



2121 41st Avenue
Suite 301
Capitola, CA 95010
PHONE 831.465.8204
FACIMILE 831.465.9384

www.svtdg.org
info@svtdg.org

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VIA E-MAIL

Achim Pross
Head, International Co-operation and Tax Administration Division
OECD/CTPA
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Responses to five tracking & tracing questions posed to BIAC in connection with modified nexus approach under BEPS Action 5

Dear Mr. Pross,

The Silicon Valley Tax Directors Group (“*SVTDG*”) hereby—in advance of the meeting held in Paris on Tuesday, March 10 on tracking & tracing aspects of Action 5 of the BEPS *Action Plan*—submits feedback on the five questions posed to BIAC. As a stakeholder in outcome of Action 5, the SVTDG welcomes the opportunity to provide these responses.

Sincerely,

A handwritten signature in blue ink, reading "Jeffrey K. Bergmann".

Jeffrey K. Bergmann
Co-Chair, Silicon Valley Tax Director's Group

1. What tracking and tracing of IP expenditures and IP income do businesses already undertake (for, example, to benefit from R&D credits or meet regulatory requirements)? Does this tracking and tracing link IP expenditures to IP income?

Background on tracking and tracing of IP expenditures and IP income among SVTDG members

As explained below, SVTDG members generally track IP expenditures at some level, although typically not to individual products or services that exploit intangible property developed by such IP expenditures. SVTDG members generally do not determine “IP income” for individual products or services. SVTDG members generally do not track or trace “IP expenditures” to “IP income” for individual products or services. Thus a fundamental requirement for being able to apply the “*agreed approach*” described in the *Explanatory Paper—Agreement on Modified Nexus Approach for IP Regimes* would not generally be met at the level of individual products, nor could it practicably be met for many taxpayers.

As a preliminary matter the notion that a one-size-fits-all tracking and tracing approach might be practicable or appropriate is questionable. Even among SVTDG member companies, there’s vast diversity in business operations, products, services, revenue, and in how IP expenditures are tracked.

With that caveat, IP expenditures of SVTDG member companies are generally tracked at the department level. There may be many departments per legal entity within a multinational group. Department numbers (identifying each department) generally identify each department as classified under a particular function (sales, marketing, manufacturing/COGS, R&D, finance/G&A, etc.). Department names can vary—e.g., a name might specify a general area of innovation, or even the name of the responsible executive or group.

Each department will typically record salary costs (salary, bonus, benefits) of individuals in the department; the external spend of the department (vendors, independent contractors, travel, training, other costs); and overhead costs of the department (real estate/facility costs, utility costs, etc.). The aggregate R&D expenditures by department are reported in consolidated U.S. generally accepted accounting principles (“GAAP”) financial statements as “R&D” or “Engineering.” Other IP expenditures are reported in consolidated GAAP financial statements in the line representing their type of expenditure.

IP expenditures for any project will typically be incurred as a result of individuals working across multiple departments, and through external spending of multiple departments. Most multinational SVTDG members conduct R&D in more than one country, so it’s common for an R&D project to include individuals and costs incurred from departments in entities in many countries.

With limited exceptions, SVTDG member companies don't use project accounting to track IP expenditures.¹ IP expenditures are not tracked by individual IP asset(s) to which they might relate.² Moreover, IP expenditures are generally not tracked by individual product.³ This is in part because companies typically have many products that use innovation (including that from R&D projects)—involving both hardware and software. IP expenditures are often only tracked at a technology group level.

IP expenditures are relevant under several provisions of the U.S. Internal Revenue Code (26 U.S.C.). The U.S. R&D credit depends on a taxpayer's "qualified research expenses" for a taxable year. Qualified research expenses include "in-house research expenses," which include both amounts paid for supplies used in the conduct of "qualified research" and wages paid to an employee for "qualified services," meaning services consisting of either engaging in qualified research or engaging in the direct supervision or direct support of research activities constituting qualified research.⁴ "Qualified research" is research meeting tests with respect to its (A) underlying expenditures; (B) purposes—which include an intention to be useful in the development of a new or improved product (thereby include unsuccessful research); and (C) activities.⁵ Such tests are applied separately with respect to each "business component" of a taxpayer, which includes any product (including computer software) held for sale, lease, or license, or used by the taxpayer in a trade or business. Although the tests must be applied separately with respect to each product, in the sense that a taxpayer must identify products to which qualified research applies, taxpayers are not required to track or trace R&D expenditures to product income (IP income or total income). For example, a software engineering department that develops software used across many products doesn't need to track or trace the qualified R&D expenses of the department to any particular product (or service); rather it is sufficient to show that the R&D expense was "qualified research" intended to be useful in the development of a new or improved business component of the taxpayer.

