

Medical Device Competitiveness Coalition **Perspectives on Corporate Tax Reform**

Background

The Medical Device Competitiveness Coalition (“MDCC”) is composed of seven U.S.-based medical device manufacturers¹ that have been working together for over two years to advocate for corporate tax reform that modernizes and simplifies the international tax rules and enhances the competitiveness of U.S. companies operating in global markets.

U.S. medical device manufacturers lead the world in the design and development of innovative devices that save and improve the lives of patients around the world. The global nature of our business and the highly specialized nature of our products make it vitally important that we locate business operations close to our customers, both within and outside the United States. International sales currently represent more than half of global sales for many device manufacturers, with future growth in foreign markets anticipated to exceed domestic growth. Even with this international growth, U.S. medical device companies continue to source much of their global manufacturing and research in the United States. As a result, international growth fuels more U.S. manufacturing and research jobs.

Key Principle for Tax Reform: Competitiveness

As our name suggests, MDCC believes competitiveness should be the guiding principle of tax reform. This principle encompasses the competitiveness of U.S.-based businesses in global markets, competitiveness of the United States as a home country for global businesses, and competitiveness of the United States as a location for innovation and investment. The device industry illustrates all three of these aspects of competitiveness.

While the United States is currently the world leader in medical device innovation and manufacturing, the U.S.-based medical device industry faces both immediate and longer-term challenges from foreign competitors. Most of our foreign competitors are based in countries with corporate tax systems that provide those companies with a competitive advantage – not only lower corporate tax rates, but also more favorable rules for the tax treatment of international earnings that don’t lock-out those earnings from domestic investment. Moreover, many foreign countries offer significant incentives to attract foreign direct investment in research and manufacturing. The tax imbalance faced by our industry has been exacerbated by the medical device tax.

Perspectives on Specific Proposals

International tax reform generally: MDCC strongly supports efforts to reform U.S. international tax rules to be more closely aligned with those under which our foreign competitors operate. Such a system would permit companies to deploy funds for business-driven purposes without overly burdensome tax penalties, making the United States a more competitive home country for U.S.-based medical device companies,

¹ BD (Becton, Dickinson and Co.), Boston Scientific Corp., Cook Medical, Inc., Edwards Lifesciences Corp., Medtronic, Inc., St. Jude Medical, Inc., and Zimmer, Inc.

leading to increased investment in U.S.-based operations. The Ways and Means Discussion Draft (the “Discussion Draft”) takes a significant step toward this objective by generally providing for a 95% participation exemption with respect to foreign subsidiary earnings.

Base erosion and domestic manufacturing: MDCC understands the desire for measures to prevent erosion of the corporate tax base that some fear may result from adopting a participation exemption system. As a general principle, MDCC’s view is that where a company has priced intangibles on an arm’s length basis, and where the company has substantial activity, including manufacturing, in the jurisdiction in which such intangibles are used, that the resulting foreign income or loss should not be subject to current U.S. tax under any anti-base erosion measures. Where income is earned from intangibles in a country in which substantial transformation and physical production does not occur, such income should be targeted by anti-base erosion measures. None of the anti-base erosion “options” in the Discussion Draft reflects this principle. Rather, they target low-taxed intangible income (Options A and C) or cross-border income (Option B), without regard to the business substance of the entity earning the income.

Moreover, the Discussion Draft’s options that target intangible income are overbroad because they would capture income from intangible property that would have had no pre-reform nexus to the U.S. tax base. For example, if a U.S.-based company acquires a competitor’s non-U.S. business, intangible income associated with that business would be subject to U.S. tax under the Discussion Draft, even though the intangible property used in the acquired business was developed outside the United States and acquired from an unrelated foreign party. Such a result would place U.S.-based companies in a non-competitive position compared to their foreign counterparts.

If policymakers choose to enact base erosion measures that target low-taxed income without regard to business substance or origin of intangible property, such measures should be drafted in a way that balances concerns about base erosion with other key objectives of tax reform, including competitiveness and simplicity. Of the proposals in the Discussion Draft, MDCC’s view is that the “carrot and stick” approach of Option C,² if modified in the following respects, could achieve an appropriate balance.

