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Client Alert

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Tax Rate on Intellectual Property Profits Would Be Cut to Approximately 10% and Appreciated Intellectual Property Could Be Repatriated Free of Current Tax under Bipartisan Innovation Box Proposal

On July 29, 2015, Charles Boustany (R-LA) and Richard Neal (D-MA) released a bipartisan discussion draft of proposed Internal Revenue Code (the "Code") amendments that would cut the United States income tax rate on corporate profits generated from patents and certain other intellectual property to approximately 10% (the "Tax Rate Proposal") and allow repatriation of appreciated intellectual property United States income tax free via the Distribution Proposal (defined and discussed below). The recent wave of highly publicized corporate inversion transactions, whereby domestic corporations reduce their United States taxes by relocating their legal domicile to a lower-tax country, or a corporate tax haven, while retaining material operations in the United States, has spurred Congress toward international tax reform. The Tax Rate Proposal and the Distribution Proposal evidence apparent bipartisan congressional interest in making the United States' intellectual property tax regime more competitive with the intellectual property taxation regimes of other countries.

Innovation Box Tax Deduction

The Tax Rate Proposal includes a deduction for "innovation box profits." The deduction for each taxable year equals 71% of the lesser of the taxpayer's (1) innovation box profit or (2) taxable income (determined without the 71% deduction).

A corporation's innovation box profit generally equals a specified percentage of the "qualified gross receipts" from the sale, lease, license or other disposition of certain intellectual property (the "Innovation Percentage"). The Innovation Percentage generally equals the corporation's expenditures for research and development incurred in the United States for the past five years divided by its total related operating costs for those same years (exclusive of cost of goods sold, interest and taxes).

The innovation box tax deduction would not be taken into account in computing any net operating loss. Thus, the deduction will not create, or increase, the amount of a net operating loss deduction; rather, it only would reduce the effective tax rate for innovation box profits to approximately 10%.

For purposes of computing innovation box profit, all members of an expanded affiliated group would be treated as a single corporation. The innovation box tax deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of innovation box profit.

Qualified Gross Receipts. Qualified gross receipts are the gross receipts from the sale, lease, license or other disposition of qualified property in the ordinary course of a United States trade or business ("USTOB"). Qualified property is any (1) 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 property described in (1) above.

For example, USTOB-generated patent license fees or proceeds from the sale of a product produced or designed via a patented process are qualified gross receipts. But sales proceeds generally do not include proceeds from sales of product to a related person, including a related foreign distributor, unless and until the product sold is resold by the related party to an unrelated person outside the United States.

Qualified gross receipts also include any compensation for infringement of the taxpayer's intellectual property rights in qualified property to the extent the compensation is included in gross income.

Innovation Box Profit. Innovation box profit for the taxable year is a taxpayer's "tentative" innovation profit multiplied by the Innovation Percentage. The taxpayer's tentative innovation profit is its qualified gross receipts reduced by the sum of (1) the costs of goods sold for the taxable year that are properly allocable to qualified gross receipts and (2) other expenses, losses or deductions (other than the 71% innovation box tax deduction) that are properly allocable to qualified gross receipts. For this purpose, the taxpayer uses the same inventory methods used to determine its taxable income in accordance with the principles of Code Sections 263A, 471 and 472. In the case of non-inventory property, such as motion picture films, costs of goods sold includes the adjusted basis of the property. Special rules apply to items brought into the United States and to property exported by the taxpayer for further manufacture. Under the Tax Rate Proposal, the Secretary of the Treasury is granted broad authority to prescribe rules for the proper allocation of items for purposes of determining innovation box profit, including promulgating rules for the proper allocation of items whether or not such items are directly allocable to qualified gross receipts.

The Innovation Percentage is determined as follows: the numerator is the amount paid or incurred by the taxpayer for research and development in its USTOB, for which a deduction is allowed under Section (a) or (b) of Section 174 (determined without regard to Sections 41 and 280(c)), for the five-taxable-year period ending with the taxable year; and the Innovation Percentage denominator is the sum of all costs paid or incurred by the taxpayer in its USTOB for the five-taxable-year period ending with the taxable year other than (1) the taxpayer's cost of goods sold, (2) interest paid or accrued and (3) taxes paid or accrued. The Innovation Percentage is intended to reflect the innovation profits that result from the taxpayer's research and development activities in the United States.

The Tax Rate Proposal would be effective for taxable years beginning after the date of enactment of the Tax Rate Proposal.

Proposed Tax-free Repatriation of Intellectual Property from a CFC

To encourage taxpayers to repatriate intellectual property owned by subsidiaries that are controlled foreign corporations (CFCs), the bipartisan proposal adds a new section to subpart F of the Code that permits CFCs to make tax-free distributions of appreciated innovation box qualified property to their United States shareholders (the "Distribution Proposal").

Under the Distribution Proposal, if a CFC distributes qualifying intangible property to its United States parent, the distributed property is treated as having a fair market value of no more than the CFC's tax basis in the property. The United States parent acquires a carryover tax basis in the property. The distribution does not result in any subpart F income and does not increase the CFC's earnings and profits (E&P).

The distribution is treated as a dividend, to the extent of the CFC's E&P, and the United States parent receives a 100 % dividends received deduction. If the distribution exceeds the CFC's E&P, the excess decreases the United States parent's tax basis in its CFC shares, with any remaining excess decreasing the United States parent's tax basis in the distributed property. To qualify, the distribution of the intangible property must be part of a plan that meets certain filing requirements. Intangible property qualifying for the

Distribution Proposal is the same as the intangible property whose sale or commercial exploitation profits can qualify for special treatment under the Tax Rate Proposal.

The Distribution Proposal would be effective for distributions made in taxable years of foreign corporations beginning after December 31, 2015.

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