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Patent box and technology incentives: Tax and financial reporting considerations

August 20, 2013
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Evolving tax law incentives

For decades, fiscal stimulus through means of tax incentives has been endorsed by governments worldwide. In recent years, the competition among jurisdictions to attract research investments has escalated. This has contributed to several trends in global markets, including the cross-border development and migration of intellectual property (IP). Government economic policies vary in scope and while some are tailored to support a specific sector, others focus on a broad consortium of industries including technology, energy, pharmaceuticals, medical devices, manufacturing, retail, construction, communications and entertainment.

In the United States (US), the goals and design of tax subsidies have evolved over the past half-century. The federal investment tax credit was introduced in the 1960s to spur investment in capital goods and manufacturing activities. The US Congress believed fixed asset investments would shift the competitive landscape in favor of domestic producers who were contending with overseas counterparts that had lower labor costs. The profile of tax subsidies progressed with the passage of the Revenue Act of 1971, which offered a more liberalized version of the investment tax credit, officially called the job development credit. That legislation also gave rise to the asset depreciation range system, which prescribed lives for classes of assets and methods for accelerating tax depreciation deductions. There have also been a number of more sector-specific tax benefits introduced, such as the intangible drilling and development costs (IDCs) deduction which seeks to attract capital to the business of natural gas and oil production.

As the US transitioned to a more technology-based economy, incentives targeting research investments were introduced. In 1981 the research and development (R&D) income tax credit was enacted under Internal Revenue Code (IRC) section 41 and has become one of the more enduring tax incentives in US history.[1] The R&D credit is not reserved exclusively for technology companies and product manufacturers. Over the years, Congress broadened the scope of qualifying R&D activities and the credit is now available for many different businesses including retailers, service providers and financial businesses involved with the development of computer software.

A more recent trend emerged with the expansion of tax incentives related to renewable energy programs. To meet greenhouse gas emission targets set by the Kyoto Protocol and other agreements, governments worldwide have been implementing initiatives to develop so-called green technologies. As part of the American Recovery and Reinvestment Act of 2009 (ARRA), the US expanded the number of companies that are eligible to benefit from 'green credits.' Several of these renewable and alternative energy programs were subsequently extended by the American Taxpayer Relief Act of 2012 (ATRA).

Although most tax law incentives historically were provided for initial investments or expenditures, some have been provided with respect to a particular category or subset of income. For example, the IRC section 199 deduction, originally enacted as part of the American Jobs Creation Act of 2004, applies to income from 'qualified production activities.' In a sense, the targeting of incentives towards specific categories of income foreshadowed what has now begun to occur with respect to research and technology activities.

In recent years, the competition among jurisdictions to attract research investments has escalated.

Technology incentives 2.0

The overarching rationale for providing a government subsidy is the anticipated excess of social-over-private rate of return on investment. Since costly technological advancements can be inexpensively copied by competitors, economists largely agree that research is one area for which government intervention in the marketplace is warranted.[2] Tax subsidies that encourage research investments by businesses are viewed as improving

[1] Most recently, the American Taxpayer Relief Act of 2012 retroactively reinstated the R&D tax credit to January 1, 2012 and extended the provisions through December 31, 2013.

[2] Joint Committee on Taxation, *Tax Incentives for Research, Experimentation, and Innovation* (JCX-45-11), September 16, 2011.

overall economic efficiency, thereby yielding a positive externality for society. These incentives are also expected to provide tangible near-term benefits by fostering commerce, creating high-value jobs and increasing innovation activities.

At the same time, there are efforts by some jurisdictions to assert that companies are subject to taxation as a result of local exploitation of IP even in the absence of having a presence in traditional forms such as property or payroll. Such competing policies among countries and states create a challenging counter-dynamic that must be navigated by businesses.

Due to the high proportion of economic growth attributable to technological advances, fiscal policy responses to attract research activities have become more pronounced. The increasing mobility of R&D activities adds to the complexities that confront businesses when attempting to identify an optimal location for technology-based IP. Key considerations in selecting a desirable R&D location include cost of facilities, IP security, regulation, immigration policy and infrastructure. The quality of educational and research institutions also can influence the selection process. The existence of these institutions often translates into lower capital investment requirements and more efficient access to skilled human resources. In turn, governments seek to strengthen the cycle of educational growth and skills development by attracting research activities. Tax incentives and income tax rates can play an equally impactful role and in certain instances can become the deciding factor in persuading innovation companies to invest in a particular R&D location.