- *Simplify the determination of intangible income:* Because Option C both creates a worldwide system for “intangible income” and provides for a reduced tax rate for “foreign intangible income,” clear definitions of these terms will be necessary to minimize controversy between taxpayers and the IRS. MDCC suggests a simple solution: treat a specific percentage of a foreign subsidiary’s active business earnings from sales or other dispositions of property subject to low foreign tax as embedded intangible income.³ If the percentage were set at an appropriate level,

² Option C generally would treat as subpart F income a foreign subsidiary’s “intangible income” subject to a foreign effective tax rate of 13.5% or less, and provide for an effective U.S. tax rate of 15% on “foreign intangible income” (i.e., intangible income arising from serving foreign markets). The 15% tax rate would also apply to foreign intangible income of U.S. corporations (effective rates assume a 25% statutory corporate tax rate).

³ Examples of other places where Congress or Treasury has provided for a simple rule in place of an otherwise complex determination include sections 936(h)(5)(C)(ii) (50/50 profit split associated with the use of intangibles) and Treas. Reg. sec. 1.863-3(b)(1) (50/50 source method for export sales).

the harm to the competitiveness of U.S.-based global businesses caused by a worldwide tax base could be mitigated. This would eliminate controversy over identifying the amount of income from intangibles and treat taxpayers similarly.

- *Expand the “carrot” to include all sales of products manufactured in the United States:* With respect to domestic manufacturing, Option C’s incentive tax rate applies only to export sales, even though the United States is one of the largest markets for innovative products. MDCC suggests expanding this aspect of Option C to include intangible income attributable to all products manufactured in the United States. This would maintain parity for U.S. companies with global manufacturing operations in serving foreign markets and create a real incentive for domestic manufacturing to serve U.S. markets.⁴

Transition: The Discussion Draft would effectively impose on U.S. companies a 5.25% tax (net of applicable foreign tax credits) on all pre-effective date foreign subsidiary earnings, with an election to pay the tax liability over an eight year period. MDCC acknowledges the importance of providing a transition rule that brings all taxpayers into the new participation exemption system at the outset. This interest, however, should be balanced with a concern that it results in phantom income to U.S. companies whose foreign subsidiaries have substantially less cash than earnings because those earnings have been re-invested in their foreign business operations. MDCC suggests minimizing this phantom income effect as much as possible.⁵ This would avoid penalizing those U.S. companies who have made business-driven decisions in the past to re-invest their foreign earnings to finance international growth.

Research credit: The members of MDCC conduct a substantial amount of research in the United States and support a permanent and enhanced research tax credit as part of tax reform. The credit encourages U.S. companies to perform new and continual research in the United States. The current credit, however, is not as competitive as it should be. According to the OECD, the tax incentive per dollar spent provided by the U.S. research credit ranks 24th out of 38 countries, at approximately 7%.⁶ For MDCC members, the credit as a percentage of research costs incurred in the United States is even lower than that.

Lower corporate tax rate: The Discussion Draft proposes to reduce the corporate tax rate from 35% to 25%. Although MDCC’s focus generally is on international reform proposals, a lower corporate tax rate is also a key component of tax reform. A lower rate will help address concerns about base erosion and make the United States a more attractive investment location for both U.S. and foreign-based businesses.

⁴ The same simplified determination of intangible income – treating a specified percentage of income from domestic manufacturing as intangible income – could be applied. Expanding the “carrot” in this fashion could also be viewed as a simplified and enhanced manufacturing deduction under section 199.

⁵ One way to address the phantom income problem is to limit the amount of pre-effective earnings subject to the mandatory transition tax to the amount of cash (including cash equivalents) held by the CFC. Any earnings in excess of that amount would be subject to the transition tax on an elective basis. In the absence of an election, post-effective dividends out of non-subpart F earnings would be deemed to first come out of pre-effective earnings (subject to full U.S. tax, less applicable foreign tax credits), and then out of post-effective earnings (which would be eligible for the participation exemption).

⁶ OECD Science, Technology and Industry Scoreboard 2009.