The U.S. domestic production activities deduction⁶ allows a taxpayer a nine percent deduction of the taxpayer's "qualified production activities income" ("*QPAI*") for a taxable year. QPAI is—for qualifying products—akin to taxable income: it's defined as the excess of a taxpayer's "domestic production gross receipts" ("*DPGR*") over the sum of the cost of goods sold allocable to such gross receipts and other expenses, losses, or deductions properly allocable to such receipts. For SVTDG members, DPGR means their gross receipts derived from the

¹ Some SVTDG member companies use project accounting for de minimis parts of their business, but even in these instances IP expenditures aren't tracked to IP income.

² Some SVTDG member companies have over ten thousand patents.

³ Some SVTDG member companies have thousands of products.

⁴ 26 U.S.C. § 41(b).

⁵ 26 U.S.C. § 41(d)(1).

⁶ 26 U.S.C. § 199.

disposition of tangible personal property (e.g., hardware) or computer software that was “manufactured, produced, grown, or extracted [“MPGE”] by the taxpayer in whole or in significant part within the United States.”⁷ DPGR is determined on a product-by-product basis, but QPAI is the aggregate DPGR less cost of goods sold allocable to aggregate DPGR and expenses allocable to aggregate DPGR. Neither the allocable cost of goods sold nor allocable expenses are determined on a product-by-product basis—i.e., there’s no requirement to track or trace such amounts to specific qualifying products to determine QPAI.⁸ To determine DPGR on a product-by-product basis, the requirement that a product be MPGE by a taxpayer in whole or in significant part within the U.S. is met if the MPGE of the product by the taxpayer within the U.S. “is substantial in nature taking into account all of the facts and circumstances.”⁹ A special rule for computer software allows a taxpayer to take into account its software R&D (“design and development”) activities when determining whether its MPGE of computer software is substantial in nature.¹⁰ A cost “safe harbor” deems a taxpayer to have MPGE computer software in whole or in significant part within the U.S. if the direct labor and overhead of the taxpayer—including software design and development costs—to MPGE the computer software account for 20 percent or more of the taxpayer’s cost of goods sold for the computer software. Taxpayers trying to avail themselves of the 20 percent cost safe harbor for computer software—but not those relying on the facts-and-circumstances “substantial in nature” test—would have to track U.S. software design and development costs to software product(s). Taxpayers who attempt this typically face increased burdens (including costs).

SVTDG members generally don’t track or trace “IP expenditures” to individual products or services, nor do they determine “IP income” from individual products or services

As discussed above, current accounting procedures used by substantially all SVTDG members generally don’t track or trace “IP expenditures” to individual products or services, nor do they determine “IP income” from individual products or services. Most, if not all, products or services sold by SVTDG member companies comprise significant intangible property assets beyond simply “IP assets.” It’s not uncommon to sell a product or service covered by hundreds of patents or other legally protected intangibles (copyrights, trade secrets, etc.). Accordingly, SVTDG members generally don’t track or trace “IP expenditures” to “IP income” for individual products (or services). Requiring taxpayers to track or trace IP expenditures to IP income on a product-by-product (or service-by-service) basis is impracticable and would impose significant compliance burdens.

⁷ 26 U.S.C. § 199(c)(4)(A)(i)(I).

⁸ U.S. Treas. Reg. §§ 1.199-4(b) & -4(c).

⁹ U.S. Treas. Reg. § 1.199-3(g)(2).

¹⁰ *Id.*

As discussed also for the U.S. R&D credit, taxpayers aren't required to track or trace R&D expenditures to product income (IP income or total income). Also, the U.S. domestic manufacturing deduction doesn't generally require taxpayers to track or trace R&D expenditures to product income (IP income or total income). For the special case of computer software, taxpayers can qualify for the deduction under a cost safe harbor by tracking U.S. software design and development costs to computer software products (as opposed to meeting a facts-and-circumstances test). Most SVTDG members claiming the deduction for computer software don't use the cost safe harbor.

