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Innovation boxes, international tax reform, and infrastructure spending

The pillars of this fall's tax legislative debate

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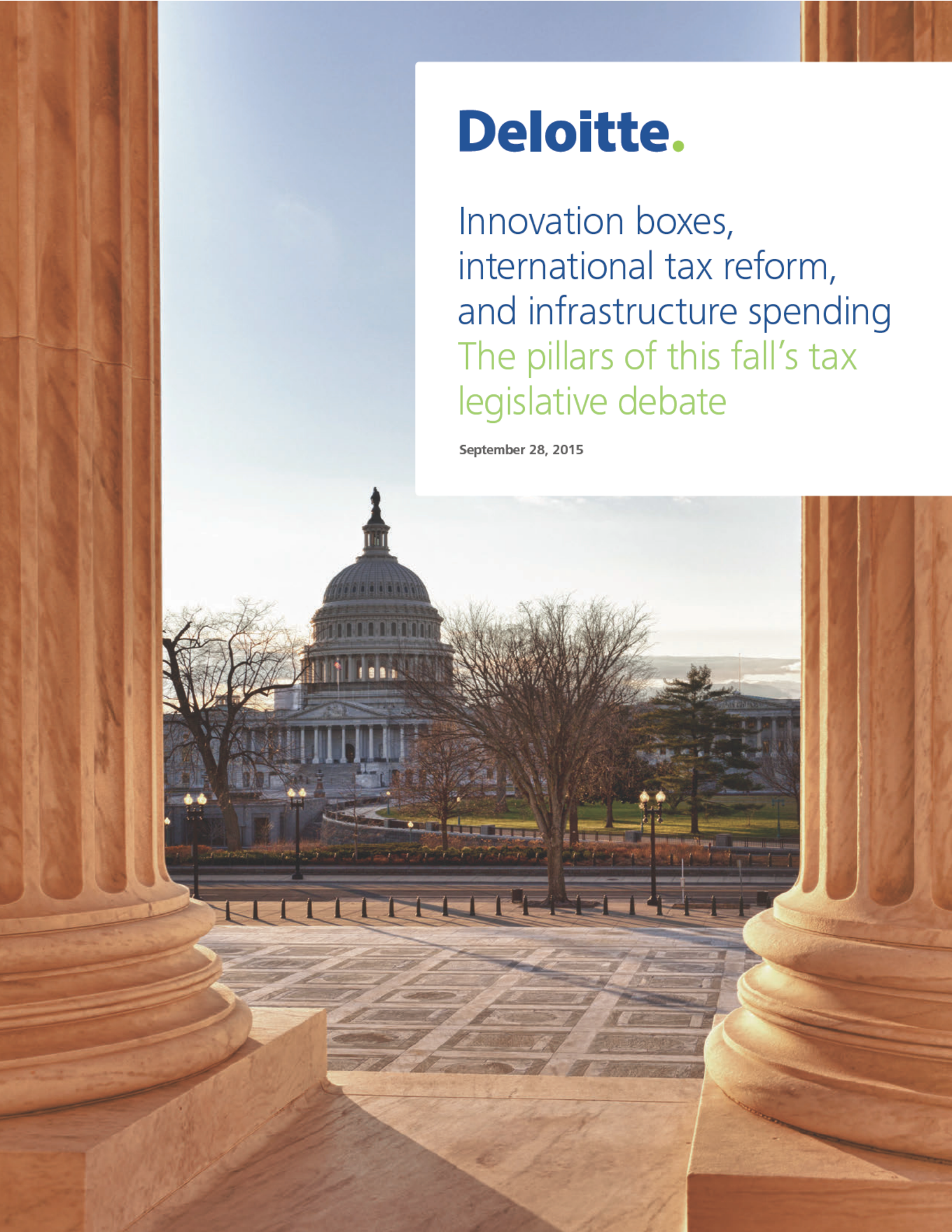

Contents

Introduction

There is continuing speculation in Washington that Congress will take up international tax reform legislation this year to help finance a long-term highway construction bill. That speculation reached a new high in late July when House Ways and Means Committee members Charles Boustany, R-La., and Richard Neal, D-Mass., released a discussion draft proposal for a so-called "innovation box" that would provide a preferential tax rate for income generated by certain intellectual property (IP). An innovation box is expected to be one of the key features of a broader international tax reform plan that may be released in the coming weeks by Ways and Means Committee Chairman Paul Ryan, R-Wis. Ryan's plan is also expected to include a deemed repatriation provision that would impose a levy on previously untaxed foreign-source income of US multinationals. (Presumably, some of the revenue that would be generated by international tax reform provisions would be used to fund infrastructure spending.)

