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The use of tax measures in the area of research and development (R & D)

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1. Introduction and background

1.1 Policy trends towards the introduction of R&D incentives

Innovation, undisputedly, belongs to the key elements of economic growth and essentially depends on the development and exploitation of intellectual assets. Fiscal and non-fiscal measures for promoting R&D are thus increasingly known in many countries. They are widely seen as important elements for the development of an innovation- or knowledge-based economy and as an important tool to become attractive for such activities or for revenues from such activities. Fiscal incentives for R&D play further an important role in the international competition for high-value jobs and innovation driven business activities. Special tax measures by policy makers are used to achieve certain objectives.

A study prepared by the OECD notes that – in 2006 – an increasing number of OECD governments are offering special fiscal incentives to business to increase spending on R&D, largely because R&D and innovation are considered key to productivity and growth performance. Many OECD governments are currently redesigning existing or introducing new R&D tax incentives[1]. Further, the debate is also beginning to capture attention in some countries, such as Switzerland in particular, which was traditionally reluctant to the introduction of such incentives[2].

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[1] OECD: Tax incentives for Research and Development: trends and issues, see http://www.oecd.org/dataoecd/12/27/2498389.pdf.

[2] See for example the study prepared by KPMG Switzerland in collaboration with the University of St. Gallen (« Tax incentives for R & D in Switzerland ») which suggests the introduction of input and output tax incentives in the Swiss tax system (http://www.kpmg.com/CH/en/Library/Articles Publications/Documents/Tax/pub_20111013_tax-incentives-for-RD_EN.pdf); as regards the introduction of an « IP box » in the canton of Nidwald, see Pascal Hinny, Lizenzbox des Kantons Nidwalden - Rechtliche Prüfung unter Gesichtspunkten des Verfassungs- und Harmonisierungsrechts in: IFF Forum für Steuerrecht (FStR) 2011/02, 138 et seq.; a few parliamentary initiatives and motions have also been submitted at the federal level

In the same vein, the European commission has encouraged Member States to improve the use and coordination of tax incentives on R&D issues. As part of the Europe 2010 strategy a new research and innovation policy is developed. As one of the objectives to be reached in 2020, 3 % of the EU's gross domestic product is to be invested in research and development[3] This philosophy further materializes in the explanatory memorandum to the proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) which states that in designing the common base supporting research and development has been a key aim of the proposal. Accordingly under the CCCTB all costs relating to research and development are deductible. This approach is designed to act as an incentive for companies opting in to the system to continue to invest in research and development[4].

In line with the foregoing, several EU and OECD Member States have introduced R&D incentives.[5] These incentives can be divided into two groups: fiscal incentives targeted at local R&D activities (R&D input promotion), and measures that fiscally privilege income from R&D activities (R&D output promotion). Typical examples of input measures are increased deduction of expenses (so-called "super deduction") or R&D tax credits. Cases of output measures are incentives providing for a lower taxation of IP income (patent exemption, innovation box etc.[6]). In some jurisdictions both these tax incentives are combined while other countries have only implemented an input or an output incentive. Finally, fiscal measures can also be coupled with non-fiscal incentives, be it direct subsidies in cash or in kind, or with more far reaching policy measures in the areas of training and education or with respect to the development of an innovation culture or the creation of innovation clusters.

1.2 R & D incentives and EU law

While the European commission has encouraged Member States to improve the use and coordination of tax incentives on R & D issues, the latter, needless to say, must comply with EU law. The issue concerns inter alia (i) the territorial scope of R&D incentives with respect to the fundamental freedoms and (ii) the relation between R&D incentives and state aid rules in light, in particular, of the selectivity criterion[7].

The first issue was addressed by the Court of Justice of the European Communities in the *Laboratoires Fournier* (Case-39/04). In this case and in relation to freedom to provide services,

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3 See Communication of 6 October 2010 from the commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Europe 2020 Flagship Initiative, Innovation Union, COM/2010/546.

4 See Proposal of 16 March 2011 for a Council Directive on a Common Consolidated Tax Base (CCCTB), COM/2011/121. Art. 12 of the draft Council Directive reads as follows: "Deductible expenses shall include all costs of sales and expenses net of deductible value added tax incurred by the taxpayer with a view to obtaining or securing income, including costs of research and development and costs incurred in raising equity or debt for the purposes of the business".

5 See among others Wim Eynatten 'European R&D and IP Tax Regimes: A Comparative Study' (2008) 36 *Intertax*, Issue 11, pp. 502–519

6 For example in the Netherlands and in Luxembourg

7 Art. 107 et seq TFEU, Commission notice on the application of the State aid rules to measures relating to direct business taxation, C 384/3, 10 December 1998

the Court held that a Member State may not restrict the benefit of a tax credit for research legislation only to research carried out in that Member State. Such legislation is, albeit indirectly, based upon the place of establishment of the provider of services and is consequently liable to restrict its cross-border activities. It cannot be justified by the need to safeguard the coherence of the tax system, to promote research or to ensure effective fiscal supervision. In the same vein, in Case-248/06 which concerned Spain, the Court held that this country could not maintain rules for the deduction of costs relating to research and development which are less favorable in respect of costs incurred abroad than those incurred in Spain. In light of the foregoing, it is thus now clearly settled that Member States may not provide territorial restrictions to R & D incentives within the European Union[8].

