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# FEATURED PERSPECTIVE

## The Innovation Promotion Act of 2015: Not the New Ireland

by Lewis J. Greenwald, Lucas Giardelli, and Christopher Odell

Lewis J. Greenwald is a partner and Lucas Giardelli is an associate with Mayer Brown in New York, and Christopher Odell is an associate with Mayer Brown in Chicago.

In this article, the authors argue that the Innovation Promotion Act of 2015 will likely not provide the incentive necessary for U.S.-based multinationals to abandon their Irish IP structures.

For decades, U.S.-based multinationals have been transferring their intellectual property to Ireland, where the corporate income tax rate for trading profits is 12.5 percent. Presumably in an attempt to reverse that trend and to compete with the various patent box regimes enacted by many U.S. trading partners, on July 28, 2015, U.S. Reps. Charles W. Boustany Jr., R-La., and Richard E. Neal, D-Mass., released a discussion draft of the Innovation Promotion Act of 2015. Their proposal would amend the Internal Revenue Code to ''allow a deduction for innovation box profit from the use of U.S. innovations and to encourage domestication of intangible property.''

The proposal would add two new code sections. New section 250 would provide a deduction for innovation box profits, and new section 966 would provide for the tax-free domestication of appreciated intangible property from a controlled foreign corporation. As noted above, the legislation likely does not provide the incentive needed for U.S.-based multinationals to abandon Ireland any time soon — in other words, it is not the new Ireland.

This article surveys the patent box regimes enacted by many U.S. trading partners[1] and reviews both the U.S. proposal and the hypothetical example found in its technical explanation.

### I. Patent Box Regimes

U.S. federal income tax law provides incentives for research activities by allowing a deduction for research expenditures (section 174) and a credit for some qualified research expenditures (section 41). Nothing in the code provides for preferential rates, deductions, or credits specifically for profits attributable to the sale or license of IP (or products using or incorporating IP). By contrast, several countries have established preferential tax regimes for income attributable to IP, often referred to as patent boxes.

Belgium, Cyprus, and Luxembourg provide an 80 percent tax deduction or exemption for some income derived from qualifying IP. The United Kingdom's patent box regime provides a 10 percent rate on income from patented inventions and other qualifying innovations. The Netherlands's patent box regime provides a 5 percent rate on income from qualifying intangibles, and Malta provides a full exemption for income from qualifying patented inventions and qualifying copyrights. The French patent box regime provides that revenue or gain derived from qualified property (not including embedded royalties) is taxed at 15 percent. In Hungary, there is a 50 percent deduction for royalties received from related third parties for the use of IP,

[1] *See* Joint Committee on Taxation, ''Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income,'' JCX-51-15 (Mar. 16, 2015).

and Spain exempts 60 percent of the net income derived from qualified property. Italy exempts income from intangible assets at graduated rates: 30 percent in 2015, 40 percent in 2016, and 50 percent thereafter.

Ireland is considering a knowledge development box with a tax rate of 6.25 percent for qualifying or IP-related income (versus the 12.5 percent corporate income tax rate for trading profits). That proposal follows the OECD and EU's so-called modified nexus approach because it requires substantial economic activity in Ireland to benefit from the preferential rate.[2]

## II. U.S. Proposal

Boustany and Neal have proposed a deduction for innovation box profits equal to 71 percent of the lesser of the innovation box profit of the taxpayer for the tax year or taxable income (determined without the 71 percent deduction) for the tax year.[3]

The deduction for innovation box profits would not be taken into account in computing a net operating loss or the amount of any operating loss carryback or carryover; thus, it could not create or increase the amount of an NOL deduction. The deduction would be available only for corporations and not for noncorporate taxpayers, such as partnerships or S corporations.

When computing innovation box profits, all members of an expanded affiliated group would be treated as a single corporation.[4] The deduction would be allocated among the members of the expanded affiliated group in proportion to each member's respective amount of innovation box profit.

Foreign corporations would not be part of the expanded affiliated group. As such, even if a CFC's IP-related income results in a subpart F inclusion to the U.S. shareholder, that income would not benefit from the proposal.

### A. New Section 250

Under the proposal, to determine innovation box profit, a taxpayer must first determine its qualified gross receipts derived from the sale, lease, license, or other disposition of qualified property in the ordinary course of the taxpayer's U.S. trade or business. New section 250 defines qualified property as any patent, invention, formula, process, design, pattern, or know-how, as well as any product made using those; motion picture film or video; and computer software. Further, any compensation for infringement of the taxpayer's IP rights to qualified property is included in qualified gross receipts if the compensation is included in the taxpayer's gross income.

One of the proposal's main limitations is that services income would not constitute qualified gross receipts, no matter how valuable the related IP is to the provision of the services. As such, the services industry (the most rapidly growing sector of the economy)[5] would be largely denied the proposal's benefits.

