The Innovation Box
What It Is and Why We Need It

To help keep research and development as well as high-paying jobs in America, Rep. Charles Boustany (R-LA) and Rep. Richard Neal (D-MA) today released a bipartisan discussion draft of an "innovation box"—or a special, lower tax rate for income derived from intellectual property. They are seeking feedback on their proposal, and an updated version is expected to be included in the broader international tax legislation that the Ways and Means Committee is pursuing this fall.

Why Do We Need It?
To discourage foreign takeovers of American companies and to keep good-paying jobs in the United States. The U.S. tax code is hobbling American job creators, who are facing stiff competition in the global economy. First, the U.S. has the highest corporate tax rate in the developed world. Second, the U.S. is one of the few developed countries to use a worldwide tax regime that charges U.S. companies twice. Third, the tax code perversely encourages foreign companies to acquire U.S. companies, costing American jobs.

Other countries have been creating "innovation boxes," or special, lower tax rates for IP-related income—typically between 5 and 15 percent. And in recent months, more foreign competitors have been acquiring U.S. companies and accelerating cross-border mergers. Meanwhile, the Organization for Economic Development and Cooperation's (OECD) project on base erosion and profit shifting (BEPS) will only make these problems worse. Unless we act, several aspects of the OECD project will harm both U.S. companies and the U.S. Treasury by increasing foreign taxes on U.S. companies (some of which are allowed as credits against U.S. taxes).

In addition, The OECD BEPS project will soon require every innovation box to include a nexus component. In other words, a company will have to locate its research and development—and the high-paying jobs that go with it—in the country offering the special tax rate.

As a result, multinational companies conducting R&D in the U.S., but paying taxes in lower-tax jurisdictions will feel pressure—from both shareholders and foreign governments—to move their R&D facilities into countries with innovation boxes. The OECD's final guidelines will be published by the end of 2015, so many U.S. companies will have to decide soon whether to restructure.

By creating an innovation box in the U.S. tax code, American companies can better compete with foreign competitors, and we can remove one of the increasing incentives for U.S.-based businesses to relocate abroad.

How Would It Work?
Under the proposal, here's how a U.S. company would use calculate its taxes on IP-related income:

1. Identify gross receipts attributable to certain technology-based IP.
2. Subtract any related costs to determine the net profit from the IP.
3. Multiply this IP profit by the ratio of domestic R&D costs to total costs.
4. Apply a 10 percent tax rate to the resulting profit (instead of the general 35 percent corporate rate).

The discussion draft also would allow companies with foreign-based IP to move that IP back to the United States without paying any U.S. tax on the transfer, so that this "domesticated" IP may be eligible for the innovation box.

Although this proposal is still being developed, an innovation box would encourage U.S. companies to invest in America's workers. Reps. Boustany and Neal and all the members of the Ways and Means Committee look forward to hearing from the public about how to encourage more companies to set up shop in America—and stay here.

TECHNICAL EXPLANATION OF THE INNOVATION PROMOTION ACT OF 2015

July 28, 2015

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Present Law

Deductions in general

The taxable income of a business generally is comprised of gross income less allowable deductions. Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses.

Moreover, Federal income tax rules provide incentives for research activities by providing (i) a deduction that allows research expenditures to be expensed instead of amortized over time, and (ii) a credit for certain qualified research expenditures.[1] There is no present law Federal income tax provision that provides for preferential rates, deductions or credits specifically for profits attributable to the sale or license of intellectual property (or products using or incorporating intellectual property) (*i.e.*, "innovation box profits").[2]

Capital expenditures

Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized[3] and recovered over time through depreciation, amortization or depletion allowances.[4] In addition, if the production, purchase, or sale of merchandise is a material income-producing factor to a taxpayer, the taxpayer must account for inventories.[5]

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the

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[1] See also Joint Committee on Taxation, *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[2] For descriptions and discussion of various intellectual property regimes introduced in several countries (including Belgium, Cyprus, France, Hungary, Italy, Ireland, Luxembourg, Malta, the Netherlands, Spain, and the United Kingdom) in recent years, see Joint Committee on Taxation, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income* (JCX-51-15), March 16, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[3] See sec. 263(a).

[4] See secs. 167, 168, 197, and 611.

