The Ineluctable Logic of Adopting an IP Box Tax Regime

By Ike Brannon

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In this article, Brannon argues that the adoption of an intellectual property box regime is an achievable corporate tax reform that could return investment and jobs to the United States while sacrificing relatively little tax revenue.

The most important innovation in the tax policy world in the past 15 years has been the introduction of the intellectual property box. An IP box is a system that taxes the profits that accrue to patents, research and development, and to various other IPs (different countries define innovations differently) at a lower rate than other profits. It has quickly become a ubiquitous feature of the corporate tax codes of most of our trading partners.

The motivation for a two-tiered tax code is simple: In a world with extremely mobile capital, it makes sense for countries to design their tax codes in a way that attracts capital as cheaply as possible. An IP box delivers a relatively high return by targeting capital that’s both relatively mobile and relatively good at increasing productivity and economic growth.

Some conservatives object to the United States adopting any sort of IP box. They aver that it amounts to the tax code picking winners and losers and thus manifests an excessive amount of government interference in the economy. It would be much better to merely lower corporate tax rates across the board, they argue.

It’s an argument that is at once facile and misleading.

First of all, a broad-based tax incentive that cuts across a wide array of industries to encourage a salutary activity does not constitute industrial policy. If it does, the same thing can easily be said about the research tax credit, something that many conservative organizations champion. Ditto the section 199 deduction for manufacturing activity. Both give tax breaks that accrue mainly to manufacturers, although the film and software industries famously managed to get themselves classified as manufacturing industries.

Second, the chances of a broad-based corporate tax cut these days are slight, and a fundamental tax reform of the sort championed by conservative opponents of the IP box is simply impossible under current constraints. In our “pay as you go” environment, the revenue lost from every rate reduction must be fully offset, typically by eliminating credits, deductions, or exclusions elsewhere in the code. For a corporate tax cut, an additional political limitation is that the revenue must be made up on the corporate side of the tax code: Any revenue increase imposed on individual taxpayers to finance a corporate tax rate reduction can be politically pilloried until it dies a quick death.

And despite rhetoric to the contrary, few tax expenditures in the corporate code can easily be eliminated. Two of the biggest are the interest deduction and bonus depreciation — both supported by the Heritage Foundation, the self-proclaimed arbiter of conservatism — along with a plethora of other powerful interests on both sides of the aisle. There is also the research tax credit, which, again, has considerable support from conservatives as well as many liberals. The various energy production tax expenditures are a common target for both liberals, who hate the various breaks that go to the production of fossil fuels, and conservatives, who don’t see the point in the never-ending subsidies for renewable energy. But these add up to less than $20 billion a year, and we get that high only by including the energy tax breaks in the personal tax code as well. The Tax Policy Center projects corporate tax revenue to be $340 billion in 2016, or just under $10 billion per percentage point, so eliminating all the energy tax breaks would buy a reduction of less than 2 percentage points in our pay-go world.

The fact is that given current political constraints, there are not enough corporate tax expenditures that we can reduce or eliminate to significantly reduce the corporate income tax rate. A 2007 Treasury report on corporate tax reform — which desperately combed the tax code for various deductions and exclusions to poach — suggested
that it would be nearly impossible to do a revenue-neutral corporate tax reform that took the rate below 30 percent solely by eliminating current tax expenditures. The presidential candidates have scarcely mentioned any pay-fors in their tax plans, perhaps because so few of them are politically viable.

Financing Corporate Tax Reform

The big pot of money with the potential to finance a corporate tax reform is, of course, the $2.5 trillion of profits parked overseas to avoid U.S. corporate taxes. Under current deferral rules, U.S. corporations do not pay taxes to the U.S. treasury on their foreign income until the money returns to the United States. Companies would rather pay the lower foreign tax rate than the higher U.S. tax rate on that income (they receive a credit for foreign taxes paid, so the profits aren’t double taxed). It therefore makes sense to invest those profits abroad; if they need money for domestic operations, they can borrow against their foreign profits. Companies domiciled abroad have no U.S. tax obligations for profits earned outside the United States, hence the surge in companies inverting the past few years.

There are several proposals to do away with the current worldwide plus deferral international tax system and replace it with a territorial system that would not tax foreign profits at all, which is what most of our trading partners have in place. Under most of the reform proposals, the money parked abroad would be assessed a transition tax of 8 to 20 percent as we convert to a territorial regime. Within the confines of a 10-year budget window, the transition tax could cover the cost of a modest tax rate reduction or an IP box similar in scope and scale to what most European countries have.

