Bloomberg BNA

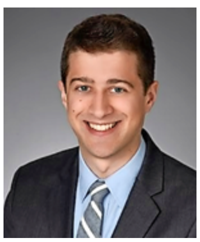
BNA's
Patent, Trademark & Copyright Journal®

VOL. 92, NO. 2271 JULY 29, 2016

PATENTS

The authors assess the likelihood of changes to taxation of profits based on U.S. intellectual property and, if it occurs, their effect on firms' IP commercialization decisions.

Tax Incentives for Intellectual Property



By Scott J. Loresch and Rod S. Berman

In the increasingly global world economy, the United States and other countries face an increasing challenge in attempting to remain attractive jurisdictions for the development and relocation of intellectual property and other ''mobile'' assets of large multinational entities. Countries seeking to encourage regional research and development have implemented tax deductions and credits incentivizing domestic research and development expenditures (*See, e.g.*, Internal Revenue Code section 41 (providing an income tax credit for qualified research expenditures); Marc Melnico, ''China Clarifies R&D Super 150 Percent Tax Deduction Rules,'' Patent, Trademark and Copyright Journal (Jan. 21, 2016) (discussing China's recent expansion of its deduction for domestic research and development expenses. (91 PTCJ 800, 1/22/16)).

Rod S. Berman is chairman of the Intellectual Property Group at Jeffer Mangels Butler & Mitchell LLP. Mr. Berman focuses on patent, trademark, trade dress, copyright, unfair competition and internet responsibilities. His law practice includes counseling, litigation, opinions, licensing, acquisition and prosecution.

Scott Loresch is a tax attorney at Jeffer Mangels Butler & Mitchell LLP. He advises individuals and business entities on a range of tax issues.

Tax incentives targeted at the commercialization of intellectual property, so called ''patent boxes,'' have also become increasingly popular in recent years among countries seeking to attract and retain the jobs, technology and revenue streams that accompany this intellectual property. In its simplest form, a patent box provides for a lower effective rate of taxation on income streams generated by patents and other favored intellectual property as compared to income from other sources. Taxpayers in the jurisdiction implementing the patent box regime are thus incentivized to develop and retain intellectual property domestically, rather than developing the intellectual property abroad or transferring existing intellectual property abroad so that the resulting revenue streams are subject to tax in lower-tax jurisdictions.

Belgium, China, France, Ireland, Italy, Luxembourg, the Netherlands, Spain, Switzerland and the United Kingdom have all implemented or are in the process of implementing patent box legislation.

For example, in 2007, Belgium introduced a deduction-based patent box regime, which allows Belgian corporations (or foreign entities subject to tax in Belgium) a deduction equal to 80 percent of the gross income generated by qualifying patents owned by the Belgian taxpayer.

 ISSN 0148-7965

The Netherlands patent box legislation, initially introduced in 2007, modified in 2010 and expected to be enacted in 2017, instead provides for a flat 5 percent tax on *net* income from qualifying intellectual property (defined broadly) (compared to a standard corporate income tax rate of 25.5 percent). Because the reduced rate applies only to net income, however, the Netherlands patent box regime only provides a benefit if and to the extent qualifying income exceeds the related costs and expenses of the taxpayer. On the other hand, the Netherlands patent box regime also may be employed by those with patent licenses, not just patent ownership. It also includes a document retention requirement for information on the taxpayer's allocation of income related to use of the patent box.

The United Kingdom recently implemented a patent box regime that applies a 10 percent effective tax rate to net income derived from patents. Like the Belgian regime, the U.K. patent box does not apply to other forms of intellectual property, such as trademarks and copyrights.

Criticism and International Reform: OECD BEPS Initiative

Not all proponents of tax reform support the patent box approach. For example, Jason Furman, chair of President Obama's Council of Economic Advisers recently criticized the patent box as encouraging only commercially safe, profitable development, rather than encouraging risk-taking and innovation. Instead, Furman has called for an expended credit for research (regardless of its profitability) (*See* Tax Analysts, 99 Tax Notes Highlights & Documents 49-1915 (March 14, 2016)).

Another line of criticism of patent box regimes comes from countries that view them as providing unfair tax advantages to mobile multinationals. For example, Germany's finance minister, Wolfgang Schäuble, has spoken out against patent boxes as providing unfair competition, and has called for a ban against them (*See* Reuters, Germany calls on EU to ban 'patent box' tax breaks (June 9, 2013); Reuters, Germany may close foreign 'patent box' tax loophole—report (Sept. 27, 2014)).

Some of this criticism is likely to be tempered by the guidelines implemented pursuant to the Organization for Economic Co-operation and Development's (OECD) Base Erosion and Profit Sharing (BEPS) Initiative.

Item 5 of the BEPS Initiative targets harmful preferential tax practices, focusing in particular on patent boxes and similar regimes. In October 2015, the OECD released a final report on BEPS Item 5, setting forth guidelines for determining whether a given patent box regime should be viewed as impermissibly harmful. In analyzing preferential tax regimes, the OECD report focuses on whether the claimant taxpayer in fact substantively contributed to the development of the intellectual property generating the income receiving preferential treatment. Generally, the report provides for a ''modified nexus'' approach under which the only portion of income from intellectual property that may qualify for preferential treatment under a patent box regime is the fraction of the income corresponding to the ratio of (A) the claimant taxpayer's modified research and development expenditures divided by (B) the claimant taxpayer's entire affiliated group's research and development expenditures (plus acquisition costs, for acquired intellectual property). The numerator of this fraction may be increased by up to 30 percent, to account for expenses that may not be allowed. The Netherlands legislation for example is intended to be consistent with the ''modified nexus'' approach.

