

# United States

## Proposal to Introduce a US Patent Box Regime

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**A discussion draft of the Innovation Promotion Act of 2015 was released in July 2015 by the US House Ways and Means Committee.**

### 1. Introduction

A discussion draft of the Innovation Promotion Act of 2015, a bipartisan proposal produced by Representative Charles Boustany, (Republican – Louisiana) and Representative Richard Neal, (Democrat – Massachusetts) of the US House Ways and Means Committee, was issued on 29 July 2015. The discussion draft, which aims to reduce the effective tax rate on income from intellectual property held in the United States, represents the first step by the United States to creating a US patent box regime to encourage research and development (R&D) in the United States and counter the patent box regimes already in existence in other countries, such as Ireland, the Netherlands and the United Kingdom. With the release of the draft, the Chairman of the US House Ways and Means Committee, Paul Ryan (Republican – Wisconsin) explained:

We have to fix our entire tax code – top to bottom. But if we don't act soon to keep American businesses here at home, that challenge is going to be much harder. Foreign competitors are taking over US companies at an alarming rate, and international pressures are only going to make the problem worse in the coming months[...] *[The] plan would allow American businesses to better compete with foreign companies and keep their research and development facilities here in the U.S. [...].*<sup>[1]</sup>

### 2. Boustany-Neal Discussion Draft

Taxable income for businesses consists of gross income less allowable deductions, which include ordinary and necessary business expenses such as salaries, wages, employee benefits, interest expenses and selling expenses, among other expenses. Current US federal income tax rules allow deductions for R&D activities by:

- expensing research cost instead of amortizing them over time; and
- providing a credit for qualified research expenses.

However, there is no current US tax law stipulating special income tax rates, deductions or credits related to innovation box profits, i.e. “profits attributable to the sale or licence of intellectual property (or products using or incorporating intellectual property)”.<sup>[2]</sup>

The Boustany-Neal discussion draft “amend[s] the Internal Revenue Code of 1986 to allow a deduction for innovation box profit from the use of United States innovations and to encourage domestication of intangible property”.<sup>[3]</sup> Specifically, the discussion draft stipulates:

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<sup>1</sup> Emphasis added; US: House of Representatives, Committee on Ways and Means, *The Innovation Box: What It Is and Why We Need It* (29 July 2015), available at <http://waysandmeans.house.gov/ryan-welcomes-boustany-neal-innovation-box-discussion-draft>.

<sup>2</sup> US: House of Representatives, Committee on Ways and Means, *Technical Explanation of the Innovation Promotion Act of 2015* (28 July 2015), at 1.

<sup>3</sup> US: House of Representatives, Committee on Ways and Means, *Discussion Draft of the Innovation Promotion Act of 2015* (28 July 2015), at 1.

[a] corporation would be allowed to deduct 71 percent of its innovation box profits derived from qualifying intellectual property (IP) or 71 percent of the corporation's taxable income, if less. A 71-percent deduction would translate into an effective tax rate of 10.15 percent on all innovation box profits.<sup>[4]</sup>

This proposed effective rate on innovation box profits is obviously substantially lower than the 35% maximum corporate income tax rate.

The discussion draft details the computation of innovation box profits which consists of three steps.

*Step 1: Calculating qualified gross receipts.* Qualified gross receipts from the sale, lease, licence or other disposition of qualified property are determined by a taxpayer. Qualified property is identified as "any (1) patent, invention, formula, process, design, pattern, or know-how, (2) motion picture film or video tape, (3) computer software, and (4) any product produced using any property described in (1) [...]".<sup>[5]</sup> If a taxpayer receives compensation from the infringement of its qualified intellectual property, this compensation can also be included in the calculation of qualified gross receipts, as long as it is included in the taxpayer's gross income.

*Step 2: Calculating initial innovation box profit.* Next, a taxpayer's cost of goods sold and other expenses for its qualified gross receipts are deducted to calculate a taxpayer's *initial* innovation box profit.