The general principle underlying the agreed approach oversteps prior FHTP work, and the directive in Action 5 of the BEPS Action Plan, which clearly supports a threshold, rather than a fractional, approach

The *Explanatory Paper* provides as a general principle that “[t]he nexus approach only allows a taxpayer to benefit from an IP regime to the extent that it can show that it itself incurred expenditures, such as R&D, which gave rise to the IP income.” We note that this general principle underlying the agreed approach without explanation oversteps prior work done by the FHTP, and the directive in Action 5 of the BEPS *Action Plan*, that simply “requir[ed] substantial activity” for any preferential regime. That is, the core FHTP demand that any preferential tax regime require substantial activity doesn't mean that “IP income cannot benefit from a patent box unless the taxpayer itself incurred the expenditures contributing to that income.” Rather, it means simply that IP income should be able to benefit from a jurisdiction's patent box if a taxpayer has substantial R&D activities in that jurisdiction. That is, the requirement of substantial activity for any jurisdiction's preferential regime simply means that all of a taxpayer's IP income should be able to benefit under the regime if that taxpayer's R&D activities in the jurisdiction exceed a threshold.¹¹ There's no explanation why the substantial activities “threshold” approach has been replaced by the “fractional” method in the agreed approach.

The agreed approach—which as discussed exceeds the BEPS Action 5 mandate—limits the sovereign right of a government to provide tax benefits to a taxpayers operating in its jurisdiction with substantial activities. It would also impose significant new administrative and documentation requirements on such taxpayers.

We recommend the agreed approach be replaced by an approach allowing any qualifying taxpayer with R&D activities, in a jurisdiction, above a certain “substantial activity” threshold to get tax benefits on all IP income earned by the qualifying taxpayer. The substantial activity threshold could be set at an agreed threshold, so a qualifying taxpayer in a jurisdiction incurring

¹¹ Such an approach assumes a taxpayer can determine its aggregate IP income. We discuss below how this could be reasonably estimated.

worldwide IP expenditures¹² at or in excess of that threshold would be entitled to tax benefits on all IP income earned by the qualifying taxpayer.

2. The general principle underlying the modified nexus approach is that IP income cannot benefit from a patent box unless the taxpayer itself incurred the expenditures contributing to that income, and this in turn requires tracking and tracing. Do businesses have suggestions as to how best to design a tracking and tracing requirement that is consistent with this principle?

A preferential tax regime meeting the threshold approach mandated by FHTP pronouncements might, of course, adopt aspects of the agreed approach in the case of qualifying taxpayer R&D activity below the threshold.¹³ That is, a preferential tax regime could grant fractional tax relief along the lines of the agreed approach to a taxpayer whose R&D activities in a jurisdiction didn't meet the "substantial activity" threshold. To this extent it's worthwhile discussing how a suitable fractional (tracking and tracing) approach should be designed. We believe such an approach should at a minimum meet eight criteria:

- [1] **Availability**—the tracking and tracing requirements shouldn't be so onerous that very few taxpayers could realistically qualify for benefits;
- [2] **Qualifying taxpayer**—all associated enterprises resident in a single jurisdiction should be treated as a (single) qualifying taxpayer.
- [3] **IP expenditures**—caution must be exercised in measuring IP expenditures, which should use existing data as far as possible. We recommend "IP expenditures" be defined so as to give a consistent measure across countries. This would enhance the integrity of the IP expenditures fraction as accurately measuring an appropriate fraction of worldwide IP expenditures incurred by the qualifying taxpayer. Measuring "IP expenditures" on the basis of headcount should be rejected. IP expenditures should include costs attributable to innovation determined under the ultimate parent's method of accounting (GAAP or IFRS). Because the definition of "IP assets" should be broadened (see criterion [5] below) to include all innovation intangibles, IP expenditures will typically include more expenses than those simply classified as R&D in financial statements.

¹² Under a substantial activities threshold approach advocated, unsuccessful IP expenditures—in the sense of either not leading to any IP assets, or not leading to IP assets used either in or to commercialize products or services—would be included in determining whether the threshold was met. The policy of incentivizing innovation, at the foundation of IP Box regimes, of course recognizes the riskiness of R&D and normatively shouldn't display any bias: successful and unsuccessful R&D should be treated equally.

¹³ Of course, a preferential tax regime meeting the threshold approach might choose simply to deny a preferential tax rate to IP income of any qualifying taxpayer whose R&D activities didn't meet or exceed the threshold.

