



**PLENARY SESSION SUBJECT 1: TAX INCENTIVES FOR  
RESEARCH AND DEVELOPMENT (R&D)**

CONGRESS CENTER BASEL  
MONDAY, 31 AUGUST 2015

## Presentation of Panelists

- **General Reporter**
  - Robert Danon (Switzerland)
- **Chair**
  - Stephen Shay (USA)
- **Secretary**
  - Thierry Obrist (Switzerland)

# Presentation of Panelists

- **Panelists**

- David Bradbury (Australia)
- Raymond Luja (Netherlands)
- Belema Obuoforibo (United Kingdom)
- Raymond Luja (Netherlands)
- Barbara Kessler (Switzerland)
- Manuel Tron (Mexico)



# **+ Introduction**

Stephen Shay

## **+ Overview of panel topics**

- Policy Objectives of Incentives for Research and Development
- General Reporter's Observations on Tax Incentives for R&D
- Treaty constraints on R&D tax incentives
- EU Law Constraints on R&D Tax Incentives
- Case Study A: Location of New R&D Operations
- Case Study B: Tax Efficient Structure for R&D Income
- Questions and answers

# **+ Policy Objectives of Incentives for Research and Development**

David Bradbury



## What is the case for government intervention?

- Innovation is a driver of economic growth
  - R&D leads to innovation, but other framework conditions
- Market failure/positive externalities
  - Markets likely to produce less than socially optimal R&D levels
  - R&D produces positive externalities that “spill over” to others because knowledge is non excludable
- Inherently more risky investments, which may affect access to debt and equity finance



## How should government intervene?

- Non-tax policy tools
  - **Public R&D:** Government, NFP and Research sector
  - **Support for private sector R&D:** Government grants, loans, guarantees and legal protection of IP rights
- Tax incentives
  - **Input incentives:** R&D tax credits, accelerated depreciation or enhanced allowances
  - **Output incentives:** Knowledge boxes, investor incentives





## How should R&D tax incentives be designed?

- **Incentive base:** R&D, wages, IP acquisition, IP income
- **Calculating the base:** volume based/incremental; caps/brackets
- **Research/activity/KBC type:** basic, applied, experimental; computerised information (e.g., software), innovative property (e.g., R&D), economic competencies (e.g., brand equity)
- **Beneficiary:** size, legal form, location, special collaboration
- **Carry back/forward, cash refunds, claw backs, transferability**
- **Novelty:** new to the world, country, product or firm



## How effective are R&D input tax incentives?

- Input incentives stimulate R&D investment
- Impact of more R&D investment on jobs, growth, productivity & innovation likely to be positive
  - Reclassification and relocation of expenditure likely
- Effects differ across firm type
  - MNEs, SMEs and younger/start-up businesses
- Effectiveness sensitive to design and process



## How effective are R&D output tax incentives?

- Much less empirical research – knowledge boxes
  - Lead to more registered patents and more income from intangibles in that country, but impact on R&D investment, jobs, growth, productivity & innovation less clear
  - Reward linked to commercial success not social benefit
  - Bias towards patentable research & reclassification risks
  - Lead to significant tax revenue losses and BEPS risks
  - Substantial activity conditions help reduce BEPS and encourage local research

# **+ Key Issues and Observations from the General Report Tax incentives for R&D**

Robert Danon

## + Main issues considered in the General Report

- Are (should) R&D tax incentives (be) **neutral**?
- Are R&D tax incentives **proportionate**: Input and output (patent box) incentives ?
- Analysis of the **G20/OECD BEPS** work in the area of patent boxes. Shall be extensively discussed in the **specific breakout session** on patent boxes
- Attempt to propose a **basic common framework** based on neutrality and proportionality

## + R&D tax incentives and tax neutrality

- What is tax **neutrality** ?
- Are R&D tax incentives be neutral ?
- Distinction between «**external**» and « **internal neutrality** » ?
- Potential beneficiaries of R&D tax incentives should be placed on an equal footing **from the perspective of the policy objective** (internal neutrality)
- Internal neutrality under **Constitutional law** (overview of branch reports) and **international standards**

## + R&D tax incentives and internal neutrality

- **From a subjective point of view**, R&D tax incentives should be available to all taxpayers irrespective of legal form (companies, partnership and individuals)
- **From an objective point of view**, conditions to benefit from R&D tax incentives should be neutral from the perspective of the policy objective (controversial area for example: distinction between patented and unpatented R&D)
- Residents and non-residents performing R&D activities should be placed **on an equal footing**



## R&D tax incentives and proportionality

- R&D tax incentives must be structured to effectively accomplish their alleged objective (**suitability component mirroring efficiency**)
- R&D tax incentives should not lead to a deviation from tax neutrality that goes beyond what is necessary to achieve the purpose (**proportionality stricto sensu**)
- Relation with Constitutionnal law and international standards

