Patent box concept emerges on the tax reform agenda for US Congress

Tax Reform Alert

Intellectual Property and Technology Alert

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Key tax writers in Congress are indicating that once Congress disposes of pending trade legislation, they will turn to their top legislative priority: reaching a consensus on international and business reform by the end of the summer.

In recent weeks, a major concept has emerged in tax reform discussions: the establishment of a patent or innovation box.

The patent box is a mechanism that is used to encourage domestic innovation and the commercialization of innovative new products. Several major US trading partners already use patent or innovation boxes as part of their tax regimes.

Under a patent box (so called because taxpayers would be required to check a box on the tax return to elect patent box benefits), income derived substantially from the domestic development and manufacture of patented products would be subject to a notably reduced tax rate in order to foster domestic innovation and commercialization of innovative technologies. An innovation box is broader and may include income from other intangible assets. The intent behind a patent box regime is to **reduce the cost and risk of innovating and to put American companies operating domestically in a stronger position to compete with innovators overseas** in jurisdictions that have both lowered their corporate rates and enacted incentives to innovate.

The tax writers currently are debating how to design a patent box for the US and are **open to suggestions from stakeholders**. In the last Congress, for example, Representative Charles Boustany (R-LA), who is drafting the current House tax reform proposal, and then-Representative Allyson Schwartz (D-PA) introduced the Manufacturing Innovation in America Act. Under that proposal, taxpayers would have had the option to exclude from tax up to 71 percent of their patent box profits for the year under a statutory formula that took their research and development expenses and the extent to which their products are developed and commercialized in the US into account. In his tax reform draft, then-Chairman Dave Camp approached the patent box issue in one of his proposed base erosion options, known as the carrot-and-stick approach, under which all foreign intangible income would be taxed immediately but at a reduced 15 percent rate (the carrot) but any such income earned in a jurisdiction with a rate below 13.5 percent would be taxed at the full US corporate 25 percent rate (to discourage American companies from moving their operations to very low tax foreign jurisdictions).

The focus on a patent or innovation box in the tax reform discussions is further evidence of the concern voiced by Senate Finance Committee Chairman Orrin Hatch (R-UT) that US business has lost its patience with Congressional inaction and a recognition that **America's trading partners have gained a competitive advantage not only by lowering their rates, but also by supporting their tax reforms with creative incentives** that could further draw future research and product development by US companies overseas.

Tax issues are being seen as mission critical by many in Congress these days. On the House side, Representative Boustany has indicated that he will by early summer **introduce the base business tax reform bill that will be considered by the Ways and Means Committee**. This bill is expected to include a lower corporate rate and a transition to a territorial tax system. The Boustany approach will likely use the mechanism of a **dividend exemption system**, whereby most of the profits earned overseas by US companies are excluded from US taxation when brought back as dividends, with the remainder taxed at the regular corporate rate. Last week, the **Senate Finance Committee working group on international tax reform** briefed their colleagues on their progress so far and reports are that there was a great deal of consensus as to their approach to reform and that the briefing was extremely well attended. The five working groups were charged to complete their work and submit written reports and if possible legislative recommendations by the end of May, but may ask for a brief extension to the early part of June.

Both Senator Hatch and House Ways and Means Committee Chairman Paul Ryan (R-WI) have indicated they are **working closely with the Administration on tax reform** and all share a deep concern that if they fail to act on business and especially international reform in this Congress, the US will see a vast number of American companies move their domiciles overseas to reduce their US tax burdens. In remarks at a private event, Chairman Hatch conceded that **the patience of US multinationals has run its course**; they will not wait beyond this year for Congress to act, and as a result, both he and Chairman Ryan need to find a way to "walk through the door" of business tax reform this year.

In the next few weeks, **Congress will also need to deal with the potential insolvency of the highway trust fund** (HTF) at the very start of the summer construction season, and Chairman Hatch has proposed to address this challenge in a two-step process. Initially, he will propose an $11 billion patch to fund the HTF through the end of the calendar year (the $11 billion must be offset), and as a way to give the tax writers time to see if they can succeed at enacting business tax reform as a way to raise revenues needed to provide HTF funding for at least five years. As of now, a consensus is emerging that a one-time tax on accumulated untaxed foreign profits as part of a transition to a territorial system would be an ideal way to raise revenues to support the HTF for at least five years, creating stability for the HTF and taking the issue off the table for the foreseeable future.

The tax reform debate will never be easy, and as Chairman Hatch has pointed out, some groups will be angry at what is proposed because someone will have to offset the cost of lowering rates and potentially enacting a costly patent box. Organizations representing small business, for example, have stepped up a campaign against limited corporate and international reform on the grounds that pass-throughs will be disadvantaged as a result; they express doubt that Congress will be able to enact temporary measures to provide an equivalent to rate relief for non-corporate entities. Both Chairman Ryan and Hatch have asked these groups to give them time to develop their proposals and have assured them that they have constructive options to successfully address their concerns.

In its first five months, the new Congress has acted to dispel the cynicism that has developed that Washington is incapable of getting anything done. Since January, for example, Congress has extended terrorism risk insurance, enacted a permanent SGR formula (the Medicare doc-fix), moved ahead with major trade legislation and addressed a number of smaller measures that failed to advance in the last Congress.   Chairman Hatch recently said that while tax reform takes time, his intent is to move as quickly as possible towards a resolution that will convince American businesses that Congress is capable of acting before they do. At least since January he is operating in an environment that has been far more conducive to results than in the recent past.

If you would like to know about how a patent box might work, or how your operations would benefit from the enactment of a patent box under US law, please do not hesitate to contact the authors.

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