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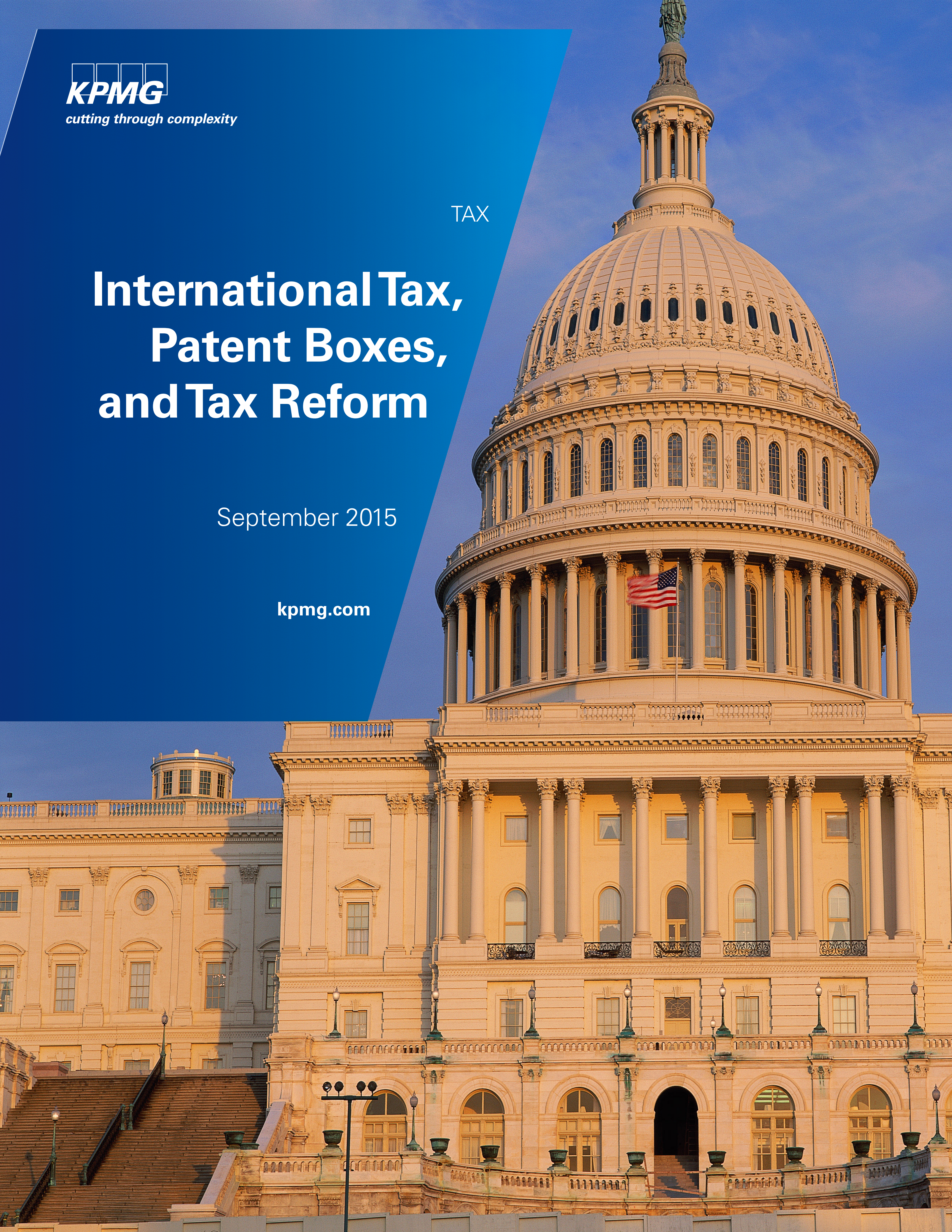

REDEFINING TAX REFORM: COULD CONGRESS “EIGHTY SIX” THE ’86 ACT?

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President Reagan, on October 22, 1986—with Republican Senate Majority Leader Bob Dole and Democratic Ways & Means Chair Dan Rostenkowski looking over his shoulder—signed the Tax Reform Act of 1986 into law. That legislation (the ’86 Act) with its sweeping reach, continues to be heralded as a triumph of tax legislation, perhaps even more so today than when it was enacted. Among the most notable characteristics of the ’86 Act are that it significantly lowered the statutory tax rate for both corporations and individuals simultaneously. Furthermore, it achieved this comprehensive tax reform on a revenue-neutral basis, by clearing out dozens of special preference items in the tax code. The law also balanced its books by closing a number of perceived loopholes and areas of tax abuse.

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Some 30 years later, the Tax Reform Act of 1986 still casts a long shadow on present day deliberations about tax reform. Perhaps it is human nature to define things by what we have known them to be, and for most tax professionals and policy-makers, the ‘86 Act is the only version of known tax reform. As such, much of the effort in recent years has been in trying to recreate the legislative success achieved in the fall of 1986, by creating a new comprehensive tax reform bill that also significantly lowers both the corporate and individual income tax rates on a revenue-neutral basis. For example, former Ways & Means Chairman Dave Camp’s proposed Tax Reform Act of 2014 largely followed the 1986 blueprint. Perhaps it is worth asking why that paradigm must be so.

Over the years since that October day on south lawn of the White House, much has changed in the United States and in the global economy. Take a moment to recall that on that day in 1986, a Cyndi Lauper single, sold on a 45-inch record, topped the singles charts. Mobile phones were an oddity; the Chevrolet Celebrity was the top selling passenger car; Sony Walkman sales were brisk; and the Commodore 64 was America’s top choice for its home computing needs. These serve a reminder that, just as technology has evolved, so has the economy, which is now significantly more global, and in which the U.S. position has changed. With all these changes, perhaps Congress, willingly or out of necessity, will eventually abandon the 1986 tax reform precedent.