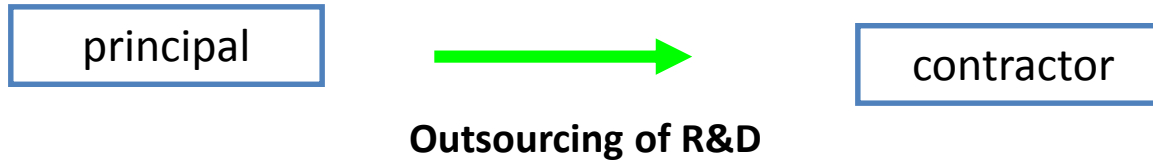


## + R&D tax incentives and proportionality

- Proportionality and **spill overs effects**
- Proportionality and **coordination of the R&D tax policy**
  - Coordination between identical incentives and different taxpayers (“double R&D dipping”)
  - Coordination between input and output incentives
  - Coordination between R&D tax incentives and direct subsidies
- Proportionality and the **definition of R&D for tax purposes ?**

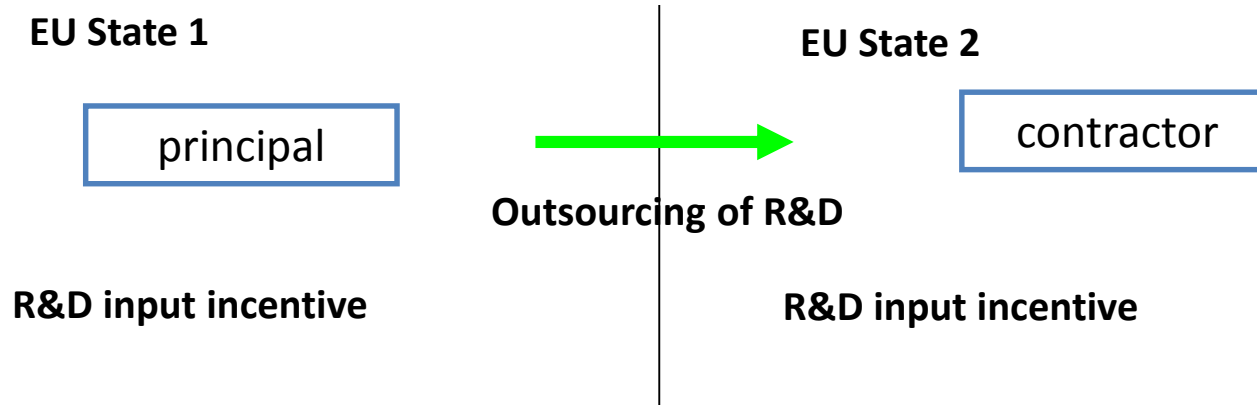
# + Proportionality and outsourcing of R&D

## *Domestic situation*



- Risk of double R&D dipping clearly identified by several lawmakers
- Input incentive **thus granted either to principal or contractor**

