[HPS] LEADING THINKING

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The Clock Is Ticking On American Innovation

Findings:

- **Countries competing with the U.S. for innovative investment and jobs have put in place preferential tax rates for Intellectual Property.**
- **These preferential rates, combined with a relatively high U.S. corporate rate, has contributed to the two trillion dollars in assets held by U.S. multinational firms abroad.**
- **The OECD's Modified Nexus rule requires multinational firms to locate IP creation in the same jurisdiction where IP-related income is taxed.**
- **If Congress fails to implement reform, billions of dollars of investment and thousands of high-skilled jobs are at risk.**

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America's status as an innovative beacon for the world could be dashed because of little-understood changes to international tax law. These changes, if left unanswered by Congress, could lead to severe and irreparable economic harm to the U.S. economy.

It started two years ago when G20 finance ministers called on the Paris-based Organization for Economic Co-operation and Development (OECD) to develop an action plan to address the issue of base erosion and profit shifting (BEPS), specifically as it relates to intellectual property (IP). In October of 2015 G20 Finance Ministers met to discuss the OECD's new rules.

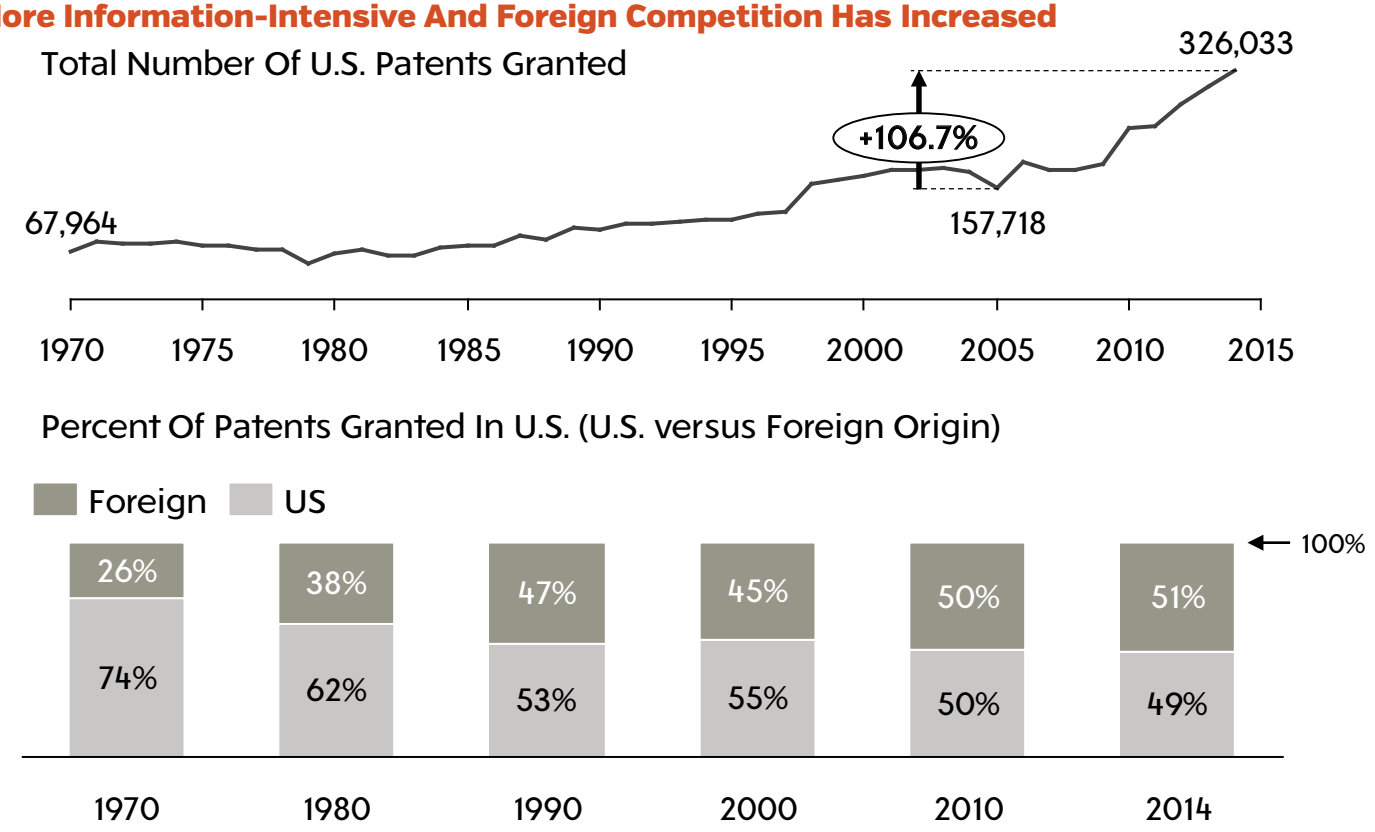
The OECD's intention is to help countries harmonize tax law across international jurisdictions. Apart from resolving tax avoidance, the OECD hopes that multilateral tax policy cohesion will provide businesses with certainty and predictability in decision making.