COMPREHENSIVE REFORM

Arguably, the most notable feature of the ‘86 Act was that it achieved comprehensive tax reform—that is, it fundamentally reformed the taxation of both corporations and individuals (and thus, by proxy, most small businesses) at the same time. Much of the discussion of tax reform since then has been how to replicate comprehensive reform in the today’s environment. A number of good arguments have been made as to why this approach makes sense. Most notably, a simultaneous reduction of the corporate and individual rates would not discriminate against small businesses based on entity type (partnership, sole proprietorship, or S corporation).

Yet, arguably the conditions for comprehensive reform are less compelling today than in 1986. The ‘86 Act reduced the top individual income tax rate from 50% to 28%—a 44 percentage reduction, made largely possible by the repeal of certain tax preferences (some would

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say tax shelters) available in 1986. It is not clear whether a reduction of similar magnitude is possible today, given the magnitude and nature of the tax preferences currently available. Former Ways & Means Chairman Dave Camp's proposed Tax Reform Act of 2014 would have achieved an individual income tax top rate reduction from 39.6% to 35%—less than a 12 percentage reduction, with certain mathematical and distributional realities limiting a more aggressive individual rate reduction.

If, like Camp, congressional tax-writers conclude only modest rate reductions are possible (or preferable) for individuals, part of the 1986 rationale for comprehensive reform becomes less relevant.

REVENUE NEUTRALITY

As noted above, one hallmark of the '86 Act is that it accomplished its policy objectives all while maintaining revenue neutrality in the official budget window. As evidenced by the proposed Tax Reform Act of 2014, the notion of revenue neutrality has been embraced by a current generation of tax reformers. Yet, some would argue that revenue neutrality is perhaps the greatest hindrance to creating a politically viable and growth-maximizing version of tax reform. That is, under the revenue-neutral model, every tax reduction in the Code must be accompanied by a tax increase elsewhere. This give-some-take-some approach necessarily creates a winners-and-losers dynamic, thus engendering the opposition of the losers.

Arguably, however, cracks are beginning to appear in the edifice of revenue neutrality. First, President Obama has proposed "long-term revenue neutrality" for tax reform. Under his scenario, taxes are increased in the 10-year budget window but then become neutral over a still undetermined long-run. While this concept has not been well-received on Capitol Hill, the idea introduces greater flexibility than is offered by the 1986 "revenue straightjacket." Under this approach, conceivably Congress could enact long-term revenue-neutral tax reform that is **revenue negative** in the 10-year budget window. This approach could be viewed as a net tax-cut in the short-term, which has the potential to erode political opposition to tax reform itself.

A second crack in revenue neutrality has appeared in the area of macroeconomic revenue estimates. The '86 Act and the proposed Tax Reform Act of 2014 were deemed to be revenue neutral using conventional revenue estimating methodologies. Under conventional scoring, macroeconomic feedbacks from the tax cuts are not considered in evaluating the law's effect on tax receipts. This year, the House adopted a rule that would require (when feasible) congressional revenue estimators to consider these macroeconomic effects in major tax law changes. Had those methodologies been used to score the Tax Reform Act of 2014, that otherwise revenue-neutral proposal would have increased tax receipts by anywhere from $50 billion to $700 billion over a 10-year period. This dynamic scoring methodology permits Congress to rethink very difficult choices it made in 1986 and since in achieving revenue neutrality.

Third, as discussed below, Congress is currently considering tax law changes as a way to fund highway and other infrastructure spending. This at least suggests the possibility of **revenue positive** tax legislation, at least in the 10-year budget window.

A final fissure in the 1986 model of revenue neutrality relates to the "tax extenders." Tax extenders are the 50 or so expiring tax incentives that Congress must periodically extend. Congress has almost never paid for

these short-term extensions of current law. In 2014 and again in 2015, however, the House proposed to make many of these extenders permanent, and would do so without offsetting revenue increases. These efforts to make certain extenders permanent, whether or not they are wrapped into tax reform, suggests (at least in the House) a more fluid definition of revenue neutrality than might have been previously understood.

CORPORATE RATE REDUCTION

Having now done violence to two "sacred cows" of the 1986 vision of tax reform, consider the most sacred of all—corporate rate reduction. Some would argue that reducing the corporate rate is the very point of tax reform. Indeed, the United States now has the highest statutory corporate tax rate in the OECD. After the '86 Act lowered the corporate rate from 46% to 34%, much of the rest of the world then followed the U.S. lead by dramatically reducing corporate tax rates.

While policy-makers on both sides of the aisle have signaled their commitment to lowering the corporate tax rate, it is something easier said than done. This is particularly true in a revenue-neutral scenario, since lowering the corporate rate from 35% to 25% is estimated to cost more than $1 trillion over the first 10 years.

This raises the question whether there might be alternatives to reducing the corporate rate that still achieve other goals of tax reform. To be clear, the question is not whether there are better ways to achieve the goals of tax reform (there probably aren't), but whether other means are easier or more probable. There is nothing magical about the term "tax reform" and Congress could apply that label to any legislation it chooses.

For example, Congress is currently engaged in discussions concerning how to fund highway and infrastructure spending. One idea with seeming currency, as a way of funding transportation infrastructure projects, is for Congress to enact a deemed repatriation on all untaxed corporate foreign earnings and then use that revenue to fund the Highway Trust Fund. Attached to this legislation, Congress is considering an innovation box regime for certain intellectual property. Finally Congress could theoretically then "bolt on" several popular tax extenders made permanent and call the whole package "tax reform." While that bill would look very little like the '86 Act in terms of scope, rate reduction, or universal appeal, it could be flagged as reform nonetheless. There are countless variations on this theme that could be viewed as intermediate steps towards a long-term tax reform ideal.

FINAL THOUGHTS

The '86 Act was a transformative piece of legislation in the tax world. It not only made the U.S. tax code simpler, flatter, and fairer, but it also set off a trend of global tax rate competition that still reverberates today. But the '86 Act was also a product of its time, circumstances, and personalities involved. The next version of tax reform—whenever and however that may come to fruition—will be a product of its own time, circumstances, and personalities. Don't be surprised if a final product bears little resemblance to an earlier generation's blueprint for reform.

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WHAT IS AN “INNOVATION BOX”? WHY SHOULD BUSINESSES CARE?

