DISCUSSION WITH U.S. TREASURY ON IP-BOX ISSUES

October 31, 2014

Agenda

- SVTDG IP Box recommendations
- SVTDG recommendations—nexus approach (OECD BEPS Action 5)

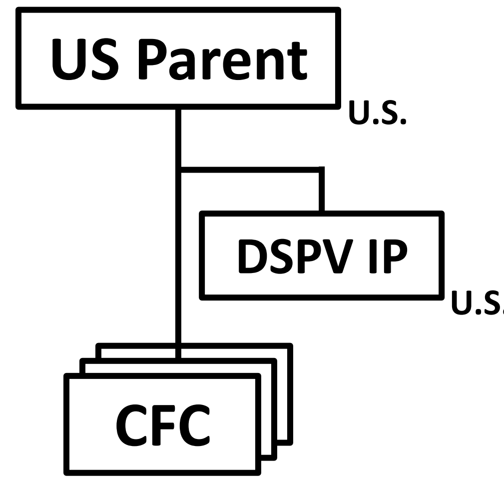
SVTDG IP BOX RECOMMENDATIONS

- ***SVTDG recommendation***—U.S. should implement an IP or patent box ("***IP box***").
- Implementation of a U.S. IP box will:
  - ◊ broaden the U.S. tax base
  - ◊ protect U.S. tax base (enables U.S. D-E-M-P-E substance to be leveraged to blunt U.S. tax base erosion desire of foreign market/source countries)
  - ◊ tax intangible income in an internationally acceptable way:
    - ➢ income subject to tax at an acceptable level of taxation (by U.S.)
    - ➢ income subject to tax where significant D-E-M-P-E substance occurs
  - ◊ preserve U.S. competitiveness (via U.S. competitive rate of tax)
  - ◊ create incentive for U.S.—not foreign—D-E-M-P-E substance
  - ◊ provides high level of certainty on allocation of intangible TP profits
  - ◊ allows IP box entity to avail itself of U.S. Competent Authority

TIME IS OF THE ESSENCE! THE U.S. NEEDS TO ACT NOW

SVTDG IP BOX RECOMMENDATIONS [CONT'D]

- IP Box would be a domestic corporation ("***DSPV IP***") whose sole, non-incidental purpose is to own, develop, & license IP.
- A broad approach, easy to administer & use, has these features:
  - ◊ DSPV IP subject to reduced tax rate on its income from royalties, or sales of IP relating to property or services ultimately consumed outside the U.S. (normal tax rate applies to all its other income);
  - ◊ To qualify, DSPV IP must have sufficient employees controlling and/or performing D-E-M-P-E functions with respect to intangibles (U.S. innovation & jobs);



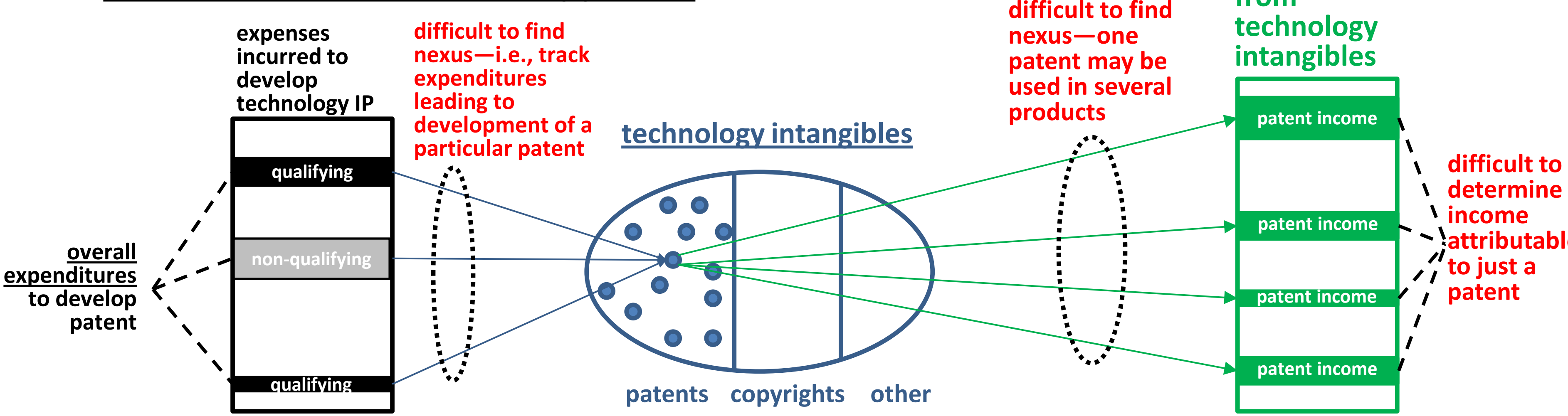
  - ◊ A broadly-based, purposive tax-free mechanism is needed for CFCs to distribute intangibles into, and restructure in connection with, DSPV IP (related U.S. corporations can contribute tax free under § 351); and
  - ◊ DSPV IP wouldn't be included in US Parent's consolidated return, but would file a separate return, and could claim limited FTC on withholding taxes imposed on "foreign" royalty income it receives in separate basket for income subject to preferential rate.