However, certain rules, like Action 5 and the Modified Nexus framework, will likely create what the business community refers to as "material impact." By requiring companies to locate activities like research and development (R&D) where IP income is taxed, firms are forced to make tough choices about where they locate investment and jobs, drastically altering the structure of their businesses and the broader economy.

The new OECD regulations, combined with higher U.S. corporate tax rates, incentivize U.S. firms to relocate innovative investment and jobs abroad.

The U.S. hosts many of the world's largest and most innovative firms, but the new OECD regulations – which go in to effect in 2016 – combined with relatively high U.S. rates, incentivize U.S. firms to relocate innovative activities abroad, placing hundreds of billions of dollars in U.S. investment and thousands of high-skilled

Fig. 1: Total U.S. Patent Grants Have Doubled In The Last Decade As Firms Have Become More Information-Intensive And Foreign Competition Has Increased



Source: U.S. Patent & Trademark Office

American jobs at risk.

If firms do not relocate, the least economical choice, they will be taxed at higher rates all over the world and be forced to cut investment and lay off workers here in the U.S.

For the U.S. economy, this is a lose-lose situation unless Congress acts to adopt rules – that many of our economic competitors have already put in place – to keep innovative companies and jobs.

The clock is ticking on U.S. innovation. The OECD deadline to adopt innovation-protective rules is June 30, 2016.

U.S. Multinational Companies Are Incentivized To Relocate

Base erosion occurs when firms locate taxable assets in lower tax jurisdictions, avoiding the higher rates where these assets were originally created. Globally, the OECD estimates that $100 to $240 billion in taxes are not going to the jurisdictions where they are owed.[1]

U.S. firms are competing at a global level and IP is more important than ever.

Fixing this problem, as the rules are intended to do, could cost the U.S. economy billions. U.S. critics of international tax reform fail to realize the implications of these rules and the economic pressure they place on U.S. firms to remain competitive.

U.S. firms are competing at a global level and IP is more important than ever. Patents granted by the U.S. Patent & Trademark Office have more than doubled in the past decade alone. Over half of these patents originated abroad – a dramatic increase from years prior (Fig. 1).