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In recent months, there has been a lot of talk on Capitol Hill about attaching an “innovation box” regime—along with an international tax “modernization” package—to a long-term highway funding bill this fall. The general concept, which has some bipartisan support, is that revenue raised by a deemed repatriation of untaxed foreign earnings of U.S. companies could be used to fund highway spending, while enhancing incentives for innovation and overhauling international tax rules could address some immediate concerns about U.S. competitiveness while serving as a step towards more expansive tax reform in the future.

10 September 2015

The following discussion answers some commonly asked questions about an innovation box and explains why businesses should be interested in the innovation box “draft proposal” that was released in July 2015 by two senior members of the Ways and Means Committee, Rep. Charles Boustany (R-TX) and Rep. Richard Neal (D-MA).

- What is a patent or innovation box?
- Why are some members of Congress talking about enacting a U.S. innovation box?
- What is the "draft proposal" of Reps. Boustany and Neal?
- How would the amount of of the draft proposal's innovation incentive be computed?
- Would the draft proposal's innovation incentive be available to corporations that don't have any international operations?
- Would the draft proposal's innovation inventive be available to S corporations and partnerships (including C corporation joint ventures)?
- Would the draft proposal's innovation incentive apply to service income?
- Would the draft proposal change the R&D credit, the section 199 deduction or section 174?
- How much would an innovation box cost the government?
- How might the cost of implementing an innovation box be offset?
- Does the draft proposal include provisions in addition to an innovation box?
- Might the draft proposal be modified, going forward?
- Is it likely that the draft proposal would become law this year?
- What should businesses be thinking about, and doing now?

WHAT IS A PATENT OR INNOVATION BOX?

An innovation box refers to a law that provides favorable tax treatment (typically a reduced rate of tax) on certain kinds of income from innovation-related intangibles. The legislation can define what kinds of intangibles and what amounts of income are subject to favorable tax treatment, and how the favorable tax treatment is implemented. Thus, the technical details of an innovation box can vary. In some foreign countries, a taxpayer might check a box to indicate that it is taking advantage of preferential tax rules for income attributable to innovation—hence, the term “innovation box.” However, U.S. lawmakers tend to use the term “innovation box” broadly to encompass providing favorable incentives for innovation in the United States, regardless of whether any kind of election by the taxpayer ultimately may be involved.

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A patent box is a type of innovation box that provides preferential treatment mainly to income from legally protected intellectual property. That is, a patent box may be "narrower" than an innovation box.

WHY ARE SOME MEMBERS OF CONGRESS TALKING ABOUT ENACTING A U.S. INNOVATION BOX?

Some lawmakers are concerned that action by certain European countries with respect to their patent box regimes may result in the migration of technology jobs overseas. These concerns have been heightened by the OECD base erosion and profits shifting (BEPS) project.

For example, as part of the BEPS project, consensus was reached that businesses should be able to participate in innovation box regimes only to the extent that the business activities that gave rise to intangibles income (such as research activities) were substantially performed in the country providing the incentive. In a report issued by the International Tax Bipartisan Tax Working Group of the Senate Finance Committee, the co-chairs of that group, Sen. Rob Portman (R-OH) and Sen. Chuck Schumer (D-NY), agreed that "…the anticipated impact of the new nexus requirements on innovation box 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." As a result, they concluded that "…we must take legislative action soon to combat the efforts of other countries to attract highly mobile U.S. corporate income through the implementation of our own innovation box regime that encourages the development and ownership of [intellectual property] in the United States, along with associated domestic manufacturing."

Rep. Paul Ryan (R-WI), the Chairman of the House Ways and Means Committee, similarly indicated that innovation box legislation could "…allow American businesses to better compete with foreign companies and keep their research and development facilities here in the U.S." Chairman Ryan has also indicated that implementing an innovation box is an important piece of international tax reform.

WHAT IS THE "DRAFT PROPOSAL"?

On July 29, two senior members of the Ways and Means Committee—Rep. Charles Boustany (R-TX) and Rep. Richard Neal (D-MA)—released for public comment the following documents regarding an innovation box proposal:

- A draft proposal [PDF 69 KB]
- A technical explanation [PDF 150 KB]
- A request for feedback [PDF 245 KB]

The draft proposal generally would provide some corporations with a new deduction for a percent of "innovation box profits." The deduction is intended to lower the income tax rates on those profits.

Reps. Boustany and Neal have made clear that the "draft proposal" is just a discussion draft and have requested input on particular issues. Thus, it is quite possible that details of the draft proposal will be modified. However, it also appears likely that Chairman Ryan will look to the draft proposal as a starting point in determining what to include in any innovation incentives he might release as part of a larger bill this fall.

It is worth noting that, in the Senate, the Finance Committee's International Tax Working Group report indicates that the co-chairs of that group are continuing to work to "…determine appropriate eligibility criteria for covered IP, a nexus standard that incentivizes U.S. research, manufacturing, and production, as well as a mechanism for the domestication of currently offshore IP." None of the members of the working group, however, has released a detailed innovation box proposal. Thus, it is not clear to what extent members of the Senate Finance Committee would design an innovation box in the same

manner as reflected in the draft proposal.

HOW WOULD THE AMOUNT OF THE DRAFT PROPOSAL'S INNOVATION INCENTIVE BE COMPUTED?

Very generally, the draft proposal would provide a deduction to a C corporation equal to 71% of an amount determined by reference to: (1) a formulaically determined amount called "innovation box profit" or (2) taxable income. As a result of this proposed new deduction, the effective top corporate tax rate on qualifying income would be around 10%.

More specifically, the draft proposal would add a new section 250 to Part VIII of subchapter B of Chapter 1 of the Internal Revenue Code of 1986—the part of the Code that provides special deductions for corporations. New section 250 would provide that, in the case of a corporation, a deduction would be allowed equal to 71% of the lesser of (1) the "innovation box profit," or (2) taxable income (determined without regard to new section 250) for the tax year. Thus, a corporation could not reduce its tax rate to below the approximate 10% rate by using new section 250, when its taxable income would be less than its innovation box profit. No deduction at all would be allowed if the corporation did not have any taxable income for the tax year. Further, the deduction could not be taken into account in computing any net operating loss (NOL) or the amount of any operating loss carryback or carryover.