This publication examines the general concept of an innovation box and the specifics of the Boustany-Neal discussion draft and provides a high-level overview of how that proposal compares to innovation box regimes currently in place in other selected countries. It also looks at the link between international tax reform and highway funding legislation and considers the policy and political issues that could influence the prospects for congressional action in the near term.

Innovation boxes and US tax policy

Over the last several years, "patent boxes," sometimes called "IP boxes," have become a popular tax policy tool in countries around the world. The first was adopted by Ireland in the 1970s. (Ireland's patent box has since been repealed and is expected to be replaced with a new regime.) The concept was slow to catch on in other countries, however. France and Hungary adopted their own boxes in the early 2000s, followed by the Netherlands and Luxembourg in 2007. Since then, several other countries, including the UK, have adopted regimes of their own.[1]

What is an innovation box?

Generally, a patent box provides a special lower tax rate for income derived from the development and exploitation of intellectual property. The regime may create incentives for locating research and development (R&D) and the resulting intellectual property in the country that offers the box. A few boxes, however, provide incentives to locate just the intellectual property—rather than the R&D—in the jurisdiction.

Within that general structure, the rules among the various jurisdictions that offer innovation boxes vary greatly. For example, under almost all systems, income generated by patents qualifies for benefits, but many regimes allow other intellectual property—such as trademarks, copyrights, or trade secrets—to produce qualifying income as well. Requirements on ownership and development also vary. In some regimes there is a requirement that the owner actually perform development; in other regimes, intellectual property acquired from third parties will qualify. In addition, the amount of the benefit and how it is calculated also vary.

Pros and cons

Proponents of innovation boxes tout them as a way to ensure that highly valued jobs in research and development either stay in or are enticed to relocate to the country that offers the box. The regimes are also seen as an anti-base erosion measure, keeping intellectual property from moving offshore to a low-tax jurisdiction by making the effective rate on the qualified income competitive with those jurisdictions. Supporters also contend that keeping the intellectual property at home increases the likelihood that the jobs harnessing that IP will also stay at home. This contention becomes even more salient as more countries adopt similar regimes: those countries that do not offer an innovation box are increasingly concerned that incremental research and development and subsequent employment harnessing the IP will migrate to nations with more favorable tax treatment of income generated from resulting IP.

Criticisms of innovation box regimes focus on several issues. First, although critics admit that an innovation box can be useful to a country that has little domestic presence of R&D-intensive industries, they question whether such a regime is necessary for countries that already have advanced technology industries and deep research and development resources and whether the incentives will actually lead to increased R&D activity. By providing tax benefits to the income generated, innovation boxes subsidize only successful investments in research or technology. This stands in contrast to other tax provisions—such as a research and development credit—that subsidize the investment regardless of whether it is successful. On economic grounds, critics say innovation boxes discriminate among industries because those businesses that are not R&D-intensive (or that do not have the "right" kind of IP or sources of income) get no benefit, and the effect can be particularly acute in countries with relatively high tax rates, where the rate differential can be substantial. Further, this differential is amplified if the country provides other tax incentives for research and development, such as a credit for R&D expenses.[2]

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[1] Joint Committee on Taxation, JCX-51-15, "Present Law and Selected Policy Issues in the US Taxation of Cross-Border Income," Mar. 16, 2015, p. 41 *et seq*.; Evers, Miller, and Spengel, Centre for European Economic Research Discussion Paper No. 13-070, "Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations," Centre for European Economic Research, Nov. 2013.

[2] *See* Ajay Gupta, "News Analysis: The Patent Box: A Bad Idea Crosses the Atlantic," *Tax Notes*, July 20, 2015, p. 245; and Curtis Dubay, Heritage Foundation Backgrounder #3049 on Taxes, "An Innovation Box for the US? Congress Should Focus on Business Tax Reform Instead," available at http://www.heritage.org/research/reports/2015/08/an-innovation-box-for-the-us-congress-should-focus-on-business-tax-reform-instead, Aug. 18, 2015.

Modified nexus and US concerns

Policymakers in the United States have taken note of innovation boxes as they have become more commonplace among global peers, but until recently had not shown serious interest in developing a US innovation box. This new interest has been prompted largely by indications that the G20 and the Organisation for Economic Cooperation and Development (OECD), as part of the Base Erosion and Profit Shifting (BEPS) project, will agree to impose limits on the circumstances under which such regimes can provide benefits, which have led a small but growing number of US lawmakers to worry about the repercussions of that agreement on the competitiveness of US firms—a concern that is underscored by the lack of a US innovation box.

The BEPS project's Action 5[3] specifically calls for a substantial activity basis for any preferential tax regime. Earlier this year, the representatives of the G20 and OECD countries to the BEPS project generally endorsed a "modified nexus" approach on how to gauge when R&D activities performed in a country are substantial.

