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Proposed Innovation Box Legislation

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On July 29, the House Ways and Means Committee released draft legislation for a so-called "patent box" proposal, which, if adopted, could mean significant tax savings for many companies engaged in research-intensive industries, and, more importantly, could help the United States stem the offshore migration of intellectual property and the high-tech jobs associated therewith. Patent boxes, sometimes more broadly referred to as "innovation" or "intellectual property" (IP) boxes, offer a lower tax rate on income derived from intellectual property. Over the past decade, IP box regimes have become commonplace throughout Europe, as countries search for ways, within their borders, to increase innovation activities, create and maintain high-tech jobs and foster the creation of IP technology. Recently, the idea has gained momentum in the United States, and we expect it to become part of a broader discussion of comprehensive tax reform, specifically as a way of making the tax code more business friendly. Historically, the United States has employed tax incentives at the front end of the innovation chain through a tax credit mechanism for qualifying research and development expenses resulting from activities within the United States. A patent box regime, on the other hand, would be a back-end incentive that reduces tax on the income arising from a company's exploitation of qualifying intellectual property. Generally, this tax relief takes the form of either 1) a reduced rate on income earned through the IP box; and/or 2) a deduction for a portion of the IP box income. The types of intellectual property that are eligible for tax relief vary by country. All countries with an IP box regime treat patents as qualifying property. Other countries, such as Ireland, Luxembourg, Spain, and Switzerland, broaden the list to include designs, copyrights, models, and certain information. China is perhaps the most ambitious in this regard, as its legislation is broad enough to encompass income derived from certain types of commercial know-how. IP proposals are not new to United States fiscal policy discussions. In 2013, legislation was introduced that would have granted a deduction of up to 71 percent for income related to intangibles. These breaks would have been tied to where research and development occurred and whether the products were sold in the United States. However, the idea has gained more traction recently, due in part to the OECD's efforts to update international tax rules for the digital age. Lawmakers are beginning to recognize that these changes, including the OECD's anticipated blessing of the IP box model in the United Kingdom, will render the United States tax system even less competitive than it already is. The U.S. corporate tax rate is already one of the highest in the developed world. As a result, the modus

operandi of many U.S. businesses is to develop and hold IP outside the United States, often in countries that have lowered their corporate tax rates and/or implemented some form of IP box incentive. U.S. pharmaceutical giant Pfizer, for example, has moved intellectual property and production facilities for several major products, including its cholesterol-lowering drug, Lipitor, to Ireland. Lawmakers recognize that they need legislation that addresses these overseas developments if the United States is to remain at the forefront of innovation. In the business world, the biggest proponents of U.S. IP box legislation include research-intensive companies that have high value intellectual property in the United States, such as motion picture, biotechnology, medical device technology, pharmaceutical. and other high technology companies. Every industry group, though, stands to gain from the IP box idea. On the political side, the experience of European countries reveals it is both politically and practically difficult to draft narrow IP box legislation that promotes innovation but does not permit widespread abuse. Part of this difficulty results from having to choose the types of innovation activities that deserve tax breaks. Many companies will respond by taking aggressive tax positions, namely finding inventive ways to designate more of their overall income as IP income. Also, the revenue cost associated with adopting an IP box regime will require cuts in other areas, which will likely result in intense political maneuvering and negotiating. Because most patent boxes were enacted recently, it is difficult to determine what effect, if any, such legislation will have on creating high-tech jobs and innovations in the United States. The available data suggests that these policies will induce U.S. companies to develop more IP in the United States, with non-patent box nations losing in their relative share of IP development. However, it is unlikely that IP box legislation will encourage non-U.S. companies to transfer and develop IP onshore. Countries with IP boxes have seen growth in industry research and development, and in high-tech product exports, that outpaces their non-IP box counterparts. However, the data also suggests that the taxes on IP box revenues will not fully offset the reduced tax revenues attributable to the lower IP box tax rates, at least in the short term. We can expect to hear more IP box proposals in the coming months, including accompanying anti-erosion proposals designed to eliminate a U.S. company's ability to defer U.S. taxation of its offshore IP-related income. Already, taxpayers and their lobbyists have lined up on both sides, ready for a long battle. The outlook for tax reform that encompasses an IP box policy is doubtful for 2015. However, we expect the issue to receive more attention as the 2016 presidential campaign gains momentum and the discussion becomes part of the larger debate over taxes and economic growth.

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