WHAT IS "INNOVATION BOX PROFIT"?

A corporation's "innovation box profit" for a tax year would equal the product of :(1) its "tentative innovation profit" for the tax year ("tentative innovation profit") and (2) a fraction, referred to by one author (Martin A. Sullivan in an August 2015 article) as the "research intensity factor."

For purposes of computing innovation box profit, all members of an "expanded affiliated group" would be treated as a single corporation and the deduction would be allocated among group members based on each member's amount of innovation box profit.

WHAT IS "TENTATIVE INNOVATION PROFIT"?

A corporation's "tentative innovation profit" with respect to a tax year generally would equal:

- The corporation's gross receipts for the tax year derived from selling, leasing, licensing, or otherwise disposing of certain "qualified property" in the ordinary course of a U.S. trade or business of the corporation (not taking into account certain related-party sales),[1] **minus**
- The taxpayer's cost of goods (COGS) sold for the tax year properly allocable to such gross receipts, **minus**
- Other expenses, losses, and deductions (other than the new section 250 deduction) properly allocable to such gross receipts.

1 Gross receipts generally would include only gross receipts from sales to an unrelated person. However, if products produced using qualified property were sold to a related person outside the United States, and resold to an unrelated person outside the United States, gross receipts from the initial sale would be qualified gross receipts. The draft proposal does not explain how taxpayers would track these resales and associate them with earlier gross receipts.

For this purpose, the draft proposal generally defines "qualified property" as any: (1) patent, invention, formula, process, design, pattern, or know-how (i.e., property described in section 936(h)(3)(B)(i)); (2) motion picture film or video tape (i.e., property described in section 168(f)(3)); (3) computer software (as defined in section 197(e)(3)(B)); and (4) **any product produced using any patent, invention, formula, process, design, pattern, or know-how** described above.

Thus, the definition of qualified property is quite broad.

The draft proposal (proposed new section 250) also would provide for

the Treasury Secretary to prescribe rules for the proper allocation of items in determining the "tentative innovation profit"—including rules providing "for the proper allocation of items whether or not such items are directly allocable to qualified gross receipts."

WHAT IS THE "RESEARCH INTENSITY FACTOR"?

Under the draft proposal, the "research intensity factor" would be determined by dividing: (1) the taxpayer's expenditures for research and development performed in the United States for the five-tax-year period ending with the tax year;[2] by (2) the taxpayer's total "costs" paid or incurred for that same five-year period, excluding cost of goods sold, interest, and taxes ("five-year total costs").[3]

2 For this purpose, "five-year research and development expenditures" would be those expenditures for which a deduction is allowed under section 174 (determined without regard to sections 41 and 280C(c)).

3 The term "cost" is not further defined. However, the five-year-total-costs would not include research expenditures for testing conducted outside of the United States if such testing were conducted outside the United States because: (1) there is an insufficient testing population in the United States; or (2) testing outside the United States is required by law.

Note that only expenditures for research and development performed in the United States are included in the numerator of this fraction. Thus, a corporation that does not perform any research and development activities in the United States would have a research intensity factor of zero and an innovation box profit of zero—and, therefore, would not qualify for any deduction under new section 250. This is consistent with the intent to encourage development of intellectual property in the United States and to discourage the migration of technology jobs overseas.

HOW WOULD THESE DEFINITIONS AFFECT THE AMOUNT OF THE DEDUCTION?

Based on the questions and answers above, highly simplified, the formula for determining the amount of the deduction for a C corporation that has taxable income in excess of innovation box profit generally would be:

0.71 x [gross receipts from qualified property – allocable COGS & expenses]

x <u>5 Year US Research Costs</u>

5 Year Total Costs

As a result, as a general matter, the size of the corporation's deduction would be relatively larger as the amount of gross receipts from qualified property increased or as the amount of expense allocable to such gross receipts decreased.

Likewise, the size of the deduction would be relatively larger the higher the taxpayer's domestic research costs over the five-year period are compared to its overall costs (excluding COGS, interest, and taxes) for that period. However, as explained above, no deduction would be available to the extent the taxpayer has no taxable income or tentative innovation box profit for the tax year or has no domestic research activities for the five-year period ending with the tax year.

An appendix [PDF 73 KB] to this report includes a simplified chart illustrating how changes in facts and assumptions can change the amount of the deduction.

WOULD THE DRAFT PROPOSAL'S INNOVATION INCENTIVE BE AVAILABLE TO CORPORATIONS THAT DON'T HAVE ANY INTERNATIONAL OPERATIONS?

Yes. Even though some members of Congress have been discussing innovation boxes in the context of international tax reform, the draft proposal is not targeted to corporations with multi-national operations. Instead, a corporation could benefit from the draft proposal's deduction even if all its operations are in the United States. Thus, even corporations with purely domestic operations would be interested in what happens with innovation box legislation.

WOULD THE DRAFT PROPOSAL'S INNOVATION INCENTIVE BE AVAILABLE TO START-UPS?

Most start-ups likely would not be able to benefit much (if at all) from the deduction described in the draft proposal because they do not have much (if any) taxable income in their initial years. As indicated above, if a corporation does not have taxable income, the amount of its deduction for innovation box profits would be zero. Further, the draft proposal would not allow innovation box deductions to be carried forward or back as part of an NOL.

WOULD THE DRAFT PROPOSAL'S INNOVATION INCENTIVE BE AVAILABLE TO S CORPORATIONS AND PARTNERSHIPS (INCLUDING C CORPORATION JOINT VENTURES)?

S corporations likely would not qualify for the draft proposal's deduction. Although an S corporation is a corporation, it is required to compute its income using rules applicable to individuals, rather than those applicable to corporations, and the Draft Proposal's deduction is not available for individuals.[4]

Partnerships also likely would not qualify for the deduction described in the draft proposal. Like S corporations, they generally compute taxable income at the entity level in the same manner as in the case of an individual (subject to specific rules regarding separately stating certain items), and flow distributive shares of items through to their owners. Even in the case of a joint venture among C corporation partners, it appears possible that neither the partnership nor the C corporation partners might be able to benefit from the draft proposal's innovation deduction. Instead, C corporations might need to conduct their domestic research and development—and to generate innovation box profit—outside of a partnership to benefit from the deduction.