Technology-based incentives, while taking many forms (e.g., tax credits, deductions, grants, loans, guarantees), generally provide participating companies with a subsidy for amounts spent on qualifying activities. Historically, these incentives have targeted the front-end of the innovation cycle, when R&D expenditures are incurred. In recent years, however, some jurisdictions have expanded the form of these incentives by offering reduced taxation of income associated with IP. In effect, these benefits are akin to those provided by a tax holiday, a form of benefit which historically had more often been used to entice established businesses to a new location.

The emergence of the trend to provide back-end incentives for the exploitation of IP is commonly referred to as a 'patent box' regime. The following table provides a sampling of technology-oriented tax credits and incentives enacted by various jurisdictions in recent years. The chart is limited and merely illustrative of the variety of approaches being used around the world.

Country	Tax incentives	Grants/other
Australia	• 45% refundable R&D tax offset for grouped turnover of less than $20 million; or • 40% non-refundable R&D tax offset for grouped turnover of more than $20 million	• Discrete grant funding available and other business incentives
China	• 150% 'super deduction' • 15% reduced corporate income tax (CIT) rate for high and new technology enterprises (HNTE) (standard CIT rate is 25%) • Business tax exemption and 15% reduced CIT rate for technologically advanced service enterprises (TASE) • CIT exemption/reduction on technology transfer income	• R&D centers may import self-used equipment, related technologies, accessories and spare parts exempt from import duties • Indirect tax incentives for R&D: – Business tax exemption for qualified offshore outsourcing services in 21 cities – Value added tax (VAT) zero-rate/exemption for export of R&D services under the new business tax to VAT pilot program
Netherlands	• 'Super deduction' of 154% for qualifying R&D investments and expenses (other than wage costs) • R&D credit for qualifying wage costs: – 38% of the first EUR 200k and 14% on the excess amount (known as WBSO) • Corporate tax deduction for IP development costs • 5% rate for qualifying IP income, subject to several conditions including income derived from patented IP or approved R&D projects	• Several grants are available for R&D, mostly for industry sectors (e.g., information and communication technology, life science, chemistry) and provide up to 50% cash grants for eligible costs

Country	Tax incentives	Grants/other
United Kingdom	• 'Super deduction' of 130% for large companies, 225% for small and medium enterprises after April 1, 2012 • 10% rate for qualifying IP income, subject to several conditions including income derived from patents or other independently verified technological innovations • Above-the-line R&D credit available after April 1, 2013 • Expenditures on assets used for R&D attract 100% tax depreciation in the year of acquisition	• Regional grants are available
United States	• ATRA extended the R&D tax credit through December 31, 2013 – 20% credit for qualified research expenditures in excess of the base amount – Alternative simplified research credit (with a 14% rate and a different base amount) may be claimed in lieu of the 20% credit • R&D expenditures are deductible in determining federal taxable income	• States provide R&D credit in addition to various business incentives

Patent box

Over the past decade, several European Union (EU) countries, including Belgium, France, Hungary, Luxembourg, Netherlands and Spain, have adopted a patent box tax regime. The United Kingdom (UK) is the latest EU member state to implement a patent box regime, which is being phased in over five years beginning April 1, 2013. The qualification requirements and operational mechanics of these regimes differ significantly among each of the countries. However, the manifestation of the patent box trend is consistent with the principles of the economic plan devised under the 2000 Lisbon Strategy, which sought to make the EU "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion."

Similar to the Dutch R&D 'super deduction' and the US R&D tax credit, patent box regimes encourage additional research investments by businesses. However, the so-called patent box offers a novel approach by enticing companies with incentives at the back-end of the innovation value chain. The objective is to reduce the corporate income tax burden for income generated from the use of IP, generally through a 40 to 80 percent deduction or exemption of qualified IP income.

Some of the variations in the EU regimes include: types of eligible IP, computation of the applicable IP-related income and the method of payment or credit. For example, qualified IP in the Netherlands is limited to patented IP or R&D IP, while Luxembourg's regime provides tax benefits for various forms of IP including patents, trademarks, designs, domain names, models and software copyrights. Likewise, the computation of IP-related income varies among jurisdictions. In France, qualified income is determined based on royalties net of IP-related management costs, while in Spain gross patent income qualifies for beneficial treatment. It is important to understand such differences, rather than simply comparing 'rates,' in assessing the attractiveness of competing incentives. Further, depending on the jurisdiction, tailored agreements may be reached with the local tax authority that impact the application and computation of benefits for a particular company. Given the various forms of income that are eligible for such benefits, the regimes would be better described as an 'innovation box' rather than a patent box.

