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Tax News & Views

July 31, 2015

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Boustany-Neal ‘innovation box’ proposal sets up fall debate on international tax reform

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 US innovation box that would provide corporations an effective tax rate of roughly 10 percent on certain income generated from patents and a broad range of other intellectual property.
URL: http://waysandmeans.house.gov/wp-content/uploads/2015/07/Innovation-Box-2015-Bill-Text.pdf

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.”
URL: http://waysandmeans.house.gov/wp-content/uploads/2015/07/FINAL-TE-Innovation-Promotion-Act.pdf
URL: http://waysandmeans.house.gov/wp-content/uploads/2015/07/Boustany-Neal-IP-box-section-by-section-FINAL.pdf
URL: http://waysandmeans.house.gov/wp-content/uploads/2015/07/2015-07-29-Boustany-Neal-Innovation-Box-Questions.pdf

An innovation box is expected to be a significant component of the international-only tax reform plan that Ways and Means Committee Chairman Paul Ryan, R-Wis., hopes to advance in conjunction with a long-term extension of spending authority for the Highway Trust Fund. And the passage of a 90-day extension of highway funding in both chambers of this week sets the stage for a debate on a long-term highway measure – and international tax reform – this fall.

Discussion draft details

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 taxpayer 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 the cost of goods sold and other expenses, losses, or deductions that are 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 over its five-year total costs. The research and development costs generally would be determined under section 174(a) and (b) and generally would include the amounts 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 over the sum of cost of goods sold and interest and tax costs. 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.

Transfers of intangible property from CFCs: The draft also would permit distributions by controlled foreign corporations (CFCs) to US shareholders of 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. 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.

Request for feedback: Boustany and Neal have requested feedback from taxpayers who would be affected by the draft. They 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.

No revenue score or offsets yet

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 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 US multinationals – another potentially expensive proposition.

These revenue constraints ultimately could cause taxwriters to modify the proposal by:

- Including stronger base erosion/minimum tax subpart F rules than many companies can support and/or
- Narrowing the 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.

International tax reform prospects boosted by 90-day highway extension

In the near term, prospects for the proposed innovation box and the broader international-only tax reform package that House taxwriters plan to develop received a significant boost as a result of the House and Senate's inability to agree on a multi-year extension of the Highway Trust Fund this month (before the trust fund's current spending authorization expires on July 31) and the passage this week in both chambers of legislation that extends highway financing for just three months. The three-month extension cleared the House on July 29 and the Senate on July 30. (See related coverage in this issue for details on the House-Senate impasse over highway funding and how the latest short-term extension came to pass.)

With the three-month extension in place, House Ways and Means Committee Chairman Ryan has made clear that he intends to use that time to develop a package of international tax reforms that can be used to help finance a longer-term highway bill. Others in Congress – most notably, Senate Finance Committee members Rob Portman, R-Ohio, and Charles Schumer, D-N.Y., who co-chaired that panel's working group on international tax reform, have also expressed support for a combined international/highway tax package; and the Obama administration has likewise called for imposing a so-called "deemed repatriation" levy on previously untaxed foreign-source income to help pay for a long-term extension of infrastructure funding.

But there are also significant obstacles that could stymie the passage of an international tax reform plan to help pay for a long-term highway bill. International reform is likely to be a complex undertaking involving lots of moving pieces, such as a transition from a worldwide to a territorial system of taxation, a deemed repatriation regime, and base erosion safeguards, all of which can present a wide range of design questions and, depending on the details, can become magnets for a wide range of policy-based objections. On a more immediate level, some congressional Republicans – notably, Senate Minority Leader Mitch McConnell, R-Ky. – have expressed concern about whether the GOP can negotiate a good deal on tax policy with President Obama and would rather defer any discussion of tax reform until at least 2017, when a new president will be in office.

When negotiations on a long-term transportation bill begin in earnest in September, McConnell likely will push for a package that uses as a starting point the six-year measure he unveiled earlier this month, which is funded for three years with tax compliance provisions and spending cuts. (The six-year bill cleared the Senate on July 30 along with the three-month House-approved funding patch that is now on its way to the White House.) If McConnell is successful in moving his long-term highway bill through Congress, it would greatly reduce the likelihood that tax reform of any kind will be enacted while President Obama is in the White House.

At the very least, however, we can expect to see Congress engaged in a robust debate this fall on an overhaul of the international tax rules that, if enacted, would profoundly affect businesses.

We will keep you apprised of developments in future editions of *Tax News & Views*.

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Congress clears three-month Highway Trust Fund patch

After a lengthy public disagreement between House and Senate Republicans on the basic contours of legislation designed to address the cash-strapped federal Highway Trust Fund, lawmakers this week voted to extend the trust fund's spending authority – that had been set to lapse after July 31 – for just three months, through October 29, and paid for the extension with a mix of tax compliance offsets and other provisions.