*Step 3: Calculating innovation box profits taxed at 10.15%.* Finally, the computed initial innovation box profit, calculated in Step 2, is multiplied by the ratio of the taxpayer's five-year R&D costs for R&D conducted in the United States to its total costs over the same five-year period to determine a taxpayer's *innovation box profits*. It is the resultant profit base that would then be subject to a 10.15% tax rate.

innovation box profits (*subject to the 10.15% tax rate*) = initial innovation profits x 5-year total R&D costs in US/5-year total costs

A taxpayer's five-year R&D costs for R&D conducted in the United States and its five-year total costs are defined in the Boustany-Neal discussion draft as follows:

- the five-year R&D costs for R&D conducted in the United States equal the amount expensed and incurred by a taxpayer for which a deduction is allowed under section 174(a) or (b), for the five-year period ending with the current taxable year. The R&D must be performed in the United States and its territories, including the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa and the Commonwealth of the Northern Mariana Islands; and
- the five-year total costs for a taxpayer are computed by taking the total costs paid and expensed over the same five-year period, ending with the current taxable year, over the total of its cost of goods sold, interest paid or accrued and taxes paid or accrued for the same five-year period.<sup>[6]</sup>

Based on the current proposal for computing innovation box profits, the more R&D conducted by a taxpayer in the United States, the higher its innovation profits subject to a lower 10.15% tax rate.

In addition to proposing a tax rate reduction for innovation box profits, the Boustany-Neal discussion draft also proposes providing distributions from qualifying intangible property<sup>[7]</sup> from controlled foreign corporations to their US parents as a tax-free distribution. By making such distributions from a controlling foreign corporation to a US parent a tax-free event, it

<sup>4</sup> US: House of Representatives, Committee on Ways and Means, *Section-by-Section Summary of the Innovation Promotion Act of 2015 Discussion Draft – Released by Rep. Charles Boustany (R-LA) and Rep. Richard Neal (D-MA) on July 29, 2015* (29 July 2015), at 1.

<sup>5</sup> *Technical Explanation of the Innovation Promotion Act of 2015, supra* n. 2, at 8. It is important to note, that to be included in the calculation of gross receipts, the qualified property must be sold to an unrelated party of the taxpayer. The sale to an unrelated party can be facilitated by a related party distributor to an unrelated party.

<sup>6</sup> *Discussion Draft of the Innovation Promotion Act of 2015, supra* n. 3, at 5-6. R&D costs for testing that occurs outside of the United States as a result of the United States' not having a sufficient population or that is required by law, is not included in this calculation.

<sup>7</sup> The qualifying intangible property subject to this proposal is the same intangible property that qualifies for the 10.15% tax rate for innovation box profits.

would seem that this may incentivize US companies to “relocate” intellectual property developed by their non-US affiliates back to the United States, and thereby further increase their innovation box profits subject to the 10.15% tax rate.

The provisions of the Boustany-Neal discussion draft will apply to taxable years after the date the Innovation Promotion Act of 2015 is enacted. However, whether the current draft is actually enacted in its current form is questionable and, of course, there is also the issue of when it will be enacted. The Boustany-Neal discussion draft is still in development and the Representatives have asked for feedback on their proposal and its impact on taxpayers, as well as comments on what the discussion draft fails to include. In addition, they have specifically asked for responses to the following questions:

- The proposal includes a broad definition of “qualified property” for purposes of determining qualified gross receipts. Is that the appropriate scope of intellectual property that should qualify for the deduction?
- To what extent should gross receipts from services that are directly related to a product that uses qualified property be included in the determination of qualified gross receipts?
- The proposal limits the deduction to the extent to which tentative innovation profit relates to the taxpayer’s research activities conducted in the United States. Are there other costs or expenditures that relate to innovation and that therefore should be included in the numerator? Can those costs be defined in a manner that limits potential abuse?
- What would be the appropriate approach in determining the expenses properly allocable to innovation profits? Should the proposal just include authority for the Secretary to adopt allocation rules or is more specific guidance necessary?
- Are there modifications to the deduction for innovation box profits that can be made to minimize the compliance burdens on taxpayers and improve (the regime’s) administrability?
- How should the deduction for innovation profits be coordinated with the R&D credit under section 41 of the Internal Revenue Code (IRC) and the manufacturing deduction under section 199 of the IRC?
- Are there particular transition rules that would be necessary to implement the deduction for innovation box profits and the special rules for transfers of intangible property from controlled foreign corporations to US shareholders?
- Does this legislation help your company remain competitive in the global marketplace, relative to your foreign counterparts? If not, please explain in as much detail as possible.”<sup>[8]</sup>

Responses to the above-mentioned Boustany-Neal questions, from interested constituencies such as impacted taxpayers, will provide an early indication of the public’s perception of the discussion draft and whether the public agrees with Chairman Ryan’s assertion that “[the] plan would allow American businesses to better compete with foreign companies and keep their research and development facilities here in the U.S”.