Also, with one exception, qualified gross receipts would not include gross receipts from the sale of qualified property to a related person. Under the proposal, if products made using qualified property are sold to a related person outside the United States, gross receipts from that sale would be qualified gross receipts if the products are resold to an unrelated person.

Once the taxpayer has determined its qualified gross receipts, it must determine its tentative innovation profit by subtracting from those receipts the sum of (i) its cost of goods sold for the tax year properly allocable to those receipts, and (ii) other expenses, losses, or deductions (other than the 71 percent deduction) properly allocable to those receipts.

Cost of goods sold would be determined using the same inventory methods used to compute taxable income under sections 263A, 471, and 472. For noninventory property, cost of goods sold would include the adjusted basis of the property. Special rules would apply to items imported to the United States and to property exported for further manufacture.

The proposal defines innovation box profit for the tax year as a taxpayer's tentative innovation profit multiplied by a fraction, the numerator of which is the taxpayer's research and development expenditures for research performed in the United States and the denominator of which is the taxpayer's five-year total costs.

In general, a taxpayer's five-year R&D expenditures would be the amount paid or incurred for R&D for which a deduction is allowed under section 174 for the five tax years ending with the current tax year or the period during which the taxpayer was in existence, if shorter.[6] For the five-year total costs, the taxpayer subtracts its cost of goods sold as well as interest and taxes paid or accrued during that period from the total costs paid or incurred during that period.

[2]*See* Ireland Department of Finance Tax Policy Division, ''Public Consultation Paper: The Knowledge Development Box'' (Jan. 2015).

[3]Proposed section 250(a). The deduction for innovation box profits does not affect the taxpayer's ability to claim a deduction for domestic production activities under section 199, the deduction for research and experimental expenditures under section 174, or the research and experimentation credit under section 41.

[4]Proposed section 250(c)(2). An expanded affiliated group is defined as it is in section 1504(a) but substituting the words ''more than 50 percent'' for ''at least 80 percent.''

[5]Consider companies such as Amazon.com Inc., Netflix Inc., or Uber Technologies Inc.

[6]Proposed section 250(b)(3). The term ''taxpayer'' includes any predecessor of the taxpayer.

The multiplication of the tentative innovation profit by that fraction is the most noteworthy element of the proposal. The use of the fraction aligns the proposal with the OECD's guidelines under its base erosion and profit-shifting project, which require nexus — that is, that the taxpayer carries out the R&D activities in its own jurisdiction. The numerator of the innovation box profit fraction is limited to R&D expenditures for research *performed in the United States*.

Further, even in the most R&D-intensive industries, taxpayers have at least some non-R&D costs (marketing expenses, for example), always making the fraction less than 1. Thus, not all the taxpayer's tentative innovation profit would translate into innovation box profit that would benefit from the proposal.

As discussed below, not all taxpayers would receive comparable benefits for their IP-related income. R&D-intensive sectors, such as the software industry, would receive a greater benefit than other industries with less significant R&D costs. That is, unlike the patent box regimes mentioned above, in which the benefits generally depend on the proportion of R&D costs incurred in the relevant jurisdiction over the aggregate R&D costs (rather than total costs).

### B. New Section 966

Under the proposal, taxpayers would be able to distribute appreciated intangible property from a CFC to its U.S. parent under a qualified plan without giving rise to taxable income, if applicable requirements are met.

In determining the tax consequences of a distribution, the fair market value would be treated as not exceeding the CFC's tax basis in the intangible property. Accordingly, the CFC would neither realize nor recognize gain or loss, which would result in a carryover basis in the intangible property.

If the distribution is a dividend, the proposal would provide a deduction for the U.S. parent equal to the excess of the amount of the dividend over the amount for which a dividends received deduction would otherwise be available. If the distribution is not treated as a dividend, the proposal would eliminate the possibility of income recognition by providing for a basis increase in the CFC stock equal to the gain that would otherwise have been recognized. For any basis increase, the U.S. shareholder would be required to make a corresponding negative adjustment to the tax basis of the intangible property it receives.

The term ''qualified plan'' means a contemporaneous written plan that describes a CFC's distribution, or series of distributions made through intervening CFCs and completed during a period not exceeding two years, of intangible property to a domestic parent corporation that is a U.S. shareholder of that CFC. The proposal states that a qualified plan must describe the distribution and intangible property being distributed and must be in effect before the distribution or series of distributions is made. It also imposes a filing requirement for the qualified plan.

The proposal defines the term ''intangible property'' as any property described in section 936(h)(3)(B)(i) (including any patent, invention, formula, process, design, pattern, or know-how), section 168(f)(3) (any motion picture or video), or section 197(e)(3)(B) (computer software).

No foreign tax credit would be allowed for any taxes paid or accrued (or treated as paid or accrued) for any distribution of intangible property for which a deduction is available to the recipient of the dividend.