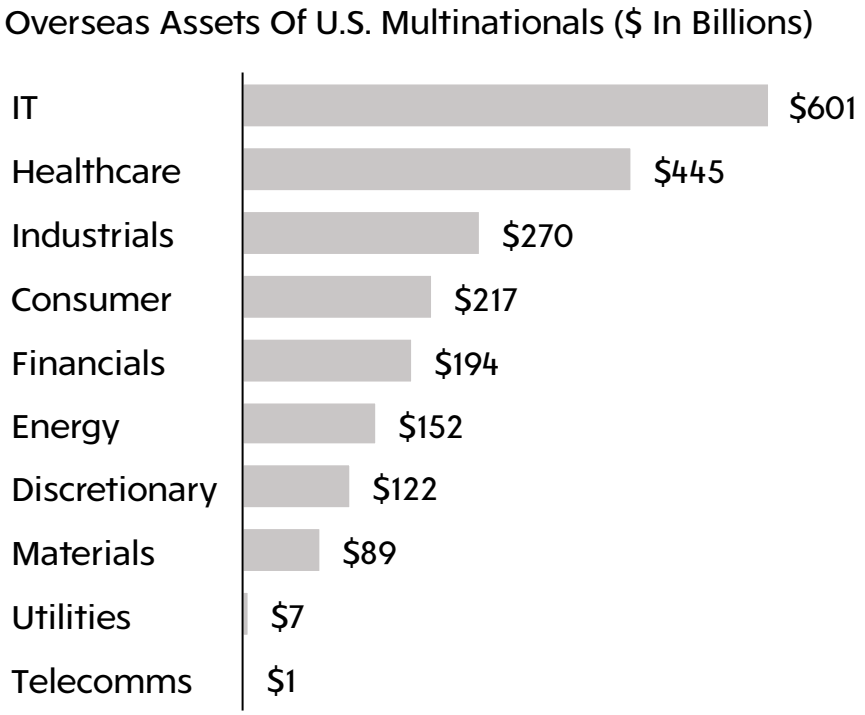
According to estimates, over two trillion dollars are held by U.S. firms overseas.[2] There are many reasons for this.

First, U.S. firms are generating more and more revenue from abroad as emerging markets show promising growth for U.S. products and services. Moreover, repatriating foreign revenue back to the U.S. costs firms more than if they simply invested it abroad due to the relatively high U.S. corporate tax rate.

Second, U.S. firms are increasingly locating IP assets abroad as foreign countries offer tax incentives for innovation-based business activity.

These preferential tax rates are known as Innovation or Patent Boxes (Innovation Box) and they are a big reason why many intellectual-capital intensive firms, like information technology and healthcare companies, hold large amounts of overseas assets (Fig. 2).

Fig. 2: Industries With Information-Intensive Assets Have Higher Overseas Holdings



Source: Bloomberg

Innovation Boxes Now Come With Red Tape

Unlike tangible assets, intangible assets are not limited by geography. A company that develops IP assets in California can offer that service to hundreds of millions of people around the world. Holding these assets in lower tax jurisdictions keeps U.S. companies competitive as global rivals often benefit from favorable rates in their home countries.

Innovation Box rates often differ dramatically from overall corporate tax rates around the world. For instance, Belgium's Innovation Box rate is 6.8 percent, while its overall corporate income tax rate is roughly the same as it is in the U.S., at 34 percent.[3]

The OECD does not seek to end preferential tax treatment for IP, but to specify whether preferential rates are deserved. The OECD's Modified Nexus approach only allows a firm to benefit from a preferential IP rate to the extent that it can show that it incurred costs, like R&D expenditures, that added real value to the creation of an IP asset.