The adoption of the modified nexus standard has created a concern among some US lawmakers that these changes will create powerful incentives for US businesses to redirect their R&D spending and other activities overseas to take advantage of other countries' regimes. As Senate Finance Committee member Charles Schumer, D-N.Y., said at a March hearing, while the United States sits on the sidelines, other countries are "enacting policies that are stealing our tax base and forcing US multinationals to send jobs and assets overseas."[4]

Schumer has been joined by fellow Finance Committee member Rob Portman, R-Ohio, in supporting the creation of an innovation box in the United States. The senators chaired the Finance Committee's working group on international tax reform and released a report in early July that reiterates their concerns about the nexus requirement and its effect on the US economy. The report states that the introduction of nexus requirements for those regimes "will have a significant detrimental impact on the creation and maintenance of intellectual property in the United States, as well as on the associated domestic manufacturing sector, jobs, and revenue base." Accordingly, the report recommends adoption of a US innovation box, but it provides no specific proposal (or even broad details) on how such an innovation box should operate.[5]

Boustany-Neal discussion draft

Legislative language for an innovation box has emerged from the other side of the Capitol, however, in the form of a discussion draft proposal released in late July by House Ways and Means Committee members Charles Boustany and Richard Neal. Explanatory materials accompanying the draft echo the concerns raised by Portman and Schumer that without a domestic innovation box, US companies will feel pressure to move offshore. According to Boustany and Neal, enactment of a US innovation box would allow American companies to "better compete with foreign competitors, and [would] remove one of the increasing incentives for US-based businesses to relocate abroad."[6]

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[3] *See* OECD, Base Erosion and Profit Shifting Project, "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance," available at http://www.oecd.org/ctp/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-9789264218970-en.htm, Sept. 16, 2014.

[4] *See* Deloitte Tax LLP, "Finance Committee hearing delves into international reform options," *Tax News & Views*, Vol. 16, No. 11, Mar. 20, 2015.

[5] *See* Deloitte Tax LLP, "Finance Committee tax reform working groups show their work," *Tax News & Views*, Vol. 16, No. 23, July 10, 2015; report available at http://www.finance.senate.gov/newsroom/chairman/release/?id=e9eefc66-7e11-4276-939f-3eca6fd6d959

[6] *See* http://waysandmeans.house.gov/wp-content/uploads/2015/07/Boustany-Neal-IP-box-one-pager.pdf

The Boustany-Neal proposal would provide corporations an effective tax rate as low as roughly 10 percent on certain income generated from patents and a broad range of other intellectual property. However, the rate generally rises as the ratio of US R&D costs to total costs falls. This has the effect of providing far less of a benefit for most firms than a 25-percentage-point reduction in the US effective tax rate.[7] In addition, the benefits of the innovation box would not be available to passthrough entities or to income from the provision of services.

Mechanically, the reduced rate under the proposed Boustany-Neal innovation box would be achieved through a corporate deduction for profits derived from certain intellectual property. Specifically, the deduction would be equal to 71 percent of the lesser of the taxpayer's "innovation box profit" or its taxable income (determined without the innovation deduction) for the taxable year.

According to the technical explanation accompanying the draft, the deduction could not create or increase a net operating loss deduction.

Calculating innovation box profit—Determining innovation box profit would involve a three-part process. First, a corporation[8] would have to determine "qualified gross receipts" from the sale, lease, license, or other disposition (in the course of a US trade or business) of "qualified property," which would include: (1) a patent, invention, formula, process, design, pattern, or know-how; (2) motion picture film or video tape; (3) computer software; and (4) any product produced using any property described in item (1).

Compensation for infringement of intellectual property rights for qualified property generally would be included. Gross receipts generally would not include proceeds from the sale of qualified property to a related person, subject to an exception for sales to related persons outside the United States if the products are resold to an unrelated party.

Next, the taxpayer would calculate its "tentative innovation profit" by subtracting from qualified gross receipts the cost of goods sold for the taxable year and other expenses, losses, or deductions that are properly allocable to qualified gross receipts. Special rules would apply for items brought into the United States and for property exported for further manufacture. The draft would authorize the Treasury Secretary to issue rules on the proper allocation of items for purposes of determining innovation box profit.

Finally, the taxpayer would determine innovation box profit by multiplying the tentative innovation profit by a fraction, calculated by the taxpayer's five-year research and development expenditures performed in the United States (including Puerto Rico and other territories) over its five-year total costs for the relevant taxable year. The research and development costs generally would be determined under section 174(a) and (b) and generally would include the amounts paid or incurred by the taxpayer for the five-year period ending with the taxable year. Calculated over the same period, total costs generally would include the excess of all costs paid or incurred by the taxpayer in the ordinary course of its trade or business over the sum of cost of goods sold, interest, and taxes. Five-year total costs would exclude research and development expenditures for testing that is conducted outside the United States if the testing is so conducted because there is an insufficient testing population in the United States or is required by law to be conducted outside the United States. This formula is intended to arrive at the tentative innovation profit that results from the taxpayer's research and development activities in the United States. The draft would authorize the Treasury Secretary to issue rules to carry out and to prevent abuse of the purposes of the provision.

