Thinking inside the box

Why it's time to pay attention to innovation/ patent box regimes

2016

As discussions continue about how to modernize the US tax code, some influential members of Congress have voiced support for an "innovation box," a type of tax regime that allows qualifying business income from intellectual property (IP) to be taxed at a rate lower than a country's corporate tax rate. An innovation box and the more narrowly applied but more commonly known "patent box" are designed to encourage companies to keep IP, research and associated jobs in their home country.

In the United States, House Speaker and former Ways and Means Committee Chairman Paul Ryan (R-WI) has indicated that an innovation box may be included in broader international tax reform legislation. The co-chairs of a Senate Finance Committee International Tax working group on tax reform have endorsed the idea of an innovation box, and Rep. Charles Boustany (R-LA), the Ways and Means Committee member who will be closely involved in drafting an international tax reform bill for committee consideration, is himself the co-sponsor of an innovation box legislative proposal issued in July 2015.

Background

While the innovation box is a relatively recent addition to the US tax reform debate, the idea of incentivizing research through the tax code is nothing new. The United States was the first major economy to enact a research and development tax credit.[1] The credit was initially enacted in 1981 as a temporary provision to allow for periodic reevaluation of its effectiveness. The credit has been extended 15 times since enactment, occasionally with some modification, and was made a permanent part of the tax code at the end of 2015.[2] Despite the United States' long history of research-linked tax incentives, it is now less generous than many other countries when it comes to the tax treatment of research, recently ranking 22nd out of 31 developed countries in terms of tax subsidies for research expenditures.[3]

Although US federal tax incentives for research have remained relatively unchanged since 1981, many other countries have adjusted their tax policies to attract and keep research and innovation within their borders — often by establishing innovation or patent box structures.

A number of the United States' European trading partners employ such regimes, which can dramatically reduce the effective tax rate (ETR) for qualifying income. In fact, in some countries with this type of regime, the ETR for qualifying income can be as low as 0%. A recent US proposal would reduce the ETR for qualifying income by roughly one-half.

Enacting an innovation box regime in the United States would introduce substantial complexity and have significant costs and trade-offs. This is especially true in a deficit-neutral legislative environment in which any tax revenue lost would need to be made up elsewhere. Also, depending on how the proposal would be paid for and designed, some industries would fare better than others.

While draft innovation box legislation has been circulated in Congress, policy discussions are still at an early stage. Companies have an opportunity to familiarize themselves with the concepts involved and provide input to members of Congress on its design and impacts.

Design and features

At a minimum, what qualifies to "fit in the box" in an IP tax regime generally includes the income derived from patents. Beyond that, however, specifics vary widely from country to country (see Table 1), including:

- How qualifying income is defined (broadly or narrowly)
- The applicable tax rate or tax benefit
- Where eligible IP and related expenses must be located
- Whether work can be performed outside the tax jurisdiction
- How the regime interacts with and affects other existing innovation incentives

In the case of the proposal circulated in July 2015 by Reps. Boustany and Neal, the innovation box benefit would not be available to partnerships, LLCs or S corporations, which make up the majority of US businesses. The proposal would also not include IP-type income from services.[4]

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1 The research tax credit was enacted as a temporary provision through the Economic Recovery Tax Act of 1981.

2 See Section 121(a)(1) of the Protecting Americans From Tax Hikes Act of 2015 (Division Q of the Consolidated Appropriations Act, 2016 (P.L. 114-113, December 18, 2015). Also note that an amendment was made as part of the statutory changes to allow small start-up taxpayers to use the research credit amount to offset payroll tax.

3 "Tax subsidy rates on R&D expenditures, 2013," OECD website. http://www.oecd-ilibrary.org/sites/sti_scoreboard-2013-en/02/11/index.html?contentType=&itemId=%2Fcontent%2Fchapter%2Fsti_scoreboard-2013-16-en&mimeType=text%2Fhtml&containerItemId=%2Fcontent%2Fserial%2F20725345&access ItemIds=%2Fcontent%2Fbook%2Fsti_scoreboard-2013-en (accessed October 26, 2015).

4 To qualify for the tax benefit, the performance of a service involving IP would need to be considered a "disposition" of the IP. This omission would seem to exclude a significant part of the IP-related income earned by US businesses. See "US Representatives Boustany and Neal release innovation box draft as part of international tax reform deliberations," EY Global Tax Alert, July 31, 2015. http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--US-Representatives-Boustany-and-Neal-release-innovation-box-draft-as-part-of-international-tax-reform-deliberations (accessed October 27, 2015).