## *Cross-border situation*

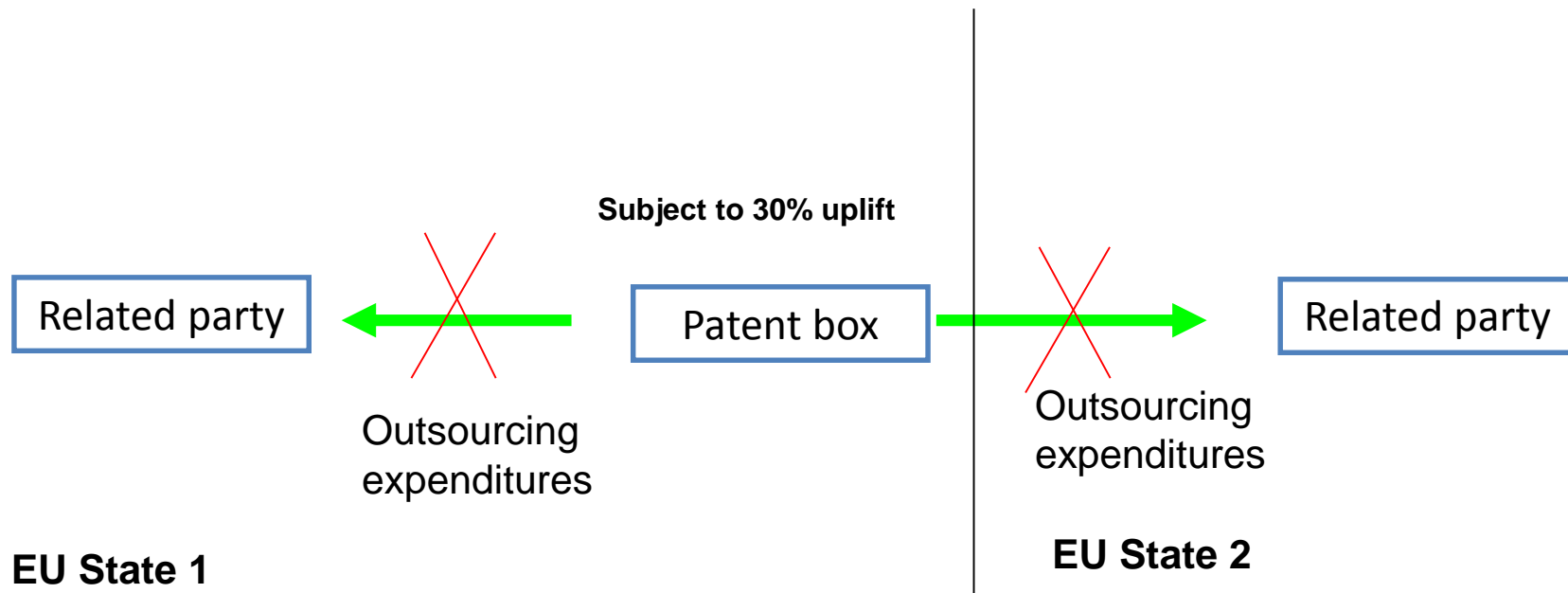


## Proportionality and outsourcing of R&D

- **Distortion between domestic and cross-border R&D activities ?**
- In the EU internal market is the problem linked to EU law or to an absence of coordination ?
- Need for a coordination on the basis of **the intensity of spillover benefits** for the relevant States ?

# + Comparison with patent boxes

## OECD modified nexus approach in the EU



## **+ Belema Obuoforibo**

R&D incentives and tax treaty issues



## Input incentives and tax treaty issues

Main issue – non-discrimination (Art 24 OECD/UN MTC)

Analysis of relevant parts of Art 24

Particular features of R&D regimes – trends and exceptions

## Article 24 OECD/UN MTC

Art 24(3): resident companies versus PEs of foreign companies

Art 24(4): conditions for deductibility regarding disbursements

Art 24(5): an enterprise of a contracting state owned or controlled by residents of the other contracting state – similar treatment to other resident companies

## **+ Article 24(3)**

“The taxation on a permanent establishment ... ”

Broad wording: covers incentives granted **by deduction** and **by credit**

Comparison: resident companies and PEs of foreign companies

Generally, no discriminatory treatment for PEs

- Sound policy considerations
- “within charge to tax”

“Permanent establishment”: some finer points



## Article 24(4)

Conditions for deductibility of “disbursements paid” by a resident of a contracting state

**Narrow scope:** Article not applicable where relief granted by means of tax credit

Conditions should be the same whether disbursements paid to a resident or to a non-resident

Policy considerations re conditions for deductibility

Analysis of notable domestic law provisions

## **+ Article 24(5)**

An enterprise of a contracting state owned or controlled by residents of the other contracting state

Taxation and allied requirements: should not be different or more burdensome than those of similar enterprises

Aim: equal treatment for resident companies

R&D incentives targeted at a particular type of company – the case of Canada

## **+** The Non-Discrimination Article

Art 24 OECD/UN MTC not always adopted wholesale in treaties (e.g. Australia, New Zealand, Canada)

### **Case in point: Australia**

- ✓ Pre 1 July 2011 regime
- ✓ Enhanced deduction system
- ✓ Restricted to companies incorporated in Australia
- ✓ Australia generally opposed to non-discrimination article
- ✓ Reservation re Article 24 MTC
- ✓ Australia's treaties:
  - ✓ R&D expressly excluded from the non-discrimination article
  - ✓ Most Favoured Nation clause in several such treaties
  - ✓ Notable exceptions: treaty with Japan (follows OECD Model); treaty with US (but contains savings clause)

## + Concluding Remarks

Art 24(3): generally not much of an issue

Art 24(4): limited applicability where the domestic discriminatory measure involves R&D **tax credits**

Art 24(5): effective provision if included in treaty

Worth noting the following:

- ✓ The position of several countries re non-discrimination articles
- ✓ Issues with dualist countries
- ✓ The trend away from enhanced deductions, and towards tax credits

## **+ EU Law Constraints on R&D Tax Incentives**

Raymond Luja



## Selected topics

- Intra-Union R&D efforts and the (re)modified nexus approach
- State Aid & CFC legislation
- Secondary legislation in progress...
  - The C(C)CTB: Will R&D tax incentives have a future?

## **Intra-Union R&D Efforts**

Fundamental freedoms versus national R&D policy objectives



## Intra-EU R&D

- Fundamental freedoms:
  - Right of (secondary) establishment
  - Freedom to provide (R&D-related) services

- CJEU in *Laboratoires Fournier*:

„national legislation which absolutely prevents the taxpayer from submitting evidence that expenditure relating to research carried out in other Member States has actually been incurred and satisfies the prescribed requirements cannot be justified in the name of effectiveness of fiscal supervision.”





## Main issue

- If a R&D incentive is offered as part of a world-wide tax base, R&D costs by permanent establishments within the EU should be taken into account
- If R&D costs by domestic subsidiaries are taken into account, then also recognise R&D costs made by subsidiaries in the EU
- Problem: (re)modified nexus approach as agreed to by the EU's Code of Conduct Group and proposed in OECD BEPS Action 5
- Not allowing outsourcing to (foreign & domestic) subsidiaries seems OK, but does the 30% uplift change anything? And what about group taxation?