SVTDG RECOMMENDATION—NEXUS APPROACHES AS DESCRIBED ARE UNWORKABLE AND SHOULD BE REPLACED

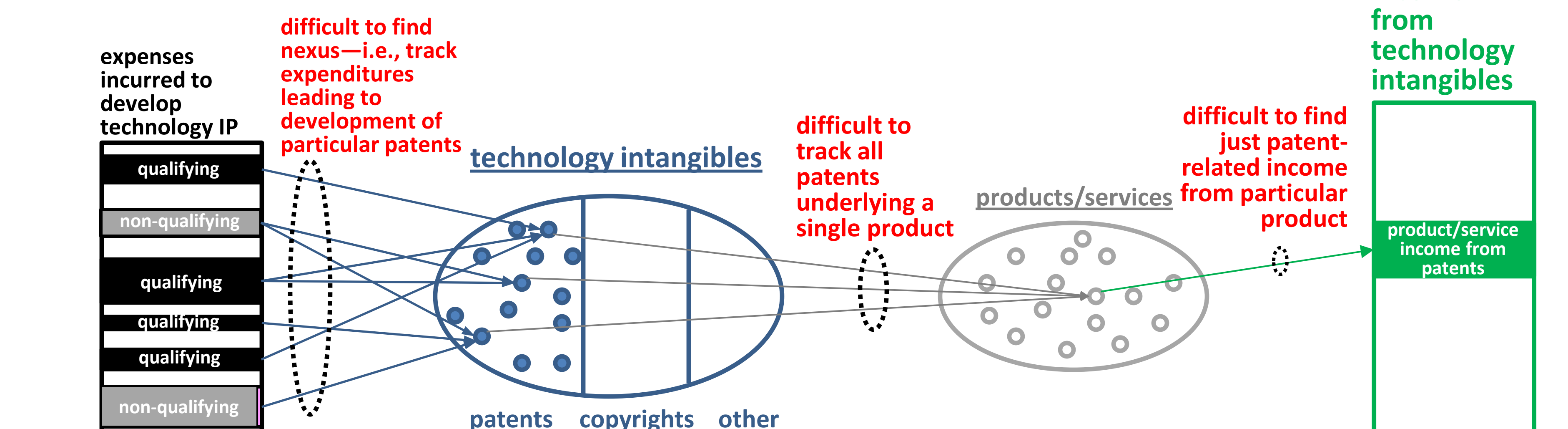
- ***1st SVTDG recommendation***—the nexus approach in the 2014 BEPS Action 5 deliverable is unworkable and should be replaced with a practicable nexus approach (outlined below).
  - the 2014 BEPS Action 5 IP-based & product-based nexus approaches are, as described, each unworkable because—
    - **IP covered—**no satisfactory reasons for limiting IP covered to just patents & functionally equivalent IP ⇒ all technology intangibles should be covered;
    - **acquisitions—**no satisfactory reasons for excluding acquisition costs from qualifying expenditures ⇒ acquirer should step into shoes of former owner;
    - **impracticability:**
      - **IP-based nexus approach—**impracticable to determine expenditures for, or income from, any particular IP asset (of which a U.S. MNE may have many thousands);
      - **product-based nexus approach—**impracticable to determine IP assets, and associated development costs, covering particular products, or IP income from such products (of which a U.S. MNE may have thousands);
      - **both approaches—**require year-by-year monitoring of changing fraction—either for each IP asset or for each product—rather than simple yes/no determination using threshold based on, e.g., D-E-M-P-E function substance.

SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

standard (IP-based) nexus approach



product-based nexus approach



SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

- ***1st SVTDG recommendation***— [cont'd]
  - ◊ the 2014 BEPS Action 5 nexus approach should be <u>replaced</u> with an approach allowing taxpayers a <u>choice</u>:
    - ➢ **election** to use a <u>practicable, safe harbor nexus approach</u> (described on next slide); or
    - ➢ **default** (if no election made) to using <u>modified</u> product-based nexus approach (described on slide 11) on a product-by-product and service-by-service basis.

SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

1st SVTDG recommendation— [cont'd]

◊ **practicable safe harbor nexus approach**—

$$\text{income receiving tax benefits} = \frac{\textit{qualifying expenditures} \text{ incurred to develop } \underline{\text{all technology IP assets}}}{\textit{overall expenditures} \text{ incurred to develop } \underline{\text{all technology IP assets}}} \times \begin{array}{l}\underline{\text{aggregate}} \text{ income from products \& services relating to} \\ \text{all technology IP assets}\end{array}$$

- **IP assets covered—**IP assets should include all technology intangibles (all intangibles other than marketing intangibles);
- **acquisitions—**acquirer should step into shoes of former owner—qualifying & overall expenditures should, for any acquired technology IP, include corresponding pre-acquisition expenditures (or, if unavailable, default ratios); "acquisitions" shouldn't include intangibles contributed to IP Box by related parties (such intangibles should already be included in IP assets covered);
- **benefiting income—**only from technology IP relating to property or services
  - **"safe harbor" elections for routine & marketing return components of overall income—**taxpayer can either prove (subtracted) routine & marketing returns based on facts & circumstances, or use TBD safe harbors (e.g., 3% × end-customer revenue as a safe harbor routine return).

SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

1st SVTDG recommendation— [cont'd]

◊ **practicable safe harbor nexus approach**— [cont'd]

$$\text{income receiving tax benefits} = \frac{\textit{qualifying expenditures} \text{ incurred to develop } \underline{\text{all technology IP assets}}}{\textit{overall expenditures} \text{ incurred to develop } \underline{\text{all technology IP assets}}} \times \underline{\text{aggregate}} \text{ income from products \& services relating to all technology IP assets}$$

➢ **benefiting income—** [cont'd]

❑ **"full inclusion" rule should apply—**if overall fraction > [20%] and "important functions" from TPG ¶ 6.56 are performed in jurisdiction ⇒ all income from technology IP assets get tax benefits.

1998 FHTP Report used "no substantial activities" as one factor to identify tax havens; BEPS Action 5 strictly requires (only) "substantial activity" for any preferential regime

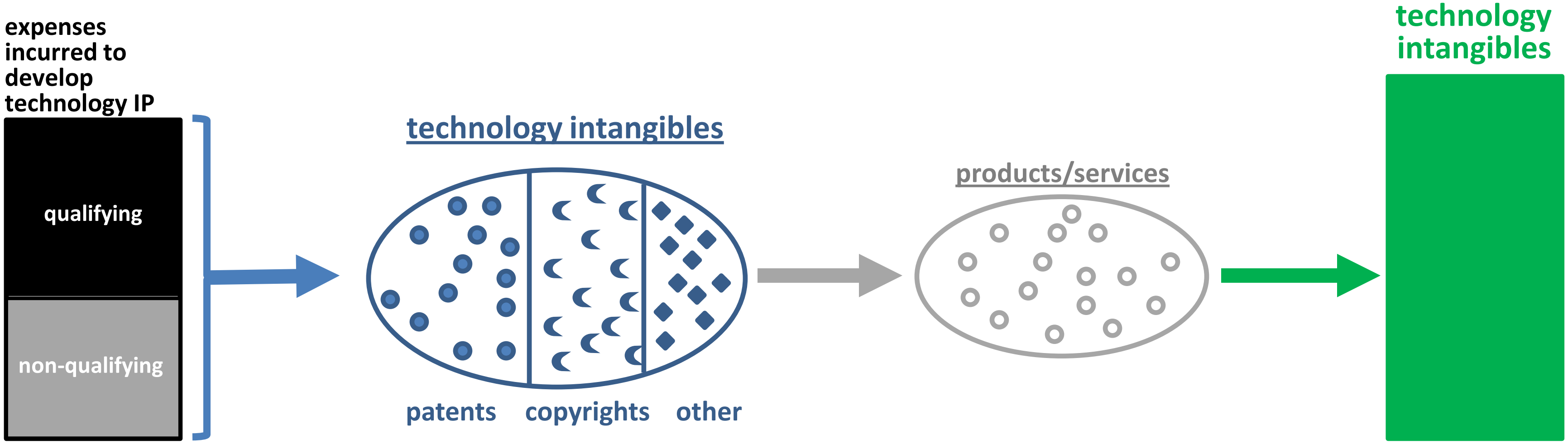
⇒ strictly, a preferential regime should pass FHTP scrutiny if it has a "substantial activity" requirement for tax benefits. Helpful guidance comes from Treasury regulations interpreting "substantial" activity in other contexts—

⌘ Under § 199, QPP treated as manufactured in whole or in significant part by taxpayer within the U.S. if U.S. manufacturing activities—including software design & development—are "substantial in nature," equivalently if 20% cost safe harbor in § 1.199-3(g)(3) is met.

