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Innovation Promotion Act of 2015: Is the United States Finally Getting Competitive in the Patent Box Arena?

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The United States finally took its first step toward a more competitive tax position for intellectual property in the United States. Although some might call it a baby step, the release this week of a discussion draft of legislation proposed to lower the tax rate on income from intellectual property to 10% was in fact a big stride forward in the effort to keep, and to attract, innovation, research, and development to the United States in the face of increasingly attractive patent box tax regimes overseas.

The "Innovation Promotion Act of 2015" was released as a discussion draft on July 29, 2015 by Charles Boustany, Jr., (R-La.) and Richard Neal (D-Mass.) of the U.S. House Ways and Means Committee.

In addition to the reduced 10% tax rate, the plan contemplates tax-free distributions of "qualifying intangible property" from a controlled foreign corporation (CFC) to its U.S. parent - an effort intended to facilitate bringing intellectual property developed elsewhere back to the United States. The proposals are designed to cover a wide array of intellectual property as "qualifying", including patents, inventions, formulae, processes, designs, patterns, knowhow, computer software, and the property they produce.

The mechanics of the proposal are technically challenging. The 10% tax rate would be achieved by permitting a U.S. company to deduct 71% of its "innovation box profit" earned from qualifying intellectual property, or 71% of its taxable income, if less, resulting in an effective tax rate of approximately 10% on profits qualifying for the deduction. The "innovation box profit" would be determined by reducing gross receipts from the sale, lease, license, or other disposition of qualified intellectual property to third parties by the associated costs (e.g., of goods sold, interest expense, and taxes). Under a complex calculation, that amount is then multiplied by a function of the U.S. company's budget allocated to U.S. research and development over the prior five years.

The tax free distribution of qualifying intellectual property from a CFC to its U.S. parent would be achieved in a more straightforward manner by treating such distributions as having a fair market value equal to its basis in order to prevent a Subpart F income inclusion to the U.S. parent. In addition, the U.S. parent would receive a 100% dividends received deduction on the distribution.

Few might expect the legislation to succeed precisely in its proposed form and critics already point to the complexity inherent in trying to tie the tax benefit via a complex calculation to research and development performed in the United States. Nevertheless, the release, finally, of a specific patent box regime proposal indicates that Washington's politicians are taking seriously the United States' business community's complaints regarding the very real threat of an innovation brain drain and the increasingly extreme overseas competition on the tax front.

As Chairman Paul Ryan (R-WI) stated in response to the release, “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 U.S. 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.”

The fact that the United States' is woefully behind relative to the fast pace at which increasingly attractive regimes are being put forth in competing countries like Ireland, the U.K., Luxembourg, and the Netherlands is a singular driver for U.S. innovators putting their efforts, and their results, in overseas companies. Consequently, many will welcome the Innovation Promotion Act of 2015 as a first step toward leveling the playing field.

Detailed feedback is being requested on the discussion draft of the proposal, with specific questions being put to the public for comment.

The Kilpatrick Townsend tax team is actively studying the proposal and we welcome any discussion or questions on this development. For further information on the Innovation Promotion Act of 2015, please contact the authors of this Legal Alert or any other member of Kilpatrick Townsend's Domestic and International Tax Team.

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