4 The part of the Code to which new section 250 would be added ("Special Deductions for Corporations") includes provisions like the section 243 corporate dividends received deduction. Because section 1363(b) generally requires an S corporation to compute its income in the same manner as an individual, an S corporation is not allowed to take the dividends received deduction. See, e.g., H.R. Rep. No. 737, 104th Cong., 2d Sess 227 (1996).

WOULD THE DRAFT PROPOSAL'S INNOVATION INCENTIVE APPLY TO SERVICE INCOME?

As was explained above, under the draft proposal, a corporation's tentative innovation profit would take into account gross receipts from selling, leasing, licensing, or otherwise disposing of any **product** produced using patents, inventions, formulae, processes, designs, patterns, or know-how (or from disposing of the property itself). The draft proposal does not define "product." However, the use of that term suggests that the draft proposal might not apply to gross receipts from selling services. Reps. Boustany and Neal have specifically requested feedback regarding to what extent gross receipts from services that are directly related to a product that uses qualified property is to be included in the determination of qualified gross receipts.

WOULD THE DRAFT PROPOSAL CHANGE THE R&D CREDIT, THE SECTION 199 DEDUCTION, OR SECTION

174?

As currently drafted, the draft proposal does not modify the rules regarding the research and development (R&D) credit, the section 199 domestic manufacturing deduction, or the section 174 rules regarding specified research and experimentation (R&E) expenditures. However, as indicated below, Reps. Boustany and Neal have requested feedback as to how the R&D credit and the section 199 rules could be coordinated with the innovation box rules. Further, as indicated below, it is possible that, to offset revenue loss associated with the innovation box regime, the ability to deduct specified R&E expenditures currently under section 174 might be repealed.

HOW MUCH WOULD AN INNOVATION BOX COST THE GOVERNMENT?

An estimate of the revenue costs associated with the draft proposal has not been released yet. Thus, it is not clear how much revenue the government would lose by providing the new innovation deduction. Nonetheless, the revenue estimate for the draft proposal could be substantial (even if macroeconomic effects are taken into account). Keep in mind that the revenue loss associated with an innovation box likely could be modified by changing the percent of qualifying income that is deductible (i.e., the "depth" of the box) or the specifications regarding the income and qualified property taken into account (i.e., the "width" and "length" of the box). Thus, some of the features of an innovation box proposal could be modified to meet revenue goals. As is discussed below, it is also possible that other tax law changes might be considered to offset the costs of an innovation box.

HOW MIGHT THE COST OF IMPLEMENTING AN INNOVATION BOX BE OFFSET?

Reportedly, Chairman Ryan may be looking at modifying section 174 to repeal the ability to deduct immediately specified R&E expenditures, such that those expenditures instead would have to be capitalized and amortized over a five-year period.

Last Congress, Rep. Camp (the then-chair of the Ways and Means Committee) included such a proposal in the tax reform bill he introduced; and the Joint Committee on Taxation (JCT) estimated that, in the context of that reform bill, the section 174 proposal would raise approximately $192.6 billion.

Keep in mind that modifying section 174, so as to require R&E expenditures to be capitalized, might affect some businesses that might not benefit from an innovation box regime (e.g., certain businesses conducted through passthrough entities). Also keep in mind that other business revenue raisers also might come into play. Thus, apart from considering the details of innovation box provisions, businesses may want to monitor developments regarding potential revenue offsets.

DOES THE DRAFT PROPOSAL INCLUDE PROVISIONS IN ADDITION TO AN INNOVATION BOX?

In addition to providing an innovation box, the draft proposal generally would provide that a controlled foreign corporation (CFC) could distribute appreciated intangible property assets to a domestic corporation that is a U.S. shareholder with respect to such CFC, pursuant to a "qualified plan," without triggering taxable income, provided that certain requirements were met. It appears that this provision is intended to encourage domestication of intangible property. Read text of the draft proposal and technical explanation for more detail on this aspect.

MIGHT THE DRAFT PROPOSAL BE MODIFIED GOING FORWARD?

As indicated above, Reps. Boustany and Neal have made clear that the draft proposal is a discussion draft, and that they are looking for public input. Thus, it is possible that the technical details could be modified to reflect comments provided regarding the proposal or to reach certain revenue, policy, or political goals.

Further, keep in mind that Reps. Boustany and Neal requested feedback on the following specific issues:

- Does the draft proposal address the appropriate scope of intellectual property that should qualify for the deduction?
- To what extent should gross receipts from **services** that are directly related to a product that uses qualified property be included in the determination of qualified gross receipts?
- Are there other costs or expenditures that relate to innovation and that, therefore, should be included in the numerator of the research intensity factor? Can those costs be defined in a manner that limits potential abuse?
- What would be the appropriate approach for determining expenses properly allocable to innovation profits? Should the proposal just include authority for the Treasury Secretary to adopt allocation rules, or is more specific guidance necessary?
- Are there modifications that could be made to minimize the compliance burdens on taxpayers and improve the administrability of the proposed regime?
- How should the deduction for innovation profits be coordinated with the R&D credit under section 41 and the manufacturing deduction under section 199?
- Are there particular transition rules that would be necessary to implement the deduction for innovation box profits and the special rules for transfers of intangible property from CFCs to U.S. shareholders?
- Does the draft proposal “help your company remain competitive in the global marketplace, relative to your foreign counterparts”?

IS IT LIKELY THAT THE DRAFT PROPOSAL WILL BECOME LAW THIS YEAR?