Design of incentives

The evolution of back-end incentives poses a dilemma for policymakers attempting to encourage R&D investments by the private sector while avoiding the detrimental economic effects from government over-spending on tax subsidies. As a result, jurisdictions deciding to offer a research benefit must evaluate whether to offer front or back-end incentives or a combination of both.

In assessing the value of front-end incentives, such as the US R&D tax credit, proponents have noted the benefit can be targeted to research activities and reduce the overall risk of R&D projects for the private sector. However, some businesses criticize what has historically been the temporary nature of the US R&D tax credit. (Each enactment of the credit heretofore has been for a specified period of time, leading to intermittent lapses and subsequent retrospective enactments.) Research projects typically span years and the lack of assurance regarding the availability of future credits increases the financial risk of the expenditure. In addition, taxpayers that are in a loss position or where a credit limitation applies may be unable to harvest the benefit of the R&D tax credit. Even in cases where the credit can be carried forward for use against future year tax liabilities, the inability to monetize the credit immediately reduces its present value. Further, according to the US Government Accountability Office (GAO), the Internal Revenue Service (IRS) reports that it is required to make difficult technical judgments in audits concerning whether research is directed to produce truly innovative products or processes. Such audits create a burden for the taxpayer in maintaining detailed records and uncertainty in interpreting the complexities related to the qualification of research activities, thereby reducing the value of the credit.[3]

Certain jurisdictions have revised their R&D tax regimes to address some of these concerns. For instance, effective April 1, 2013, the UK has implemented an 'above-the-line' R&D credit. The credit will be available to loss-making companies by way of a cash refund subject to certain limitations. Similarly, in France, R&D credits assessed on eligible expenses incurred after January 1, 2010 are immediately refundable for small and medium enterprises (SMEs). For companies exceeding the SME thresholds, the R&D credit can be carried forward and offset against corporate income tax over a three-year period. If an excess R&D credit remains after the three years, then a cash refund will be available.

More expansive legislation that enhances taxpayers' ability to utilize or otherwise convert incentives into cash has not been limited to R&D credits. In recent years, the US enacted tax laws that provided transferable or refundable green credits. For example, the alternative fuel mixture credit was available as either an income tax credit, reduction in excise tax payments or cash refund. Other transferable federal incentives included the renewable energy investment tax credit (REITC) and the renewable electricity production tax credit (PTC). ARRA expanded several aspects of the PTC, including the ability for qualifying facilities to opt instead for the REITC or an equivalent cash grant from the US Department of Treasury.[4] Further, there have been leasing and partnership financing transactions arranged to provide companies a method to monetize certain tax incentives. However, such 'self-help' financing transactions can be costly, complex and yield less benefit to the taxpayer than originally intended by the incentive.

While back-end incentives can be subject to similar compliance burdens and uncertainty, they can potentially provide taxpayers with more flexible benefits and less business disruption. For instance, the US R&D tax credit is limited to research activities performed within the US. Conversely, the EU patent box regimes generally do not require IP development activities to be performed domestically. By offering an attractive tax environment for the creation and commercialization of IP, patent box regimes discourage the shifting of IP income and related resources abroad. For countries within the Organisation for Economic Co-operation and Development (OECD) that have yet to embrace a patent box regime, it may be challenging to present a competitive location for developing and holding IP. For instance, royalty and license income earned from US-owned IP is now taxed at a much higher rate than IP held in the average OECD country. The disparity is even greater when compared with countries offering a patent box whereby qualified IP income typically is taxed at effective rates between 5 and 15 percent. As discussed later, this trend has become an influential theme in current US legislative discussions regarding potential corporate tax reform.

[3] Id.

[4] The availability of the cash refund or grant option for these incentives expired December 31, 2011.

Financial reporting considerations

Depending upon the particular laws, the accounting for certain tax credits and incentives may seem counterintuitive at first. While the benefits are generally provided in the income tax laws and may be claimed on an income tax return, a number of features can make the benefits more equivalent to a government grant or subsidy. Even if considered an income tax benefit rather than a grant, the accounting can vary depending upon whether the benefit is considered an income tax rate reduction versus a tax deduction or credit. Companies must therefore analyze the requirements and terms of each credit or incentive to determine its accounting.

A threshold determination must be made as to whether: (1) the credit or incentive falls within the scope of income taxes and is accounted for in determining income tax expense or (2) the benefit does not fall within income taxes and is accounted for in determining pre-tax income. Benefits that are within the scope of income taxes would be accounted for in accordance with ASC 740, *Income Taxes* (or IAS 12 for statements prepared under International Financial Reporting Standards).

