Introduction

- The Walt Disney Company greatly appreciates the opportunity to comment on how to improve the tax code and tax incentives for U.S. manufacturers and producers and thanks the members of the Manufacturing Working Group and Chairman Camp for engaging stakeholders in this process.
- Disney produces intangible property ("IP") including films, television programming and video games. This IP is owned in the U.S. and is licensed directly or indirectly through our U.S. and foreign subsidiaries to unrelated parties both here in the U.S. and abroad for distribution in a number of commercial markets, including motion picture theaters, home entertainment, television, consumer products, video and internet games, and sound recordings. In exchange, Disney receives royalty income, all of which constitutes income taxed in the U.S. on a current basis.
    - The motion picture and television industry contributes significantly to the U.S. economy and, with our production activities spread across the country, generates economic benefits and highly-paid jobs in communities nationwide.
    - Our industry – principally based in the U.S. at the current time – consistently generates a positive balance-of-trade to the U.S. economy through foreign exploitation of our U.S. created and owned IP.
- While Disney owns theme parks and resorts in the U.S., we also own an interest in theme parks and resorts in foreign countries – France, Hong Kong and China. The Disney-branded theme parks and resorts in Japan are owned by an unrelated party. In all instances, we license our IP to those operations in exchange for royalty income. Again, this royalty income is taxed in the U.S. on a current basis.
- We are encouraged by and agree with the growing bi-partisan consensus that the U.S. tax system needs to be reformed. However, we believe that one fundamental question must be addressed - whether the U.S. tax system should provide incentives designed to retain ownership of IP and operations related to the creation and exploitation of that property in the U.S. We believe the U.S. should actively encourage companies to locate their IP creation, ownership and commercialization activities in the U.S.
- In our view, the two most important changes to the U.S. corporate income tax system that must be considered in connection with tax reform are: (1) the enactment of a meaningful reduction in the corporate tax rate; and (2) the adoption of incentives to reverse the erosion in the stock of important and valuable U.S.-owned IP and related jobs.

1. Manufacturing Tax Incentives: A Tax Code to Increase U.S. Manufacturing

a) From the perspective of your industry/company, which provisions in the current Tax Code do you consider the most important to manufacturers?

- The following tax provisions aimed at production are important for Disney and our industry:

- Section 199 (the "manufacturing deduction") is currently the most beneficial provision to our Company and, we believe, our industry. To qualify for this provision, a significant portion of the production of our intangibles must occur in the U.S. Since Disney produces most of its IP in the U.S., we are able to access this provision. Section 199 provides incentives to produce our IP here in the U.S. and without it – or some alternative that encourages Disney to continue to produce our IP in the U.S. – the potential benefits associated with moving production activities and IP ownership offshore would be significantly more compelling.
- Section 181 permits Disney to currently deduct up to $15 million of production costs per property. To qualify for this accelerated deduction, a significant portion of the production activities must take place in the U.S. The goal of this provision is to encourage production of films and television programming here in the U.S. and, in general, is viewed as our industry's version of bonus depreciation (a provision from which our industry was excluded). Because of the $15 million cap, Section 181 generates relatively small benefits for motion picture films – which typically cost more than $150 million to produce – and, therefore, provides minimal incentives for their production in the U.S. However, production costs for television programming are materially less, and this provision does provide an incentive for U.S. production activities for that IP. On a comparative basis, Section 199 is significantly more important to Disney than Section 181.
- Disney receives little, if any, benefit from other incentives in the Tax Code designed for manufacturers and producers of property, including IP.
  - The film industry is not eligible for bonus depreciation.
  - The overwhelming majority of the costs to produce our IP do not qualify for research and development ("R&D") tax benefits, e.g., Section 174 deductions and Section 41 credits.
  - The film industry is not eligible for various beneficial sourcing rules, e.g., Treas. Reg. §1.861-17 related to R&D costs.

b) Of these tax provisions, in the context of comprehensive tax reform, which of these would you be willing to give up in return for a lower tax rate?

- We believe it is critically important for the U.S. to reduce its corporate income tax rate in order to enhance the attractiveness of the United States as a place to invest and grow jobs. For a meaningful reduction in the corporate tax rate – near the OECD average of 25% - we would be willing to forego the benefits of both Section 199 and Section 181 and would support the consideration of other base broadeners.

2. The U.S. Corporate Rate, Manufacturing Tax Incentives, and the Global Landscape

a) **Are the tax incentives available to U.S. manufacturers similar to the tax incentives available to your international competitors? If not, please provide examples.**
   - More and more countries have enacted regimes which provide incentives to create IP in their jurisdiction – many of these incentives are quite attractive and are described by Entertainment Partners at http://www.entertainmentpartners.com/incentives/.
   - Many countries have adopted additional measures (e.g., patent or innovation box regimes) to encourage companies to locate IP businesses – development, creation, ownership, management and/or commercialization – in those countries. These regimes generally target IP that is important to the local economy. As the U.S. film industry is one of the few industries that consistently generates a positive balance-of-trade, film IP should be included if an innovation box regime is enacted by the United States.
   - Finally, all developed countries have lower statutory corporate income tax rates than the U.S. and, in most cases, the rate differentials are quite significant.
   - The high U.S. tax rate and the lack of meaningful tax incentives for keeping activities related to the creation and commercialization of IP in the U.S. will likely contribute to the migration of more and more of such activities offshore and continued erosion of the U.S. tax base.