[5] See secs. 471, 472, and 263A. See also Treas. Reg. sec. 1.471-1.

beginning of the period to the purchases made and production costs incurred during the period, and subtracting from that sum the taxpayer's inventory at the end of the period. Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows.[6] In addition, the uniform capitalization ("UNICAP") rules require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[7] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

<u>Research and experimental expenditures</u>

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[8] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[9] If taxpayers choose to forgo a current deduction, they may capitalize their research expenditures and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[10] In the alternative, taxpayers may elect to amortize their research expenditures over a period of 10 years.[11] Generally, such deductions are reduced by the amount of the taxpayer's research credit (discussed in more detail below under "research credit").[12]

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[6] See, *e.g.*, secs. 471 and 472.

[7] Sec. 263A.

[8] Secs. 167 and 263(a). Except where otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[9] Secs. 174(a) and (e).

[10] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize its section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

[11] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime.

[12] Sec. 280C(c). Taxpayers may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing deductions otherwise allowed. Sec. 280C(c)(3).

Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a)[13] or section 263A.[14]

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[15] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[16] For purposes of section 174, the term "product" includes any pilot model, process,[17] formula, invention, technique, patent, or similar property whether used by the taxpayer in its trade or business or held for sale, lease, or license.[18] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[19] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[20] In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.[21]

Research or experimental expenditures under section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with literary, historical, or similar projects.[22] For purposes of section 174, quality

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[13] Sec. 263(a)(1)(B).

[14] Sec. 263A(c)(2).

[15] Treas. Reg. sec. 1.174-2(a)(1) and (2).

[16] Treas. Reg. sec. 1.174-2(a)(1).

[17] Treas. Reg. sec. 1.174-2(a)(11), Example 10, provides an example of new process development costs eligible for section 174 treatment.

[18] Treas. Reg. sec. 1.174-2(a)(3).

[19] Treas. Reg. sec. 1.174-2(a)(1).

[20] See Treas. Reg. sec. 1.174-2. The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent. Treas. Reg. sec. 1.174-2(a)(1).

[21] Rev. Proc. 2000-50, 2000-2 C.B. 601.

[22] Treas. Reg. sec. 1.174-2(a)(6).

control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.[23]

Generally, no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[24] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[25]

Research credit

General

Different types of research credits are available, depending on the method elected by the taxpayer or the type of research performed. First, for general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[26] Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified credit (with a 14-percent rate and a different base amount) may be claimed in lieu of this credit.[27]

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.[28] This separate credit computation commonly is referred to as the basic research credit.

[23] Treas. Reg. sec. 1.174-2(a)(7).

[24] Sec. 174(c).

[25] Sec. 174(d). Special rules apply with respect to geological and geophysical costs (section 167(h)), qualified tertiary injectant expenses (section 193), intangible drilling costs (sections 263(c) and 291(b)), and mining exploration and development costs (sections 616 and 617).

[26] Sec. 41(a)(1).

[27] Sec. 41(c)(5).

[28] Sec. 41(a)(2) and (e). The base period for the basic research credit generally extends from 1981 through 1983.

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.[29] This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the basic research credit and the energy research credit, expired for amounts paid or incurred after December 31, 2014.[30]

Computation of general research credit

The general research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).[31] In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

Alternative simplified credit

The alternative simplified credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years.[32] The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any

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[29] Sec. 41(a)(3).

[30] Sec. 41(h).

[31] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

[32] Sec. 41(c)(5)(A).

one of the three preceding taxable years.[33] An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.[34]

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[35] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of section 174, but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[36] In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for internal use by the taxpayer;[37] (6) conducted outside the United States, Puerto Rico, or any U.S. possession; (7) in the social

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[33] Sec. 41(c)(5)(B).

[34] Sec. 41(c)(5)(C).

[35] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

[36] Sec. 41(d)(3).

[37] See Prop. Treas. Reg. sec. 1.41-4 (REG-153656-03) for recently proposed regulations on the application of the research credit to software development costs.

sciences, arts, or humanities; or (8) funded by any grant, contract, or otherwise by another person (or government entity).[38]

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[39] Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[40]

Explanation of Provision

The provision establishes a deduction for innovation box profits. The deduction has the effect of lowering the income tax rate on profits that qualify for the deduction. The deduction is equal to 71 percent of the lesser of the (1) "innovation box profit" of the taxpayer for the taxable year or (2) taxable income (determined without the 71 percent deduction) for the taxable year.[41] This results in an effective tax rate of approximately 10 percent on innovation box profits. The deduction for innovation box profit is not taken into account in computing any net operating loss or the amount of any operating loss carryback or carryover. Thus, the deduction cannot create, or increase, the amount of a net operating loss deduction.