Several questions may be considered when analyzing whether the accounting for a credit or incentive is within the scope of income taxes:

- Is there a direct relationship between the benefit received and taxable income or income tax liability otherwise due?
- How is the benefit claimed?
- If there is more than one manner in which the benefit may be obtained, is the election irrevocable?
- Can the benefit be sold?
- Is the benefit refundable? For example, if a benefit claimed on an income tax return exceeded tax otherwise due (including as a result of a subsequent loss carryback), would the benefit nonetheless be refundable?
- Is the benefit taxable? Does taxability depend upon the manner in which the benefit is obtained?

These and other questions help to determine which overall accounting model is most appropriate for recognition of the benefit.

The application of income tax accounting is generally warranted if a particular credit or incentive can be claimed only on the income tax return and can be realized only through the existence of taxable income or income tax otherwise due. Where there is no dependency upon income taxes payable or taxable income and where the credit is refundable, the benefit should generally be accounted for under an income recognition model.

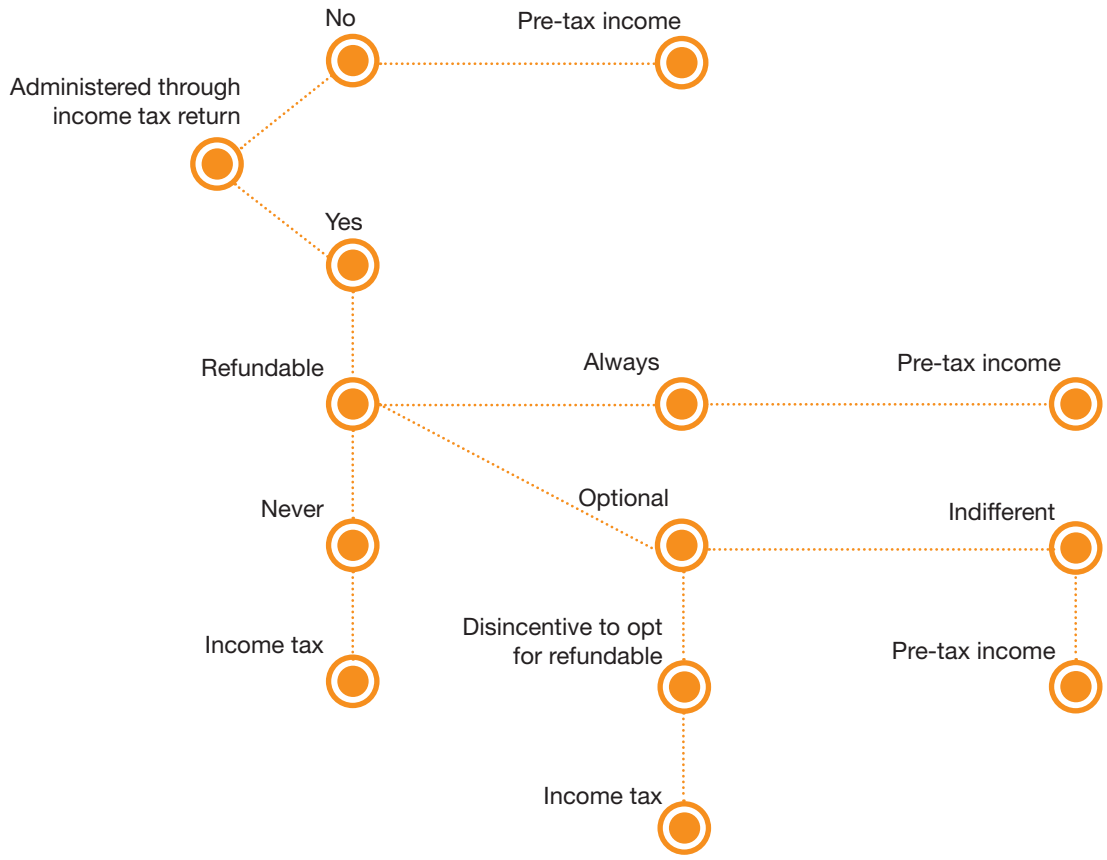
Although less common, it is worth noting that some jurisdictions have enacted laws which provide businesses with up-front income tax allowances or additional tax basis that can be applied to reduce future taxable income. The terms and operation of such laws can in some instances result in the recording of a deferred tax benefit for the incentive, when the incentive in itself is considered a temporary difference or equivalent to a tax carryforward asset.

