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International Tax

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Innovation box discussion draft released; robust international tax reform debate expected this year

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Overview

Tax reform, an issue that has generated considerable discussion in Congress in recent years but has thus far proved to be an elusive goal, suddenly has jumped to the top of the legislative agenda. The strong bipartisan desire to fund a long-term highway construction program is providing the opportunity to consider international tax reform as a mechanism to fund this important infrastructure priority while also altering U.S. international tax rules to make our tax code more competitive.

Many members of Congress have come to believe that international tax reform, which would generate some revenues through the deemed repatriation of the previously-untaxed foreign income of U.S. firms, is, at least in concept, the most acceptable way to close the gap between anticipated highway program revenue and desired spending. Passage this week of a three-month highway bill – which will keep the Highway Trust Fund afloat through October 29 – means debate on international tax reform will kick into high gear. Because these proposals impact research and development expenses as well as broader tax reform efforts, they should be carefully monitored and evaluated by all companies, regardless of their international footprint. As with everything in politics, however, there are no guarantees, and even proponents of using international tax reform to help finance highway construction recognize some steep hurdles must be overcome in order for this to be enacted.

Setting the stage – Permanent Subcommittee on Investigations hearing

In recent months, there has been increasing focus in Congress on certain inconsistencies in our tax code, particularly with respect to the treatment of multinational businesses. Earlier this month, for example, the Senate Finance Committee's working group on international tax reform, co-chaired by Republican Rob Portman of Ohio and Democrat Chuck Schumer of New York, recommended, in broad terms but without key details, a complete rethinking of our current worldwide system. The group's findings were hailed as an important

step in building the bipartisan support for badly needed international tax reform. (For more details of their work, see the July 10, 2015 issue of Tax News & Views.)

More recently, a Senate Permanent Select Subcommittee on Investigations hearing on July 30 turned the spotlight on the impact of the U.S. tax code on domestic employment. Subcommittee Chairman Rob Portman used the session to continue to make the case that our tax rules are badly in need of reform. The hearing reviewed some recent cross-border transactions and noted that the U.S. tax code does not encourage companies to be domiciled in the United States. Chairman Portman took pains to make clear his view that the companies studied complied with the law and that the fault for this situation lies with the U.S. tax code, not the taxpayers.

In conjunction with the hearing, Chairman Portman's staff released a report concluding that

> [t]he high U.S. corporate tax rate and worldwide system of taxation are competitive disadvantages that make it easier for foreign firms to acquire American companies. Those policies also strongly incentivize cross-border merging firms, when choosing where to locate their new headquarters, not to choose the United States. The long-term costs of these incentives can be measured in a loss of jobs, corporate headquarters, and revenue to the Treasury.

The subcommittee's ranking member, Missouri Democrat Claire McCaskill, echoed similar themes, showing the increasing bipartisan interest in reforming the code rather than singling out as "bad actors" companies who are in full compliance with it and struggling to compete globally. In her opening comments, Sen. McCaskill said:

> Our tax code is broken. Our tax code needs to be fixed. . . . Blaming companies for doing the math that our tax code represents is a waste of time. And what Congress needs to do instead is hold the mirror up to ourselves, because it is our inability to come together and compromise in a comprehensive way that is holding us back from reforming our tax code in a way that levels the playing field for our businesses. . . .

First action – Innovation box draft

House Ways and Means Committee members Charles Boustany, R-La., and Richard Neal, D-Mass., on July 29 released a discussion draft proposal for a U.S. innovation box that would provide for lower tax rates on income generated from patents and certain other types of intellectual property.

In conjunction with the draft proposal, Boustany and Neal also released a technical explanation and a section-by-section summary as well as a list of questions to stakeholders that is intended to elicit "detailed feedback on the discussion draft and how it affects specific taxpayers."

Missing from the discussion draft and related descriptive materials that Boustany and Neal released are a revenue estimate for the proposal as drafted and details around possible revenue raising provisions – such as base erosion safeguards – to offset the cost.

An innovation box could result in a substantial revenue loss relative to current

law, and the broader international tax reform plan that House taxwriters intend to develop is also expected to include a shift to a territorial system for taxing foreign-source income of U.S. multinationals. These proposals would be offset by a tax on the deemed repatriation of offshore earnings from controlled foreign corporations owned by U.S. companies, as well as other revenue raisers. The tax on the amounts deemed to have been repatriated would be imposed at a lower tax rate and likely payable over a period of years.