With the new section 966 provision, the proposal attempts to complement its preferential effective tax rate for IP-related income with an incentive for U.S.-based multinationals to relocate their offshore IP back to the United Sates tax free.

## III. Hypothetical Example

The proposal's technical explanation provides a hypothetical example regarding the mechanics of computing the deduction for innovation box profits in which Watch Corp., a U.S. corporation, designs and manufactures watches for sale in the United States and abroad. It does not sell or produce any other product or service. Watch Corp. consists of U.S. operations (USCo) and a branch located in Germany (GB), and owns several CFCs.

For tax year 2016, USCo has income of $4 billion, which includes $3.8 billion of income from U.S. watch sales and $200 million in interest income earned from its bond portfolio. It incurs $2.8 billion in total costs, including $1 billion in cost of goods sold, $700 million in U.S. research expenses, and $100 million in interest expenses. For tax years 2012-2015, USCo incurred a total of $11.6 billion in costs, including $5 billion in cost of goods sold, $2.1 billion in U.S. research expenses, and $500 million in interest expense. All USCo's costs allocable to its watch sales.

For tax year 2016, GB has gross income of $2 billion, all of which consists of income from watch sales outside the United States. It incurs $1.1 billion in total costs, including $500 million in cost of goods sold and $180 million in research expenses incurred in Germany. For tax years 2012-2015, GB incurred a total of $4 billion in costs, including $1.5 billion in cost of goods sold and $750 million in research expenses incurred in Germany. All costs are allocable to its watch sales.

Innovation box profit is calculated using the following formula:

$$\text{Innovation Box Profit} = \frac{\text{5-Year Total U.S. R\&D Costs}}{\text{5-Year Total Costs}} \times \text{Tentative Innovation Profit}$$

USCo and GB are treated as part of an expanded affiliated group and thus as a single corporation; the

CFCs are not included in the expanded affiliated group because they are foreign corporations.[7] Therefore, Watch Corp.'s innovation box profit reflects the income and operations of USCo and GB but not the operations of any of its CFCs.

Watch Corp.'s tentative innovation profit in tax year 2016 equals its gross receipts from the sale of qualified property minus all deductions properly allocable to those receipts. Under the proposal, the watches sold by Watch Corp. are considered qualified property because they incorporate intangible property, such as watch face design. Therefore, the $5.8 billion in USCo's and GB's 2016 watch sales ($3.8 billion + $2 billion) is included as gross receipts in the calculation of tentative innovation profit.[8] Further, the $3.9 billion in total USCo and GB expenses ($2.8 billion + $1.1 billion) is properly allocable to their watch sales. As such, Watch Corp.'s 2016 tentative innovation profit is $1.9 billion ($5.8 billion - $3.9 billion).

Watch Corp.'s five-year total costs are $10.9 billion, or the $19.5 billion sum of all of USCo's and GB's costs incurred in tax years 2012-2016 ($14.4 billion + $5.1 billion) minus $8.6 billion in interest expense ($600 million) and cost of goods sold ($6 billion + $2 billion).

Watch Corp.'s five-year total U.S. R&D costs are $2.8 billion ($2.1 billion + $700 million). GB incurred $930 million in research expenses during that same period, and while those costs are included in the calculation of Watch Corp.'s five-year total costs, those expenses do not count for the innovation box profit calculation because they stem from activities conducted in Germany.

Having computed the tentative innovation profit, five-year total costs, and five-year U.S. R&D costs, Watch Corp.'s innovation box profit for tax year 2016 comes to approximately $488.1 million. That amount is eligible for a 71 percent deduction, and the total tax liability due on that profit is approximately $49.5 million ((1 - 0.71) * 0.35 * $488.1 million). The $1.41 billion remainder of the 2016 profit ($1.9 billion in tentative profit - $488.1 million in innovation box profit) is subject to tax at 35 percent (less FTCs), for a tax bill of approximately $494 million.

The calculation makes the effective tax rate on income from all 2016 watch sales approximately 28.6 percent — hardly newsworthy.

## IV. Conclusion

A September 2015 article reviewed the proposal's effect on six industries: pharmaceuticals, electronics, motor vehicles and parts, aerospace, medical device and equipment, and oil and gas.[9] That analysis, like this one, indicated that the proposal's use of total costs in the calculation penalizes any sector that engages in significant marketing or otherwise has a cost structure with high selling, general, or administrative expenses.

Again, the U.S. proposal is not the new Ireland. In light of its less-than-fabulous effective tax rates, it is highly unlikely that U.S.-based multinationals will abandon the Emerald Isle for it. ◆

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7GB is part of USCo for U.S. tax purposes because it is not a separate legal entity.

8By contrast, USCo's $200 million in gross interest income is not included in the calculation of tentative innovation profit because it is not attributable to the sale, lease, or license of qualified property.

9Jason Osborn et al., ''Which Cos. Are Most Likely to Benefit From Innovation Box?'' Law360, Sept. 9, 2015.