Business Roundtable℠

New Administration Tax Proposal Would Repeal Deferral for "Excess" Profits Earned on Intangible Assets by Worldwide American Companies

A major new tax hike on worldwide American companies – proposed by the Administration in its FY 2013 Budget – would repeal "deferral" for certain income derived from "intangible assets" used in overseas operations. Deferral was designed to provide a level playing field for U.S. companies competing with foreign-headquartered multinational companies in international markets.

Background

Under current law, transactions between a U.S. parent company and its foreign subsidiaries are required to use the same prices that the parent company and its foreign subsidiaries would use with unrelated companies – also known as the "arm's-length" standard. Intangible assets are routinely transferred through sales or license agreements between a U.S. parent and its foreign subsidiaries in exchange for an arm's-length royalty or cost sharing payments.

- The United States has long championed the use of the arm's-length standard and it has been and it continues today as the foundation of U.S. and OECD transfer pricing guidelines. Arms-length transfer pricing is a mainstay of corporate income tax policy because it best reflects the underlying economics of business operations. It is also the recognized basis used to resolve double taxation issues in numerous U.S. tax treaties.
- Treasury regulations have addressed issues with respect to transfers involving intangible assets – such as inventions, scientific discoveries, patents, designs, trademarks, brand names, and copyrights.

Administration Proposal

The Administration's budget proposes to tax worldwide American companies on "excessive returns" of their foreign subsidiaries without deferral when an intangible asset has been transferred to a foreign subsidiary if there is evidence of "excessive income shifting" and the foreign subsidiary has a "low" effective tax rate.

While little detail is provided in the Treasury Department's explanation of the proposal, including the definition of "excessive returns," it appears the Administration's proposal would apply to transfers of intangibles that comply with the arm's-length standard. The proposal would repeal deferral for this income, resulting in current taxation of the same income both in the jurisdiction of the foreign subsidiary and in the United States.

Proposal Creates an Unlevel Playing Field for Worldwide American Companies

The loss of deferral under the Administration proposal would create a competitive disadvantage for worldwide American companies expanding into foreign markets, exposing a portion of their foreign earnings to immediate U.S. taxation. Most OECD trading partners (26 of the 34 OECD countries) exempt

from home country tax the foreign income of their multinational companies, and the other four OECD countries defer from home country tax the foreign income of their companies.

- The proposal to tax currently the "excess" earnings from intangibles would discourage U.S.-headquartered companies from undertaking R&D in the United States and from making other U.S. investments and acquisitions giving rise to intangible assets, since income earned from the transfers of these assets would be subject to immediate U.S. taxation. The new tax would create an incentive for companies to move R&D activities offshore.
    - Loss of R&D to foreign locations would slow U.S. economic growth and sacrifice high-paying U.S. jobs.
- The proposal would favor foreign-headquartered companies over U.S.-headquartered companies. Foreign-headquartered companies could exploit intangibles developed in the United States (and in other countries) in foreign locations without being subject to U.S. tax on their foreign profits.
    - This advantage to foreign companies might make U.S. companies acquisition targets as their intangible assets could be more profitably exploited in foreign locations by foreign-headquartered companies rather than remaining under the control of U.S.-headquartered companies and their foreign subsidiaries.
- The Administration's proposal, in circumventing the internationally accepted arm's-length standard, may encourage other countries to adopt rules that deviate from arm's-length pricing and impose greater foreign tax on U.S. foreign subsidiaries than would arise under the arm's-length standard – further eroding U.S. competitiveness.

Summary

The proposal would discourage creation of intangible assets in the United States and result in a loss of high-paying U.S. jobs. It would repeal deferral for worldwide American companies on a portion of their foreign earnings and place worldwide American companies at a competitive disadvantage relative to their foreign counterparts, resulting in a further loss of U.S. jobs and less growth for the U.S. economy.

As the rest of the world makes it easier for their companies to operate worldwide, this proposal would be a movement in the opposite direction, endangering U.S. jobs and making it more difficult for American companies to compete in overseas markets.

A massive increase in taxes will disadvantage American companies and make U.S. workers less secure.

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