### 3. Why Introduce a US Patent Box Regime Now?

The US House Ways and Means Committee specifically cites the following reasons for introducing a US patent box regime:

- other countries have already created patent box regimes with lower tax rates for intellectual property income;
- foreign competitors have been acquiring US companies; and
- the OECD base erosion and profit shifting (BEPS) project.<sup>[9]</sup>

#### 3.1. Other countries have already created patent box regimes with lower tax rates for intellectual property income

Most countries with patent box regimes only created them in the mid to late 2000s. Countries that already have patent box regimes include Belgium, France, Hungary, Luxembourg, the Netherlands, Spain and the United Kingdom, with tax rates for patent box regimes ranging from 5% (for the Netherlands) to 15% (for Spain and France), with a median of 9.50% for these specific countries. The full impact of patent box regimes is difficult to determine, partly due to the fact that patent box regimes have been in existence for only a short period of time. However, certain studies have shown that countries with patent box regimes have experienced both an increase in domestic inventors patenting R&D activities, as well as an increase of patenting by foreign inventors.<sup>[10]</sup>

<sup>8</sup> *Innovation Promotion Act of 2015, Requests for Feedback* available at <http://waysandmeans.house.gov/wp-content/uploads/2015/07/2015-07-29-Boustany-Neal-Innovation-Box-Questions.pdf>.

<sup>9</sup> *The Innovation Box: What It Is and Why We Need It*, supra n. 1.

<sup>10</sup> See P. Hassbrink & E. Edwall, *The Short Term Effect of Patent Box Regimes: A Study of the Actual Impact of Lowered Tax Rates on Patent Income*, Stockholm School of Economics, Department of Economics (Spring 2013).

In the United Kingdom, companies could use a patent box regime from April 2013 and were taxed on net income for qualifying intellectual property at 10%. One of the immediate impacts of the UK patent box regime was the announcement by FTSE 100 drug manufacturer GlaxoSmithKline plc (GSK) in December 2013 of its GBP 200 million investment in pharmaceutical innovation in the United Kingdom. Roger Connor, GSK's President of Global Manufacturing and Supply, explained:

The establishment of the Patent Box has transformed how we see the UK as a place to invest. As a result, last year we announced we were building our first new factory in the UK for 40 years... The investments announced today are in addition to that and will allow us to harness new technologies that have the potential to deliver a step-change in how we make medicines. [...] I am delighted that we have been able to bring these investments to the UK.<sup>[11]</sup>

Further evidence that GSK utilized the UK patent box regime is seen in its exchanges with the US Securities and Exchange Commission (SEC). When asked by the SEC which overseas tax rates and IP incentives impacted GSK's financials and how patent box regimes impacted GSK's tax rate so significantly in 2014, GSK explained:

[GSK's] UK statutory rate was significantly reduced in 2014 compared with 2013 due to the completion of internal reorganisations of intellectual property ownership, through which the Company moved intellectual property ownership into the UK from countries with tax rates lower than the UK statutory rate. The countries contributing most significantly to the increased tax rate were the USA, India, Japan and France.

Patent box regimes provide a reduced rate of corporate income tax on profits earned from qualifying patents. Since 2012 the Company has centralised Pharmaceutical intellectual property and product inventory ownership into the UK, following the introduction of a UK patent box regime. The UK patent box benefit is the most significant element of the total patent box benefit in 2013 and 2014, accounting for nearly 75% of the total benefit in 2014. The regime is being phased in over a number of years, starting from April 2013, and as a result 2013 does not include a full year of benefit.<sup>[12]</sup>

It would appear from initial analysis of the impact of patent box regimes, as well as the GSK story, that companies take into consideration patent box regimes when making business decisions related to R&D activities and investment. This provides potential support to (i) introducing a US patent box and (ii) the US House Ways and Means Committee's claims that a US patent box regime would "keep good-paying jobs in the United States" and that "[t]he US tax code is hobbling American job creators, who are facing stiff competition in the global economy".<sup>[13]</sup>