For purposes of computing innovation box profit, all members of an expanded affiliated group are treated as a single corporation.[42] The deduction is allocated among the members of

[38] Sec. 41(d)(4).

[39] Sec. 280C(c). For example, assume that a taxpayer makes credit-eligible research expenditures of $1 million during the year and that the base period amount is $600,000. Under the standard credit calculation (*i.e.*, where a taxpayer may claim a research credit equal to 20 percent of the amount by which its qualified expenses for the year exceed its base period amount), the taxpayer is allowed a credit equal to 20 percent of the $400,000 increase in research expenditures, or $80,000 (($1 million - $600,000) * 20% = $80,000). To avoid a double benefit, the amount of the taxpayer's deduction under section 174 is reduced by $80,000 (the amount of the research credit), leaving a deduction of $920,000 ($1 million - $80,000).

[40] Sec. 280C(c)(3). Taxpayers making this election reduce the allowable research credit by the maximum corporate tax rate (currently 35 percent). Continuing with the example from the prior footnote, an electing taxpayer would have its credit reduced to $52,000 ($80,000 - ($80,000 * 0.35%)), but would retain its $1 million deduction for research expenses. This option might be desirable for a taxpayer who cannot claim the full amount of the research credit otherwise allowable due to the limitation imposed by the alternative minimum tax.

[41] This deduction does not affect the ability of the taxpayer to claim the deduction for domestic production activities under section 199, the current deduction for research and experimental expenditures under section 174, or the research and experimentation credit under section 41.

[42] For these purposes and expanded affiliated group is an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

the expanded affiliated group in proportion to each member's respective amount (if any) of innovation box profit.

Qualified gross receipts

To determine innovation box profit, a taxpayer must first determine its qualified gross receipts. Qualified gross receipts are the gross receipts of the taxpayer derived from the sale, lease, license, or other disposition of qualified property in the ordinary course of a U.S. trade or business of the taxpayer. Qualified property is any (1) patent, invention, formula, process, design, pattern, or know-how,[43] (2) motion picture film or video tape,[44] (3) computer software,[45] and (4) any product produced using any property described in (1) above. Additionally, any compensation for infringement of the taxpayer's intellectual property rights to qualified property is included in qualified gross receipts to the extent the compensation is included in the gross income of the taxpayer.

With one exception, qualified gross receipts do not include gross receipts from the sale of qualified property to a related person.[46] If products produced using qualified property are sold to a related person outside of the United States, gross receipts from the sale are qualified gross receipts only if the products are resold to an unrelated person.

For example, if a taxpayer licenses the right to use a patent, qualified gross receipts would include the license fees received by the taxpayer. If a taxpayer uses a process or formula to produce a product or the product includes a patented design, the gross receipts from the sale of the product would also be qualified gross receipts for purposes of the provision. If a taxpayer produces a product using qualified intangible property and sells the product to its related foreign distributor, gross receipts from the sale of the product to the related foreign distributor would be qualified gross receipts if the products are sold by the related-party distributor to unrelated persons outside the United States.

Tentative innovation profit

Once the taxpayer determines its qualified gross receipts, the taxpayer must determine the amount of tentative innovation profit by subtracting from qualified gross receipts the sum of (1) the taxpayer's costs of goods sold for the taxable year that are properly allocable to qualified

[43] The provision refers to intangible property described in section 936(h)(3)(B)(i).

[44] The provision refers to property described in section 168(f)(3).

[45] The provision refers to computer software as defined in section 197(e)(3)(B). Section 197(e)(3)(B) defines computer software as any program designed to cause a computer to perform a desired function. The term does not include any database or similar item unless the database or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

[46] For these purposes, a person is a related person if they are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) or (b) of section 52 shall be made without regard to section 1563(b).

gross receipts, and (2) other expenses, losses, or deductions (other than the 71 percent deduction) that are properly allocable to qualified gross receipts.

For purposes of the provision, costs of goods sold is determined using the same inventory methods that the taxpayer uses to compute taxable income in accordance with the principles of 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.