Some credits or incentives may be refundable either through the income tax return or in some other manner (e.g., direct cash from the government or offset against other taxes such as excise or VAT) at the option of the taxpayer. In general, regardless of the method a company chooses to monetize the benefit, such optionality would cause the accounting to be within the pre-tax accounts. There may be some exceptions to this general analysis. For example, if the method of monetizing the benefits could result in significantly different taxation or other economic consequences of the benefit, it may be that the accounting model will follow the method of monetizing the benefit. In this regard, it is also important to understand whether the choice to monetize (or not) is irrevocable.

The question of taxability or uncertainty regarding taxability must also be considered even if the benefit is recorded outside the income tax accounts. While an income recognition model may be applied, uncertainty with regard to taxability of the benefit would be determined under the income tax accounting standard, with any unrecognized tax benefits appropriately recorded in income taxes.

Another factor to consider is the impact of a subsequent tax law change affecting the features of either existing or similar future credits or incentives. It may be appropriate for the credits and incentives generated before the tax law change to continue to be accounted for by following the accounting model used before the tax law change. Any credits generated after the tax law change should be accounted for under the accounting model that would then apply.

The following diagram may be helpful in identifying questions to determine the appropriate accounting model:



Income tax accounting model

Incentive benefits determined to be within the scope of ASC 740 are subject to the following principles of the income tax accounting standard.

- A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- An uncertain tax benefit is recognized only if it is more likely than not sustainable under the tax law.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- A valuation allowance is recorded against deferred tax assets that are not, based on applicable evidence, considered more likely than not to be realized.

Incentives that fall within the scope of ASC 740 are reflected in the income tax provision thereby reducing the effective tax rate, subject to an assessment of uncertainties and realizability.

Income recognition model

For incentive benefits that fall outside of income tax accounting, the appropriate pre-tax income recognition model to apply depends on the facts and circumstances of the credit or incentive. One model is known as grant accounting. Although US GAAP does not provide specific guidance for grant accounting, most companies analogize to the International Financial Reporting Standards (IFRS) IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

Under IAS 20, front-end research expenditure grants would generally be reflected in the income statement to match them with the cost they are intended to compensate. Typically, these types of grants would be recognized as income in the same period as the research expense. Judgment is required to determine the appropriate income statement classification that should be consistently applied.

Management needs to assess when the company has satisfied all criteria for receiving the benefit. This includes making required filings with the appropriate governmental authority and performing all actions required to claim the benefit. Similarly, with a grant, a company would generally record the benefit only after all conditions to receive the grant have been met.

In some instances, there may be uncertainty as to whether a company qualifies for an incentive or the amount the government will ultimately approve. In these cases, companies need to make their best estimate of what they expect to realize and record that amount in their financial statements. Ultimately, the amount of the benefit that a company records should be based on the guidance found in the relevant pre-tax recognition and measurement guidance.

Special deduction vs. reduced tax rate

With respect to patent box regimes and similar back-end incentives that fall within income tax accounting, it may be necessary to determine whether the benefit should be treated as a 'special deduction' or as a reduced tax rate. Special deductions are generally recognized in the year they are included in the tax return (i.e., similar to general business tax credits), whereas a reduced tax rate is applied in measuring deferred taxes.

ASC 740 does not define 'special deductions,' but it does provide examples: (1) statutory depletion, (2) special deduction available for certain health benefit entities, (3) special deduction for small life insurance companies and (4) IRC section 199 deduction for qualified domestic production activities.

In general, the specified special deductions have tax law requirements or limitations that are based upon future performance of specific activities. For instance, the IRC section 199 deduction is contingent upon the performance of qualified production activities and the amount of wages paid in the tax year. In contrast, for example, dividends received deductions (DRDs) are a consequence of a future event (i.e., a distribution), but are not contingent upon any specific performance or income-generating activity. As a result, DRDs are reflected in the tax rate applied to measure deferred taxes on the undistributed earnings of a subsidiary or investee if they are expected to be available under the relevant law. Accordingly, it may be necessary to evaluate whether the particular incentive has a performance requirement or other limitation that would differentiate it from being equivalent to a tax rate reduction.

Although tax benefits from special deductions are recognized no earlier than the year in which the special deductions are deductible on a tax return, they should be considered in deferred tax computations if graduated rates are a significant factor. In addition, special deductions would be considered in assessing the need for a valuation allowance against deferred tax assets when considering future taxable income.

