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The Honorable John Thune
Co-Chair, Business Tax
Senate Finance Committee

The Honorable Benjamin L. Cardin
Co-Chair, Business Tax
Senate Finance Committee

The Honorable Rob Portman
Co-Chair, International Tax
Senate Finance Committee

The Honorable Charles E. Schumer
Co-Chair, International Tax
Senate Finance Committee

Dear Senators Cardin, Portman, Schumer and Thune:

The MPAA and its member companies are grateful to you and your staffs for your efforts to reform the U.S. tax system. We very much appreciate the Committee's request for comments from interested stakeholders on how best to improve the system "to make it simpler, fairer, and more efficient" and are pleased to submit the following comments focused on business and international tax reform.

We believe the current tax system needs to be reformed by lowering the corporate income tax rate close to OECD norms and bringing our international tax system more in line with our major trading partners. Also, to encourage innovation in the United States and help counteract actions being taken overseas, an "innovation box" should be created to encourage the development, ownership and exploitation of intangible property ("IP") in the United States. This type of meaningful tax reform is essential to preserve and create U.S. jobs and to generate economic growth in an increasingly competitive global marketplace.

By contrast, tax reform should not include base-broadening changes that overstate a corporation's economic income by denying or deferring deductions for ordinary and necessary business expenses. Such changes are counterproductive in that they increase effective tax rates above stated marginal rates.

Introduction

The MPAA's six members—Walt Disney Studios Motion Pictures, Paramount Pictures Corporation, Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLC, and Warner Bros. Entertainment Inc.—produce, distribute and export theatrical motion pictures, television programming, and home video entertainment. The studios typically license their IP directly, or indirectly through subsidiaries, to unrelated parties for distribution in U.S. and foreign markets. In exchange, they receive royalties that historically have been subject to tax in the United States.

The motion picture and television industry is an important productive component of the U.S. economy. The industry employed directly or indirectly nearly 2 million people in the United States in 2013 and generated $113 billion in wages. Core production, marketing, manufacturing, and distribution jobs paid an average of $84,000, which is nearly 70 percent higher than the national average. The industry is comprised of a nationwide network of tens of thousands small businesses across all 50 states, with 85 percent of these businesses employing fewer than 10 people. The industry also supports good jobs and wages in thousands of companies with which it does business, such as caterers, hotels, equipment rental facilities, lumber and hardware suppliers, transportation vendors, and many others. Finally, the industry creates one of our country's most successful products, garnering a positive balance of trade with virtually every country to which we export and generating an overall $13.4 billion trade surplus in 2013.

Current Law

Our industry benefits from only a few provisions that are listed by the Joint Tax Committee as tax expenditures under existing law.

Section 199. The most important provision for our industry is Section 199, which allows production companies to deduct nine percent of their qualified income from eligible domestic films. For film production to qualify under section 199, more than 50 percent of the compensation costs for the film must be incurred in the United States.

Congress enacted section 199 in the American Jobs Creation Act of 2004 to encourage manufacturing and production in the United States, and to replace the Foreign Sales Corporation ("FSC") and Extraterritorial Income ("ETI") provisions. FSC and ETI had been adopted to promote domestic production and exports, and to counteract tax advantages offered by other countries to their producers and exporters. The WTO ruled that the FSC/ETI provisions were export subsidies that violated certain trade agreements. Given the need to respond to the WTO ruling, Congress recognized that repealing the FSC/ETI provisions would have adverse effects on U.S. production and therefore decided to replace them with section 199 as a new incentive for domestic production. Congress also believed that enacting section 199 would foster job creation and would enhance the ability of domestic producers to compete in the global marketplace. We believe those arguments remain equally valid today and that section 199 should be retained.

Section 181. Another important provision that promotes domestic film production is section 181, which allows companies to deduct immediately the first $15 million ($20 million for films produced in certain low-income areas) of costs associated with certain film and television productions. For a film to be eligible, at least 75 percent of the total compensation of the production must be compensation paid for services performed in the United States by actors, directors, producers, and other relevant production personnel. Like most of the other extenders, section 181 expired at the end of 2014 and needs to be extended once again.