The provision grants the Secretary 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. It is intended that the Secretary will prescribe rules for the allocation of expenses, losses, and deductions to the qualified gross receipts of the taxpayer.

Innovation box profit

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

A taxpayer's five-year research and development expenditures is the amount paid or incurred by the taxpayer for the performance of research and development 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.

For purposes of determining whether the research and development was performed in the United States, the United States includes the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

A taxpayer's five-year total costs is the excess of all costs paid or incurred by the taxpayer for the five-taxable year period ending with the taxable year over the sum of (1) the taxpayer's cost of goods sold for the five-taxable year period, (2) interest paid or accrued for the five-taxable year period, and (3) taxes paid or accrued for the five-taxable year period. A taxpayer's five-year total costs do not include any research and development expenditures for any testing conducted outside the United States if such testing is conducted outside the United States because there is an insufficient testing population in the United States, or because testing is required by law to be conducted outside the United States. For example, assume a taxpayer develops a product and wants to sell the product in Country X. Country X requires products to be tested locally on its own population before a product can be sold for use by the Country X population. The costs related to the local testing will not be included in the computation of the taxpayer's five-year total cost.

The taxpayer's costs paid or incurred is intended to include all costs paid or incurred by a taxpayer in the ordinary course of its trade or business. Such costs include cost of goods sold, research and development, distribution, marketing, other costs of operations, taxes and financing costs of the taxpayer. For these purposes, costs paid or incurred by the taxpayer do not include section 165 losses or losses from the sale or exchange of capital assets. A taxpayer subtracts its cost of goods sold, interest and taxes, from the total costs paid or incurred by the taxpayer, to arrive at the five-year total costs included as the denominator for purposes of computing the innovation box profit of the taxpayer. The intent is to determine the tentative innovation profit that results from the taxpayer's research and development activities in the United States.

If a taxpayer was not in existence for the entire taxable-year period, the provision shall be applied on the basis of the period during which the taxpayer was in existence. Additionally, the term taxpayer includes any predecessor of the taxpayer.

The Secretary is granted authority to provide for the application of the provision in cases where the taxpayer acquires or disposes of a major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year. Additionally, the Secretary is granted authority to prescribe regulations as appropriate to carry out and to prevent abuse of the purposes of this provision.

Hypothetical calculation

Facts

To illustrate the mechanics of the innovation box calculations, consider, as part of a hypothetical example, the Watch Corporation, a U.S. corporation that designs and manufactures watches for sale in the United States and abroad.[47] It does not sell or produce any other product or service. It consists of a U.S. parent company ("USCo"), a foreign branch located in Germany ("Branch1"), and a number of controlled foreign corporations ("CFCs").[48]

USCo

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 $2.7 billion in total costs, divided among $1 billion in cost of goods sold, $750 million in advertising expenses, $700 million in U.S. research expenses, $200 million in royalty payments it makes to its CFCs for the rights to use certain watch designs and movement technology, $100 million in interest expense, and $50 million in expenses related to its U.S. headquarter operations

[47] The numbers (and product) used in this hypothetical example are for illustrative purposes only.

[48] A foreign corporation is a CFC if more than 50 percent of the total combined voting power of all classes of stock of the corporation or total value of the stock of the corporation is owned by United States shareholders on any day during a taxable year of the corporation. A United States shareholder means, with respect to a foreign corporation, a U.S. person that owns or is considered as owning under applicable constructive ownership rules, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation. Generally, ownership includes stock owned directly plus a proportionate amount of stock owned through certain other foreign entities. Additionally, the rules of attribution contain constructive ownership rules that attribute stock on the basis of the value of shares owned. Secs. 951(b), 957, and 958.

(*e.g.*, compensation for executives and administrative staff, depreciation of buildings and furniture, etc.).

For tax years 2012-2015, USCo incurs a total of $11.6 billion in costs, divided among $5 billion in cost of goods sold, $3 billion in advertising expenses, $2.1 billion in U.S. research expenses, $800 million in royalty payments it makes to CFCs, $500 million in interest expense, and $200 million in U.S. headquarter expenses. Assume that all expenses incurred by USCo are properly allocable to its watch sales.