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[7] *See* Deloitte Tax LLP, "Boustany-Neal 'innovation box' proposal sets up fall debate on international tax reform," *Tax News & Views*, Vol. 16, No. 27, July 31, 2015.

[8] For purposes of computing innovation box profit, all members of an expanded affiliated group (EAG) are treated as a single corporation. The deduction is allocated among the members of the EAG in proportion to each member's respective amount (if any) of innovation box profit.

Inbound transfers of intangible property from CFCs—The draft also would permit distributions by controlled foreign corporations (CFCs) to US shareholders of appreciated patents, inventions, formulas, processes, designs, patterns, know-how, motion picture films or video tapes, and computer software without giving rise to taxable income or gain realization if certain requirements are met. The rule would apply to a distribution only if the distribution is pursuant to a contemporaneous written "qualified plan" that describes the property and the distributions, that is in effect before the distribution is made, and that is filed with the Treasury Secretary.

Other issues—Although the draft includes legislative language, it leaves some policy questions unanswered, and Boustany and Neal have requested feedback on those issues from affected taxpayers. Boustany and Neal note that they are particularly interested in specific questions that include, among others: whether the definition of qualified property is appropriate; how gross receipts from services directly related to a product using qualified property should be included in qualified gross receipts; what the appropriate approach should be for allocating expenses to innovation profits; and how the innovation box deduction should be coordinated with the current research credit and section 199 deduction.

(See the table at the end of this publication for an overview of how the Boustany-Neal discussion draft compares to innovation box regimes in selected countries.)

Highway funding: The road to near-term action?

Legislation to implement an innovation box in the US is not likely to move on its own. However, the Boustany-Neal innovation box discussion draft has heightened speculation that several key lawmakers will pursue such a proposal this fall as part of a broader rewrite of the international tax rules that is also designed to help finance a long-term extension of funding for the federal Highway Trust Fund—a legislative strategy that has been endorsed by several prominent policymakers across the political spectrum.

Currently, all eyes are on House Ways and Means Committee Chairman Paul Ryan who has publicly backed the concept of an innovation box and is expected to take the lead in rolling out additional components of an international tax reform and highway funding plan in the coming weeks.

Ryan has at least some support for this approach across the Capitol. As already noted, a report released in July by the co-chairs of the Senate Finance Committee's working group on international tax reform—Sens. Rob Portman and Charles Schumer—endorses, in general terms, an innovation box as part of a broader plan that would shift toward a territorial system for taxing the foreign-source income of US multinationals. The report also gives a nod toward investing in highways with revenue raised through the deemed repatriation of previously untaxed foreign income of US firms. (A separate Finance Committee working group on community development and infrastructure, co-chaired by Sens. Dean Heller, R-Nev., and Michael Bennet, D-Colo., also called for some form of deemed repatriation to help fund additional highway construction spending.)

President Obama's recent budget proposals and the comprehensive tax reform plan put forward last year by former Ways and Means Committee Chairman Dave Camp, R-Mich.—while silent on an innovation box—also propose to link international tax reform and infrastructure spending.

The Highway Trust Fund, which is financed mainly through excise taxes on gasoline and diesel fuel, has been chronically cash-strapped in recent years as vehicles have become more fuel-efficient while federal fuel tax rates have remained unchanged since 1993. (Federal fuel taxes are fixed on a cents-per-gallon basis, and as the public gravitates to more fuel-efficient cars they are "using more roads" on the same gallon of fuel.) Going forward, taxes dedicated to the trust fund are projected to fall short of anticipated spending by roughly $16 billion per year, according to estimates from the nonpartisan Congressional Budget Office. Earlier this summer, Congress reluctantly approved the thirty-fourth short-term extension of federal highway programs since 2009. That extension lasts through October 29, 2015.

But despite lawmakers' frustration with repeated stop-gap highway bills, broad agreement that US international tax rules are outdated, and some bipartisan support for linking international tax reform and a long-term highway reauthorization, significant questions remain unanswered, making it especially difficult to predict how this issue will be resolved.

Riding the express lanes to international reform

Several dynamics are combining to make enactment of international tax reform, potentially including an innovation box regime, look like a real possibility this fall.

Deemed repatriation more palatable than gas tax hike—Although supported by many transportation policy experts and at least some members of Congress, increasing the main excise taxes dedicated to the Highway Trust Fund—i.e., the 18.3 cents-per-gallon tax on gasoline and the 24.3 cents-per-gallon tax on diesel fuel—is considered a political nonstarter by congressional leaders and the Obama administration.