Enacting innovation box legislation this year will be difficult. As explained above, discussions about enacting innovation box legislation this year have centered on attaching such legislation to a long-term highway funding measure, along with deemed repatriation of offshore earnings of multinationals and an international tax modernization package. However, such an approach raises a number of issues. For example:

- There is not much time left on the congressional calendar and Congress already has a busy schedule for the remainder of the year (including passing legislation to fund the government and potentially to increase the “debt limit”).
- Given that next year is an election year, some members of Congress may be reluctant to vote on a significant tax bill that includes controversial revenue raisers or that is not perceived as helping individuals or small (“Main Street”) businesses.
- Some members of Congress may be reluctant to vote on using tax revenues from deemed repatriation to fund highway spending, both because some have pledged not to increase taxes to offset spending and because some may be concerned as to how using tax revenues to fund highways could factor into negotiations regarding non-defense spending levels more generally.
- Although some key players in the Senate support modernizing the international tax rules and providing enhanced innovation incentives as a general matter, they have expressed concern about attaching those measures to a highway funding bill.
- Putting together the international tax modernization component of a larger bill itself raises challenging issues. Read TaxNewsFlash-

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- Some parts of the domestic business community may be concerned that, if an international tax modernization package is enacted, much of the impetus for broader tax reform may dissipate.

Moreover, even if these issues could be surmounted, finalizing and enacting an innovation box regime itself likely would face challenges. For example:

- At this time, it is not clear whether the Obama Administration supports an innovation box proposal.
- Some economists have expressed concerns about implementing U.S. innovation box legislation.
- Given the potential for an innovation box (and any revenue offsets) to affect different businesses differently, different aspects of the business community may have different views about the desirability of enacting such legislation, which could affect the political support for an innovation box.
- Although some of the political concerns possibly could be mitigated by expanding the availability of the benefits under an innovation box, such expansion could increase the revenue cost of an innovation box and might necessitate reducing the rate of the proposed new deduction or finding other revenue offsets.

Thus, enacting innovation box legislation this year appears to be a long shot. However, keep in mind that, even if innovation box legislation is not enacted this year, lawmakers are likely to pursue innovation box legislation in the future—particularly in light of concerns regarding European patent box regimes. And, any decisions that are made this year regarding the scope and design of such legislation might be hard to change in the future.

WHAT SHOULD BUSINESSES BE THINKING ABOUT, AND DOING, NOW?

As explained above, innovation box legislation could benefit many C corporations, regardless of whether or not those corporations have multinational operations. However, under the draft proposal, the amount of the benefit for a particular corporation could vary depending on the particular facts, including the size of the research intensity factor, the level of innovation box profit, and the amount of taxable income. Further, some businesses might not benefit from the proposed new deduction at all, including, for example, partnerships, S corporations, and start-ups and other businesses with no taxable income.

Thus, as a threshold matter, businesses may want to assess how much of a benefit they could expect to receive under the draft proposal (both in isolation and vis-à-vis their competitors), taking into account their particular facts and projections. They also might want to quantify the expected impact (if any) of a potential repeal of the ability to immediately deduct R&E expenditures under section 174—and to stay tuned to legislative developments in the event other changes in tax law are raised as potential revenue offsets. In addition, businesses may want to consider the specific issues on which Reps. Boustany and Neal have requested feedback.

To the extent that businesses have views regarding the draft proposal (or innovation box legislation more generally) that they would like to convey to lawmakers, they may want to work with their industry or trade associations in expressing those views, or to communicate those views directly, to relevant decision makers. As explained above, even if a business does not believe that enactment of innovation box legislation in the near future is likely, keep in mind that work being done now on an innovation box regime potentially could serve as a cornerstone for future legislation and design details may be more settled and more difficult to change at that time.

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Legislative update: What is an "innovation box"? Why should businesses care?

Appendix

This chart provides a highly simplified illustration of how changes in various facts and assumptions could affect the amount of the deduction. Numbers relating to "bolded items" in the far left column were computed. Numbers relating to other items were assumed. All R&D expenses were assumed to be allocable to dispositions of qualified property. For sake of simplicity, facts and calculations relating to COGS, interest, and taxes were excluded.

	Base Case	**More QP Gross Receipts**	**Fewer Costs Allocable to QP**	**More US R&D**	**More US/Less Foreign R&D**	**Little Taxable Income**
Gross receipts from QP	100	200	100	100	100	100
Other gross income	100	100	100	100	100	0
Total income	200	300	200	200	200	100
U.S. R&D	20	20	20	30	40	20
Foreign R&D	20	20	20	20	0	20
Other costs allocable to QP	20	20	5	20	20	20
Total expenses allocable to QP	60	60	45	70	60	60
Other expenses	20	20	20	20	20	50
Total expenses	80	80	65	90	80	110
Taxable income	120	220	135	110	120	-10
5-year US Research Costs	100	100	100	150	200	100
5-year Total Costs	400	400	325	400	400	400
Tentative Innovation Profit *(gross receipts from QP - allocable costs)*	40	140	55	30	40	40

Research Intensity Factor *(5-yr US Research/5-yr total costs)*	0.25	0.25	0.30769231	0.375	0.5	0.25
Innovation Box Profit *(Tent. Inn. Profit x Research Intensity)*	10	35	16.9230769	11.25	20	10
Lesser of Innovation Box Profit or Taxable Income	10	35	16.9230769	11.25	20	-10
Deduction	7.1	24.85	12.0153846	7.9875	14.2	0

Source: KPMG LLP

IS HIGHWAY BILL POSSIBLE ROUTE TO BUSINESS TAX REFORM?

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In recent months, there has been considerable talk on Capitol Hill of combining highway funding legislation with a sweeping overhaul of the tax rules affecting multinational businesses. The general concept—which has some bipartisan support—is that revenue raised by a deemed repatriation of untaxed foreign earnings of U.S. companies could be used to fund highway spending, while at the same time modernizing the international tax rules and enhancing incentives for innovation. This limited legislative success could then serve as a step towards more expansive tax reform in the future.

9 September 2015

The talk about enacting such “limited scope tax reform” escalated in July 2015 and can be expected to continue now that Congress has returned from the August recess and when it tries (again) to find a multi-year solution to highway funding concerns.