Table 1, below, summarizes USCo's income and expenses for tax years 2012-2016.[49]

Table 1.–USCo Income and Expenses
(in millions)

USCo	2012-2015	2016
Income		
Watch Sales	$14,500	$3,800
Interest	$1,000	$200
Total	$15,500	$4,000
Expenses		
Cost of Goods Sold	$5,000	$1,000
Advertising	$3,000	$750
Research	$2,100	$700
Royalty Payments	$800	$200
Interest	$500	$100
Headquarter Operations	$200	$50
Total	$11,600	$2,800
Net Income	**$3,900**	**$1,200**

<u>Branch1</u>

For tax year 2016, Branch1 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, divided among $500 million in cost of goods sold, $200 million in advertising expenses, $180 million in research expenses incurred in Germany, $200 million in royalty payments to CFCs of USCo for

[49] USCo's income for tax years 2012-2015 is not relevant in determining tax year 2016 innovation box profit for Watch Corporation, and is shown here for the sake of completeness.

the rights to use certain watch designs and movement technology, and $20 million in German headquarter expenses.

For tax years 2012-2015, Branch1 incurs a total of $4 billion in total costs, divided among $1.5 billion in cost of goods sold, $1 billion in advertising expenses, $750 million in research expenses incurred in Germany, $650 million in royalty payments to CFCs of USCo, and $100 million in German headquarter expenses. Assume that all expenses incurred by Branch1 are properly allocable to its watch sales.

Table 2, below, summarizes Branch1's income and expenses for tax years 2012-2016.[50]

Table 2.–Branch1 Income and Expenses
(in millions)

Branch1	2012-2015	2016
Income		
Watch Sales	$6,000	$2,000
Interest	$0	$0
Total	$6,000	$2,000
Expenses		
Cost of Goods Sold	$1,500	$500
Advertising	$1,000	$200
Research	$750	$180
Royalty Payments	$650	$200
Interest	$0	$0
Headquarter Operations	$100	$20
Total	$4,000	$1,100
Net Income	**$2,000**	**$900**

Calculation

Watch Corporation's innovation box profit for tax year 2016 is determined by the following formula:

[50] Branch1's income for tax years 2012-2015 is not relevant in determining tax year 2016 innovation box profit for Watch Corporation, and is shown here for the sake of completeness.

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

For Watch Corporation, USCo and Branch1 are part of an expanded affiliated group—and treated as a single corporation under the provision—while USCo's CFCs are not included in the expanded affiliated group because they are foreign corporations.[51] As a result, Watch Corporation's innovation box profit reflects the income and operations of USCo and Branch1 and not the operations of any CFCs.

Tentative innovation profit

Watch Corporation'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 gross receipts. The watches sold by Watch Corporation are considered qualified property under the innovation box provision because they incorporate intangible property, such as movement technology and the design of the watch face. Therefore, income from all of Watch Corporation's watch sales from USCo and Branch1 ($3.8 billion + $2 billion = $5.8 billion) in tax year 2016 are included as gross receipts in the calculation of tentative innovation profit.[52] Assuming that all of USCo and Branch1's expenses ($2.8 billion + $1.1 billion = $3.9 billion) are properly allocable to its watch sales, Watch Corporation's tentative innovation profit in tax year 2016 is $1.9 billion ($5.8 billion – $3.9 billion).[53]

Five-year total costs

Watch Corporation's 5-year total costs are equal to the sum of all of USCo and Branch1's costs incurred in tax years 2012-2016 ($14.4 billion + $5.1 billion = $19.5 billion) minus the cost of goods sold ($6 billion + $2 billion = $8 billion) and interest expense ($600 million), or $10.9 billion.

Five-year total U.S. R&D costs

Watch Corporation's 5-year total U.S. R&D costs for the 2012-2016 time period are $2.8 billion ($2.1 billion + $700 million). Branch1 incurred $930 million in research expenses during that time period, and while those costs are included in the calculation of Watch Corporation's 5-year total costs, those research activities were conducted in Germany and do not count toward Watch Corporation's U.S. R&D costs for purposes of the innovation box profit calculation.

[51] Branch1 is part of USCo for U.S. tax purposes because it is not a separate legal entity.

[52] In contrast, USCo's $200 million in gross interest income is not included as part of the calculation of tentative innovation profit. That income is not attributable to the sale, lease, or license of qualified property.

[53] Out of the $3.9 billion in total expenses for USCo and Branch1 in tax year 2016, $1.5 billion is attributable to cost of goods sold. The remainder is attributable to advertising ($950 million), research ($880 million), royalty payments ($400 million), interest ($100 million), and headquarter operations ($70 million).