# **State Aid Rules & CFC Legislation**

## + State aid rules

- Article 107(1) TFEU restricts Member State ability to offer tax incentives to particular products or certain sectors of industry
- Targeted (selective) R&D(&I) incentives may be approved of by the European Commission; mostly limited to input incentives
- General „R&D“ incentives fall outside of the scope of state aid review, such as broadly defined R&D boxes (Patent boxes investigations on hold for political pressure?! Please visit Seminar A)



## Main issues

- If an R&D incentive is approved as it contributes to EU policy goals (like regional development or Europe 2020), may other EU Member States then apply CFC legislation if the remaining tax burden would be considered too low?
- May we withhold R&D incentives from economic operators subject to income tax (self-employed persons, certain partnerships), while we offer them to competitors subject to corporation tax?

## **Secondary legislation in progress...**

Will R&D incentives survive a C(C)CTB?



## Common (Consolidated?) Corporate Tax Base

- Common Tax Base does not provide for R&D incentives of its own; 2020 objectives?
- Member States will not be allowed to introduce national R&D incentives to deduct from the (apportioned?) common tax base nor will they be allowed to offer special tax credits
- National non-tax incentives (subsidies) may be included as profits in the common tax base and, if consolidated, apportioned to other Member States

## + Main issues

- 2011 proposal for an optional but consolidated regime may lead to opt-out for R&D driven multinationals
- 2015 announcement of mandatory, non-consolidated regime would still block national R&D incentives as part of corporate tax (both input & output incentives)
- Options? List of allowable tax incentives?  
Clearance procedure by Commission/Council?

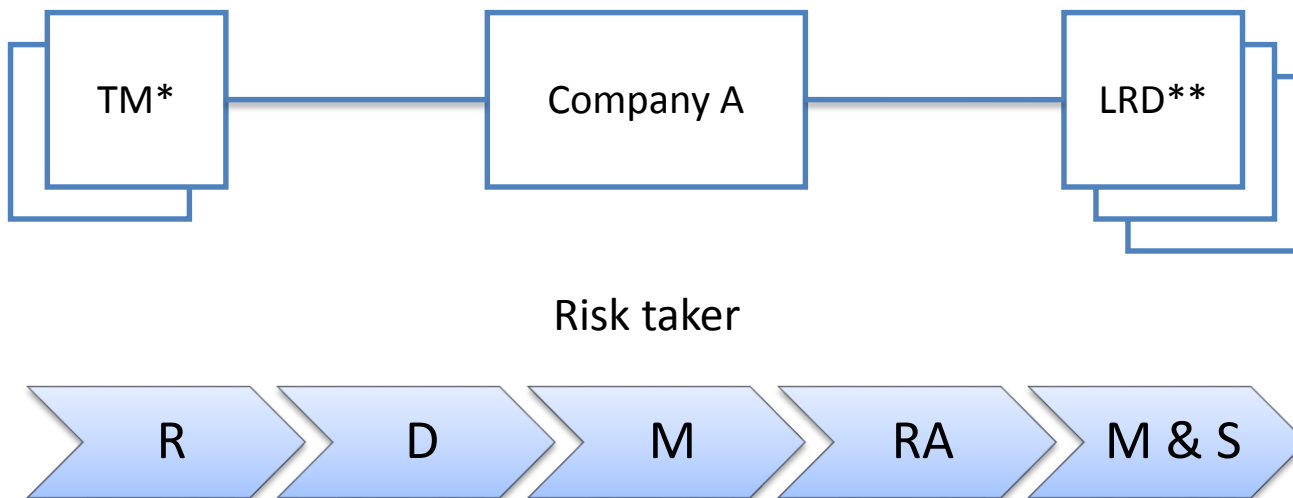
# + Case Study A – Location of New R&D and IP Restructuring

Barbara Kessler





# Company A is a Pharmaceutical Company Based in Country A



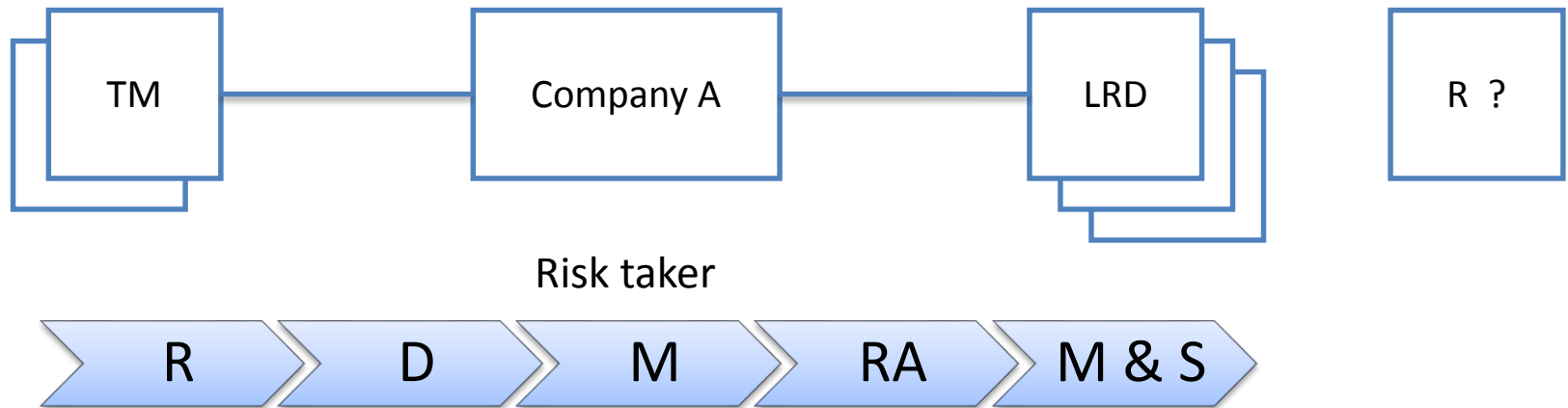
**Company A is located in Country A which has low corporate income tax rates and does not offer R&D incentives**