Enacting even limited scope tax reform in the near future would be difficult and the chances of such reform becoming law this year, while not zero, appear to be small. The potential implications of the tax law changes being discussed, however, would be substantial, and some of the changes could affect businesses with solely domestic operations as well as those with multinational operations. Further, proposals for international tax reform and innovation incentives, even if unsuccessful, could be building blocks for future legislative efforts. Thus, businesses would be well advised to monitor developments this fall.

BACKGROUND

In recent years, talk about tax reform generally has centered on reform of the entire Internal Revenue Code, including the provisions relating to the taxation of individuals. Nonetheless, as 2015 has progressed, congressional tax-writers appear to have abandoned efforts to enact comprehensive tax reform before the next presidential election. Among the many obstacles are the policy differences between the administration and congressional Republicans regarding the appropriate individual rate structure and revenue.

As a result, some members of Congress have shifted their focus to modernizing the tax rules applicable to multinational businesses and toward providing enhanced incentives for innovation in the near future—issues with respect to which there is some bipartisan agreement, at least as a “down payment” on enacting more comprehensive tax reform in 2017 or thereafter. Further, some lawmakers believe that a multi-year highway bill could be a vehicle for such legislation because repatriation could pave the way for multi-year highway funding.

WHY THE INTEREST IN MOVING LIMITED SCOPE TAX REFORM THIS YEAR?

Although different lawmakers may have different reasons for trying to advance limited scope tax reform this year, some of the commonly cited reasons for the current effort include the following.

Interest in implementing a “patent” or “innovation” box: Some lawmakers are concerned that action by some European countries with respect to their patent box regimes in light of the OECD base erosion

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and profits shifting (BEPS) project may result in the migration of technology jobs overseas. Very generally, these patent box regimes offer a reduced rate of tax on income attributable to certain intellectual property. Thus, some U.S. lawmakers are interested in enacting U.S. patent or innovation box legislation.

In fact, on July 29, two senior members of the Ways and Means Committee—Rep. Charles Boustany (R-TX) and Rep. Richard Neal (D-MA)—released for public comment a discussion draft, technical explanation, and request for feedback regarding an "innovation box" proposal. This draft proposal generally would substantially lower the rate of tax for C corporations with respect to dispositions and licenses of intellectual property (IP) and products produced using IP. The draft proposal would benefit many C corporations, including those with multinational operations. Read TaxNewsFlash-United States

Nevertheless, as currently drafted, the proposal does not appear to apply to individuals or passthrough entities. The proposed bill would add the deduction for innovation box profits to a new section in Part VIII of subchapter B of Chapter 1 of the Internal Revenue Code—this part of the Code relates to special deductions for corporations. Note that, under section 1363(b), an S corporation generally is treated as an individual for income computation purposes.

OECD base erosion and profit shifting (BEPS) project: Congressional tax-writers have been closely watching the activities of the OECD's BEPS project and considering possible implications for U.S.-headquartered companies and the U.S. tax base. Some are concerned that the U.S. government would be forced to respond legislatively to changes in tax laws that could be made in other countries under the auspices of the BEPS project's recommendations.

Apparent belief that Congress and the White House actually could reach agreement on a package of multinational tax reforms: Although the details of the international tax provisions in the comprehensive tax reform bill introduced last year by then Ways and Means Chairman Dave Camp (the "Camp reform bill") and the Obama Administration's most recent budget proposal differ, there is agreement among interested parties that the current system is broken in many respects and that there are substantial conceptual similarities between the proposed solutions. Read a KPMG chart [PDF 683 KB] showing similarities between the Camp reform bill and the administration's budget proposal.

Further, from public comments made and the apparent level of private dialogue taking place among the various interested parties, it appears that some congressional Republicans and officials at the White House believe they may be able to reach consensus on some sort of international tax modernization package.

WHY THE POTENTIAL LINK BETWEEN HIGHWAYS AND LIMITED SCOPE TAX REFORM?

Revenues currently dedicated to the "highway trust fund" recently have been falling billions of dollars short of highway funding needs each year. With many members of Congress averse to increasing the gas tax, lawmakers are looking for additional ways to fund highway spending. Some lawmakers believe that deemed repatriation of the estimated over **$2 trillion** of foreign earnings of U.S. multinational corporations could provide revenue that could be used to fund a multi-year highway spending bill. Some lawmakers, however, also believe that from a political and revenue standpoint, deemed repatriation to fund

highway spending can work only if it is part of a larger package that also addresses modernization of the current international tax rules, prevents future U.S. tax base erosion, and provides enhanced incentives for U.S. innovation.

The potential link between highway funding and international tax modernization was apparent in recent negotiations between the House and the Senate on the short-term highway bill that was enacted in July 2015.

- Senate leadership generally supported a six-year highway bill, the costs of which were offset for three years; the offsets included both tax and non-tax provisions, and some were perceived as controversial.
- The House, however, sought only a short-term extension, which Ways and Means Chairman Paul Ryan reportedly suggested would "buy time" for Congress and the president to try to reach agreement on international tax reform that would include deemed repatriation to fund infrastructure.

Facing highway funding that was set to expire at the end of July, the House and Senate ultimately agreed to a short-term bill, by extending highway funding until October 29, 2015. The president signed this extension into law.

As a result, Congress will have to re-visit highway spending again in the fall, and repatriation, international tax modernization, and innovation boxes are likely to be discussed as Congress considers (again) how long to extend highway funding and how to offset the costs of that spending.

WHAT MIGHT LIMITED SCOPE TAX REFORM ENCOMPASS IF ADDRESSED THIS YEAR?

If Congress does put together a multi-year highway spending bill that includes limited scope tax reform, what kinds of tax provisions might the bill include? Although it is impossible to know with certainty, possibilities include:

- Deemed repatriation of accumulated earnings at an as yet undetermined rate, but no tax on repatriation of future foreign earnings
- Taxation (potentially at reduced rates) of some future foreign earnings of multinationals to balance base erosion and competitiveness concerns (e.g., income from mobile intangible property)
- Some form of innovation box regime, likely based on the discussion draft released by Reps. Boustany and Neal
- No reduction in C corporation tax rate
- Tightening of section 163(j) interest limitation rules
- Other items, such as extension of expired provisions, reform of the Foreign Investment in Real Property Tax Act (FIRPTA) rules, and miscellaneous items

HOW DIFFICULT WOULD ENACTING LIMITED SCOPE TAX REFORM THIS YEAR BE?