Innovation box profit

Having computed Watch Corporation's tentative innovation profit, 5-year total costs, and 5-year U.S. R&D costs, Watch Corporation's innovation box profit for tax year 2016 can be computed as follows:

$$Innovation\ Box\ Profit = \frac{\$2.8\ billion}{\$10.9\ billion} \times \$1.9\ billion \cong \$488.1\ million$$

The innovation box profit of approximately $488.1 million is eligible for a 71 percent deduction, and the total tax liability due on this profit is approximately $49.5 million.[54] The remainder of Watch Corporation's profit from watch sales made by USCo and Branch1 ($1.9 billion – $488.1 million = $1.41 billion) is subject to tax at a 35 percent U.S. corporate rate (less foreign tax credits), so that the total worldwide tax liability due on these profits is approximately $494 million ($1.41 billion * 0.35). As a result, the effective tax rate on income from the watch sales of USCo and Branch1 in tax year 2016 declines from 35 percent to approximately 28.6 percent under the innovation box provision.[55]

Effective Date

The provision applies to taxable years beginning after the date of enactment.

[54] (1 – 0.71) * 0.35 * $488.1 million ≅ $49.5 million.

[55] The total tax liability due on USCo and Branch1's watch sales (approximately $49.5 million + $494 million = $543.5 million) divided by their profit from watch sales ($1.9 billion) is approximately 28.6 percent.

B. Special Rules for Transfers of Intangible Property From Controlled Foreign Corporations to United States Shareholders

Present Law

Property distributions - effect on corporation

Generally, a corporation does not recognize gain or loss upon making a non-liquidating distribution of property to its shareholder with respect to its stock. However, in the case of a non-liquidating distribution of property that has a fair market value in excess of basis (*i.e.*, built-in-gain property), gain is recognized to the distributing corporation as if the property were sold to the shareholder at fair market value.[56] Accordingly, gain is recognized by the distributing corporation to the extent of the excess of fair market value over its basis in the property.

When a corporation makes a distribution out of earnings and profits, the corporation's earnings and profits is reduced by the amount of the money plus the fair market value of other property distributed (in the case of built-in-gain property).[57] With respect to a distribution of appreciated property, the concomitant gain recognition causes an increase in the earnings and profits of the distributing corporation in the amount of the gain, which is immediately followed by a decrease to its earnings and profits in the amount of the fair market value of the property. These adjustments have the effect of a net decrease in earnings and profits equal to the basis in the property distributed in the case of a distribution of appreciated property.

In the case of a non-liquidating distribution of property that has a basis in excess of fair market value (*i.e.*, built-in-loss property), loss is not recognized by the distributing corporation.[58] In such case, a reduction is made to the earnings and profits of the distributing corporation in an amount equal to the basis in the distributed property.[59] The amount of the shareholder distribution is equal to the fair market value of the property.[60]

Property distributions - effect on shareholder

Treatment of distribution amount received

Generally, when a distribution is made out of the earnings and profits of a corporation, the amount received is a dividend and is taxable as ordinary income to the recipient. When a distribution is made in excess of the corporation's earnings and profits, the recipient is not taxed to the extent of the recipient's basis in the stock of the distributing corporation. Distributions in

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[56] Secs. 311(a)(2) and 311(b).

[57] Sec. 312(b).

[58] Sec. 311(a)(2).

[59] Sec. 312(a)(3).

[60] Sec. 301(b)(1).

excess of earnings and profits and basis generally are taxed as if the shareholder had sold the stock of the distributing corporation and the shareholder recognizes capital gain in the amount of such excess.[61]

The amount of any distribution is the amount of money received plus the fair market value of the property received.[62] In addition, the tax basis of property received by a shareholder as a distribution is equal to the fair market value of such property.[63]

Application of cost recovery rules with respect to intangible property

Since the distribution of appreciated property to a shareholder is treated as if the property were sold to such shareholder at fair market value, the shareholder's tax basis in such property is equal to the fair market value of the property and cost recovery rules generally apply.