b) **In general, what impediments are there in the U.S. Tax Code that makes it difficult for American manufacturers to compete in a global marketplace?**
   - Rather than focusing on the competitiveness of U.S.-based MNCs, we believe that a more important objective is promoting the overall competitiveness of the U.S. economy.
     - Taxes are a cost of doing business in any location and the high U.S. corporate tax rate diverts domestic *and* foreign capital away from the United States and limits investments that could favorably impact American workers.
     - In addition, current U.S. tax rules provide large tax benefits to foreign operations of U.S. companies that are not available for business operations inside the United States.
       - The ease of shifting profits out of the United States results in large disparities in effective tax rates among U.S. corporations and large revenue losses to the U.S. treasury.
   - Although most foreign countries have territorial tax systems which, to some extent, exclude income earned offshore from home country taxation, many of these countries have begun to focus on "base erosion" and "anti-abuse" provisions and are adopting provisions to bring some of the income from offshore operations into the home country tax system.
   - If the U.S. adopts a territorial tax system, we believe it is imperative that it is designed to eliminate incentives to shift investment and income offshore, includes

strong measures to prevent erosion of the U.S. tax base, and is designed to promote the creation and ownership of IP in the United States.

- We support Chairman Camp's anti-base erosion Option C which would operate to encourage Disney to create and own our IP in the United States, and we believe other IP-creating companies will be similarly encouraged.

c) Are companies at a disadvantage due to the fact that the U.S. currently has the highest statutory corporate tax rate of all OECD countries?

- Yes, but the magnitude of the effect depends on the structure and footprint of the U.S. company.
    - o Some U.S. companies have a presence only in the U.S. and generate most or all of their income from U.S. sources. The high U.S. tax rate causes harm to them in economic terms, but since their operations are predominantly in the U.S., the lower tax rates in foreign countries are generally irrelevant.
    - o Multi-national companies ("MNCs") such as Disney have a significant presence in the U.S., creating and owning our IP here, and licensing exploitation rights to that IP both here and abroad in exchange for royalties. The higher U.S. tax rate is applied on a current basis to all of our U.S.-source profits and the vast majority of our foreign-source earnings, which are received as royalty income. The full U.S. tax on these earnings at the high rate reduces the cash available for our operations, and actually provides incentives to move IP ownership outside of the U.S.
    - o On the other hand, some U.S. MNCs own a large amount of their property (including IP) and operations outside of the U.S. For these companies, some of the detrimental effects of the high U.S. tax rate are avoided since they are typically able to keep their foreign profits offshore and pay lower taxes. These companies also achieve significant effective tax rate and financial statement benefits under accounting rules, which is viewed positively by the financial markets and has the effect of increasing their stock price. The main disadvantage to these MNCs is that the high U.S. tax is imposed, net of a credit for foreign taxes paid, on those funds when they are repatriated (the so-called "lock out" effect).
- A meaningful reduction in the U.S. corporate tax rate would greatly mitigate many of the challenging issues that exist under the current system.
    - o The current *dis*incentive to repatriate foreign earnings (the "lock-out effect") would be reduced.
    - o Pressure on current transfer pricing rules would be reduced – a U.S. tax rate on par with our trading partners would reduce the incentive to shift income offshore, which is accomplished through aggressive transfer pricing arrangements.
    - o A lower U.S. tax rate would make the United States a less attractive place to borrow, thereby protecting the U.S. tax base.

d) **Would eliminating the tax expenditures listed in #1 and replacing such expenditures with a meaningful reduction in the statutory corporate rate help manufacturers to better compete domestically and/or internationally? What about for pass-through entities and smaller manufacturers if the individual marginal rate is reduced?**

- Assuming the U.S. tax rate was reduced to a level comparable to the average rate of OECD countries, U.S. corporations would benefit.
  - All U.S. companies would have increased after-tax cash. Such cash could be invested in plants here, increasing U.S. jobs. Increased purchases of machinery and equipment would – to the extent purchased from U.S. manufacturers – generate more jobs at those companies.
  - U.S. MNCs that sell property or license IP outside of the U.S. would see similar after-tax economic gains and an enhanced competitive position.
- Importantly, the competitiveness of the United States as a place to grow and invest would be greatly enhanced.
- Many U.S. businesses are operated outside of the corporate form and taxed at the individual rate, either directly or via pass-through entities such as partnerships. For the same reasons, a reduction in the rate that applies to their business income, accompanied by an expansion of their tax base, should enhance the competitiveness of those businesses.
  - However, the existing U.S. tax on corporate profits subjects corporations to two levels of taxation – first at the corporate level, and then at the shareholder level. This two-level tax does not exist for businesses which operate in non-corporate form. Thus, the current U.S. tax system is not neutral when it comes to deciding whether or not to operate a business in corporate form.