There are those who believe that enacting limited scope tax reform this year would be very difficult. For example, from a "big picture" perspective, some of the issues and obstacles that would need to be confronted are:

- There is not much time left on the congressional calendar, and Congress already has a busy schedule for the remainder of the year (including passing legislation to fund the government and potentially to increase the "debt limit").
- Given that next year is an election year, some members of Congress may be reluctant to vote on limited scope tax reform that includes controversial revenue raisers or that is not perceived as helping individuals or small ("Main Street") businesses.
- Some members of Congress may be reluctant to vote on using tax

revenues from deemed repatriation to fund highway spending, because they have pledged not to increase taxes to offset spending and/or because they may be concerned as to how using tax revenues to fund highways could factor into negotiations regarding non-defense spending levels more generally.

- Although some key players in the Senate support modernizing the international tax rules and providing enhanced innovation incentives as a general matter, they have expressed opposition to using repatriation to offset the costs of highway spending.
- Some parts of the domestic business community may be concerned that, if an international tax modernization package is enacted, much of the impetus for broader tax reform may dissipate.

Moreover, even if these issues could be surmounted, there could be other difficult issues relating to the design of an innovation box and multinational tax modernization package. For example:

- How would a repatriation provision be structured to raise enough money to fund a long-term highway spending bill—as well as (possibly) to offset the costs of implementing an innovation box and other components of a modernization bill?

In a cost estimate dated July 14, 2015, the Congressional Budget Office (CBO) estimated that implementing the Senate six-year highway bill (S. 1647) would cost about $157 billion over a five-year period and about $256 billion over a 10-year period. As indicated below, it is not clear how much an innovation box would cost; however, depending upon the scope and the amount of rate reduction provided, it could be substantial. Keep in mind that the Joint Committee on Taxation (JCT) estimated that a previous proposal for **elective** repatriation at a reduced rate for a temporary period of time would **lose** revenue. That proposal was not part of a broader overhaul of the international tax rules. By contrast, in the context of a broader tax reform proposal, the JCT estimated that a mandatory (deemed) repatriation of offshore earnings at reduced rates would **raise** about $170 billion in revenue[1] (not taking into account possible macroeconomic effects).[2]

- What rate would apply to “old” foreign earnings that are deemed repatriated, and would such earnings be treated differently depending upon whether or not they have been invested in illiquid business assets?
- What future foreign earnings would be subject to U.S. tax, and at what rate?
- Could a repatriation proposal, along with the rest of the provisions in an international tax modernization bill, be designed in such a manner that the entire business community—including multinationals that have invested significant overseas earnings in operations—could support the overall bill? Note that, in connection with a June hearing on the repatriation of foreign earnings as a source of funding for the highway trust fund, held by the Select Revenue Measures Subcommittee of the Committee on Ways and Means, several business groups expressed opposition to the use of repatriation to fund infrastructure.
- Could meaningful modernization of the international tax rules be accomplished without lowering the C corporation income tax rate? Reducing the effective tax rate on foreign earnings without reducing the C corporation rate could provide an incentive to move business operations offshore. In the past, reducing the C corporation income tax rate has been an important component of international tax reform discussions. However, lowering the C corporation income tax rate would increase the revenue cost substantially, possibly requiring the inclusion of additional base-broadening provisions that would be politically unpopular. Moreover, it could be politically difficult to reduce the C corporation income tax rate without also addressing the individual income tax rate at which many owners of passthrough entities pay tax.
- Might providing a lower rate through an innovation box serve as a proxy for reducing the C corporation rate? What kind of feedback will lawmakers receive on the current innovation box discussion draft—

and might an innovation box ultimately be drafted so as to benefit passthrough businesses? If not, how might this affect support for such legislation? Keep in mind that, given revenue constraints, there may be a trade-off between the scope of an innovation box (i.e., what taxpayers and what income benefits) and the tax rate benefit provided (i.e., a "wide" box is likely to be more "shallow" than a narrow box).

- How would innovation box rules be coordinated with the existing research credit and domestic manufacturing deduction?
- What other revenue raisers might be included—and how would these affect support for the bill?

1 The Camp reform bill proposed that, as part of the transition to a territorial system, accumulated, untaxed foreign earnings would be deemed to be repatriated to the United States. Those earnings would be taxed at one of two reduced rates, depending on how the CFC had deployed the earnings. Earnings in cash or cash equivalents would be taxed at 8.75%, while other earnings, perhaps invested in plant and equipment, would be subject to a 3.5% rate. The resulting tax could be paid in installments over eight years. The JCT estimated that, in the context of the larger Camp tax reform bill, this proposal would raise approximately $170 billion over 10 years.

2 Under the Budget Resolution passed by Congress earlier this year, in the case of "major" tax legislation, the JCT and the CBO are required "to the extent practicable" to produce a point estimate of the revenue effect that takes into account macroeconomic changes. This estimate is the official estimate of the budgetary effects of such legislation for the House, but is used for informational purposes only for the Senate. The White House's Office of Management and Budget (OMB) does not use macroeconomic estimates for tax law changes. However, query whether the White House might ultimately accept the use of macroeconomic scoring for limited scope tax reform done in conjunction with a highway bill if congressional Republicans were to agree to take into account the macroeconomic impact of increased infrastructure spending. If so, query whether or not this might make it significantly easier to put together an international tax reform bill from a revenue perspective.

CONCLUSION

As indicated above, tax-writers are giving significant attention to issues associated with intellectual property and international tax modernization.

Further, even though enacting limited scope tax reform this year could be very difficult, congressional efforts on these issues today can be expected to shape tax reform discussions in the future—and technical design decisions made by policymakers now could be hard to change in the future. Thus, businesses would be well advised to stay tuned to what lawmakers continue to say—and do—now that Congress has returned from recess.

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