Should the United States Adopt an Innovation Box?: The Post-BEPS Landscape

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Introduction

This policy brief examines the positives and negatives of the patent/IP/ innovation box. This issue is increasingly relevant given the OECD's recent release of new principles governing the global tax system.

On October 5, the OECD released the final reports of their Base Erosion and Profit Sharing (BEPS) Project.[1] The comprehensive recommendations in the reports are designed to force multinationals to pay more taxes by substantially eliminating many of the tax avoidance strategies they currently use.[2]

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However, the BEPS reports do effectively bless one way to reduce taxes—the granting of tax incentives for innovation and R&D-related activities. As one BEPS report says:

> "...it is recognized that IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for research and development (R&D) activities, provided that they are granted according to the principle agreed by the [BEPS Report]."[3]

In broad terms, there are two types of innovation-related tax incentives: R&D tax credits, and patent/IP/innovation boxes. The first provides a credit for R&D spending, whether or not it results in a useful product. The second provides for a lower rate on corporate profits that arise from innovation-related investment. In other words, the patent/IP/innovation boxes favor those companies who are successful with their innovation.

The terminology difference between a patent box, an IP box, and an innovation box reflects the breadth of the intangibles covered, ranging from simply patents, to other types of intellectual property such as copyrights, or a broader range of spending related to innovation. The OECD uses the technical term 'IP regime' to cover all three.

There is much fear that IP regimes can be used as a "harmful tax practice," by sheltering income that is not really related to innovation. So the OECD proposes a "substantial activity" test as a way of ensuring that IP regimes are drivers of growth and employment:

> "It is not the amount of expenditures that acts as a direct proxy for the amount of activities. It is instead the proportion of expenditures directly related to development activities that demonstrates real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook. The nexus approach applies a proportionate analysis to income, under which the proportion of income that may benefit from an IP regime is the same proportion as that between qualifying expenditures and overall expenditures."[4]

In other words, companies get more tax benefits from spending money and hiring workers to innovate in the country with the IP regime.

There are currently 11 OECD countries with an IP regime in place. They give varying preferential rates on IP income, from 5 percent (Netherlands) to 15 percent (France and Spain). U.S. legislators are considering a recently issued discussion draft of an innovation box bill that would give a 10.15 percent tax rate on a very broad range of innovation-related income.

Benefits of a Patent/IP/Innovation Box

Encouraging innovation is beneficial for economic growth

Innovation has been recognized as a key factor in driving economic growth.[5] Research, development, and innovation lead to new markets and investment opportunities, which in turn increase productivity and growth.

In a 2015 report, the OECD emphasizes this point, writing "productivity is expected to be the main driver of economic growth and well-being over the next 50 years, via investment in innovation and knowledge-based capital."[6] Thus, a policy that stimulates investment in innovation and knowledge-based capital would help boost long-term growth.

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Economic advantage in a globally competitive world

In today's global environment, the United States faces economic competition from foreign countries. Corporations have a choice in where to base their operations and the tax code they will face in a location plays a significant role in this decision.

The United States has the highest overall corporate tax rate of all industrialized countries at 35%, almost 12% higher than the OECD average of 23.2%[7]. Now that many European and other OECD countries have IP regimes in place, in addition to their already lower overall corporate tax rates, it is becoming increasingly difficult for the United States to remain a competitive location for businesses.

Even if a patent/IP/innovation box fails to spur investment in intellectual property and innovation, it will still have the effect of lowering the effective tax rate for companies in innovation-based industries, reducing our economic disadvantage.

Keeps high-paying R&D jobs in America

R&D and innovation-related businesses and jobs have become increasingly mobile as many nations are acquiring the necessary knowledge and technological infrastructure.[8] It is much easier to pick up your research team and move them to Europe than it is to move a manufacturing plant or a grocery store, for instance. However, it is exactly these high-paying knowledge based jobs that we would most like to keep in our country.