⌘ Under § 954(d)(1), sale of property treated as sale of manufactured product if assembly of component parts into final product is "substantial in nature," equivalently if 20% cost safe harbor in § 1.954-3(a)(4)(iii) is met.

SVTDG RECOMMENDATIONS—*NEXUS APPROACHES* [CONT'D]

practicable safe-harbor nexus approach



income receiving tax benefits = **(*qualifying expenditures* incurred to develop all technology IP assets) / (*overall expenditures* incurred to develop all technology IP assets)** × **aggregate income from products & services relating to all technology IP assets**

SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

◊ **modified product-based nexus approach—**

$$\text{income receiving tax benefits} = \frac{\textit{qualifying expenditures}\text{ incurred to develop }\underline{\text{all IP assets}}\text{ contributing to }\underline{\text{the product/service}}}{\textit{overall expenditures}\text{ incurred to develop }\underline{\text{all IP assets}}\text{ contributing to }\underline{\text{the product/service}}} \times \text{overall income from the }\underline{\text{product /service}}\text{ linked to all underlying IP assets}$$

- **IP assets covered—**should include all technology intangibles—i.e., all intangibles relating to a product/service other than marketing intangibles;
- **acquisitions—**acquirer should step into shoes of former owner—qualifying & overall expenditures should, for any acquired IP, include corresponding pre-acquisition expenditures (or, if unavailable, default ratios); "acquisitions" shouldn't include intangibles contributed to IP Box by related parties (such intangibles should already be included in IP assets covered);
- **benefiting income—**only from technology IP relating to property or services;
- **"safe harbor" elections for routine & marketing return components of overall income—**(outlined on slide 8) should be allowed for each product/service; and
- **product-relevant fraction—"full inclusion rule"** (outlined slide 9) should apply on a product-by-product or service-by-service basis.

SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

- ***backup alternative SVTDG recommendation***—<u>if</u> the 1st SVTDG recommendation can't be adopted, as a <u>second-best</u> alternative the 2014 BEPS Action 5 proffered IP-based and product-based nexus approaches should be <u>replaced</u> by the <u>modified product-based nexus approach</u>.

2014 BEPS Action 5 offerings

~~IP-based nexus approach~~

~~product-based nexus approach~~

1st SVTDG recommendation →

- **<u>elect</u> to use <u>practicable safe harbor</u> nexus approach; or**
- **<u>default</u> to using <u>modified</u> product-based nexus approach.**

2014 BEPS Action 5 offerings

~~IP-based nexus approach~~

~~product-based nexus approach~~

backup alternative SVTDG recommendation →

use <u>modified</u> product-based nexus approach

SVTDG RECOMMENDATIONS—NEXUS APPROACHES [CONT'D]

comparison of BEPS Action 5 and SVTDG-recommended nexus approaches

feature	OECD BEPS Action 5 nexus approaches	SVTDG recommended approaches: practicable safe harbor nexus approach	SVTDG recommended approaches: modified product-based nexus approach
IP assets	only include patents and functionally equivalent IP	**all** technology IP assets (defined on slide 8)	**all** technology IP assets (defined on slide 8)
treatment of acquisitions in qualifying & overall expenditures	qualifying expenditures (but not overall expenditures) exclude acquisition costs	◊ qualifying expenditures include pre-acquisition qualifying expenditures; ◊ overall expenditures include pre-acquisition overall expenditures; ◊ absent pre-acquisition expenditure data, appropriate default ratios should apply	◊ qualifying expenditures include pre-acquisition qualifying expenditures; ◊ overall expenditures include pre-acquisition overall expenditures; ◊ absent pre-acquisition expenditure data, appropriate default ratios should apply
income that can qualify for tax benefits	**IP-based approach**—owner's worldwide income from particular IP asset **product-based approach**—owner's worldwide income from particular product directly linked to IP assets	owner's aggregate worldwide income from products & services linked to underlying technology IP assets	owner's worldwide income from product/service linked to underlying technology IP assets
relative ease for taxpayer to implement & for tax administration to audit	**IP-based approach—**extremely difficult (practically impossible for companies with non-de minimis IP portfolios) **product-based approach—**difficult	◊ complex but manageable ◊ "full inclusion" rule eases burdens for taxpayers & tax administrations; also provides added incentive for substance	◊ difficult ◊ "full inclusion" rule eases burdens for taxpayers & tax administrations; also provides added incentive for substance