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INTRODUCTION

In many countries, including the United States, governments have implemented regulations that aim to encourage expenditure on research and development ("R&D"). Often, the regulations used to encourage R&D can have the effect of stifling innovation. This is because the tax incentives available for R&D disproportionately benefit large multinational enterprises ("MNEs") and do little to benefit startups and small businesses. As a result of the disparate benefits received from R&D-related regulations, startups and small businesses, which often have very innovative and cutting-edge ideas, are unable to compete with large MNEs. Because of this inability to compete, innovative ideas are left unrealized.

A. Tax Incentives Can Create an Unlevel Playing Field

A report issued in 2013 by the Organisation for Economic Co-operation and Development ("OECD") looked at the effect of tax incentives, which make up more than a third of all public support for R&D in the industrialized world.[1] The OECD report concluded that MNEs benefit the most from tax incentives, because they can use tax planning strategies to maximize support for innovation.[2] The OECD found that this creates an unlevel playing field that handicaps domestic companies and startups.[3]

MNEs are able to maximize the benefits of tax incentives for R&D through the use of cross-border tax planning strategies. For example, a MNE could perform R&D through a company located in a country that provides a R&D tax

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[1] *Supporting Investment in Knowledge Capital, Growth and Innovation*, OECD 1 (2013), *available at* http://bit.ly/2nFfV8h.

[2] *Id* at 17.

[3] *Id* at 38.

credit (such as the United States), but then move the intellectual property ("IP") that is produced by the R&D to a holding company located in a country with a more favorable tax system (such as the Netherlands). The Dutch holding company could then license the IP to the U.S. company and pay little to no tax on the income from licensing the IP due to favorable tax rates on royalty income in the Netherlands. Through this cross-border tax planning, the MNE is able to benefit from the U.S. R&D tax credit while also benefitting from the more favorable tax rates in the Netherlands when it uses the IP. The United States gets the short end of the stick as a result, since it is not able to tax the income produced by the IP that it subsidized through the R&D tax credit. Unlike a MNE, a startup or small business is unable to use cross-border tax planning to maximize the benefits it receives from R&D tax incentives. For example, a startup or small business that only does business in the U.S. that receives a R&D tax credit relating to its production of IP has no option but to use the IP in the U.S., and thus will pay tax to the U.S. Government on income produced by the IP.

In addition to the competitive disadvantage created by tax planning opportunities, until recently U.S. startups and small businesses were also disadvantaged because they were sometimes not able to benefit from the U.S. R&D tax credit[4] Before the rules relating to the R&D tax credit were amended by the PATH Act in 2015,[5] the R&D tax credit disproportionately benefited large corporations, while many of the nation's most innovative companies were unable to claim the credit in their first years of operations. This was happening because the R&D tax credit required companies to have a federal income tax liability to be offset by the credit. The majority of startups are not profitable during their first few years of operations, and thus pay no federal income taxes. Incomprehensibly, many of the nation's cutting-edge startups

[4] Section 41 of the Internal Revenue Code and the Treasury Regulations thereunder contain the requirements for using the R&D tax credit. The R&D tax credit is available to companies in a variety of industries that develop new or improved products or processes. The credit (1) is for 20% of current year qualified spending that exceeds a base amount related to gross receipts in certain earlier years and (2) can't exceed 10% of the total spending in the current year on qualified research. Taxpayers can alternatively choose a simpler calculation, but such choice is irrevocable once made. *See* 26 U.S.C. § 41 (2012).

[5] On December 18, 2015, President Barack Obama signed H.R. 2029, the Protecting Americans from Tax Hikes (PATH) Act of 2015, which made the Section 41 R&D tax credit, which expired on December 31, 2014, a permanent provision of the Internal Revenue Code. The law extended the R&D tax credit permanently, retroactive to January 1, 2015. The law also expanded the availability of the R&D tax credit, as discussed in section B of this article. *See* Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, 129 Stat. 224 (2015).

were unable to take advantage of the R&D tax credit that was designed to reward the type of innovations they were working towards.

B. The Playing Field Became a Little More Level in the United States Thanks to the PATH Act

The changes made to the R&D tax credit by the PATH Act have helped to level the playing field for startups and small businesses. The PATH Act made the R&D tax credit permanent for the first time in its 34-year history, and, most significantly for startups and small companies, also greatly expanded the R&D tax credit to benefit companies that had been effectively barred from eligibility.