Bipartisan support

The fact that there are supporters of an IP regime on both sides of the aisle is evidence of the important role of the tax system in boosting innovation and keeping business in the United States. In addition, bipartisan support is fundamental in getting a proposed IP regime legislation passed.

Costs of an IP Regime

Costly in terms of lost tax revenue and the trade-off for other tax reforms

An IP regime, by lowering the effective tax rate for many corporations, would cost the U.S. tax revenue in the long term. According to one news report, a recently drafted innovation box proposal would potentially cost "hundreds of billions of dollars."[9] However, if dynamic scoring is used in the official calculation to account for increased future growth, this estimate could be significantly reduced.

A downside to IP or innovation boxes: Any policy that favors a particular industry or corporation would tend to impose economic distortions.

In addition to the monetary cost of IP regime legislation, there are fiscal and political opportunity costs as well. Proponents of corporate tax reform are putting their top priority on lowering the overall corporate tax rate. Enacting an IP or innovation box would likely lower the chances of achieving broader corporate tax reform.

Distorts the economy by favoring certain industries

Only those companies that are heavily investing in intellectual property would benefit from an IP or innovation box. In general, any policy that favors a particular industry or corporation would tend to impose economic distortions.

It could be argued, though, that the distortion is justifiable and potentially even favorable since economists generally agree that are many positive spillovers associated with R&D and knowledge-based capital. However, given the importance of investment in physical capital, such an argument in favor of an IP regime would require further study.

Difficult to determine "qualifying" income

An IP or innovation box can be more difficult to administer than an R&D tax credit. Depending on how the rules for the IP or innovation box are written, it is not obvi-

ous how much of the company's earnings should be attributed to its investments in innovation and intellectual property. For example, a major criticism of the U.K. patent box is that income is included from a large product even if only a small part of it is patented. Moreover, many implementations of the IP or innovation box do not offer tax incentives for further innovation or development of that product.[10]

Encourages the commercialization of research rather than research itself

Unlike R&D tax credits, an IP or innovation box only "pays" for innovation that becomes commercialized and generates profits for a company. This attribute can be considered a benefit or a cost depending on viewpoint.

The broadness of the proposed draft reflects the nature of the U.S. economy, which is heavily dependent on intangible investment.

Advocates may see this as an advantage of IP boxes because taxpayers aren't paying for "unsuccessful" research. Rewarding the commercialization of innovations encourages companies to focus investment on those products that will make it to market and generate income. And remember, it is only those products that make it to market that benefit society—no one reaps the medicinal benefits of a pharmaceutical drug that never goes on sale.

One the other hand, many great technological advancements have come after failed first attempts. If corporations are given incentives to only make the safest bets, society may miss out on many innovations. In addition, if spurring research and innovation is the goal, it is sensible to make the tax benefit proportional to the research effort, rather than the profit that comes from that research.

Current U.S. Legislation: Innovation Promotion Act

Currently the United States has an R&D tax credit, but no special tax benefits for innovation-related income. Reps. Charles Boustany (R-La.) and Richard Neal (D-Ma.) recently released a discussion draft of their Innovation Promotion Act of 2015, an innovation box bill that proposes a 10.15 percent tax rate on a broad range of innovation related income, including intangible property such as patents, inventions, formulas, processes, design, patterns, or know-how. Additionally included in the draft are computer software and any motion picture film or videotape, making this proposal more comprehensive that any IP boxes currently in existence.

The broadness of the proposed draft reflects the nature of the U.S. economy, which is heavily dependent on intangible investment. According to one recent estimate, annual intangible investment in the US equals 11.4 percent of GDP in 2010, compared to 8-9 percent in countries such as France and the United Kingdom.[11]

The United States certainly needs to revamp its corporate tax code. As we have described elsewhere, the best option would be a cut in the overall corporate tax rate. As a second best alternative, some form of innovation box has both pluses and minuses. We look forward to continuing the discussion.

Endnotes

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