

Which Cos. Are Most Likely To Benefit From Innovation Box?

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U.S. Reps. Charles W. Boustany Jr., R-La., and Richard Neal, D-Mass., both senior members of the Ways and Means Committee, released draft legislation on July 28, 2015, that would create an “innovation box regime” in the U.S. tax code. The release of the legislation follows a bipartisan recommendation by U.S. senators for the creation of a U.S. patent box regime. The congressmen have requested that interested stakeholders provide feedback and comments on their legislative proposal, presumably signaling that changes to the proposal are possible.

This article examines the details of the proposal, reviews potential factors taxpayers could consider when reviewing the legislation, and examines which of six sectors (pharma, electronics, motor vehicles, aerospace, medical equipment, and oil and gas) may benefit the most if the legislation were enacted into law. While we found that each of the six sectors that we examined would stand to realize a significant reduction in effective tax rates (ETR) under the proposed innovation box regime, the sector that would benefit the most out of these six would be electronics, and the sector that would benefit the least out of these five would be oil and gas. However, none of these six sectors (and likely, no real-world company) would achieve a reduction in ETR that even remotely approaches the 10.1 percent rate that is theoretical possible under the proposal.

Summary of Legislation

In summary, the legislation provides a 71 percent deduction on the lesser of qualified innovation box profits or total taxable income. Innovation box profits are determined by qualified gross receipts less qualified expenses. Qualified or “innovation” gross receipts (QGR) are those from the sale, lease, license or disposition of (1) a patent, invention, formula, process, design, pattern or know-how; (2) motion picture film or video tape; (3) computer software; or (4) any product produced using any of the property

described in category (1) above. Qualified expenses are those allocable to the receipts described above. Receipts from (4) presumably include the full value of the product as opposed to only the share of the value derived from the qualifying IP right.

This creates a strong incentive for taxpayers to include some minimal amount of qualifying IP in a product in order to obtain innovation box treatment. It is not unreasonable to assume that this is likely to create disputes with the IRS over what constitutes sufficient IP in a product to qualify for the innovation box regime.

The 71 percent deduction is further limited by applying a ratio equal to a corporation's five-year U.S. research and development expenses over its five-year total costs. R&D expenses are defined as "expenses allowable under section 174 (determined without regard to sections 41 and 280C(c)."

Presumably, this definition will allow taxpayers benefiting from the Section 41 R&D tax credit to also benefit from the innovation tax regime.

Total costs are the excess of all costs over the sum of (1) cost of goods sold and (2) interest and taxes paid or accrued. For purposes of this calculation, costs incurred by foreign branches of the U.S. corporation are included in the corporation's total costs (denominator of the ratio), but non-U.S. R&D expenses of the foreign branches are not included in the R&D expenses (numerator of the ratio), with the additional exception that R&D conducted in a U.S. possession is eligible for inclusion. This ratio is multiplied by the corporation's innovation profits to determine the amount of income eligible for the 71 percent deduction.

This R&D expenditure ratio or "R&D governor" is presumably included to satisfy the growing international consensus that patent or innovation box regimes must include provisions that create a requirement or "nexus" that in order to benefit from the regime, the taxpayer must perform the R&D in that country. In addition, as defined in the legislation, the calculation puts a significant premium on the development of IP that can be patented.

Income not eligible for the 71 percent deduction is subject to otherwise generally applicable tax rules. Additionally, income associated from the sale or disposition of property to a related party is not eligible for the deduction except in the case of property sold to a related person outside the United States, if such property is subsequently sold to an unrelated party outside the United States.

Lastly, the proposal allows a controlled foreign corporation (CFC) to distribute intangible property to the U.S. parent without triggering U.S. tax liability by (1) deeming the fair market value of the property as equal to the CFC's tax basis in the property; (2) providing an additional dividends received deduction in excess of what would otherwise be available under Section 245; or (3) providing for additional CFC stock basis if the distribution otherwise would result in gain recognition at the shareholder level. Foreign tax credits would not be allowed with respect to any foreign tax triggered on the distribution. Such a distribution must take place through a qualified plan filed with the U.S. Treasury and such transfer must be completed within two years.

Assuming the most favorable possible fact pattern, qualifying income would be subject to an effective tax rate (ETR) of approximately 10 percent under this proposal. However, in the real world, few if any taxpayers would likely obtain an ETR that approaches 10 percent. The R&D governor will significantly limit the benefits to any taxpayer that has significant non-R&D costs other than costs of goods sold, interest and taxes (since such costs decrease the benefit by increasing "total costs" in the denominator of the R&D governor).

Analysis of Sector Data

In an effort to better understand which taxpayers might most benefit from the proposal, we have compiled the financial data for selected U.S.-domiciled firms in six different sectors — pharmaceuticals, electronics, motor vehicles and parts, aerospace, medical devices and equipment, and oil and gas. The financial data used in these examples are derived from actual financial data reported by companies in these sectors. It is important to note that these data are taken from the companies’ consolidated financial statements and therefore may include R&D and other expenses incurred outside the United States. However, presumably, the purpose of the R&D governor in the legislation is to incentivize companies to conduct all or most of their R&D in the United States. If so, then these data are arguably representative of the outcome that the drafters intend as it treats all R&D as if it were conducted in the United States.