Current U.S. Tax Strategies Relating to Intellectual Property

Given the United States' relatively high federal corporate income tax rate of 35 percent, U.S. multinationals are incentivized to shift profits from intellectual property overseas, to the extent possible. Given the mobility of intangible assets, an obvious approach might be for a U.S. parent corporation to contribute its already-developed intellectual property to a controlled foreign subsidiary in a lower-tax jurisdiction. However, Section 367(d) of the Internal Revenue Code prevents this end-run around U.S. income tax by requiring the contributing U.S. parent corporation in such a transaction to recognize income as though it had sold the contributed property to the foreign corporation in exchange for a stream of income commensurate with the income generated by the intellectual property.

Instead, U.S. multinationals engage in other strategies so that the intellectual property in question is owned, at least in part, by a foreign subsidiary from its initial stages of development. One such strategy is to have several controlled entities enter into a cost-sharing agreement, under which each participant contributes a given investment to a research pool in exchange for a set interest in any resulting intellectual property. The effectiveness of this approach is somewhat limited, however, since the transfer pricing regulations under Section 482 of the Internal Revenue Codeprovide strict rules for how the rights under such related-party arrangements are assigned, to prevent cherry-picking of profitable intellectual property.

A second approach is to have a foreign subsidiary contract with a related U.S. research and development company to conduct the research and have management at the foreign subsidiary make the substantive decisions as to how the research is conducted. The foreign subsidiary is then treated as the owner of the resulting intellectual property outright, paying the related U.S. research and development company only for its costs plus a markup. This approach can also be difficult, since the taxpayer must show that the foreign subsidiary is in substance making the business decisions and taking on the risk that warrant it owning the property (rather than, for example, management at the U.S. parent company directing the research and development).

In recent years, U.S. multinationals have also threatened to expatriate or ''invert'' into foreign jurisdictions, i.e., engage in a reorganization or merger resulting in the U.S. entity effectively reincorporating in a foreign jurisdiction with a more favorable worldwide tax regime. Congress has significantly limited domestic corporations' ability to engage in such expatriation. Under anti-inversion rules in Section 7874 of the Internal Revenue Code, the resulting corporation may be treated as a domestic corporation notwithstanding its new jurisdiction of organization unless a substantial portion of the stock of the expatriated corporation is owned by new owners.

U.S. Tax Reform Proposals

In recent years, members of Congress from both parties have shown an increasing interest in broad reform of the U.S. international tax regime to increase the competitiveness of U.S. multinational entities in the global marketplace. For example, in 2014, Rep. Dave Camp (R-Mich.), then chair of the House Committee on Ways and Means, introduced draft legislation providing for broad domestic and international tax reform. More recently, in July 2015, Sens. Rob Portman (R-Ohio) and Charles Schumer (D-N.Y.) released a joint proposal for a new regime for the taxation of the foreign earnings of U.S. companies. Both the Camp and Portman-Schumer proposals call for a ''territorial'' tax regime, under which the foreign earnings of U.S. companies would effectively be exempt from U.S. tax, provided they are taxed above a minimum rate in the source country.

On July 29, 2015, Reps. Charles Boustany (R-La.) and Richard Neal (D-Mass.) introduced a discussion draft of proposed legislation, the *Innovation Promotion Act of 2015*, that would implement a patent box regime for U.S. intellectual property (90 PTCJ 2842, 8/7/15). The patent box proposed by Boustany and Neal would provide domestic corporations with a 71 percent deduction for ''innovation box profits'' derived from qualified intellectual property, resulting in an effective U.S. federal income tax rate of 10.15 percent on those profits (29 percent x the current 35 percent federal corporate income tax rate). Innovation box profits would be determined by multiplying the corporation's tentative innovation profit by a ratio equal to (A) the corporation's domestic research and development expenditures over the preceding five years divided by (B) the corporation's total costs over the preceding five years. Tentative innovation profit is in turn defined as (X) gross receipts from the sale, lease, license or other disposition of qualified intellectual property (defined broadly to include patents, formulas, inventions, processes, know-how and property developed using that intellectual property) reduced by (Y) the expenses related to those profits.

The Boustany-Neal patent box also encourages repatriation of intellectual property previously moved to or developed by a U.S. corporation's controlled foreign subsidiaries (CFCs). If a CFC distributes qualified intellectual property to its domestic parent, the value of the property is deemed to be equal to the CFC's tax basis in the property (preventing any taxable gain to the CFC on the distribution), and the U.S. parent is allowed a 100 percent dividends received deduction (effectively eliminating any U.S. federal income tax on the repatriation).

Positioning for Transition

It appears increasingly likely that Congress will implement significant federal tax reform within the next few years, which will probably include changes to the U.S. taxation of foreign income. However such legislation may need to wait until 2017, as President Obama has expressed objection to presently articulated patent box regimes. Nevertheless, given general bipartisan support for patent box legislation, U.S. multinationals may soon find themselves in the position of having to re-evaluate the structure of their intellectual property development and commercialization.

International tax reform is likely to include transition rules, such as those in the Boustany-Neal patent box proposal discussed above. U.S. businesses developing new IP and seeking to commercialize existing IP should consult with their tax and legal advisers to determine the best way to minimize their overall tax liability while maintaining the flexibility to take advantage of a U.S. patent box or other similar incentive should the opportunity arise.