\*TM: Toll Manufacturing

\*\*LRD: Limited Risk Distributor



# Company A selects a Country to build a New Research Facility



Country X :

- Limited scientific resources
- Attractive R&D credits
- Moderate tax rates
- Cost level comparable to Country A

Country Y :

- First class universities, hospitals, scientific resources
- Cost level comparable to Country A
- High tax rates

**In which country should A establish a research facility?**

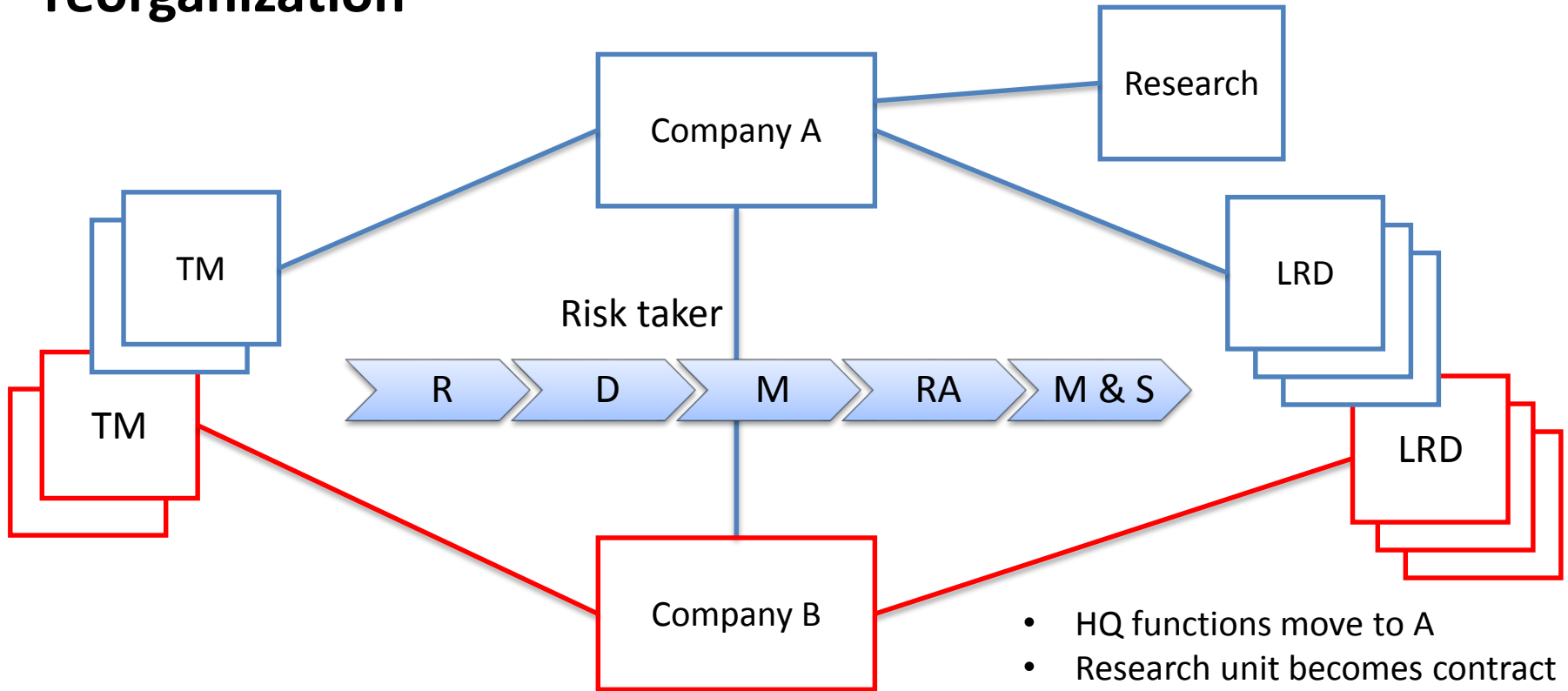
**What is the impact on IP ownership?**



## R&D Tax Credits

- Incremental vs volume based incentives
- Capped or unlimited
- Proprietary research (emphasis on ownership, control and financial risk)
- Contract research included (emphasis on performance of activity)
- Outsource research (partially) included or excluded