As a result, many have come to believe that international tax reform—which could be designed to help extend the Highway Trust Fund's solvency by several years by transferring to it a certain amount of revenue raised through deemed repatriation—is, at least in concept, an acceptable way to close the gap between anticipated highway program revenue and desired spending, provided it is done as part of a broader international reform effort that also transitions the US toward a territorial system.

Growing support for moving international reform before comprehensive—While many taxwriters in both parties still want to enact comprehensive tax reform that broadens the tax base and lowers marginal rates for both businesses and individuals, partisan differences on key individual income tax issues—notably, whether tax reform should be used to raise revenue and/or to make the tax code more progressive—appear impossible to overcome at this time. Even discussions around so-called "business-only" tax reform faltered earlier this year due to concerns expressed by small business groups as to how passthrough entities and sole proprietorships would fare, relative to their corporate peers, under such an approach.

The political obstacles facing a comprehensive tax code overhaul—and even business-only reform—have helped to create an environment in which more politicians, Republicans and Democrats alike, are warming to the idea of tackling a discrete aspect of business reform they deem critical, especially if the effort also could be leveraged to help resolve another front-burner policy dilemma.

Sense of urgency created by inversions, foreign acquisitions, and BEPS project—Setting aside the often marked differences in their desired policy prescriptions, there is growing consensus among taxwriting members of both parties that overhauling our international tax rules is one of the most urgent tax reform priorities and perhaps cannot wait for Congress to pass a broader rewrite of the code.

The political impetus for international tax reform is being driven by several factors: continued corporate redomiciling activity after IRS Notice 2014-52; an uptick in foreign acquisitions of US firms; and a concern that some multinationals are using legal means to reduce their tax liabilities in the US to levels that, from a political standpoint, are seen as unacceptably low, which detractors argue both gives foreign firms an unfair advantage over domestic-only firms and impacts the public treasury as the nation faces substantial deficit problems.

Also creating a sense of urgency around international tax reform is the OECD's BEPS project, whose final guidelines to be released this fall are expected to include a nexus component for patent and innovation boxes which some fear could pressure US firms to shift high-skilled research jobs abroad in order to substantiate their qualification for patent box benefits in those countries currently offering such incentives. A properly designed US innovation box, some argue, could alleviate that pressure and encourage the redomestication of US-based firms' intellectual property.

Opportunities for gridlock

All that said, however, there are equally compelling arguments as to why efforts to link international tax reform and highway spending this fall may prove impossible.

Details matter—The broad scope of the project, combined with the narrow window for its completion, will challenge taxwriters to identify and work through an array of detailed policy questions in a way that satisfies often conflicting goals around increasing the competitiveness of US firms, protecting the tax base, and addressing the varied concerns of lawmakers and private stakeholders.

It is not yet clear that Republicans and Democrats agree on more than the broad outlines of a combined international tax reform/infrastructure plan. For example, the proposals put forward by former Ways and Means Committee Chairman Camp and President Obama contain major differences on key tax policy issues including the rate imposed on deemed repatriations and whether the rate varies for liquid versus nonliquid assets, base erosion measures, and the extent to which the US should transition toward a territorial system.

The possible inclusion of an innovation box—with all its concomitant policy issues—could further complicate negotiations and lawmakers' ability to maintain support within the business community. These trade-offs are evident in the Boustany-Neal draft, which, by precluding noncorporate firms and companies that provide services, including software as a service, from its benefits could face opposition from various entities.

Even on transportation policy, Republicans and Democrats are not entirely on the same page. Most multi-year highway reauthorization plans advanced or supported by Republicans have not called for spending above what is projected in the Congressional Budget Office's current law baseline (i.e., current spending adjusted for inflation in later years). The president's plan, however, would boost

highway spending considerably above baseline. These differences could have a profound impact on the required deemed repatriation rate that would be needed to finance each vision.

Short window of opportunity and a crowded calendar—As already noted, the three-month highway patch passed by Congress in July extended the Highway Trust Fund's spending authority through October 29. However, that legislation transferred enough money from the government's general fund to keep the highway fund solvent for a longer period, possibly until well into 2016, according to a recent release from the Department of Transportation. That is a potentially significant development, as Congress had previously thought the short-term bill passed in July provided only enough money to extend federal highway construction and repair funding to sometime late in 2015. This raises the specter of yet another short-term highway reauthorization in the fall—that need not be paid for—if lawmakers have not reached agreement on a long-term transportation package by late October. And if they choose to push the authorization into the middle of 2016, the prospects for action on international tax reform will dim substantially, as Congress is unlikely to tackle such a thorny policy question so close to the 2016 presidential elections.