For patent box benefits that constitute a reduced tax rate, deferred tax assets and liabilities that are expected to reverse into applicable IP income would be tax-effected at the lower IP income tax rate. This approach is consistent with the objective of measuring deferred taxes using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

There is no specific guidance in IFRS regarding special deductions. However, IAS 12 does provide the following general guidelines with respect to measurement of deferred taxes:

- Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.
- When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (or loss) of the periods in which the temporary differences are expected to reverse.

Both for US GAAP and IFRS purposes, it may be helpful to start the analysis with a rebuttable presumption that the tax accounting treatment would reflect the tax law characterization. For instance, if the tax law describes the incentive benefit as a deduction, the tax accounting assessment would begin with the presumption of special deduction. However, this presumption can be overcome if facts and circumstances suggest the deduction is the economic equivalent of a reduced tax rate.

If a patent box is determined to provide a reduced tax rate, the patent box regime should be factored into the assessment of the tax rate that is expected to apply to IP-related profits. Deferred taxes would be measured at the reduced patent box rate as opposed to the general corporate tax rate. This may require what could be a complicated assessment to determine the temporary differences which will reverse at the applicable patent

box rate as compared with those expected to reverse at the otherwise applicable corporate rate.

Depending on the jurisdiction, certain restrictions may apply that impact the tax accounting for the patent box incentive. These restrictions vary in scope and may influence the recognition and realizability of deferred taxes. For instance, in Belgium the patent income deduction may not be used to create a net operating loss and thus the benefit may not be carried forward. In Spain, a credit is granted for withholding taxes paid related to royalty revenue generated from sources outside of Spain. However, the credit is limited to the lower of: 1) the amount effectively paid abroad because of a tax identical or analogous to Spanish corporate income tax or 2) the amount that would have been levied under Spain's patent box regime had that income been earned in Spain.

Tax holidays

Tax incentives to encourage business investments are also offered by governments in the form of 'tax holidays.' Other incentives known as 'special enterprise zones' may offer similar benefits in attracting businesses to what may be struggling or underdeveloped regions. The tax accounting for a tax holiday is similar to accounting for a tax rate reduction. Deferred tax assets and liabilities that are expected to reverse during the tax holiday would be measured at the lower tax rate, depending on whether the holiday offered a full or partial exemption from tax. However, the holiday in itself does not result in recognition of a tax benefit at inception. It may therefore be necessary to determine whether the particular incentive constitutes a tax holiday, rather than additional tax basis or a tax carryforward asset.

The following questions may be helpful in making this determination:

- Is the benefit a fixed and certain amount?
- Does the sustainability of the benefit depend on future events (e.g., maintaining expenditures related to payroll or fixed assets)?
- Is the benefit revocable by the applicable governmental authority?
- Does utilization of the benefit depend solely on the existence of taxable income or do other limiting factors need to be considered?
- Is the benefit transferable in the context of a change in ownership?

In order to properly account for a tax holiday, careful consideration must be given to the specific aspects of the tax holiday, including the approval process, terms and conditions. In general, under ASC 740 the effects on existing deferred income tax balances resulting from either the initial qualification for a tax holiday or its extension/renewal should be recognized on the approval date or on the filing date if approval is not necessary. There may be exceptions, for instance, if government approval is considered perfunctory because the qualification requirements can clearly and objectively be assessed. In those cases, depending upon a company's specific facts and circumstances, the effects of the holiday may be recorded prior to the approval.

In addition, differences often exist between the book and tax bases of assets and liabilities on balance sheet dates within the holiday period. If these differences are scheduled to reverse during the tax holiday, deferred taxes should be measured for those differences based on the conditions of the tax holiday (e.g., full or partial exemption). If the differences are scheduled to reverse after the tax holiday, deferred taxes should be provided at the rate that is expected to be in effect after the tax holiday expires. The expiration of the holiday is similar to an enacted change in future tax rates, which must be recognized in the deferred tax computation. In some circumstances tax planning actions to accelerate taxable income into the holiday or to delay deductions until after the holiday may be considered.

The financial statements should include disclosure of an applicable tax holiday, including: (1) the aggregate dollar and per-share effects of the tax holiday and (2) brief description of the factual circumstances, including the date on which the special tax status will terminate.

The emergence of patent box and other incentive regimes has had an influence on the management of investments in IP.

There is no specific guidance in IFRS regarding tax holidays, but the treatment of holidays is typically not substantially different than under US GAAP. However, for temporary differences that reverse after the tax holiday period, deferred taxes should be measured at the enacted or substantively enacted tax rates that are expected to apply after the tax holiday period.