Congress enacted section 181 in light of the job-creation, economic growth, and other benefits that flow from filmmaking in the United States. A major motion picture shooting on location contributes roughly $225,000 every day to the local economy. Recognizing the economic benefit of film production to their local economies, many of our major trading partners (e.g., Australia, Canada, France and the United Kingdom) offer significant wage credits and other above-the-line incentives to attract film productions and jobs abroad, in addition to their lower statutory rates. In fact, the United Kingdom last month sweetened its film and television production incentives by increasing its refundable tax credit from 20% to 25% for all qualifying UK film expenditure.

Section 181 helps to respond to these foreign film incentives and encourages feature film and television productions to remain in the United States. Maintaining film production in the United States is critical to providing well-paying jobs and significant economic benefits to local communities nationwide. Thus, while tax reform is under consideration, we believe it is important to maintain section 181 to continue to promote film production in the U.S.

Business Tax Reform

We believe that reducing corporate rates to OECD norms by broadening the base will improve our nation's competitiveness and efficiency, and understand that some of the base-broadening measures could have adverse effects on our industry. Base-broadening changes should not be made, however, if they are uneconomic and counterproductive. In particular, we believe it would be a mistake to adopt proposals that curtail ordinary and necessary business deductions, such as the costs of advertising and interest.

For example, a couple of recent tax reform proposals have proposed that a portion of a corporation's advertising expenses be capitalized and amortized over a period of years, with the remaining amount being immediately deductible as under current law. We believe this change is unwarranted and would have significantly harmful effects on our industry. Advertising expense is an ordinary and necessary cost of doing business and should remain fully deductible in measuring taxable income, as it has been since the inception of the tax code and is for financial accounting purposes. Curtailing this type of ordinary and necessary business deductions arbitrarily will overstate corporations' economic income and raise their cost of capital, thereby undermining any intended economic benefits from reducing tax rates.

Advertising is the lifeblood of our industry in two respects. We are both major consumers and major providers of advertising. Thus, the proposed change would hit us twice, harming a principal source of revenue and significantly increasing one of our largest costs.

A critically important factor in determining a film or television program's financial success is the marketing and advertising campaign. A studio often will spend over one-third of its budget on print and advertising to release a film into the domestic theatrical market. The studio bears the bulk of these expenses before the film earns a dollar of revenue. Requiring studios to capitalize and amortize half of these ordinary and necessary business expenses over a period of years will increase the cost of producing and distributing a film or program, and ultimately affect the scope and/or number of projects the studios green-light for production in a given year. That would harm job creation, economic growth, and U.S. exports.

This problem is exacerbated by the fact that the proposed change also significantly impacts a major revenue source for our industry. Most of the income for television programming is derived from advertising revenue. Television programming is expensive to produce. Thus, the potential to derive sufficient advertising revenues is essential to a decision whether to produce a program. By effectively increasing the cost of advertising, the proposed capitalization could significantly reduce the amount our customers are willing to purchase. The resultant loss of revenue could limit the amount and type of television programming studios slate for production, which in turn again would harm job creation, growth and exports.

International Tax Reform

We believe one of the most important elements of tax reform will be to modernize our international tax system in order to put American companies on a level playing field when competing in the global market place. The current U.S. worldwide system is an outlier among major developed countries with its high statutory rates and the imposition of a residual U.S. tax on foreign earnings. This has a number of adverse economic consequences, causing our companies to be less competitive overseas, encouraging foreign ownership of IP, and locking out cash that could be used for domestic investment. We agree with Chairman Hatch that adoption of a competitive international "dividend exemption" tax system more in line with our trading partners, combined with lower statutory rates, will result in "more worldwide American companies establishing or retaining their corporate headquarters in the United States, more exports to global markets, and retention and reinvestment of money in the United States rather than abroad."[1]

In addition to adopting lower statutory rates and a dividend exemption system, the U.S. needs to take specific steps to address developments overseas that, if left unanswered, will result in significant U.S. job and revenue loss. Other countries are aggressively seeking to attract IP creation and commercialization through the introduction of broad IP regimes and other incentives. In addition, the OECD Base Erosion and Profits Shifting ("BEPS") project will likely require a stronger "nexus" between economic activity and location of IP income in order to take advantage of these incentives. Because companies like ours are facing increased pressure from stakeholders to take advantage of these incentives, many will decide to locate IP ownership and a higher proportion of IP development functions overseas to establish the requisite "nexus" to claim such benefits or to justify a higher allocation of income attributable to that IP. This will cause U.S. tax revenues to shrink as the U.S. tax base attributable to IP

[1] See Press Release, "Hatch Outlines Seven Principles for Comprehensive Tax Reform," Senate Committee on Finance, December 16, 2014. While the U.S. international tax regime remains uncompetitive, there will be an advantage favoring acquisitions of U.S. corporations or selective business units or divisions by foreign investors, which can lead to erosion of the U.S. income tax base similar to "inversions".

decreases and credits for foreign taxes paid on IP developed and owned overseas increase.