The definition of IP expenditures should make it clear (and some examples would be helpful) that overall (IP) expenditures include just expenditures borne by the qualifying taxpayer to develop IP assets exploited in the relevant product or service family or grouping, and don't include expenditures borne by any other persons to develop such IP assets. This clarification is necessary to address situations—e.g., cost contribution arrangements (“CCAs”)—in which taxpayers split IP expenditures in exchange for proportional benefits from developed intangibles. For example, suppose associated enterprises A & B in separate jurisdictions—each adopting IP boxes using an agreed approach—are in a CCA and share 50:50 the IP expenditures to develop IP assets under the CCA in exchange for a 50:50 split of anticipated benefits from exploiting such IP assets in products (e.g., suppose A & B each get to exploit developed IP assets in different geographic territories). If the anticipated benefits materialize, A & B will each derive 50 percent of the worldwide income from products exploiting the IP assets. The IP expenditure fraction for each of A & B should be 50/50 (and not 50/100), so that all of the IP income of each of A & B qualifies for tax benefits.

IP expenditures should also include costs incurred on “blue sky” or unsuccessful research—i.e., R&D that may not be directly tracked to particular products or services. R&D is inherently speculative, and we believe sound tax policy dictates being able to take blue sky and unsuccessful research into account in determining income qualifying for tax benefits. Failure to include blue sky or unsuccessful research could lead to distortions in the IP expenditures fraction, and to tracking issues because taxpayers typically don't distinguish between successful research versus unsuccessful or blue sky research.

Likewise, IP expenditures should include R&D costs incurred to develop any technology platform a qualifying taxpayer uses to sell products or services. Work done to develop such platforms can be highly technical, and should qualify as the sort of work meeting the substance requirement of a preferential tax regime. Development costs for such a platform could for purposes of Action 5 tracking and tracing requirements be treated as associated with development of products or services sold using the platform.

It's unclear why related party outsourcing IP expenses are excluded from qualifying IP expenditures. We believe such expenses should be treated as qualifying IP expenditures if a taxpayer can demonstrate that the R&D could have been outsourced.

[4] **Tracking**—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).¹⁴

¹⁴ This constraint is especially important because many companies simply don't trace IP expenditures to IP income on a product-by-product or service-by-service basis, nor could they practicably do so.

Taxpayers should be allowed to demonstrate compliance using statistical sampling techniques. This is consistent with approaches permitted under tax provisions in certain jurisdictions,¹⁵ and can significantly ease the burden on both taxpayers and tax administrations without material loss of integrity.

[5] “**qualifying IP assets**”—see discussion below under our response to question 4.

[6] “**IP income**”—should include all income from the relevant product/service grouping (e.g., product or service family, or Business Unit) or other monetization method grouping (e.g., licensing or leasing), less amounts attributable to routine returns and marketing returns, determined either—

[a] using a taxpayer’s facts and circumstances; or

[b] using safe harbors—e.g., safe harbor routine returns and marketing returns could be 10% markup on relevant costs (other than COGS and IP expenditures), or 3% × end customer revenue.

“IP income” should include income from services, leasing, and any other income arising from the exploitation of the IP assets—i.e., not simply income from product families/groupings that exploit IP assets.

[7] **Acquisitions**—a taxpayer acquiring IP assets (e.g., either directly or through acquiring a company) should be able to step into the shoes of the former owner of such assets, in the sense that it can avail itself of the former-owner’s qualifying and overall IP expenditures, determined either using—

[a] historic, pre-acquisition IP expenditures (if known) of the acquired business; or

[b] default ratios (if unknown).

Because post-acquisition IP income from an acquisition will be included in the acquirer’s overall IP income, the pre-acquisition IP expenditures of an acquired business should be included in the IP expenditures fraction. There’s no good policy reason why historic IP expenditures shouldn’t be taken into account by an acquirer of IP assets, particularly given that (i) in the fractional approach cumulative IP expenditures are used, so such expenditures pre- and post-acquisition are relevant; and (ii) IP expenditures otherwise entitling a taxpayer ultimately (when it generates income) to a fractional benefit under a preferential tax regime would otherwise lie fallow, thereby discouraging the sort of behavior such preferential tax regimes intend to encourage.