But even if Congress's hard deadline for addressing highway funding is in 2015 (whether October 29 or sometime in December), lawmakers have little time to conclude a bipartisan deal on matters as complex as international tax reform and transportation policy, particularly as Congress will also be occupied with a number of other politically thorny fiscal issues, including legislation to lift the statutory debt limit later in the year.

This fall, Congress may debate cybersecurity legislation, reform of elementary and secondary education programs, and reauthorizations of the Export-Import Bank and the Federal Aviation Administration. Additionally, lawmakers also must find time to consider the dozens of so-called tax extenders which most recently lapsed at the end of 2014.

First, though, Congress must find a way to keep funding the government before the new fiscal year begins on October 1, and there is a very real prospect of brinksmanship—which could lead to another partial government shutdown—over whether to continue to fund Planned Parenthood. A partial government shutdown would likely slow legislative action on unrelated items, including international tax reform. (For advocates of international tax reform, this could seem like a replay of the fall of 2013: then-Ways and Means Committee Chairman Camp had hoped to roll out his tax reform plan only to have that shelved during an unsuccessful effort by Republicans to use a government shutdown as leverage to force repeal of the Affordable Care Act.)

Upcoming leadership changes in the House—Also expected to consume time in the House in the coming weeks will be the process of choosing a successor to Speaker John Boehner, R-Ohio, who announced September 25 that he will give up the speaker's gavel and resign his seat in Congress at the end of October. Boehner's decision to step down – which took many observers by surprise – is expected to set up a short but intense campaign for his job – and likely others, because if he is replaced by a member currently serving in another leadership position it would create an additional vacancy that would need to be filled. On a broader level, it is too early to say with any certainty what impact – if any – the election of a new speaker and any resulting changes in the House GOP leadership roster may have on the future trajectory of tax reform. Generally, though, it is believed the House will be reluctant to tackle difficult legislative issues during a period of leadership transition if those issues could otherwise be deferred.

High-profile policymakers skeptical—Senate Majority Leader Mitch McConnell, R-Ky.—along with several other senators—has been openly critical of efforts to tie international tax reform to a long-term highway bill, expressing doubt that Congress and the president can come together on such complex legislation during what has already shaped up to be an incredibly busy and contentious fall.

McConnell, who has been trying to get highway funding off the congressional calendar at least until after the November 2016 elections, is expected this fall to continue to press for a long-term highway deal using legislation

approved in the Senate this summer as a starting point. The Developing a Reliable and Innovative Vision for the Economy (DRIVE) Act would extend highway programs for six years, while financing about three years of the shortfall between trust fund spending and dedicated revenues—or roughly $50 billion—with a conglomeration of budget offsets ranging from selling oil in the Strategic Petroleum Reserve to reducing the dividend rate paid by the Federal Reserve on stock held by certain member banks.

For its part, the White House has been clear that it supports using deemed repatriation to help finance a long-term highway bill. However, its views on an innovation box are not as well understood, and may in fact be negative. In comments on Twitter shortly after the Portman-Schumer report was released, Jason Furman, the chairman of the president's Council of Economic Advisers, responding to a question on whether the White House could support an innovation box as part of international tax reform, seemed to indicate that the administration instead preferred a permanent and expanded research credit along the lines of what it has proposed in its recent budgets.

"We support expanded R&E credit, directly encourages investments in new innovation, best bang-for-buck," Furman tweeted.

Budget constraints—Developing any proposal that combines international tax reform with highway funding will require lawmakers to thread a fine budgetary needle. An innovation box is likely to result in a substantial revenue loss relative to current law: although an official revenue score has not yet been released, Boustany recently told reporters that the Joint Committee on Taxation staff has estimated that his draft proposal in its current form would reduce federal revenues by roughly $280 billion over 10 years. Likewise, shifting to a territorial system registers as a significant tax cut. Including these policies in a plan that is also designed to provide tens of billions of dollars to the Highway Trust Fund means Congress will have to make many difficult choices to offset those costs.

It is unclear whether there is enough money to be raised through deemed repatriation, measures to protect the tax base, and other acceptable budget offsets to pay for (1) a broadly defined innovation box, (2) a move to territorial taxation, and (3) a boost in highway funding. To solve that dilemma, it has been suggested that lawmakers may try to "double-count" the money, such as by crediting amounts raised through deemed repatriation both toward the Highway Trust Fund and toward helping finance a new territorial system.

But this approach, while consistent with how the nonpartisan Congressional Budget Office estimates changes to federal highway programs, could run into opposition from some on both the left and the right as being fiscally irresponsible. In the past, the Obama administration has been adamant that one-time revenue increases (i.e., revenue increases that will not persist indefinitely, such as those raised through deemed repatriation) should not be used to finance permanent tax cuts.

These revenue constraints could also cause taxwriters to modify proposals—such as by including stronger base erosion safeguards or a higher tax rate on deemed repatriations, or by narrowing the scope of an innovation box by limiting the types of qualifying intellectual property and/or reducing the tax benefit provided to qualifying income—in ways that may diminish support for the overall plan.