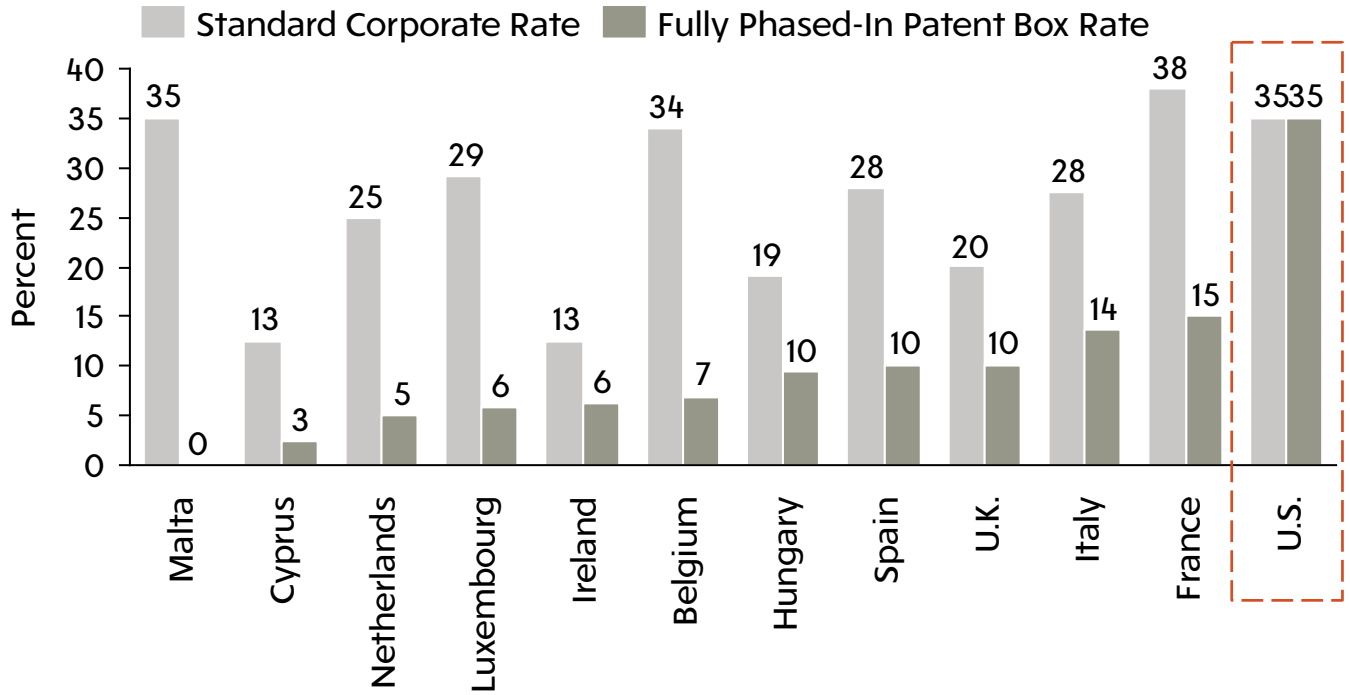
This approach was endorsed by all OECD and G20 countries and many have already implemented or are planning to respond with changes to attract innovative firms (Fig. 3).

According to the OECD's timeline, countries with IP regimes that are inconsistent with the BEPS' framework must start amending their legislative process by the end of 2015. Companies cannot receive tax benefits for IP income that does not meet BEPS criteria after June 30, 2016. The OECD has found 16 IP regimes to be partly or wholly inconsistent with the proposed framework.[4]

Countries Rush To Stay Competitive In Advance Of Regulatory Shifts

Fig. 3: The United States Lags Competitors In The Implementation Of An Innovation Box

Corporate Versus Innovation Box Tax Rates By Country



Source: Senate Finance Committee, International Tax Reform Working Group: Final Report

While the BEPS Project may be well-intentioned, new regulations will force both countries and companies to make difficult choices. Looking to get ahead of the OECD rules change, some countries are proactively lowering corporate tax rates and increasingly offering preferential Innovation Box rates.

Many major economic competitors of the U.S. have already lowered their corporate income taxes or plan to in the near future. The U.K. slashed corporate taxes to 20 percent in 2014, with a special 10 percent tax rate by 2017 for income from IP. Japan's business tax rate was reduced from 34.62 percent to 32.11 percent, with additional cuts planned for 2016.