Under section 197 of the Code, when a taxpayer acquires intangibles held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years.[64] Such intangibles generally include, among others, any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item. So-called "anti-churning" rules also may apply to prevent pre-section 197 intangibles that would not have been amortizable but for section 197 from being transferred among related parties and becoming eligible for the 15-year amortization.[65]

Property distributions from controlled foreign corporations

Special rules apply in the context of distributions from CFCs to their United States shareholders. If a property distribution gives rise to gain recognition to a CFC, the gain may be subpart F income included in the taxable income of United States shareholders on a current basis even if not distributed.

Generally, subpart F income includes certain passive and other highly mobile income. Specifically, subpart F income includes, among other categories, foreign base company

[61] Secs. 301(c) and 316, which includes accumulated and current earnings and profits undiminished by current year distributions.

[62] Sec. 301(b)(1).

[63] Sec. 301(d).

[64] Secs. 197(d)(1)(F) and 197(f)(4). A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

[65] Sec. 197(f)(9).

income,[66] which, in turn, includes foreign personal holding company income ("FPHCI").[67] There are specific exceptions that apply to certain types of income that are generally included in the definition of FPHCI.[68]

FPHCI generally consists of several enumerated types of income, including, among others, net gains derived from the sale or exchange of certain property. Such property transactions include gain from the sale of property "which gives rise to…royalties…" and "property which does not give rise to any income."[69] With respect to gain from the sale of property which gives rise to royalties, an exception from FPHCI is provided in relation to the disposition of property upon which previous royalty income had met an exception from FPHCI for royalties generated in the active conduct of a trade or business from unrelated persons.[70] With respect to gain from the sale of property which does not give rise to any income, an exception from FPHCI is provided in relation to the disposition of intangible property to the extent it was used, or held for use, in the CFC's trade or business.[71]

When a CFC generates subpart F income, there are rules that prevent United States shareholders from being subject to double taxation on the earnings of a CFC when the earnings (*i.e.*, previously taxed income) are actually distributed to the United States shareholder. Specifically, distributions of earnings and profits that were previously included in a United States shareholder's income under subpart F generally are excluded from gross income.[72] The previously taxed income rules provide an ordering rule under which all previously taxed income (PTI) is treated as distributed before any other earnings are distributed.[73]

Subject to certain limitations, domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the

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[66] Sec. 952(a)(2).

[67] Sec. 954(a).

[68] For example, while royalties are included in the definition of foreign personal holding company income, there is an exception for certain royalties derived in active business. Sec. 954(e)(2).

[69] Sec. 954(c)(1)(B).

[70] Treas. Reg. sec. 1.954-2(e)(1)(ii)(C).

[71] Treas. Reg. sec. 1.954-2(e)(3)(iv). Even if exceptions to FPHCI income are met, in certain circumstances, the gain from the sale of intangible property may give rise to foreign base company sales income (FBCSI) under sec. 954(d) if it was originally purchased in a cross-border transaction. See subpart F coordination rules of Treas. Reg. section 1.954-1(e)(4)(ii).

[72] Sec. 959(a).

[73] Secs. 959(c) and (f). In addition, see stock basis adjustment rules of sec. 961, in relation to increases and decreases of a CFC's previously taxed income. Consideration may also be given to measuring potential foreign exchange gain or loss with respect to a distribution that is sourced from previously taxed income, which is recognized as "ordinary" gain or loss under sec. 986(c).

voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[74] A distribution of appreciated property to a shareholder would normally carry deemed-paid foreign taxes to the shareholder, either with respect to a subpart F inclusion that arises from gain recognition in connection with the distribution of the appreciated property, or if the gain is not so included, as deemed-paid foreign taxes with respect to the distribution itself.

Property distribution - example

If a property distribution gives rise to gain recognition, then the distributing corporation's earnings and profits increase by the amount of the gain and decrease by the FMV of the distributed property. The shareholder includes in income any amount treated as a dividend. When the gain at the CFC level upon distribution gives rise to subpart F income, then a PTI account is created in the amount of the subpart F income. In this case, the distribution is treated as being first sourced from PTI, which is not taxed again to the shareholder. Any amount of the distribution in excess of the PTI is first treated as a dividend to the extent of earnings and profits of the distributing corporation, then as recovery of basis, and then as capital gain.