Some businesses may oppose—Although the optics may make this appear to be a boon for multinational companies, it is not clear that an international-only tax reform package would be warmly received across the business community. For example, some US firms—especially those without substantial foreign operations—are likely to be more interested in a reduction in the corporate statutory rate than in international tax reform and may worry that action in this area reduces the likelihood of Congress later enacting broader tax reform.

Similarly, inbound companies may worry that an international reform plan will offer them little benefit but could raise their US tax liabilities if lawmakers seek to protect the tax base by further limiting interest deductions on related-party debt. US multinationals who might benefit from a transition to a territorial system may balk at the tax rate on deemed repatriations and/or other base erosion safeguards included in any package or may find that the fine print of the innovation box renders it less attractive than they had hoped.

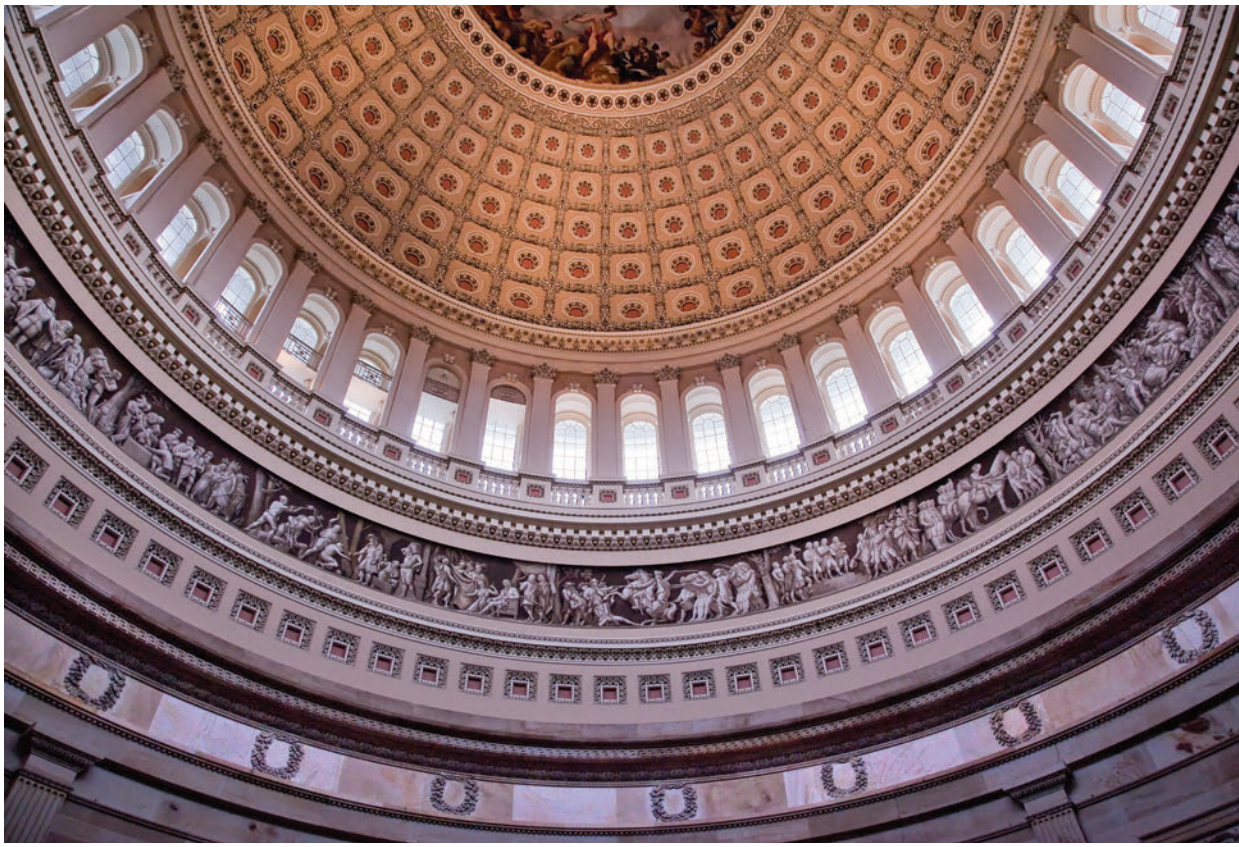
Despite the uncertainty, the debate cannot be ignored

The fact that there are compelling arguments for success and failure of attempts to link international tax reform and long-term highway funding presages uncertainty, both for members of Congress and the business community. Each development will be carefully scrutinized to assess what it means for the substance of the package, its impact on business, and the prospects for its eventual enactment.

