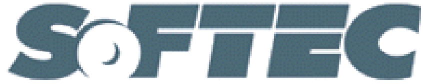

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THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

COMMENTS OF THE SOFTWARE FINANCE AND TAX EXECUTIVES COUNCIL

Submitter Category:

Organizations and Association

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SUMMARY OF COMMENTS

The Software Finance and Tax Executives Council (SoFTEC), a trade association representing the interests of the software industry in the areas of tax, finance and accounting, appreciates the opportunity to present these comments to the President's Panel on Federal Tax Reform. Our comments are summarized as follows:

1. Equalize the treatment of foreign software rent and royalty revenue with foreign sales revenue. Generally, U.S. companies are able to defer U.S. taxes on income earned from the active conduct of a trade or business by their foreign subsidiaries. Rents and royalties generally are considered passive forms of income and not eligible for deferral. Because software license revenues earned by foreign distribution subsidiaries of U.S. software companies may take the form of rents and royalties, the resulting income is generally ineligible for deferral. Any reform of the Internal Revenue Code should include equalizing the deferral treatment of foreign software rent and royalty revenue with foreign sales revenue.

2. **If the panel considers a territorial option, it should be crafted in a manner that does not discriminate against any sector of the economy.** Any proposal that exempts foreign earnings from taxation should not focus on the form (i.e., dividend, royalty, interest, etc.) by which such earnings are received by the US taxpayer; rather, the focus should be on whether such earnings are active or passive. *Active* foreign dividends, royalties, interest or other forms of income should be exempt from U.S. taxation, and passive income from those categories of income should be subject to tax. Such an approach would ensure that there would be no discrimination against any sector of the economy. Any proposal that would exempt only dividends would discriminate against the software industry because a significant portion of its revenue is in the form of royalties.

3. **Make the U.S. more competitive with its trading partners by substantially reducing the corporate tax rate, which is approximately 10 percentage points higher than the average corporate tax rate in OECD member countries.** If the United States is to continue to compete successfully against other countries in attracting, retaining, and growing these innovative businesses, it must have a tax and regulatory system that is competitive with other economies. There is a strong inverse correlation between corporate rates and the flow of capital to the taxing country. Historically, relatively high U.S. corporate tax rates discouraged the development and commercialization of highly profitable new technologies in the U.S. In order for the United States to stay competitive in this environment, it must consider a significant corporate income tax rate reduction to bring the high U.S. corporate tax rate in line with the OECD average and restore the level of capital flows essential to the development of new technologies and industries.

4. Do not raise taxes on business to finance individual tax reform. The 1986 tax reforms shifted approximately $120 billion in tax burden from individuals to business. A repeat of that tax shift could have a serious impact on business investment in the U.S. As noted above, the U.S. corporate rate is already one of the highest in the developed world.

COMMENTS

Exempt software rents and royalties from personal holding company income to stop discrimination against the software industry in subpart F.

Generally, U.S. companies are able to defer taxes on income earned from the active conduct of a trade or business by their foreign subsidiaries. Rents and royalties generally are considered passive forms of income and not eligible for deferral. Because revenues earned by U.S. software companies' foreign subsidiaries from leases and licenses of their software products generally take the form of rents and royalties, the resulting income is generally ineligible for deferral. Any reform of the Internal Revenue Code should include equalizing the deferral treatment of foreign software rent and royalty revenue with foreign sales revenue.

Subpart F, like many other areas of the current tax Code, discriminates against rent and royalty income by generally treating them as passive income ineligible for deferral. Subpart F attempts to limit its discriminatory treatment of rent and royalty income by providing a limited exception for certain active rents and royalties. This provision excludes from foreign personal holding company (passive) income rents and royalties that are both derived in the active conduct of a trade or business and received from an unrelated person. Although this active rent and royalty exception clearly shows Congress's intent to distinguish income that is earned through active business activity from passive income derived solely from the ownership of intangible property, Treasury regulations make this determination with respect to each foreign subsidiary ("controlled foreign corporation" or "CFC") on a stand-alone basis. This separate application of Subpart F to each CFC was appropriate in the era when Subpart F was enacted because foreign subsidiaries were likely to operate on a stand-alone basis. However, computer software companies, like most knowledge-based companies, operate in an integrated global manner,

unlike the manufacturing companies that were the norm when Subpart F was enacted. This business model is far different from the country-specific model that was the norm when Subpart F was enacted.

In order for the computer software industry to obtain parity with other industries that deliver their products only by means of sales of goods, subpart F must be modernized by eliminating the inequitable treatment of software rent and royalty income. This can be accomplished by eliminating the current prohibition on deferral for related party software rents and royalties in current section 954(c)(2)(A) and by rationalizing the active trade or business test so that it includes activities performed by members of the CFC's affiliated group of corporations and activities performed by third parties on behalf of the CFC.

If the panel considers a territorial option, it should be crafted in a manner that does not discriminate against any sector of the economy.