### 3.2. Foreign competitors have been acquiring US companies

To support its assertion that foreign competitors are acquiring US companies, the US House Ways and Means Committee cites:

- the United States has the highest corporate tax rate among the developed economies;
- the US tax regime charges US companies twice through a high corporate tax rate and worldwide tax system; and
- "the [US] tax code perversely encourages foreign companies to acquire US companies, costing American jobs".<sup>[14]</sup>

This assessment has been supported by the Business Roundtable and Ernst & Young, who explain that the US corporate income tax rate affects the competitiveness of US companies and that the difference between the US statutory corporate tax rate and an average rate for the OECD has increased from 2 percentage points to 10 percentage points over the last ten years.<sup>[15]</sup> However, data from their study show that for the period from 2004 to 2013, US companies were not only the largest targets of cross-border mergers and acquisitions, by deal value, but were also the largest acquirers.<sup>[16]</sup>

11 GSK, *GSK Announces £200 Million Investment in UK Advanced Manufacturing and Science* (11 Dec. 2013), available at <http://www.gsk.com/en-gb/media/press-releases/2013/gsk-announces-200-million-investment-in-uk-advanced-manufacturing-and-science>.

12 Letter from Simon Dingemans, GSK Chief Financial Officer, to the Securities and Exchange Commission (6 May 2015), available at <http://www.sec.gov/Archives/edgar/data/1131399/000090342315000295/filename1.htm>.

13 *The Innovation Box: What It Is and Why We Need It*, supra n. 1.

14 *The Innovation Box: What It Is and Why We Need It*, supra n. 1.

15 Ernst & Young, *Buying and Selling: Cross-Border Mergers and Acquisitions and the US Corporate Income Tax – Prepared for the Business Roundtable* (Mar. 2015), at ii.

16 Ernst & Young, supra n. 14, at 7.

### 3.3. The OECD BEPS project

The aim of the OECD BEPS project is:

to equip governments with the domestic and international instruments [to challenge] tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.<sup>[17]</sup>

The OECD BEPS Action Plan, which identified fifteen key areas to address, was approved by G20 member countries in July 2013.

The interim September 2014 BEPS progress report provided guidance on seven action items, one of which – Action 5: Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance – enhanced the substantial activity requirement of existing OECD guidance and presented the nexus approach. Under the nexus approach, a taxpayer may benefit from an IP patent box regime only if the taxpayer can demonstrate that it actually incurred the IP expenses, such as R&D costs, that led to the IP income. Following a proposal presented by the United Kingdom and Germany, Action 5 was subsequently amended as follows:

- qualifying expenditures related to IP income may, in certain circumstances, be uplifted by 30%;
- countries with patent box regimes that do not comply to the OECD’s nexus approach will start to amend them in 2015 and there will be no new entrants to these regimes after June 2016; and
- taxpayers using any current patent box regimes which do not comply with the OECD’s nexus approach may not use those regimes after June 2021.

The US House Ways and Means Committee explains that “the OECD BEPS project will soon require every innovation box to include a nexus component. In other words, a company will have to locate its research and development – and the high-paying jobs that go with it – in a country offering the special tax rate”.<sup>[18]</sup> The Committee believes that this will invariably lead to companies moving their R&D facilities out of the United States to countries with patent box regimes.

The OECD’s final guidelines on its BEPS project are scheduled to be presented to G20 finance ministers in October 2015, with a presentation on the additional work required and a timetable for implementation. According to the US House Ways and Means Committee, this impending OECD deadline will lead to US companies’ making their restructure plans sooner rather than later. Therefore, in the eyes of the Committee, the need to create a US patent box regime is imperative so that “American companies can better compete with foreign competitors [...]”<sup>[19]</sup> and the lure of foreign patent box regimes (which incentivize US-based companies to relocate) is removed.

As with most things, only time will tell if, indeed, a US patent box regime will be enacted, and what its impact will be on the United States and the global economy.

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<sup>17</sup> OECD, *About BEPS*, <http://www.oecd.org/tax/beps-about.htm>.

<sup>18</sup> *The Innovation Box: What It Is and Why We Need It*, *supra* n. 1.

<sup>19</sup> *The Innovation Box: What It Is and Why We Need It*, *supra* n. 1.