Attempting to affix specific odds to this endeavor is not possible, especially at this time when so many critical details have yet to be unveiled. Nevertheless, the current alignment of policy concerns and political opportunity means that international tax reform could receive a level of bipartisan consideration in the coming weeks that may be greater than any tax reform proposal in nearly three decades.

As details and drafts continue to emerge, business leaders will want to analyze how their firms would be impacted. This may require modeling outcomes under multiple assumptions, including whether an innovation box, along with any policies designed to offset its cost, is or is not included a package that transitions toward a territorial system.

Table comparing Boustany-Neal proposal and selected innovation box regimes begins on next page.



Appendix

How the Boustany-Neal draft proposal compares to selected innovation box regimes					
	Italy	Luxembourg	Netherlands	UK	Boustany-Neal (Proposed)
IP covered	Industrial patents, biotech inventions, utility models, patents for plant varieties, semiconductors' topographies, formulas and processes, legally protected designs and models, software copyrights, trademarks, know-how, and trade secrets that can be legally protected	Patents, trademarks, designs, domain names, software copyrights (if licensee receives source code and thus has ability to adapt software), and models	Patents, and unpatented IP from approved R&D activities	Patents and closely associated know-how, trade secrets, software copyrights, and new plant varieties	Patents, inventions, formulas, processes, designs, patterns, know how, and any product produced using such IP, motion pictures films and video tape, and computer software
IP not covered		Know-how, copyrights other than for software, formulas, and client lists	Marketing intangibles (e.g., trademarks, brand names, logos), nontechnical design rights, and literary copyrights	Trademarks, and registered designs	Marketing intangibles (e.g., trademarks, brand names, logos), trade secrets, and copyrights
Qualifying income	Net income from qualifying IP, after application of a ratio of allowable costs. Also, full tax exemption over capital gains from sale of qualifying intangibles if 90% of consideration is reinvested in maintenance, enhancement, or development of other qualifying intangibles by the end of the second FY following the year of the disposal	Net income from qualifying IP acquired or self-developed after 12/31/07	Net income from self-developed qualifying IP, where income exceeds certain expenses, including R&D and amortization; includes embedded royalties if 30%+ of derived income attributable to patent	Net income, before interest and after routine returns and brand value, from self-developed qualifying IP after 4/1/13	Net income from qualifying IP, multiplied by the ratio of U.S. R&D costs to total costs (less interest, cost of goods sold, and taxes) for a 5-year period
Amount of benefit	50% exemption	80% exemption	80% exemption		71% deduction

How the Boustany-Neal draft proposal compares to selected innovation box regimes					
	Italy	Luxembourg	Netherlands	UK	Boustany-Neal (Proposed)
Effective tax rate	15.7%	5.8%	5%	10%	10.15%
Limitations	Requires a 5-year irrevocable election. Trademark inclusion is not in line with OECD principles, and trademarks will not be covered after 2021; trademark holders must opt in by 6/30/16 to take advantage of this window.	Luxembourg company must be the economic owner of the rights (does not include rights acquired from a related party)	Acquired IP does not qualify unless further developed into a new qualifying asset. Dutch company must be the economic owner, have control and bear the risks associated with ownership; development activities must be conducted at the risk of, and under the control of, the Dutch company, though R&D can be done elsewhere.	Acquired IP does not qualify unless further developed. Available only to corporate taxpayers.	Available only to C corporations. Qualifying income must be in the form of income derived from property (e.g., the sale or lease of goods), not compensation for services.
Other notable details	Final regulations of the scheme are imminent. This scheme is being phased in over three years, with a 30% exemption in 2015, 40% in 2016, and 50% in 2017.	This scheme is likely to be amended by 2016, with grandfathering until 2021 if entered into by 6/30/16. The new scheme is expected to include a restriction on the nature of eligible IP and stricter substance requirements, i.e., R&D to be carried out in Luxembourg or through a foreign branch.		This scheme is being phased in over 5 years, with the full 10% rate applicable for FY after 4/1/17. No new entrants after 6/30/16, and the scheme will be replaced by 2021 with one more closely aligned to UK-based R&D activity.	

Notes on other innovation box regimes

1. **Ireland**—Although Ireland pioneered the patent box concept in 1973, it repealed the key element of its system in 2010 and is preparing to introduce a new scheme, called a Knowledge Development Box, based on OECD principles developed through the BEPS process.
2. **China**—China's system operates differently from western models. Under its scheme, a company applies for High and New Technology Enterprise (HNTE) status, which requires a certain amount of qualifying IP (patents, inventions, utility models, certain designs, software copyrights, integrated circuit layout design proprietary rights, new plant varieties, know-how, and trade secrets), IP-related income, R&D employees, college-educated employees, and R&D expenses. Once a company attains HNTE status, it gets a 15% tax rate (vs. 25%) on all profits.

Acknowledgements and Contacts

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