Using these data, we calculated the ETR for each sector after the application of the innovation box regime. Solely for purposes of isolating the effect of the innovation box regime, we ignored the actual taxes paid by companies in each sector and instead assumed that each sector would have an ETR equal to the 35 percent U.S. corporate income tax rate before application of the innovation box regime. As a result, our analysis did not take into account the effects of state and local taxes, foreign tax rates lower than the 35 percent U.S. tax rate, and other existing U.S. tax incentives such as the R&D tax credit and the Section 199 domestic manufacturing deduction. While we could not accurately take into account the combined impact of the innovation box regime with other existing U.S. tax incentives on each sector’s ETR because the necessary data is not publicly available, the combined effect of such other incentives would of course need to be taken into account by any company attempting to evaluate the likely actual impact of the proposed innovation box on its own ETR.

Further, we estimated ETRs for each sector assuming different ratios of income meet the requirements of the innovation box regime. For simplicity, we considered three different scenarios in which 100 percent, 75 percent and 50 percent of each sector’s revenue was assumed to meet the definition of QGR.

The results of this analysis showed that on average, the six sectors would achieve the following ETRs after application of the innovation box regime, all on the assumption that the sector ETRs would be 35 percent in the absence of the innovation box:

	Pharma	Electronics	Motor Vehicles	Aerospace	Medical Equipment	Oil & Gas
R&D Governor Ratio (@100% QGR)	31%	41%	31%	28%	16%	4%
R&D/Net Income Ratio	61%	75%	101%	34%	42%	3%
ETRs						

100% QGR	27.3%	24.9%	27.2%	28.2%	31%	33.9%
75% QGR	29.5%	28.3%	30.3%	29.4%	31.8%	34%
50% QGR	32.7%	33.2%	35.1%	31.5%	33%	34%

As expected, the results of the analysis are driven by the degree to which the R&D governor limits the application of the 71 percent exemption. Although less strong, there also seems to be a correlation between the ETR reduction and the sector’s R&D to net income ratio, meaning that generally, sectors and companies that depend the most on R&D expenditures to generate a given amount of net income may stand to benefit more than sectors and companies less dependent on R&D.

Key Takeaways

It is clear from these calculations that the R&D governor significantly reduces the potential reduction in ETR. As noted above, the most favorable ETR theoretically possible under the innovation regime is approximately 10 percent. In this analysis, even assuming 100 percent of revenue comes from the sale of products that satisfy the definition of qualifying IP, no sector had an ETR that even remotely approached 10 percent. Further, while there of course may be some companies that could achieve a significantly greater benefit than the sector averages, the R&D governor will likely serve as a significant limitation for any real-world taxpayer. This is because the “total costs” denominator of the R&D governor includes operating expenses (e.g., selling, general and administrative expenses) incurred by virtually every company.

Consequently, the proposed legislation’s use of a “total costs” denominator in the R&D governor can have the effect of penalizing companies from any sector that engage in significant marketing or otherwise have a high SG&A cost structure. In this regard, the proposed legislation generally seems more restrictive than the consensus “modified nexus approach” for IP regimes adopted by the Organization for Economic Cooperation and Development’s Forum on Harmful Tax Practices (FHTP) in connection with Action 5 of the OECD’s Action Plan on Base Erosion and Profit Shifting.[1]

Similar to the proposed legislation, the FHTP’s modified nexus approach seeks to condition the benefits of the regime based on the local performance of R&D activities using an R&D expenditures ratio. However, the R&D expenditures ratio of the modified nexus approach generally uses a denominator based on total development costs incurred by the taxpayer or other parties, rather than the total costs incurred by the taxpayer. As such, the modified nexus approach penalizes R&D outsourced to related parties[2] but, unlike the proposed legislation, would not appear to penalize marketing or other SG&A-intensive business activities.

Further, we would note that our analysis focused primarily on the effect of the R&D governor as a limitation on the potential benefit of the innovation box regime. While the R&D governor would appear to be the most significant limitation on the benefits of the proposed innovation box regime, the definition of QGR will likely serve as another critical limitation. As noted above, for simplicity, we considered three different hypothetical scenarios in which different levels (100 percent, 75 percent and 50 percent) of revenues meet the definition of QGR. However, in reality there are likely significant

sector-to-sector and company-to-company variations in the extent to which this definition limits the potential benefit. In particular, we would note that the definition of a QGR by reference to “the sale, lease, license, or other disposition of qualified property” may significantly limit the benefit to sectors and companies deriving significant revenues from services. It may also create uncertainties and the potential for dispute for companies in the software sector over whether certain types of income, such as income from cloud-based offerings or services accessed by customers after downloading “free” software apps qualify for the benefits, not unlike the disputes that have arisen in the context of the Section 199 domestic manufacturing deduction.[3]

Notwithstanding that almost all companies will likely receive a tax benefit significantly less generous than theoretically possible, our analysis nevertheless found that the reduction in ETR compared to the statutory rate of 35 percent can still be significant. Additionally, most companies that can utilize the innovation box presumably will also benefit from other tax policies, such as the R&D tax credit and Section 199, to further lower their effective tax rate.

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[1] See OECD, BEPS Action 5 2014 Deliverable: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance (Sept. 2014); OECD, Agreement on Modified Nexus Approach for IP Regimes (February 2015).

[2] However, the modified nexus approach mitigates its penalty of outsourced R&D by permitting up to a 30 percent “uplift” to be applied to qualifying expenditures in certain circumstances (generally, where the taxpayer incurs otherwise non-qualifying IP acquisition and outsourcing costs).

[3] See IRS AM 2014-008 (Nov. 21, 2014) (taking the position that a taxpayer does not generate qualifying receipts for purposes of section 199 where it provides customers with free apps that enable the customer to access online services).