To some extent at least, the compatibility of R & D incentives with state aid rules remains, on the other hand, controversial. Indeed, the European Commission, in relation to Spain, has approved an output tax incentive under the state aid rules. The Commission found that the tax incentive at stake was opened to all companies, irrespective of their size or sector, that there was no restriction concerning the location of the eligible activities, and that the public administration had no discretion in applying the measure as the criteria were objective and defined *ex-ante* in the implementing regulation[9]. Yet, it remains to be seen whether this conclusion could be revisited in the future in light of the selectivity test as construed by the European Court of Justice in the *Gibraltar case* (Joint Cases-106/09 and C-107/09).

1.3 R & D in international tax practice

Apart from the foregoing conceptual policy issues, R&D, needless to say, raises controversial questions in international tax practice. These issues concern inter alia (i) the cross-border emigration/immigration of intangibles as well as (ii) the development and management of intangibles.

These operations may be approached both from a domestic tax and DTC point of view (for example exit tax situations with respect to emigration of intangibles).

Moreover, these questions are at the heart of the work currently produced by the OECD in the area of transfer pricing[10]. The same holds true as regards base erosion and profit shifting (BEPS), the first report in this area having being published earlier this year[11].

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8 With respect to input incentives taking the form of an extraordinary deduction, in our opinion, the same conclusion already flows from the non-discrimination provision of art. 24(4) of the OECD Model Tax Convention

9 Commission Decision of 13 February 2008, State aid N 470/2007

10 See OECD discussion draft relating to the revision of the special considerations for intangibles in chapter VI of the OECD TP guidelines, http://www.oecd.org/ctp/transferpricing/50526258.pdf and comments relating thereto (http://www.oecd.org/ctp/transferpricing/Intangibles_Comments.pdf)

11 http://www.oecd.org/tax/beps.htm

2. Structure and content of national reports

In light of the foregoing, the national reports should be structured into three parts.

2.1 Tax policy trends in the field of R & D incentives

The first part of the reports would be dedicated to conceptual tax policy trends/issues in the field of R&D incentives. Accordingly, the national reporters would inter alia cover the following:

1. Tax policy reasons for introducing (or not introducing) R&D incentives
2. Constitutional foundations (if any) supporting the introduction of R&D incentives
3. Forms of R&D incentives i.e. input and/or output incentives
4. With respect to input incentives inter alia:
   - Definition of qualifying R & D (for instance Frascati manual etc.)
   - Form of incentive selected (i.e. for example multiple deduction or R&D credit)
   - Carry forward possibilities of R&D incentives, limits set for R&D incentives (amounts, scope, effects, kind of R&D activities, business sectors, time period, new business, etc.
   - Territorial restrictions to R&D incentives and compatibility with EU law and DTCs (in particular art. 24(4) OECD MC)
5. With respect to output incentives inter alia:
   - Form of incentives (i.e. innovation box, patent box etc.)
   - Definition of income falling within the scope of incentive

It is submitted that this comparative analysis would help to get a better picture of the policies followed by the countries in this respect and of the specific measures that are used in practice. It would also contribute to a better understanding the impact of R&D incentives and to find out whether the measures are primarily used get a competitive advantage for a business location or whether the objective is to promote R&D and an innovation culture in a country.

2.2 R &D in international tax practice

In this second part, the national reporters would adopt a more practical approach and would concentrate on issues of international tax practice such as inter alia:

1. Emigration and immigration of intangibles (transfers between two separate enterprises or HO-PE transfers, restructurings, etc.), domestic tax (exit tax/step up in basis, etc.), DTCs (art. 13(5) or 7 OECD MC) and transfer pricing issues associated thereto
2. Transfer of intangibles to low tax jurisdictions,
3. Legal versus economic ownership of intangibles from a domestic tax and transfer pricing perspective
4. Etc.

2.3 Compatibility of R & D incentives with international principles

In this third part, national reports would discuss the question of whether their domestic R & D incentives, whether in particular input or output, are in compliance with international principles.

This issue would first of all be discussed from a EU law perspective. Accordingly, national reporters would in particular discuss whether their domestic R & D incentives raise or (could raise in the future) issues of compatibility with respect to the (i) the territorial scope of R&D incentives in relation to the fundamental freedoms and (ii) the relation between R&D incentives and state aid rules in light, in particular, of the selectivity criterion. The foregoing concerns primarily EU Member States but may also affect third States having concluded agreements with the EU, such as for instance Switzerland[12].

Last but not least, the issue of compliance would be examined in light of the work undertaken in this area by the OECD, in particular in so-called "pressure areas" i.e. transfer pricing, availability of harmful preferential tax regimes for certain activities (for example problems raised by IP Box regimes?) and effectiveness of anti-avoidance measures, in particular GAARS and CFC regimes[13], etc.

[12] Notably in light of the pending dispute concerning the impact of the 1972 Free Trade Agreement between the EU and Switzerland

[13] See in particular OECD, 2013, Addressing Base Erosion and Profit Shifting, p. 48 et seq.