The PATH Act made a crucial amendment benefitting startups (businesses with gross receipts of less than $5 million for the current tax year and no gross receipts for any tax year before the five tax years ending with the current tax year). The startup provision addresses the disconnect between the purpose of the R&D tax credit and the inability of startups to benefit from it. The provision provides that, for taxable years after 2015, startups are able to take the R&D tax credit, capped at $250,000, against their payroll tax liability. This allows startups with no taxable income to still have the opportunity to benefit from the R&D tax credit.

In addition to the startup provision, starting in 2016, small businesses (businesses with average annual gross receipts of $50 million or less for the three preceding tax years) are able to claim the R&D tax credit against their alternative minimum tax[6] liability. This removes the obstacle that previously prevented small businesses from taking advantage of the R&D tax credit.

C. The Implementation of an IP Box Regime Could Help to Further Level the Playing Field

IP box regimes[7] are tax regimes that provide a reduced rate of tax on income arising from the license or use of IP. The reduced rate of tax is generally through a special deduction or separate schedule. In contrast to the

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[6] The alternative minimum tax (commonly referred to as "AMT") is a supplemental income tax required in addition to baseline income tax for certain individuals, corporations, estates, and trusts that have exemptions or special circumstances allowing for lower payments of standard income tax. It requires certain taxpayers to calculate their income tax liability twice—once under the rules for the regular income tax and once under the AMT rules—and pay the higher amount. *See* 26 U.S.C. § 55 (2012).

[7] IP Boxes are also commonly referred to as "patent boxes" or "innovation boxes."

U.S. R&D tax credit discussed above, which provides an income tax incentive at the front-end of the innovation process, IP boxes provide a back-end tax reduction for successful innovations. IP box regimes have been growing in popularity—over the last 15 years, 16 countries have adopted some form or another of IP box regimes. The U.S. does not currently have an IP box regime; however, the idea of implementing such a regime has been gaining traction recently.[8]

If the U.S. decides to implement an IP box regime, it may help to level the playing field. This is because an IP box regime is in part designed to address the issue of MNEs moving IP offshore after it is developed in order to receive more favorable tax treatment. An IP box regime could help to counter the pressure felt by MNEs to move IP development activities offshore due to the uncompetitive U.S. tax code. The implementation of an IP box regime would also give startups and small businesses the chance to realize some of the back-end tax benefits that MNEs have been enjoying.

An IP box regime would be most likely to aid in leveling the playing field if it follows the directives provided in the OECD's Base Erosion and Profit Shifting ("BEPS") Project[9] Action 5 of the BEPS Project requires that IP box regimes only grant preferential treatment to income derived from substantial activities effectively carried out by the taxpayer obtaining the benefit. This requirement adopts a nexus approach, which is used to assess whether or not there is substantial activity in IP box regimes. Substantial activity is determined by looking to the proportion of expenditures directly related to development activities that demonstrates real value added by the taxpayer. The requirements for IP boxes in the BEPS Project help to increase the likelihood that MNEs are not encouraged to engage in strategic cross-border tax planning in order to take advantage of various countries' R&D-related tax incentives.

[8] In 2015, U.S. Representatives Charles Boustany (R-LA) and Richard Neal (D-MA) released a discussion draft of an IP box, and U.S. Senators Rob Portman (R-OH) and Charles Schumer (D-NY) included the concept in a bipartisan framework for international tax reform, among other congressional proposals. Additionally, it is anticipated that the tax-writing committees in Congress will consider including an IP box in developing U.S. tax reform proposals.

[9] The BEPS Project was developed to create a single set of consensus-based international tax rules to protect tax bases while offering increased certainty and predictability to taxpayers. The BEPS Project contains 15 action items to equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. In recent years, the BEPS Project has been a hot topic in the realm of international taxation, and cannot be properly summarized in a footnote. For more information, visit the OECD website at: http://www.oecd.org/ctp/beps-actions.htm.

The BEPS Project requirements will, in turn, help to level the playing field for domestic companies that are unable to engage in cross-border tax planning.

CONCLUSION

Although the U.S. Government intended to encourage expenditure on innovation when it created the R&D tax credit, the reality is that the R&D tax credit effectively stifles the innovation of some startups and small businesses. MNEs benefit much more from the R&D tax credit than startups and small businesses, and this disparity results in an unlevel playing field. This is a shame and is counter to the purpose of the R&D tax credit. Because startups and small businesses struggle to compete on such an unlevel playing field, some of the most cutting-edge businesses are stifled by the tax provisions that are intended to encourage and bolster their innovative pursuits. This, however, does not have to be the case. The U.S. Government must continue to take steps to level the playing field. The PATH Act amendments were a step in the right direction, and the implementation of a well thought-out IP box regime could significantly improve the ability of startups and small businesses to compete with MNEs.