Table 1: Key features of select patent/innovation box regimes

	Ireland	Luxembourg	UK	United States (Boustany-Neal proposal)
Qualifying IP	‣ Broad range of IP rights	‣ Software copyrights, patents, trademarks, domain names, designs and models	‣ UK and EU registered patents (and patents registered in certain other EEA states) and other specific forms of IP relevant to the pharmaceutical and agricultural industries ‣ IP rights owned by or exclusively licensed to a UK company, provided the group has undertaken qualifying development ‣ The UK intends to move to a nexus approach after July 1, 2016	‣ Patents, inventions, formulas, processes, designs, patterns and know-how; motion picture films and videos; computer software; and products produced using any of the items listed in the first grouping above; property does not need to be created by the taxpayer or created in the United States, but gross receipts from the qualifying IP need to be from a disposition of qualifying IP in the ordinary course of a taxpayer's US trade or business
Qualifying income	‣ Regime not income-based; instead provides for tax depreciation of the capital expenditure incurred on the qualifying IP	‣ Net income from IP licensing and royalties ‣ Net income embedded in sales price for product or services ‣ Capital gains	‣ Several types of IP-related income, including from sale of products incorporating qualifying IP, licensing income, IP-derived income and profits on disposal of qualifying IP	‣ Determined using a multi-step calculation to arrive at the "innovation box profit," which is subject to the IP regime rate; broad definition of income associated with IP (other than services income), but significantly reduced by the ratio of US research costs to overall worldwide expenses
IP regime rate	‣ Rate of tax depreciation normally consistent with amortization under GAAP ‣ Taxpayers may elect to alternatively claim tax depreciation over a 15-year period ‣ New Knowledge Development Box to be introduced January 1, 2016, with an effective tax rate of 6.25% on qualifying IP profits	‣ 5.84% effective tax rate for 2015	‣ Will gradually reduce to 10% by 2017	‣ 10.15%
Can work be performed outside jurisdiction?	‣ Yes	‣ Yes. The Luxembourg company or branch that can benefit from the regime must remain the economic owner of the IP	‣ Yes. The UK company must be actively involved in the ongoing decision-making connected with the development or exploitation of the patent	‣ Yes. Qualifying property is not limited to property created in the United States, although the deduction is limited to the extent to which tentative innovation profit relates to the taxpayer's research activities conducted in the United States (without regard to whether these research activities are related to the gross receipts from the disposition of qualifying property)
Must IP be registered and/or legally owned locally?	‣ No	‣ No	‣ Yes	‣ No

Table 1: Key features of select patent/innovation box regimes

	Ireland	Luxembourg	UK	United States (Boustany-Neal proposal)
R&D incentive availability	‣ R&D credit of 25% for qualifying R&D expenditure, in addition to any existing deduction for R&D expenditure ‣ Cash refunds available for excess R&D tax credits ‣ May also claim R&D credit on qualifying plant, machinery and buildings	‣ R&D aid is available for investments and certain research and pre-competitive development activities and related activities ‣ Incentive corresponds to 25% to 100% of the research costs	‣ R&D incurred prior to election into patent box is deductible from the corporate tax rate, although R&D clawback provisions apply ‣ Two additional incentive regimes currently available for small and medium enterprises ‣ Within the patent box regime, enhanced R&D deductions are not included in the calculation of qualifying IP profits and are effectively received at the full corporation tax rate. This should be available alongside the patent box incentive at the statutory rate	‣ The R&D credit under Section 41, the R&D deduction under Section 174 and accelerated cost recovery for R&D-related property are available

The Organisation for Economic Co-operation and Development (OECD) has called for a "nexus" approach to benefits granted under such regimes as part of its package of final reports under the OECD's Action Plan on Base Erosion and Profit Shifting. Many countries are already amending or have amended their existing patent box structures to align with the OECD's nexus approach, under which a company would have to locate its R&D and associated jobs in the country offering the preferential tax rate in order to receive the benefit.

Trade-offs, costs and complexities

Certain industries benefit more than others from an innovation box, and the breakdown depends on the specific design of the box. Generally, businesses with high R&D expenses and those in which R&D plays a larger role, such as high-tech or pharmaceutical industries, could be expected to see a greater benefit than companies that have little R&D expense.

The revenue cost of an innovation box provision is also a factor. In the United States, the revenue cost of implementing an innovation box could be high. How such costs are offset could reduce the tax benefit to businesses if it involves limiting other current deductions or credits or attaining less reduction in the corporate income tax rate in a broader tax plan. In the January Tax Reform Barometer, a survey on the prospects for tax reform conducted by The Tax Council and EY, more than half of business tax professionals (58%) suggested an innovation box proposal should be funded with more stringent anti-base erosion provisions, while 44% said it should be funded by scaling back existing R&D-related tax provisions.[5]

Countries have sometimes taken years to work through the details of their IP regimes, and the complexities involved are worth careful consideration. Upon releasing their proposal, Reps. Boustany and Neal requested feedback from the business community on some of the issues that might make an innovation box complex – such as the allocation of costs to qualified gross receipts and potential compliance burdens on taxpayers.

Should an innovation box proposal move forward in the United States, companies will want to provide input on several issues. These include how qualifying IP should be defined, how income should be allocated to that IP and whether the tax benefit of an innovation box would affect a taxpayer's eligibility for or use of existing incentives, such as the current research credit and the deductions under Sections 174 and 199.

Conclusion

Companies, especially those in technology, pharmaceutical, and other industries that rely heavily on patents and IP, need to pay careful attention to the current discussions on innovation boxes. Many companies are already taking these steps, with nearly half of business tax professionals in the recent survey by The Tax Council and EY reporting that their organization is modeling the potential effect of an innovation or patent box proposal on their organization's federal tax liability.[6] As talks progress and proposals take shape, affected companies will want to keep abreast of these changes so they can provide input on key issues such as design, nexus, tax rates and interaction with existing incentives.

5 "Tax Council – EY Tax Reform Business Barometer," January 2016. http://www.ey.com/US/en/Services/Tax/Tax-Policy/Business-tax-reform-and-trends-survey-views (accessed February 22, 2016).

6 Id.

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