Impact on business planning

The emergence of patent box and other incentive regimes has had an influence on the management of investments in IP. Businesses increasingly have initiated new research operations, restructured existing operations or acquired new operations across geographic boundaries. Often these efforts are facilitated or accompanied by intercompany transactions among

members or reporting units within a consolidated reporting group. While the pre-tax accounting effects of such intercompany transactions are generally eliminated in consolidated financial reporting, ASC 740 provides an 'exception' to general tax accounting for certain intra-entity transactions. Under this exception (known as 'intra-entity deferral') the tax effects of a transfer of assets among affiliates filing separate tax returns or in different jurisdictions are generally reported over the economic productive life of the underlying property. Under IFRS there is no intra-entity deferral exception and therefore the income tax effects of intercompany transactions are recognized as incurred.

The structure, terms, duration and legal aspects of such transfers have become ever more complicated and varied. In certain instances, an IP arrangement may constitute an outright sale or an exclusive license over the entire economic life of the asset. However, it is often the case that significant judgment must be exercised to determine whether the arrangement represents an in-substance sale of IP or merely a license to use the IP. The tax effects of intercompany licensing or service transactions do not generally fall within the intra-entity deferral exception. In addition, IP business planning often requires consideration of the tax accounting implications related to many other topics including exit taxes, transfer pricing, indefinite reinvestment assertions, computational and realizability assessments of tax attributes, acquisition accounting and uncertain tax positions.

Government consideration of financial reporting impacts

As discussed, the financial reporting consequences of what may be viewed as economically similar tax law changes can vary depending on the particular terms and

While many incentives are intended to achieve similar economic goals, the financial reporting impacts sometimes vary more widely than anticipated.

operation of the legislation. While many incentives are intended to achieve similar economic goals, the financial reporting impacts sometimes vary more widely than anticipated. At the same time, a particular legislative approach can be influenced by a number of other government institutional factors such as budget implications and legal risks or concerns as to whether a particular incentive program may be challenged as unfair.

As discussed, refundable tax credits or grants are recorded in pre-tax income. Tax rate changes and holidays produce an immediate adjustment to existing deferred taxes and tax expense, whereas tax credits and certain special deductions are not recognized until the tax benefit is claimed. The total effect of tax rate changes on deferred tax balances is recorded as a component of the income tax provision related to continuing operations for the period in which the law is enacted, even if the deferred taxes had been recorded in other comprehensive income, discontinued operations, or as part of a prior business combination. (Under IFRS, the resulting change in deferred tax is recognized in the income statement except to the extent the tax arises from a transaction or event that was previously recognized outside of the income statement. This is sometimes referred to as 'backwards-tracing.')

The dichotomy between tax rate changes and special deductions has led some lawmakers to design tax legislation to avoid or neutralize an immediate accounting impact. For example, a tax rate decrease may prompt the recognition of a significant tax charge for a company that maintains net deferred tax assets. The write-down in the value of existing loss carryfowards and other deferred tax assets would correspondingly decrease the book value of the company.

The desire to avoid an adverse accounting impact was influential, for example, in the legislative process leading to the enactment of the IRC section 199 deduction. The design of that incentive as a special deduction evolved from original proposal alternatives that included potentially offering a reduced tax rate on eligible income. Similarly, to mitigate the impact of recording a tax charge, some jurisdictions have provided offsetting long-term tax deductions that are recorded as deferred tax benefits. Although the deductions serve to offset the detrimental financial reporting effects imposed by the tax legislation, the economic benefit is debatable. The deferred income tax amounts shown on a company's balance sheet are not discounted and therefore do not reflect the present value of expected future cash flows, particularly when future recovery or settlement periods are prolonged.

Policymakers are increasingly giving consideration to the financial reporting impacts of potential legislative proposals. They must often navigate the competition among different industry groups seeking tax incentives. The emergence of the trend to provide back-end technology incentives may contribute to such competition. For instance, a manufacturing business with substantial pension and other retirement obligations might maintain significant deferred tax asset balances. If new legislation provides a rate reduction, the manufacturing company may need to record a substantial tax charge

related to the write-down of existing deferred tax assets. Conversely, an innovation-based company that has engaged in business combinations might maintain deferred tax liabilities resulting from acquisition accounting. The enactment of a rate reduction may result in the innovation company recognizing a tax benefit related to the release of deferred tax liabilities.