# + Expansion of A Group - Purchase of B Group and reorganization



- HQ functions move to A
- Research unit becomes contract researcher for A
- B assumes development functions from A to become global development Center

**What is the impact on R&D incentives in Country B?**

## R&D tax incentives

### Input tax incentives

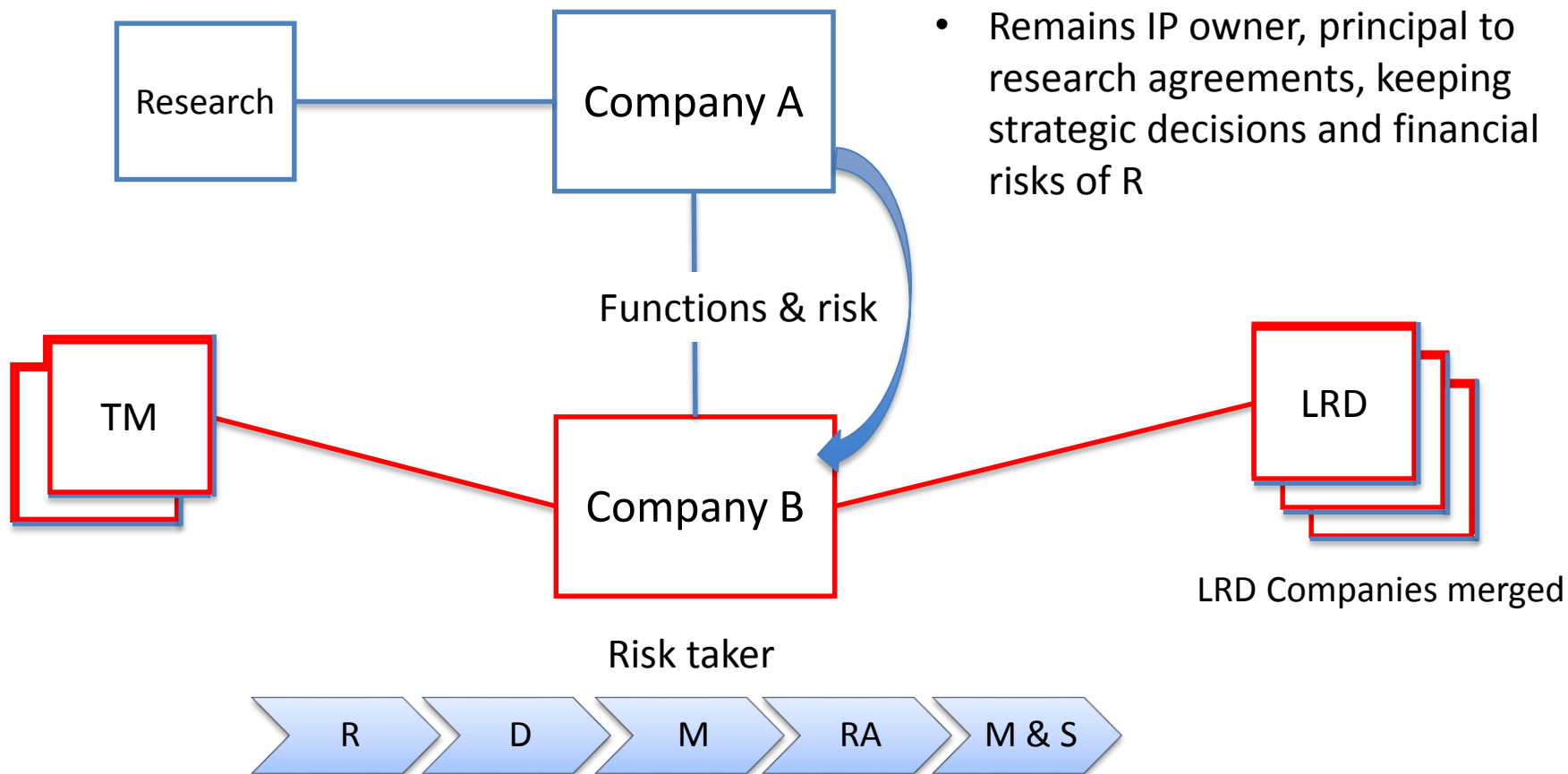
- Tax credits
- Enhanced allowances (super deductions)
- Accelerated depreciation

### Output tax incentives

- Patent box



# Further Integration of A and B group and change of Business Model



Is central IP ownership after transfer of R&D activities a good option from a R&D incentive point of view?