There’s no satisfactory reason for including IP asset acquisition costs in the denominator of the IP expenditures fraction (i.e., in the overall IP expenditures). Costs of acquiring IP assets outright are, of course, equal to the value of the IP assets, not costs to create such assets (the

¹⁵ See, e.g., U.S. Treasury Rev. Proc. 2011-42, 2011-37 I.R.B. 318.

values of IP assets are typically high multiples of the aggregate cost to develop such assets). Including such costs in the denominator thus mixes apples and oranges and skews the fraction downward. Even more distortive, costs of acquiring a company that owns IP assets include not only a component attributable to the value of the IP assets, but also components attributable to all expected future income (including that expected from future developed IP assets), routine returns, and a control premium. Permitting a 30 percent uplift in qualifying expenditures (as under the agreed approach) doesn't adequately mitigate these significant distortions.¹⁶

We believe IP acquisition costs shouldn't be included in the denominator of the IP expenditure fraction. If the decision is made to include IP expenditure costs in the denominator of such fraction, such costs should be restricted to those incurred in related-party transactions in which a primary purpose of the acquisition was to obtain tax benefits from an IP regime.

[8] **Time periods**—Because the agreed approach involves cumulative (with time) IP expenditure ratios, involving IP expenditures relating possibly to thousands of IP assets, each with different development cycles and useful lives, in the interests of practicability we recommend that qualifying taxpayers should be able to choose any one of four alternative ways to calculate the IP expenditure ratio for each product or service family/grouping—

- [a] current year IP expenditures—i.e., no historic expenditures would be used in the IP expenditures fraction;
- [b] current year IP expenditure fractions as proxies for cumulative fractions, with data from each successive year contributing to the cumulative fraction;
- [c] a default cumulative period (e.g., four years—the current taxable year and three prior years—this serves as a proxy for an average or blended development cycle/useful life); or
- [d] any other period, if a taxpayer can demonstrate a different period is more appropriate based on the facts-and-circumstances.

3. Do businesses have suggestions for how a tracking and tracing requirement could be designed to ensure that taxpayers that have already incurred qualifying expenditures in the past can qualify for benefits under the modified nexus approach now or in the future?

A tracking and tracing approach meeting the eight criteria outlined in the response to question 2 would largely ensure that taxpayers that have already incurred qualifying expenditures (i.e., expenditures leading to the development of qualifying IP assets, as more broadly referenced in criterion [5] and defined in the response to question 4, below) in the past can qualify for

¹⁶ The agreed approach provides an up-to 30 percent uplift in qualifying expenditures to the extent that expenditures in the context of outsourcing and acquisitions have taken place.

benefits under a modified nexus approach. Criterion [7], relating to acquisitions—permitting a qualifying taxpayer acquiring IP assets to step into the shoes of the seller—ensures that pre-acquisition IP expenditures (qualifying and overall) are taken into account in the IP expenditures fraction. Criterion [8] gives sufficient flexibility to allow qualifying taxpayers that have already incurred qualifying expenditures to qualify for benefits under the modified nexus approach.

4. The 2014 FHTP Progress Report states that patents and other functionally equivalent IP assets that are legally protected and subject to approval and registration processes, where relevant, qualify for benefits under the modified nexus approach, whilst trademarks and other marketing-related IP assets do not qualify for benefits. This distinction is partly due to the fact that it is easier to establish a nexus between the expenditures and income associated with patents. Based on this or other considerations, can businesses suggest other functionally equivalent IP assets that should also qualify under the modified nexus approach?

“**Qualifying IP assets**”—i.e., intangible property for the development of which a taxpayer incurs “IP expenditures”—should include all innovation intangibles—i.e., all intangibles other than marketing intangibles,¹⁷ and such assets should include those not necessarily exploited in commercialized products or services.

There’s no satisfactory reason for limiting IP assets to patents and functionally equivalent IP. Because IP expenditures typically lead to the development of a broad suite of innovation intangible property assets, all such innovation assets should qualify. For this purpose, innovation assets should be defined as intangible properties exploited in products or services, other than marketing intangibles. In any event it’s unclear what’s meant by “IP assets that are functionally equivalent to patents.” Broadening the definition to all intangibles other than marketing intangibles would sweep in know-how, copyrights, trade secrets, etc. Significantly, IP assets should include intangible property used in deriving IP income, not simply intangible property exploited in products or services themselves—e.g., manufacturing process intangibles, technology platform intangibles, and data center intangibles would be included.

5. Do businesses have any other suggestions in the context of tracking and tracing?

SVTDG suggestions for improving a tracking and tracing approach have been incorporated into our responses above.

¹⁷ See, OECD BEPS Action 8: 2014 Deliverable *Guidance on Transfer Pricing Aspects of Intangibles*, p. 32 (defining marketing intangible).