3. Improving the Tax Code for Manufacturers: Reforming Manufacturing Tax Incentives

a) **Should any of the manufacturing tax provisions be modified to ease the administrative burden of compliance such as R&D? If so, how should such provisions be modified?**

- As a general matter, simplification of the U.S. tax system is a worthwhile goal, in part to reduce administrative burdens on taxpayers and the government.
- Section 199 provides significant benefits to Disney and other U.S. companies, but the underlying rules are complex and application of these rules is fraught with areas of potential controversy.
- Greater conformity with GAAP rules should be considered and could be desirable as a means of simplifying the corporate income tax system. The corporate tax systems of other countries generally embody greater book/tax conformity than the U.S. system.

b) **Can you discuss how your company relies on or takes advantage of certain cost recovery provisions in the Tax Code, such as accelerated depreciation? How do those recovery methods help manufacturers manufacture cash flows? Do you think there are areas in the rules governing depreciation that should be evaluated or modified in tax reform?**

- Absent the limited benefit from cost recovery on films and television programming under Section 181 discussed above, our filmed entertainment business receives no material cash flow benefits from accelerated (including bonus) depreciation.
- Our film and television IP costs are recovered under the Section 168 "income forecast" method. Under this method, capitalized costs for a property are deducted as revenues from that property are generated. There is a time lag between when cash is used to produce IP and when revenue generating activity from that IP occurs. Since depreciation is only available in later periods as revenues are received, current U.S. cost recovery methods do not help fund the production of our films and television programming.
- Other industries that create IP receive benefits that are not available to ours. For example, research and development ("R&D") type expenses are expensed as they are incurred, while income from the IP created by that R&D is recognized in later years when the IP enters the market. Thus, these industries obtain cash flow benefits that are not available to our industry.
- Our theme parks business does realize a significant benefit from accelerated depreciation. However, we believe a modification to the cost recovery rules should be considered as a potential base broadener in connection with any tax reform proposal that includes a meaningful reduction in the corporate tax rate.

c) **How can the Tax Code better encourage manufacturers to innovate and develop new products here in the U.S.?**

- Providing economic incentives for all industries engaged in the production of IP in the U.S. is necessary in today's economy. Moreover, all companies should be provided incentives to own their IP here in the U.S. A combination of approaches seems appropriate, including a lower corporate tax rate and an innovation box type regime.

- As Congress considers fundamental tax reform it will be important to recognize that over the past several decades a greater share of the cost of funding the United States government has shifted to domestic companies and away from multinational companies that record a growing amount of income offshore. Favoring multinational income offshore eventually causes those companies to invest in innovation and IP creation outside the U.S., where the ownership of those patents and other IP, and the jobs they create, will remain. Now is the time to level the playing field and that can best be accomplished by lowering the tax rate, broadening the tax base by eliminating the preferences and incentives that benefit one class of corporate taxpayers over another, and offering incentives to expand U.S. investment in intellectual property.

d) Many of our global competitors utilize patent boxes or "innovation boxes" which essentially provide tax benefits for the commercialization of successful R&D. Do you believe implementing such a structure in the U.S. would help manufacturers compete globally?

- Yes. The effects of technological innovation and globalization have materially affected traditional business models and created completely new businesses. The U.S. economy faces intense global competition for economic advantage, particularly in innovation-based, higher wage industries. The U.S. and global economies are increasingly based on innovation and the creation of IP, both of which are inherently risky and highly mobile. Foreign countries have recognized that providing tax benefits for the creation of IP addresses only part of the business that they are attempting to attract. They realize that commercialization is the link between innovation and economic growth, and have adopted provisions giving tax benefits to companies that own and commercialize IP in their country. The U.S. should similarly provide tax benefits as an incentive for creating and commercializing IP in the United States.
    - The U.S. needs to be the leader in the creation of new IP, and all IP that is economically significant to the United States – patents, copyrights, trademarks, brands, etc. – should be embraced. Providing a significant benefit for these activities will be necessary to meet the challenge from foreign countries.
        - Requiring a portion of such investments and costs to be incurred in the U.S. in order to access these benefits would likely drive desired behavior.
        - Most foreign regimes permit IP acquired from an unrelated party to qualify, though some countries place restrictions on accessing the benefits (e.g., the acquired IP must be improved or developed further by the taxpayer).
    - The U.S. should also encourage companies to own their IP in the U.S. Since most IP generates royalty income as the IP is commercialized – either directly or as part of the purchase price of property that incorporates IP – having ownership in the U.S. will result in a federal revenue annuity equal to the taxes on the flow of royalties into the U.S. over the period of commercialization. These activities would likely occur in the U.S. and would not be shifted offshore if sufficient benefits were available (e.g., as discussed above). This goal could be accomplished by requiring U.S. ownership of the IP in order to access tax benefits.

    - Most foreign countries that have such regimes require legal or beneficial ownership to be in the home country in order to access the benefits.
  - Commercialization of the IP is the engine that drives revenues, and typically requires a significant number of high-paying jobs. The U.S. should encourage location of commercialization activities here in the U.S. rather than in a foreign country by providing tax benefits on revenues or profits generated by IP. Chairman Camp's base erosion Option C provides such an incentive.