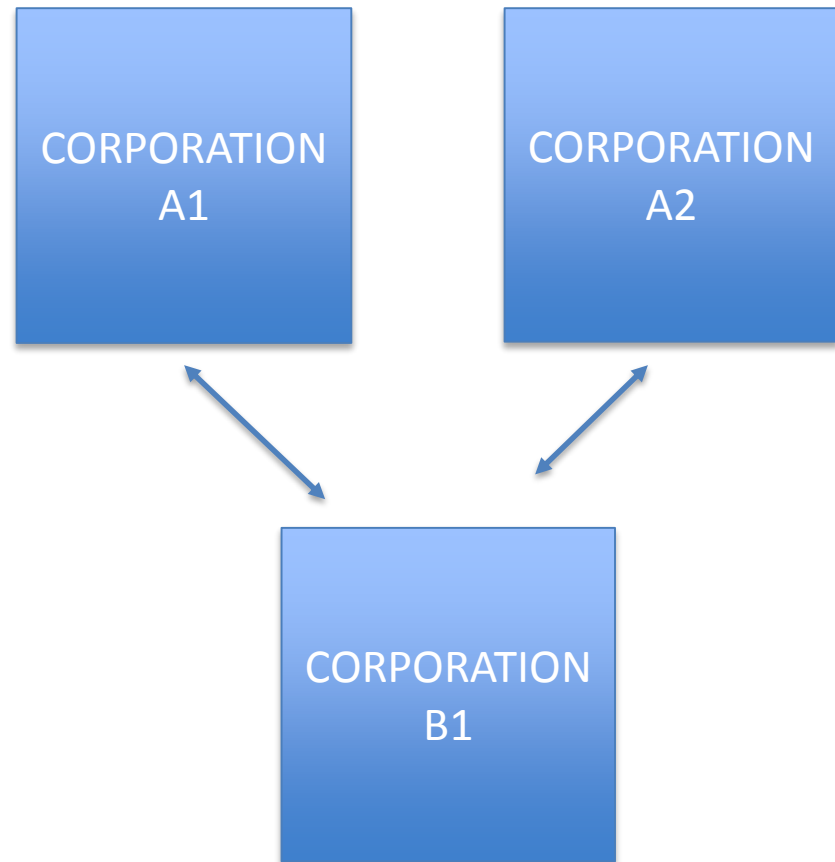
# **+ Case Study B – Tax Efficient Structure for R&D Income**

Manuel Tron



## Case Study B: Tax Efficient IP Structure – Pre-BEPS

- Ongoing R&D activities in Country A
- Cost sharing agreement with B1 resident in Country B
- Right to intangible exploitation in B1