Overall, the number of OECD countries with dividend exemption systems has grown from nine in 1986 to 28 in 2011, reflecting the increased desire to remain economically competitive in the information economy.[5]

It is easy to see how the OECD's attempt to regulate the location of business activity creates a perverse incentive for businesses that have the U.S.-based R&D operations. Companies can continue to do R&D in the U.S. and suffer wildly uncompetitive corporate tax rates (by far the highest in the OECD), or relocate these activities to a tax jurisdiction committed to protecting IP with an updated tax code.

High corporate rates combined with the lack of comparable protections for IP, creates a dramatically uncompetitive tax landscape.

The Outdated U.S. Corporate Tax Code Risks American Jobs And Economic Growth

The U.S. corporate tax rate is significantly higher than other developed economies. Combined with the lack of comparable protections for IP, this creates a dramatically uncompetitive tax landscape.

Bipartisan proposals have been put forth in both the House of Representatives

and the Senate seeking to level the playing field for American companies and workers.

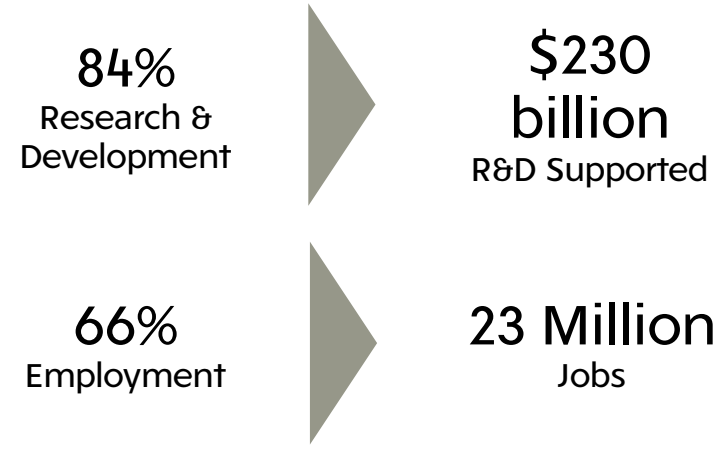
The final report from the Senate Finance Committee's International Tax Reform Working Group, co-chaired by Senator Charles Schumer, (D-New York) and Senator Rob Portman (R-Ohio) proposed the adoption of an Innovation Box for U.S. firms, in order to encourage "the development and ownership of IP in the United States."[6]

While U.S. multinational firms are increasingly global players, they still have significant business operations here at home that could be jeopardized by the BEPS Project's treatment of IP.

By some estimates, U.S. multinationals have "70 percent of their value added, 66 percent of their employment, 73 percent of their capital investment, and 84 percent of their R&D" still located in the U.S. (Fig. 4).[7] The R&D investment for U.S.-based multinational enterprises, and the 23 million high-skill jobs it supports, totaled $230 billion in 2012.[8]

This is precisely the economic activity at risk of leaving as businesses are forced to migrate towards countries with competitive tax rates.

Fig. 4: U.S. Multinational Firms Have Significant Business Activity In The U.S.



Source: E&Y

Notes:

[1] OECD, "Reforms to the international tax system for curbing avoidance by multinational enterprises," Press Release, 5/10/2015

[2] Richard Rubin, "U.S. Companies Are Stashing $2.1 Trillion Overseas to Avoid Taxes," Bloomberg Business, 3/4/15

[3] Quantria Strategies, "Patent Boxes, Technological Innovation and Implications for Corporate Tax Reform," American Action Forum, 8/24/15

[4] OECD, "BEPS - Frequently Asked Questions"

[5] Washington National Tax Services, "Opportunities and challenges ahead: 2015 Tax Policy Outlook," PricewaterhouseCoopers, 1/15

[6] US Senate Committee on Finance, "International Tax Bipartisan Tax Working Group Report," 7/15

[7] Dr. Laura D'Andrea Tyson, Finance Committee, U.S. Senate, Testimony, 2/24/15

[8] Ernst & Young, "Buying and Selling: Cross-border mergers and acquisitions and the US corporate income tax," Business Roundtable, 3/15