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Boustany–Neal Innovation Box: Complex and Unsound Policy

Curtis Dubay and David Burton

Talk in Congress of establishing an innovation box (also called a patent box) has increased in recent days. An innovation box would lower tax on income earned from certain types of intellectual property (IP).

Innovation boxes exist in several countries around the world, including many major U.S. trading partners. The purpose of the boxes is to lower the tax rate on certain types of highly mobile income derived from IP. There is, however, considerable variance in how particular countries lower taxes on income on which they choose to bestow a tax benefit, in addition to variance in the size of the benefit and the rules and regulations governing the innovation box. Regardless of their intent or structure, innovation boxes are poor policy because they pick winners and losers, in addition to a number of other problems.[1]

Nevertheless, discussion in Congress of an innovation box has arisen as an addition to a plan that would move the taxation of foreign business income from a worldwide tax system to a territorial one. That plan would also deem foreign earnings repatriated and tax them at a lower rate relative to current law in order to offset the tax cut from moving to a territorial system. This plan would simultaneously use the new revenue from the deemed repatriation to bailout the highway trust fund, which will be exhausted later this year.

The push for an innovation box in that package intensified in early July when the Senate Finance Committee's Working Group on International Tax Reform, co-chaired by Senators Rob Portman (R–OH) and Charles Schumer (D–NY), recommended that Congress create an innovation box.[2]

The Boustany–Neal Innovation Box Is Terribly Complex

Congressmen Charles Boustany (R–LA) and Richard Neal (D–MA), Members of the House Ways and Means Committee, recently proposed legislation that would create an innovation box.[3] In addition to being unsound policy, innovation boxes, in general, are notoriously difficult to implement because of the host of questions the law must answer to prevent abuse and to insure that the box conveys the benefits its authors intend.

The most important question is what type of income derived from IP would qualify for the box. (The answer to this question is important because it reveals the purpose of the box.) Additionally, how would businesses and tax authorities determine if particular types of income qualify? Subsequently, how would businesses align costs incurred to the qualifying income? These are difficult questions to answer. The difficulty is akin to the troubles that plague the transfer pricing rules guiding international transactions between corporate parents and their subsidiaries.

Other important questions for the box creators to consider: How involved does a business need to be in the creation of the IP in order for the income

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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it generates to qualify for inclusion in the box? How should existing policies that are closely related to the box be treated?[4] The Boustany and Neal bill makes no mention, for example, of the research and development (R&D) credit.

Rather than tackle these important issues, the Boustany–Neal bill avoids them by broadly designing the box and allowing almost all types of business income to qualify. The bill would then narrow the qualifying income by reducing the income by a ratio of R&D expenses to total expenses.

The Boustany–Neal bill works as follows:

Income "derived from" the sale of qualifying property in the U.S., which is income from the sale of anything using a patent, invention, formula, process, design, pattern, know-how, films, or software,[5] goes into the box. Nearly all goods would qualify, except for commodities. Many services would qualify as well. "Derived from" is not defined in the bill, however, and thus would be up to the Treasury Department and the IRS to define.

Businesses then subtract "properly allocable" expenses from qualifying income to arrive at their "Tentative Innovation Profit." The term "properly allocable" is not defined in the bill, and therefore would also be defined by the Treasury Department and the IRS.

Businesses then multiply their Tentative Innovation Profit by the ratio of their five-year R&D expenses to their five-year total expenses. The result is their "Innovation Box Profit." The non-qualifying income is taxed at the regular business rate.

The Innovation Box Profit would receive a 71 percent exemption from tax. The remaining 29 percent would be subject to the 35 percent corporate tax rate, which works out to an effective tax rate on Innovation Box Profit of approximately 10 percent.

Innovation Box Profit =
(5-year R&D Costs / 5-year total costs)
x Tentative Innovation Profit

Innovation Box Profit x (1-0.71) x 35 percent =
tax on Innovation Box Profit

This terribly complicated mechanism would keep many accountants, lawyers, and economists employed figuring out how the box reduces businesses' taxes. The upside of the mechanism for its creators is that it relieves them of the unpleasant task of answering those difficult questions.

The Boustany–Neal bill avoids the question of how businesses are supposed to properly allocate expenses. In effect, they transfer that authority to the Treasury Department and the IRS. This shifting of responsibility is problematic. Businesses would have a strong incentive to allocate expenses to income outside the box in order to reduce further their tax liability. Leaving the Treasury Department (by regulation) and the IRS (by audit decisions) to decide in place of Congress is inexcusable because it conveys Congress's authority to agencies with no guidance as to how Congress intends them to handle the issue. This could create serious issues because the IRS would be besieged by businesses aggressively allocating expenses to maximize their benefit from the box.

Businesses with High R&D Expenses Would Benefit Most

A business's effective tax rate on all its income, after accounting for the reduction of tax on the income that qualifies for the box, would be determined by the size of the R&D-to-total expenses

1. Curtis Dubay, "An Innovation Box for the U.S.? Congress Should Focus on Business Tax Reform Instead," Heritage Foundation *Backgrounder* No. 3049, August 18, 2015, http://www.heritage.org/research/reports/2015/08/an-innovation-box-for-the-us-congress-should-focus-on-business-tax-reform-instead.
2. U.S. Senate, Committee on Finance, "The International Tax Bipartisan Working Group Report," July 2015, p. 73, http://www.finance.senate.gov/download/?id=E1FA3F08-B00C-4AA8-BFC9-7901BD68A30D (accessed August 10, 2015).
3. U.S. House of Representatives, Committee on Ways and Means, "Technical Explanation of the Innovation Promotion Act of 2015," July 28, 2015, http://waysandmeans.house.gov/wp-content/uploads/2015/07/FINAL-TE-Innovation-Promotion-Act.pdf (accessed August 10, 2015).
4. For further basic questions legislators should answer when forming an innovation box, see Curtis Dubay, "An Innovation Box for the U.S.? Congress Should Focus on Business Tax Reform Instead."
5. U.S. House of Representatives, Committee on Ways and Means, "Technical Explanation of the Innovation Promotion Act of 2015," p. 8.

ratio. Those businesses with higher R&D costs will see a greater reduction in their effective tax rates. Businesses in industries where R&D plays a large role, such as tech and pharmaceuticals, would likely see large benefits.

Those businesses that see larger benefits will also see increased profitability and competitiveness compared to businesses that see smaller, or nonexistent, benefits because they do not have substantial R&D expenses. Such a policy picks winners and losers through the tax code and is anathema to tax reform. It distorts the economy and makes it less productive. Tax reform should level the playing field so that no business or industry has an artificial, government-created advantage. For businesses, Congress should lower the tax rate, minimize complexity, expense capital purchases, and move to a territorial system.

Focus on Tax Reform

If Congress passed an innovation box, whether the Boustany–Neal version or another, it would impair the ongoing tax reform efforts by moving the tax code in the wrong direction. Instead of establishing an innovation box, Congress should focus on fundamental tax reform. Alternatively, it could broadly reform business taxation since the current system is such a large drag on economic growth, job creation, and wage increases.[6] Either way, Congress should not be trying to convey benefits on particular businesses and industries.

*—**Curtis S. Dubay** is Research Fellow in Tax and Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation. **David R. Burton** is Senior Fellow in Economic Policy in the Roe Institute.*

6. Curtis Dubay and David Burton, "How Congress Should Reform Business Taxes," Heritage Foundation *Backgrounder* No. 3022, June 4, 2015, http://www.heritage.org/research/reports/2015/06/how-congress-should-reform-business-taxes.