany and Ranking Member Neal which details our recommendations on features of the IP Box.[4]

Any changes to the U.S. anti-deferral rules under subpart F should not discriminate against intangible property. The existing foreign base company services income and foreign personal holding company income rules enacted more than 50 years ago are severely outdated. There is a long-standing bias in the Internal Revenue Code that royalties are passive income, while in the software industry they represent active business income. Any revisions to subpart F therefore should not impose different tax burdens on software companies due to the fact that their income arises from the exploitation of intellectual property.

A lower U.S. statutory corporate tax rate, coupled with an IP box regime, would provide many benefits to the United States. First, it would preserve the competitiveness of U.S. multinationals by imposing a competitive rate of tax on IP income. Second, it would encourage the repatriation of IP by those U.S.

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[4]See our letter from the Software Coalition to Representatives Boustany and Neal dated September 14, 2015. That letter describes the following features of a "best-in-call IP Box: (1) provide a competitive rate for qualifying intangible income; (2) cover all forms of innovation IP, including both software and the underlying software copyrights; (3) cover the exploitation of IP through the provision of both products and services, including software as a service; (4) provide a nexus standard that is appropriate and administrable; for example, use a transfer pricing based approach to identify the income derived from qualified intangible property; and (5) provide an effective mechanism to allow the tax-free domestication of IP that is currently held offshore.

MNCs which now hold their IP offshore, and discourage newly emerging companies from migrating their IP outside the United States in the first place. This would broaden the U.S. tax base since income from intangible property which is now earned offshore would become currently subject to U.S. tax. Third, it would reduce the incentives for inversions through foreign acquisitions by enabling competitive bidding by U.S. acquirers, and diminishing the incentive for tax-motivated foreign take-overs. Finally, it would encourage U.S. job growth in innovative industries by decreasing the incentives which now exist for U.S. MNCs to locate R&D jobs offshore in countries with IP box regimes.

4. Further Work to be Done

The work on BEPS is not finished. Therefore, we would encourage U.S. Treasury to continue taking an active role in ongoing technical discussions to be held in 2016 and beyond. In particular, Treasury should continue to actively participate in the further revisions of the OECD Transfer Pricing Guidelines relating to the use of the profit split method to divide taxable income among companies in a MNC group, to ensure that the rules are not changed in a way that allows unprincipled applications of those rules to tax larger shares of the income of U.S. MNCs. Now that the definition of taxable nexus in tax treaties has been revised, 2016 will see the further work necessary to define how much taxable income actually will be subject to these new nexus rules. Treasury will need to play an active role in those discussions to ensure that the result of that work is consistent with existing international norms on what income should be taxed by a market country.

The new nexus rules will present two choices for many U.S. MNCs: they either must report a taxable presence in market countries based on sales into those countries; or restructure their foreign sales operations to avoid creating a new tax liability of the supplier entity. In both cases, U.S. MNCs will suffer considerable unnecessary expense and increased compliance burdens. Accordingly, Treasury should encourage countries to adopt alternative means of compliance and reasonable transition periods. Finally, Treasury should participate fully in the discussions about the multilateral instrument, and should continue to advocate for mandatory binding arbitration.

5. Closing

I very much appreciate the opportunity to provide testimony on behalf of the Software Coalition regarding the effects of BEPS on the U.S. tax base and U.S. jobs, and the long-term positive benefits to U.S. competitiveness of adopting international tax reform and an effective IP Box regime. I would be pleased to answer any questions.