Dividends Received Deduction

A dividends received deduction is available in certain circumstances with respect to dividends paid by a domestic corporation. Generally, a corporate shareholder receives a dividends received deduction equal to 70 percent of the amount of the dividend received. If the corporate shareholder owns 20 percent or more of the stock of the distributing corporation, the dividends received deduction equals 80 percent of the amount of the dividend received. If the distributing corporation is a member of the same "affiliated group" as the corporate shareholder, then the dividends received deduction generally equals 100 percent of the amount of the dividend received.[75]

Although the dividends received deduction is generally limited to dividends paid by domestic corporations, there are two circumstances in which the dividends received deduction is available for dividends paid by foreign corporations.

Dividends paid by a foreign corporation out of earnings and profits that were originally accumulated by a domestic corporation (*e.g.*, a predecessor corporation) during a period in which the domestic corporation was subject to U.S. taxation are treated as paid from a domestic

[74] Secs. 902 and 960.

[75] Sec. 243(b)(2) defines the term "affiliated group" by reference to the consolidated return rules, which requires ownership of at least 80 percent of the voting power and value.

corporation and generally are eligible for a dividends received deduction as if paid by a domestic corporation.[76]

In addition, a corporation that receives a dividend from a "qualified 10-percent owned foreign corporation" is entitled to a dividends received deduction in an amount equal to the percentage specified above *(i.e.*, 70, 80, or 100 percent) multiplied by the "U.S.-source portion" of the dividend.[77]

Aside from those limited circumstances, a dividends received deduction is not available for dividends paid by foreign corporations.

Explanation of Provision

The provision provides that taxpayers may distribute appreciated intangible property assets from a CFC to a domestic corporate parent that is a United States shareholder with respect to such CFC, pursuant to a qualified plan, without giving rise to taxable income with respect to the distribution if applicable requirements are met.

Under the provision, for purposes of determining the tax consequences of a distribution of intangible property from a CFC to a United States shareholder pursuant to a qualified plan, the fair market value is treated as not exceeding the tax basis that the CFC has in such intangible property. Accordingly, gain or loss is neither realized, nor recognized, by the CFC. With respect to a distribution of intangible property that has a built-in-gain, this has the effect of providing for a carryover basis in the intangible property.

If the distribution is a dividend, the provision provides a deduction to the domestic parent equal to the excess of the amount of the dividend over the amount for which a dividends received deduction[78] would otherwise have been available. To the extent the distribution is not treated as a dividend, the provision eliminates the possibility of income recognition by providing for a basis increase in the CFC stock equal to the amount of gain that would otherwise have been recognized. In the case of any such basis increase in the CFC stock, the United States shareholder is 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 the distribution, or series of distributions that are made through intervening CFCs and completed during a period not exceeding two years, of intangible property from a CFC to a domestic parent corporation that is a United States shareholder with respect to such CFC. A qualified plan must

[76] Sec. 243(e).

[77] Under sec. 245(a)(2), a "qualified 10-percent owned foreign corporation" is any foreign corporation, other than a passive foreign investment company, if the taxpayer owns at least 10 percent of the stock of such corporation, by vote and value. Under sec. 245(a)(3), the "U.S.-source portion" of the dividend equals the following fraction: "post-1986 undistributed U.S. earnings" / "post-1986 undistributed earnings."

[78] Sec. 245.

describe the distribution and the intangible property that is being distributed, and must be in effect before the distribution, or series of distributions, is made.

The provision imposes a filing requirement with respect to the qualified plan. To be considered a qualified plan, it must be filed with the Secretary by the tax return due date of the United States shareholder receiving the distribution for the tax year in which it receives the distribution, or in the case of a plan that describes a series of distributions through an ownership chain of CFCs, the earlier of such date or the tax return due date for the year that includes the close of the first taxable year of the CFC that receives such distribution.

The provision grants the Secretary authority to treat a late-filed plan as having been timely filed, if the following conditions are met: (i) the Secretary determines that there was reasonable cause for the failure to timely file the plan, (ii) such plan is filed not later than three years after its original due date, and (iii) the taxpayer has not taken a position on any tax return that is inconsistent with the provisions of this provision that apply to the distributions described in the plan.

For purposes of the provision, the term "intangible property" means any property which is intangible property described in section 936(h)(3)(B)(i) (including any patent, invention, formula, process, design, pattern, or know-how), property described in section 168(f)(3) (any motion picture film or video tape), or computer software as defined in section 197(e)(3)(B).

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

Effective Date

The provision applies to distributions made in taxable years of foreign corporations beginning after December 31, 2015, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.