Given those pressures, it is possible that as the international reform plan takes shape, taxwriters may have to address revenue constraints by narrowing the scope of an innovation box, such as by limiting the type of intellectual property that qualifies for preferential rates and/or reducing the tax benefit provided to qualifying income.

Other pieces to follow

Following the Boustany-Neal release, we can expect House Ways and Means Committee Chairman Paul Ryan, R-Wis., to take the lead in rolling out additional components of an international tax reform plan, which is likely to generally include these features:

- A transition from our current worldwide taxation system to a dividend exemption system;
- Deemed repatriation of the previously untaxed foreign income of U.S. firms;
- Base erosion safeguards, which could include changes to the Subpart F rules and some kind of a minimum tax; and
- Other offsets needed to ensure the program does not increase the deficit, which could include provisions requiring the capitalization of certain research and experimentation expenditures, and further limits on the deductibility of related-party interest under section 163(j).

Chairman Ryan has yet to tip his hand on exactly how he would address these issues, but it is important to note that he and others have been clear that they would support deemed repatriation only as part of a broader set of international tax policy reforms that would presumably include a transition away from a worldwide system of taxation.

The difficulty of these issues is matched only by the wide variety of options available to policymakers to address them. To cite but one example, even if there is agreement over the idea of deemed repatriation, design questions abound: Will the tax apply to all unrepatriated amounts or just those accumulated since some point in time, such as post-1986? The rate of tax on deemed-repatriated income will be lower than the full U.S. corporate rate, but by how much? And, on a related note, how long will companies that are subject to the deemed-repatriation tax have to pay it? Will there be one rate for all unrepatriated income, or will the plan include different rates for cash versus bricks-and-mortar investments?

As Chairman Ryan and his colleagues seek to answer these and other design questions, they can draw insight from prior proposals, including the tax reform plan released by former Ways and Means Chairman Dave Camp, R-Mich., last year, the elements of international tax reform unveiled by then-Senate Finance Committee Chairman Max Baucus, D-Mont., in 2013, and international tax changes proposed by President Obama in his FY 2016 budget. Summaries of those proposals can be found here.

What is not expected as part of the process

As this effort will focus on international tax issues, it is unlikely to include provisions reducing the statutory rates for corporations or for individuals (including the owners of passthroughs), a feature of tax reform that many businesses view as critical.

Next steps

The decision by the House and Senate to pass only a short-term highway plan doesn't guarantee passage of international tax reform this year, but it does make a vigorous debate more likely.

International tax is likely too complex to enact before the end of October – when the just-passed three-month highway bill expires – especially in light of the upcoming legislative calendar. The House adjourned for its traditional summer recess on July 30 and will not return to Washington until after Labor Day; the Senate currently plans to remain in session through August 7 before it goes into recess – also until after Labor Day; and lawmakers are likely to be in Washington for only about a dozen legislative days in September. Thus, in the next 90 days, proponents of using international tax reform to help finance highway construction (including Chairman Ryan, as well as key Senate Finance Committee members such as Republican Rob Portman and Democrat Chuck Schumer) will have to show their colleagues the details of their vision in an effort to win new supporters and gain more time, probably until the end of the year, to complete action on their plan.

With House members now scattered across the country for the recess, Chairman Ryan may opt against releasing any additional pieces of an international tax reform plan until he and his colleagues can gather to discuss them when Congress reconvenes. Even if that is the case, we can expect that Chairman Ryan and his staff will use the recess period to refine proposals and work with the Joint Committee on Taxation to score them, since the end of October will be here quickly.

Keep in mind, too, that the three-month patch that passed this week might be easily extended until later in the year. The three-month measure contained enough offsets to fund the highway program until at least December 18. What expires in October is not the supply of funding but rather the authorization to spend it. Thus, if Chairman Ryan and his colleagues are making good progress on international tax reform as October draws to a close, Congress could extend the Highway Trust Fund's spending authorization for an additional two months – giving international reform proponents more time to complete their work – without having to find and approve new revenue offsets. And given the difficulty of finding acceptable offsets to pay for infrastructure (or almost anything else in Washington), the lure of an extension that requires no further spending cuts or tax increases will be attractive to many members of the House and Senate.

