

# A U.S. Patent Box: Issues

October 15, 2015 (IN10289)

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Congressional interest in a tax subsidy that would impose a lower rate on certain income from intellectual property (frequently referred to as "intangibles") has appeared in past legislative proposals and [continues to attract interest](#) as a part of tax reform. Congressional proposals for the subsidy (known as a patent or innovation box) include a draft proposal by Representatives Boustany and Neal, [the Innovation Promotion Act of 2015](#), proposed legislation by [Senator Feinstein](#), and a bill introduced by Representative Schwartz in the 113<sup>th</sup> Congress ([H.R. 2605](#)). The Feinstein proposal provided a 15% tax rate on income from patents developed and used for manufacture in the United States, whereas the Boustany and Neal proposal and [H.R. 2605](#) allowed a 71% deduction of income, which produces an effective 10% rate.

A number of countries have introduced patent boxes, [with varying rules](#), including the UK, France, the Netherlands, and China. Rates generally range from 5% to 15%.

## Designing a Patent Box

The design of patent boxes raises several issues. One is the breadth of coverage. Specifically, should a patent box

- restrict coverage to licensing fees and royalties from patented inventions;
- include income embedded in products produced with patented inventions;
- include income embedded in products produced from non-patented innovations; and
- include income from items not reflecting technological innovation such as trademarks, business names, and copyrights?

Other design issues include whether to restrict the benefit to innovations developed in the United States and whether to restrict benefits for innovations only to the extent of earnings from domestic manufacture. The European patent boxes generally do not have these restrictions but this lack may be due to constraints imposed by the European Union.

Another issue is the treatment of income from existing patents and innovations. If the objective is to encourage domestic innovation, limiting benefits to new innovations may be appropriate.

## Evaluating Patent Box Proposals

Several reasons may be advanced to support a patent box, or innovation box. (An innovation box would include income from unpatented innovations; some firms feel they can better protect their innovations by keeping them secret.) One

reason is to further subsidize research and development that has spillover benefits for society that are not captured by the firm. Another rationale is based on the argument that there is synergy in innovation and manufacturing of the products associated with that innovation; hence, a patent/innovation box that includes income from production and is restricted to domestic invention and production would increase high technology manufacturing in the United States. In this latter case, restrictions to domestic production would be a central feature. Finally, lower rates for intangible income in the United States might reduce the amount of artificial profit shifting achieved by locating intangibles in low-tax jurisdictions abroad. A related concern of U.S. multinational business is that [the base erosion and profit-shifting \(BEPS\) initiatives of the OECD](#) might lead some foreign countries to assert the claim to intangible income of U.S. firms due to production and marketing in their countries. With a U.S. patent box, firms would have a low-tax alternative to allocate profits to the United States.

Several critiques can be directed at developing a patent box. One is that providing tax benefits for patent box income, especially if broadly defined, will lose revenues and make lowering overall corporate tax rates more difficult to achieve in a revenue-neutral tax reform.

Other critiques look at the patent box option in the context of existing incentives for innovation, considering tax incentives already available and what types of tax incentives may be most effective. Tax benefits for research already exist through the expensing of investment in research and experimentation (R&E) and the [R&E tax credit](#), which respectively cost \$4.6 billion and \$7.6 billion per year. As an "[extender](#)," the temporary R&E credit has been renewed, usually for one or two years, since its enactment in 1981. Expensing of investment leads to a zero effective tax rate for equity investment, and the addition of the credit leads to a negative effective tax rate. Because most investment in R&D is expensed, lowering the tax rate on net profit from R&D (as is the object in the congressional innovation box proposals noted above) does not affect the incentive because expensing leads to a zero tax rate regardless of the statutory rate applied.

Economic theory also suggests that it may be more desirable to subsidize investment in R&E rather than reduce the tax rates on the returns: higher tax rates reduce variance (the variation in return that occurs depending on the success of the research) as well as return and may, in some circumstances, increase risk taking. For example, an investor may restore some of his or her original desired return and risk combination by increasing the share of risky investments in the portfolio. Thus, if additional research subsidies are desired, it may be more effective to allow them in the investment phase.

Critics might also note that the shifting of profits to foreign jurisdictions can be addressed by including excess intangible income in low-tax jurisdictions in U.S. income. Such an approach was taken in [H.R. 1](#), the tax reform proposal introduced in the 113<sup>th</sup> Congress by then-chairman of the Ways and Means Committee, Dave Camp. His proposal also introduced a lower tax rate of 15% on this income located abroad (along with a lower tax rate on royalties from foreign sources).

Another issue associated with patent boxes is the potential administrative challenges, particularly if the benefit includes the share of earnings from production attributable to the patent. Including earnings attributable to non-patented innovations will add further complications. The R&E credit has been criticized on administrative grounds as well, but determining what share of income from production is attributable to the innovation will likely be more difficult than determining whether investment qualifies as research.