US tax reform proposals

On October 26, 2011, House Ways and Means Committee Chairman Dave Camp (R-MI) released for public comment a discussion draft on tax reform. Highlights of the proposal include a reduction of the top corporate income tax rate to 25%, adoption of a territorial tax system and a 95% dividends received deduction, which would be provided for eligible foreign-source dividends. The territorial tax system and related international tax proposals are intended to be revenue neutral. The proposals consist of a partial inclusion in taxable income of historic 'earnings and profits' of 10% or more US-owned foreign companies as well as anti-base erosion options.

Among the anti-base erosion alternatives, Chairman Camp's 'Option C' offers a 40% deduction that would apply to IP income earned by a US company in connection with goods and services for use or consumption abroad, resulting in an effective tax rate of 15% (i.e., 60% of 25%). Intangible income earned by controlled foreign corporations (CFCs) would be currently taxable to US shareholders as if distributed and a credit for associated foreign income taxes would be allowed. A 40% deduction would similarly apply if the CFC's IP income is earned in connection with goods and services for use or consumption outside the US.

Since the benefit is in the form of a deduction, rather than a specified tax rate, it is necessary to evaluate whether the benefit would be accounted for as a special deduction as opposed to a reduced tax rate. If Option C were considered for accounting purposes to be a reduced tax rate rather than a special deduction, it would be applied in measuring deferred taxes for the future effects of temporary differences that will reverse into IP income from goods and services used or consumed abroad. Similar to the patent box regimes as discussed, this may require what could be a complicated assessment to determine the temporary differences which will reverse at the 15% rate as compared with those reversing at the full 25% corporate rate. To the extent that a US taxpayer has book-tax basis differences in (or within) its CFCs, it may likewise be appropriate to consider the 40% deduction in measuring the deferred taxes on the relevant portion of those temporary differences.

Given the significance of such potential US tax law changes, policymakers can be expected to confer with the financial reporting standard setters to achieve clarity on the anticipated financial reporting impacts of proposals that move forward. The debate surrounding US tax reform may illustrate, once again, the interplay of financial reporting with the evolution of corporate tax laws.

The takeaway

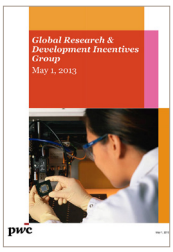
The high proportion of economic growth attributable to technological advances has escalated the competition among governments to attract research investments through the use of tax subsidies. Depending on the terms and operation of each specific incentive, varying financial reporting impacts may occur. The incentives may yield potentially disparate results, depending on the industry and the existing accounting profile and policies of a particular company.

Given the myriad credits and incentives existing today, companies need a strong internal controls environment that facilitates timely identification, reporting and disclosure of such benefits. This can be particularly challenging since these benefits are often provided through tax legislation, yet financial reporting outside of the income tax accounts may be required.

Competing interests among governments and industries combined with financial reporting considerations can be influential in the development of tax law and incentive programs. As this dynamic process unfolds in debates regarding US tax reform proposals as well as in other jurisdictions, we may observe further meaningful changes in how tax law is designed and the related impact on financial reporting.

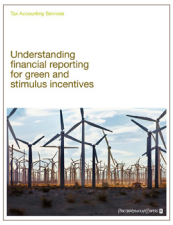
Additional resources

For additional insight on related topics, kindly refer to these PwC publications:



Global Research & Development Incentives Group
May 2013

Is it Time for the United States to Consider the Patent Box?
March 2012



Understanding Financial Reporting for Green & Stimulus Incentives
December 2009

Let's talk

PwC is committed to helping companies navigate tax accounting issues. Our global network of specialized tax accounting resources can help you tackle a wide range of needs. With that in mind, please visit ***www.pwc.com/us/tas*** to view our comprehensive library of tax accounting thought leadership, webcasts, and tools addressing the business and technical issues related to tax accounting.

For more information, please reach out to your local PwC partner or the following PwC partners:

Ken Kuykendall
Global & US Tax Accounting Services Leader
+1 (312) 298-2546
o.k.kuykendall@us.pwc.com

Jim Shanahan
Global R&D Incentives Group Leader
+1 (202) 414-1684
jim.shanahan@us.pwc.com

Jennifer Spang
Tax Partner
+1 (973) 236-4757
jennifer.a.spang@us.pwc.com

Questions or comments related to this publication can also be directed to its primary authors:

Edward Abahoonie
Tax Accounting Services Technical Leader
+1 (973) 236-4448
edward.abahoonie@us.pwc.com

Jonathan DeFeo
Tax Director, National Professional Services Group
+1 (973) 236-7088
jonathan.d.defeo@us.pwc.com

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