There has been substantial debate on the pros and cons of moving to a territorial tax system. While there is no definitive territorial proposal, the proposal included in the Joint Committee on Taxation's ("JCT") tax compliance options report [1] (which would increase taxes on business by $57 billion over ten years) appears to be one of the most widely discussed of the proposals. This proposal envisions a dividend exemption system under which income earned abroad by foreign subsidiaries of U.S. parent corporations would fall into one of two categories: (1) passive and other highly mobile income, which would be taxed to the U.S. parent on a current basis under subpart F; or (2) all other income (i.e., active, less-mobile income not subject to subpart F) which would be exempt from U.S. tax and thus could be repatriated free of any tax impediment. The deferral and repatriation tax at the heart of the present-law system would be

[1] Options To Improve Tax Compliance And Reform Tax Expenditures, Joint Committee on Taxation, Jan. 27, 2005 (JCS-02-05, pp. 186-197)

eliminated and the foreign tax credit system would serve a more limited function than it does under present law.

The problem this proposal creates for the software industry is that it treats all rents and royalties, both domestic and foreign, as passive or highly mobile income not eligible for the dividend exemption and subject to current tax. However, rents and royalties attributable to inter-company software leases and licenses that have their origin in the foreign distribution to end users of computer software are neither passive nor "highly mobile" income.

Makers of manufactured products transfer their goods to their foreign distribution affiliates through inter-company sales. Under the Joint Committee's proposal, the affiliate's profits would be remitted to the U.S. parent in the form of dividends, which would be eligible under the dividend exemption proposal because the subsidiary's income is derived from the "active" business of selling manufactured products. Software companies on the other hand transfer their products to their foreign distribution affiliates through the inter-company transfer of a master copy of their product along with a license to make copies for ultimate distribution to customers. The software distribution affiliate earns a profit by selling, licensing or leasing software copies to customers. Dividends attributable to the profit from the rental and license of software to customers, if characterized as passive rent or royalty income, would not be eligible for the territorial exemption for dividends from profits earned from selling manufactured products, creating an additional U.S. tax burden for U.S. software companies. Exempting dividends from sales income earned by manufacturers and taxing dividends attributable to royalties earned by software companies discriminates against U.S. based software vendors.

In our view, any proposal that exempted foreign earnings should not focus on the form (i.e., dividend, royalty, interest, etc.) by which such earnings are received by the U.S. taxpayer;

rather, the focus should be on whether such earnings are active or passive. Active foreign dividends, royalties, interest or other forms of income should be exempt from U.S. taxation and passive income from those categories of income should be currently taxed. Such an approach would ensure that there would be no discrimination against certain sectors of the economy.

Make the U.S. more competitive with its trading partners by substantially reducing the corporate tax rate, which is approximately 10 percentage points higher than the average corporate tax rate in OECD member countries

America's comparative advantage in the global economy is based on the creation and application of technologies that improve productivity and create innovative new products and services. The establishment of centers of innovation for research, production and management provides significant job creation and wage advances for the U.S. workforce, with spillover benefits to other businesses as knowledge learned from these operations enters the mainstream economy.

Successful competition against other countries by the United States in attracting, retaining and growing these innovative businesses hinges on it having tax and regulatory systems that are competitive with other economies. Relatively high U.S. corporate tax rates discourage the development and commercialization of highly profitable new technologies in the United States, making development opportunities in other competitive jurisdictions that offer lower tax rates more attractive.

The United States, once a trend setter by significantly lowering its top corporate rate from 46 percent to 34 percent in 1986 (subsequently increased to 35 percent in 1993), now lags well behind most developed countries. Between 1997 and 2003, the developed economies of the Organization for Economic Cooperation and Development (OECD) lowered their corporate tax rates by an average of almost seven percentage points, while the US rate remained unchanged.

The U.S. federal corporate tax rate of 35 percent is *tied for highest* within the OECD. This combined federal, state, and local corporate tax rate of 39 percent is the *second highest* after Japan and is *nearly 10 percentage points higher* than the average of the other OECD countries.

Other developed countries now recognize the inverse relationship between corporate tax rates and capital flows and maintain competitive tax environments that attract and retain highly mobile international investment. Germany, with a combined corporate rate just below the U.S. rate, has announced *plans to lower its corporate tax rate by six percentage points*. The new deduction for U.S. manufacturing income, equivalent to a 3-percentage point reduction in the tax rate by 2010, is not sufficient and is a highly inefficient method of bridging this gap in competitive tax rates.

In order for the United States to stay competitive in this environment, it must consider a significant corporate income tax rate reduction that brings the high U.S. corporate tax rate in line with the OECD average. Otherwise, the U.S. risks losing the future development of advanced technologies to other countries.

Energize the economy by reducing (not increasing) taxes on businesses, including the software industry.

There is significant concern in the business community that individual tax reform will be offset by tax increases on the business sector. In 1986, an estimated $120 billion of tax was shifted from individuals to the business community with disastrous results for certain sectors of the economy.

SoFTEC believes that tax reform options that fosters the creation and retention of high paying jobs and spurs economic growth should propose reducing rather than increasing taxes on the business community. As noted previously, the U.S. corporate tax rate already is one of the highest among developed economies.

Conclusion:

We thank the Panel for the opportunity to provide these comments and hope that it will find them useful in its deliberations.