An IP box would do more than just keep patents and IP from flowing overseas: It would help the United States retain and attract R&D activity as well, since that tends to move with IP. What’s more, myriad industries exhibit economies of scope whereby it makes sense to produce specific products near where they do their R&D. An IP box would also help keep manufacturing — and the jobs it creates — in the United States.

A 2015 study that I coauthored surveyed the chief tax officers of the major biological and life sciences companies. We reported that a majority of the companies that responded would consider returning their patents and other IP to the United States if it were to adopt an IP box. Moreover, a sizable proportion of respondents said that bringing their IP back would also lead to them increasing the amount of manufacturing they would do in the United States.

The connection between IP, R&D, and manufacturing can be easy to see in some businesses. For example, the heavy equipment manufacturer Caterpillar Inc. has numerous production operations overseas, but these tend to produce high-volume, low-margin equipment for local markets. Their high-value-added equipment, such as their large trucks used in mining operations, continue to be produced in Central Illinois, a short distance from the company’s main tech center, which is home to the bulk of their engineers.

The drug maker Biogen Inc. recently announced that it would construct its next production facility in Switzerland. No one locates in Switzerland because of its labor costs. This move is a cost-efficient response to a more copacetic tax environment in Switzerland, which includes an IP box regime.

Fundamental Precepts for Tax Reform

Any structural change in the U.S. tax code should account for the world as it is and not the world we wish we lived in. And we inhabit an incredibly global society: U.S. trade as a proportion of GDP is the highest it’s ever been.

The increased globalization of the economy has many causes, chief among them being that barriers to trade have been gradually falling since the end of World War II. It is a trend that shows no signs of stopping. The odds are good that at some point in 2016 Congress will pass the Trans-Pacific Partnership, a comprehensive trade agreement between the United States and a dozen Asian countries. Negotiations to create a comprehensive free trade agreement encompassing the United States and Europe are picking up steam as well.

The receding trade barriers continue to increase global trade, and this in turn means that the tax policies of our major trading partners have a larger impact on our own corporations than ever before.

Capital has also become more mobile over the past few decades. Today, companies and investors find it exceedingly easy to move investments across the globe to seek out higher returns. And with more countries operating under the precepts of a market economy, there are more places to invest than ever before.

In the past two decades, our primary trading partners have responded to the increasing globalization of the world economy by radically altering their corporate tax codes to retain and attract capital. The most obvious way they have done this is by
reducing their corporate rates. For instance, the average corporate tax rate in the OECD has fallen by about 10 percentage points since 2000. All the OECD members have reduced their corporate income tax in the past two decades, except one — the United States. There have been more than 100 corporate tax rate reductions in the past 15 years among the OECD countries, and few have been paid for by compensating tax revenue increases elsewhere. These changes have left U.S. companies at a distinct disadvantage when it comes to taxes.

In a world in which most of our trading partners have an IP box, it behooves the United States to have one as well. The conclusion of the OECD’s base erosion and project-shifting project has essentially blessed IP boxes, and it’s a safe bet that nearly all the OECD member countries will have some form of an IP box before too long.

A pro-growth agenda should reduce current barriers to economic growth. Our tax code does a terrible job of that. We have a high tax on capital income in the form of the corporate income tax, and in many situations we tax that money again when the shareholder receives a dividend or capital gain.

A full-scale reform of the tax code would make a lot of sense. One idea afoot is to move to corporate integration, which would tax each dollar of corporate income once, and precisely once, by ascribing it to the shareholder and giving him the burden of the tax. Another idea is to concomitantly lower corporate rates and reduce the number of individuals with income tax liability and make up for that revenue through a VAT. Neither proposal has much support in Congress, and it’s hard to see either one being accomplished anytime soon.

An IP box is only an incremental change to the current tax system, but it’s a reform that’s actually achievable without some sort of legislative sleight of hand or scoring subterfuge that sets aside pay-go. What’s more, it has the potential to return both investment and jobs to the United States while sacrificing relatively little tax revenue — an unavoidable constraint in today’s politics.

Even if we managed to accomplish a comprehensive tax reform, an IP box would still provide a way for the tax code to encourage the economic activity most likely to increase productivity and create jobs.