The Highway Trust Fund, which is financed mainly through excise taxes on gasoline and diesel fuel, has been chronically short-changed in recent years. 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.

Differing views on duration, financing of highway legislation

Throughout the House-Senate standoff, House leaders – on both sides of the aisle – stood by a plan passed in that chamber on July 15 by a wide bipartisan majority that called for using several tax compliance offsets, as well as other provisions, in order to keep the Highway Trust Fund solvent through December 18, 2015, with the goal of buying time for bipartisan negotiations to continue on legislation that would leverage international tax reform to help finance a long-term highway bill. (For prior coverage, see *Tax News & Views*, Vol. 16, No. 24, July 17, 2015.)
URL: http://newsletters.usdbriefs.com/2015/Tax/TNV/150717_1.html

Meanwhile, Senate Majority Leader Mitch McConnell, R-Ky. – as well as several other senators – expressed skepticism that bipartisan agreement on international tax reform could be reached this year, and instead pushed for passage of legislation with sufficient funding to keep the Highway Trust Fund off the congressional calendar at least until after the November 2016 elections.

A collaboration between Sen. McConnell and Sens. Jim Inhofe, R-Okla., and Barbara Boxer, D-Calif. (the chair and ranking member of the Senate panel with jurisdiction over federal highway programs) – with input on budget offsets from Senate Finance Committee Chairman Orrin Hatch, R-Utah, and other key senators – led to the Developing a Reliable and Innovative Vision for the Economy (DRIVE) Act. That legislation would extend Highway Trust Fund spending authority for six years, through September 2021, and finance about three years of the shortfall between trust fund spending and dedicated revenues – or roughly $50 billion – with a mix of tax compliance offsets similar to those in the House bill and several other larger nontax provisions, including a controversial proposal that would save $16 billion by reducing the dividend rate paid by the Federal Reserve on stock held by certain member banks. (For prior coverage, see *Tax News & Views*, Vol. 16, No. 25, July 24, 2015.)
URL: http://newsletters.usdbriefs.com/2015/Tax/TNV/150724_1.html

For a variety of reasons, the DRIVE Act faced many challenges during its consideration on the Senate floor. But the chamber ultimately passed the plan on July 30 on a bipartisan, 65-34 vote. During floor debate, the chamber also successfully attached to the bill an amendment providing for a four-year reauthorization of the Export-Import (Ex-Im) Bank – something staunchly opposed by many congressional conservatives. (The Ex-Im Bank, whose charter lapsed at the end of June, is an independent federal agency which provides credit support to foreign buyers of US goods and services.)

House-Senate impasse leads to three-month patch

The apparent Senate strategy was to pass the DRIVE Act and put pressure on the House to accept it before that chamber was scheduled to adjourn for its summer recess at the end of this week. But, as they did last week, House Republican leaders made clear they would not take up the Senate plan.

Instead, the House voted 385-34 on July 29 to pass a three-month patch – dubbed the Surface Transportation and Veterans Health Care Choice Improvement Act – before departing Capitol Hill to begin the five-week recess. The Senate – left with few other options – cleared the short-term plan by a vote of 91-4 on July 30 (shortly after approving the DRIVE Act, which now heads to the House).

Although the White House previously indicated it would not accept highway legislation during July that did not also reauthorize the Ex-Im Bank, administration spokesman Eric Schultz indicated on July 29 that the president would not follow through on that threat and would sign the three-month extension that subsequently was passed by both chambers.

"[The] unfortunate reality is that due to inaction, Congress will need to pass this other short-term extension to keep federal funding for America's surface transportation system flowing, and the president would sign that," Schultz said.

Familiar tax compliance offsets: The three-month patch extends Highway Trust Fund spending authority through October 29, but transfers enough money, about $8 billion, from the government's general fund to keep the Highway Trust Fund solvent for a longer period, possibly until year-end – raising the specter of another short-term extension of highway program authorization in the fall (that need not be offset) if lawmakers have not coalesced around a long-term highway bill by the end of October.

The $8 billion general fund transfer is partially financed by a handful of tax compliance and enforcement offsets – which also appeared in the longer-term House and Senate highways bills – including provisions that would:

- Require mortgage lenders to provide the IRS with additional information on outstanding loans – including the origination date of the mortgage, outstanding principal balance, and property address, which is estimated by the Joint Committee on Taxation (JCT) to increase federal revenues by about $1.8 billion over 10 years;
  URL: https://www.jct.gov/publications.html?func=startdown&id=4804
- Require estates with positive estate tax liability to provide the IRS with property value detail in order to ensure consistent basis reporting by beneficiaries for income tax purposes (JCT estimated 10-year revenue gain: $1.5 billion);
- Clarify that a six-year statute of limitations for the IRS to reassess taxpayers who substantially understate their income applies in the case of overstatement of basis (JCT estimated 10-year revenue gain: $1.2 billion);
- Adjust certain tax and information return filing deadlines in a manner that generally would require passthrough entities to filed in advance of C corporations (JCT estimated 10-year revenue gain: $314 million); and
- Extend through 2025 a current-law provision (set to expire in 2021) that allows employers to transfer excess defined benefit plan assets to retiree medical accounts and group term life insurance (JCT estimated 10-year revenue gain: $172 million).