If, on the other hand, lawmakers are uncomfortable with the direction being proposed by Chairman Ryan and others, the House and Senate could pass a longer-term highway funding bill in October using a Senate-approved six-year highway bill (with three years of funding) as a starting point, thereby reducing substantially the likelihood that tax reform will be enacted until after a new president takes office in 2017. While there are significant issues that call for

immediate action on our international tax rules, it is generally agreed that Congress will not tackle international tax reform unless it is paired with some action-forcing event.

Outlook

Enactment of a plan that combines international tax reform with highway funding could be characterized either as inevitable or impossible, making it especially difficult to predict how this issue will be resolved.

The case for inevitability – the argument for inevitability appears strong.

- ***Support for tax overhaul remains strong but consensus is elusive*** – While many taxwriters in both parties still want to enact comprehensive tax reform that broadens the tax base while lowering marginal rates for both corporations and individuals (including the owners of passthrough businesses), 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.
- ***Sense of bipartisan urgency around international tax*** – The Senate Permanent Subcommittee on Investigations hearing convened this week by Chairman Portman is the latest indication that perceived flaws in our international tax code require Congress to act sooner rather than later on those issues.
- ***Strong desire to fund highways*** – Support in Congress for finding more funds for infrastructure is very strong and bipartisan, but a gas tax increase appears to be off the table, and there has yet to be identified any other way of raising the roughly $90 billion dollars needed to close the gap between trust fund receipts and a desired spending level that is acceptable to both Republicans and Democrats. Without such an agreement, deemed repatriation looks increasingly attractive, as it raises substantial revenue in a way that at least some affected companies have expressed a willingness to support.

The case for impossibility – All that said, however, there are equally compelling arguments why efforts to link international tax reform and highway spending may prove impossible.

- ***Details matter*** – As noted above, the broad scope of the project, combined with the narrow window for its completion, will challenge taxwriters to identify and work through the array of detailed policy questions in a way that satisfies often conflicting goals of increasing the competitiveness of U.S. companies, protecting the tax base, and addressing political concerns of key stakeholders in and out of government.
- ***Politics of seeming to help only international firms*** – Some members of Congress may balk at the politics of seeming to provide tax reform/tax benefits to international companies while providing little, if any, tax relief for individuals or small businesses or even large but domestically-focused businesses.
- ***Budget constraints?*** – Developing such a proposal will require lawmakers to thread a fine budgetary needle. There is unlikely to be

enough money in deemed repatriation and a minimum tax on foreign-source income 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, some plan supporters may try to double-count the money – essentially by crediting the money raised to the general fund and earmarking similar amounts to be spent on highways, but then also enacting policy changes – the innovation box and territoriality – that result in less future revenue. Others have indicated they have concerns with that approach, making this one place where the common ground on the broad outline may be insufficient to bring the sides together.

- ***Some businesses may oppose*** – Despite the fact that the optics may make this appear like a boon for multinational companies, it is not clear such a targeted tax bill would be warmly received by the business community. For example, some companies – especially those without substantial foreign activities – 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 worry that an international reform plan will offer them little benefit but could raise their taxes by further limiting deductions for related-party debt. And even multinational companies who might benefit from a transition to a territorial system may balk at the tax rate on deemed repatriation and/or the other base erosion safeguards included in the package.

Conclusion

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

The barriers to passage are high, but supporters like Paul Ryan, Chuck Schumer, and Rob Portman bring a great deal of legislative expertise to the table. Opponents likewise include many skilled legislators. Some will have specific policy objections. Others, including Senate Majority Leader Mitch McConnell, R-Ky., are concerned about whether Republicans, who control the House and Senate, can conclude a tax reform package with President Obama and have expressed concern that the effort will lead to both higher taxes and higher spending.

Attempting to affix specific odds to this endeavor is not possible, especially at this early stage when so many critical details have yet to be unveiled.

Nevertheless, the current alignment of policy concerns and political opportunity means the international reform proposals will receive a level of bipartisan consideration that is greater than any tax reform proposal in nearly three decades. Few can afford to ignore it.

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