Thus, to prevent greater migration of IP ownership and quality jobs to other developed countries, and loss of the associated tax revenue, the U.S. should respond quickly by adopting an IP box that encourages the development, ownership and commercialization of IP in the United States. A delay in adopting a competitive IP system significantly increases the risk that IP development will shift overseas, causing the U.S. to lose significant jobs and revenue to other developed countries.

To ensure the purposes of adopting an IP box are fully met, qualifying IP should be defined broadly to include income attributable to patents, know-how, technology, copyrights, trademarks, and other IP.[2] The production of all of these forms of IP generates high quality jobs and significant tax revenue. Moreover, ownership and development of these forms of IP are highly susceptible to the incentives offered by other developed countries. Consequently, a narrow definition of IP (e.g., limiting eligibility to patents) would risk the U.S. losing the jobs and revenue base associated with any excluded types of IP.

One potential approach to implementing an IP box in the U.S. would be to adopt an approach similar to the one taken by former Ways and Means Committee Chairman Camp in his tax reform bill (H.R. 1) to address base erosion.[3] By establishing a competitive tax rate on IP income and a balance between the treatment of exported IP and IP owned overseas, the "carrot and stick" approach of H.R. 1 will promote the creation, ownership and commercialization of IP in the United States.

The incentive effect of the "carrot" in H.R. 1 could be enhanced in several sensible ways. For example, the carrot will be heavily dependent on how intangible property development expenses are allocated for purposes of determining foreign intangible income. Specific rules are provided in the regulations under section 861 to allocate and apportion R&D expenses (Treas. Reg. sec. 1.861-17). These rules were adopted in part to encourage domestic research and development. Applying similar allocation and apportionment rules to film industry content and other intangible property for purposes of determining net foreign intangible income would provide similar incentives and help to ensure the carrot properly encourages domestic production of intangible property.

It would also enhance the "carrot" to specify that indirect expenses are not taken into account in computing net foreign intangible income. This would exclude expenses not directly allocable to IP development, including SG&A, stewardship and interest costs. A similar approach is used in Chairman Camp's discussion draft to define foreign source taxable income for purposes of the foreign tax credit limitation. This would provide a consistent approach for both purposes.

[2] See, e.g., Code sec. 936(h)(3)(B).

[3] See H.R. 1, "The Tax Reform Act of 2014," sec. 4211.

Finally, similar to the computation of the "stick" (which is done on a CFC-by CFC basis), net losses from one transaction should not offset net intangible income from other transactions in determining the carrot under the bill.

Conclusion

We are very appreciative of the work by the Committee and your respective working groups to improve our tax system in order to promote domestic job growth and enhance the global competitiveness of U.S. businesses.

Our industry is highly sensitive to global competition. Recent technological developments have created an environment where jobs related to the production of underlying works, and the creation and commercialization of valuable intellectual property, are more highly mobile than ever before. Other countries are becoming more aggressive in using lower statutory tax rates, targeted tax incentives, broad innovation box regimes, and other subsidies to attract IP production and ownership overseas. Moreover, the OECD BEPS project has already caused a growing focus on the substance and extent of activities supporting the allocation of profits of a globally integrated enterprise. These actions by other highly developed economies are creating a real and immediate threat to U.S. jobs.

The U.S. must move quickly to respond to these challenges so U.S. companies remain highly competitive overseas, and IP development (and the resultant revenue base) remains at home. We believe that a significant reduction in the U.S. corporate tax rate and adoption of a dividend exemption system with an appropriate IP box will successfully achieve these goals.

Please contact Patrick Kilcur (202) 378-9175 if you have any questions or need anything else from us. We look forward to working with the Committee members and the staff on these important issues.

Sincerely,

Joanna McIntosh
EVP, Global Policy and External Affairs

cc:
Chairman Orrin Hatch
Ranking Member Ron Wyden
Members of the Business Tax Working Group
Members of the International Tax Working Group