Revenue-losing provisions: The bill also includes revenue-losing provisions that would:

- Tax liquefied natural gas, liquefied petroleum gas, and compressed natural gas on an energy-equivalent basis – which would reduce the tax on liquefied natural gas to 14.1 cents per gallon and the tax on liquefied petroleum gas to 13.2 cents per gallon, (JCT estimated 10-year revenue loss: $90 million);
- Exempt employees with health coverage under TRICARE or the Veterans Administration (VA) from being included in the employee headcount for purposes of the Affordable Care Act's "employer mandate" to provide affordable health insurance to employees (JCT estimated 10-year revenue loss: $816 million); and
- Loosen the rules requiring individuals to be enrolled in a high-deductible health plan (and have no other coverage) in order to be eligible to make pre-tax contributions to a Health Savings Account (HSA) by providing that otherwise eligible veterans are not disqualified from making such HSA contributions merely for receiving medical care from the VA for a service-connected disability (JCT estimated 10-year revenue loss: $384 million).

Focus shifts back to the House, international tax reform

In separate remarks to reporters on July 28, House Speaker John Boehner, R-Ohio, and Senate Majority Leader McConnell confirmed their intentions to use the three-month Highway Trust Fund patch as a bridge to a long-term solution.

“We’ve been trying to do this for four years, it’s time to get it across the finish line. And I’m going to do everything I can to get a long-term highway bill by the end of October,” Boehner said.

For his part, McConnell remarked that “[t]he House of Representatives, as a result of our passing a multi-year bill, now feels they should pass a multi-year bill. That’s a good first step. And when they do that in September, we’ll follow regular order. We’ll have a conference, we’ll try to work out the differences, and we’ll try to agree to how to pay for it.”

House Ways and Means Committee Chairman Paul Ryan, R-Wis., intends to spend the fall months developing a package of international tax reforms that also could be used to help finance a long-term highway bill – an approach backed by House Republican leaders including Boehner and Majority Leader Kevin McCarthy, R-Calif. The White House also endorsed a broadly similar approach to highway funding in its fiscal year 2016 budget. But whether Congress and the White House can come together on such complicated, politically fraught, and potentially expensive legislation in such a short time remains to be seen. (See separate coverage in this issue for details on House Republican efforts to use international tax reform as vehicle for long-term highway funding.)

Senate Majority Leader McConnell, who would prefer to keep tax reform out of the infrastructure spending debate, is expected to press for a long-term highway deal using the Senate-approved DRIVE Act as a starting point.

An already-packed fall just got busier

Further complicating efforts to move long-term highway legislation is a jam-packed congressional calendar. After the two chambers return from their summer recesses on September 8, they will have only a few weeks to negotiate discretionary spending levels for fiscal year 2016 (which begins on October 1), and to reauthorize programs under the Federal Aviation Administration which also are set to lapse at the end of the current fiscal year.

Later in the fall, Congress also will have to address the federal debt limit. The statutory debt limit was technically reached on March 16, and since that time the Treasury Department has been utilizing so-called “extraordinary measures” to finance the government. In a letter to Speaker Boehner dated July 29, Treasury Secretary Jack Lew noted these accounting maneuvers likely will last “for at least a brief additional period of time” beyond late October.
URL: http://www.treasury.gov/connect/blog/Pages/Treasury-Sends-Debt-Limit-Letter-to-Congress.aspx

Lawmakers also need to address the so-called “tax extenders” – the dozens of temporary tax provisions that most recently lapsed at the end of 2014. The House and Senate are on different pages on this issue as well, with the House voting this year to make permanent a handful of these provisions (from the research credit to the itemized deduction for state and

local sales taxes in lieu of income taxes), and the Senate Finance Committee recently reporting to the full Senate legislation that would retroactively extend nearly all of the provisions for through 2016. (For prior coverage, see *Tax News & Views*, Vol. 16, No. 25, July 24, 2015).
URL: http://newsletters.usdbriefs.com/2015/Tax/TNV/150724_3.html

Also likely to take up lawmakers' time this fall are votes on other major issues, including President Obama's deal related to Iran's nuclear program, trade agreements, cybersecurity, and reform of federal programs for elementary and secondary education – not to mention a scheduled address by Pope Francis on September 24 to a joint meeting of Congress.

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