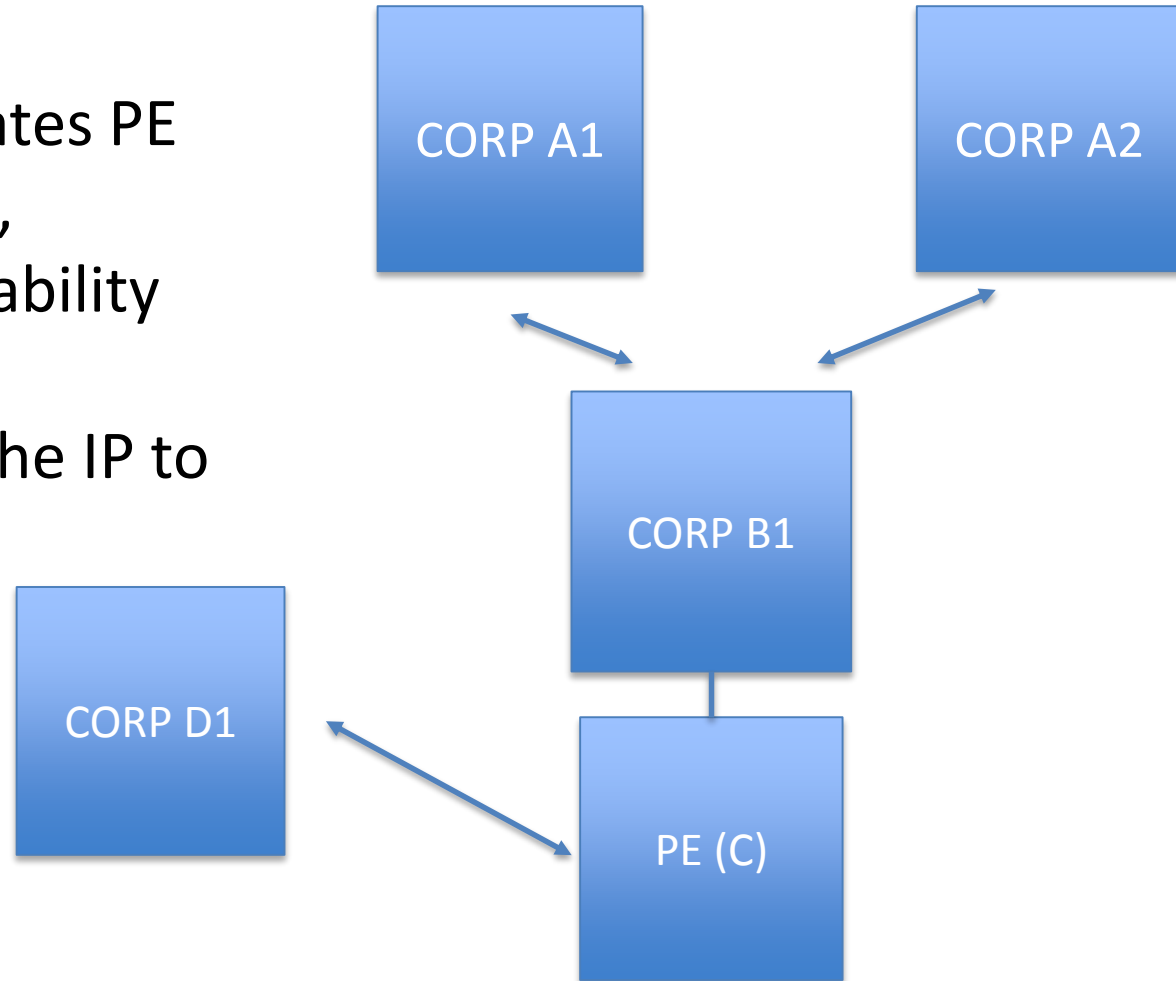






## Case Study B: Tax Efficient IP Structure – Pre-BEPS

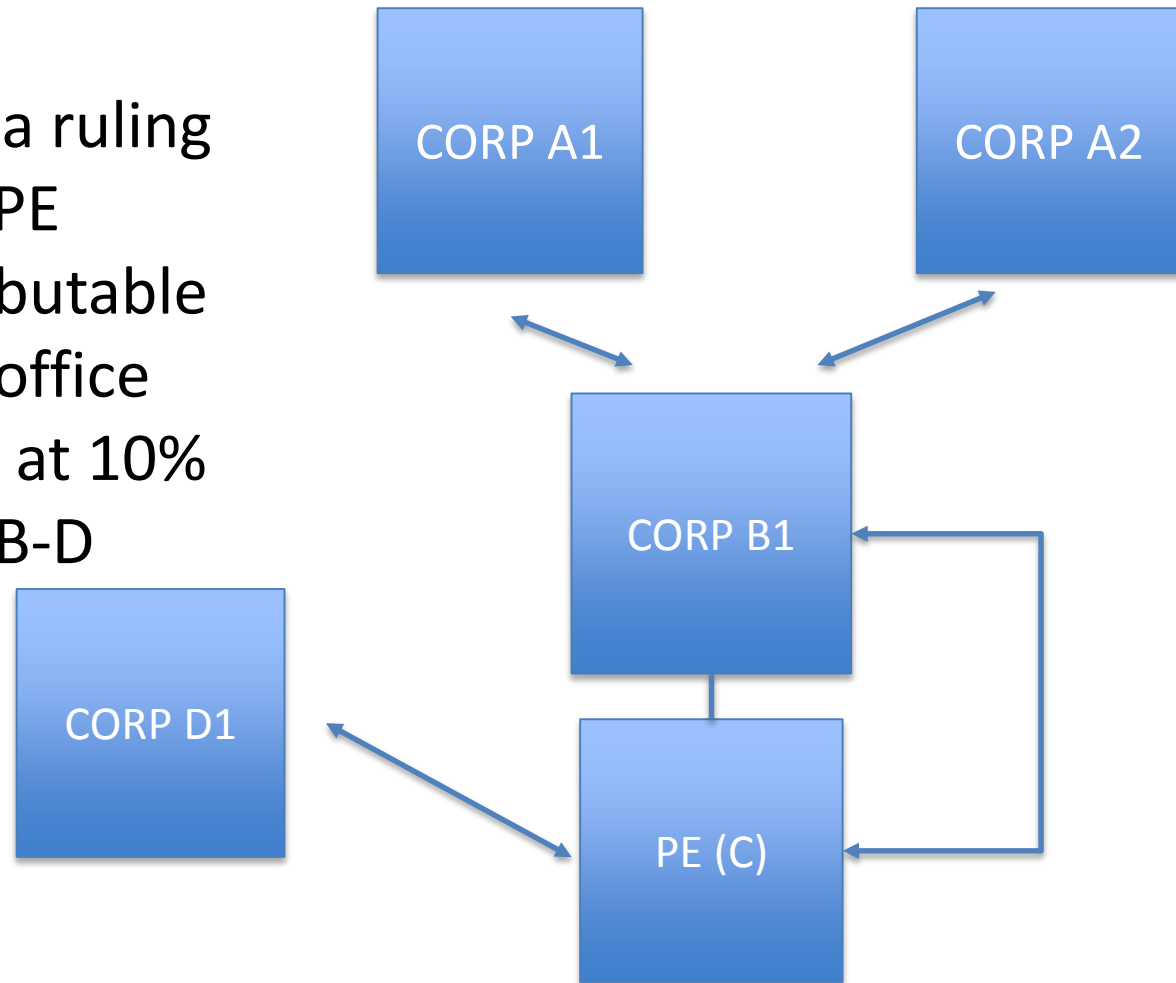
- Corp B1 creates PE in Country C, contributes ability to license IP
- PE licenses the IP to Corp D1





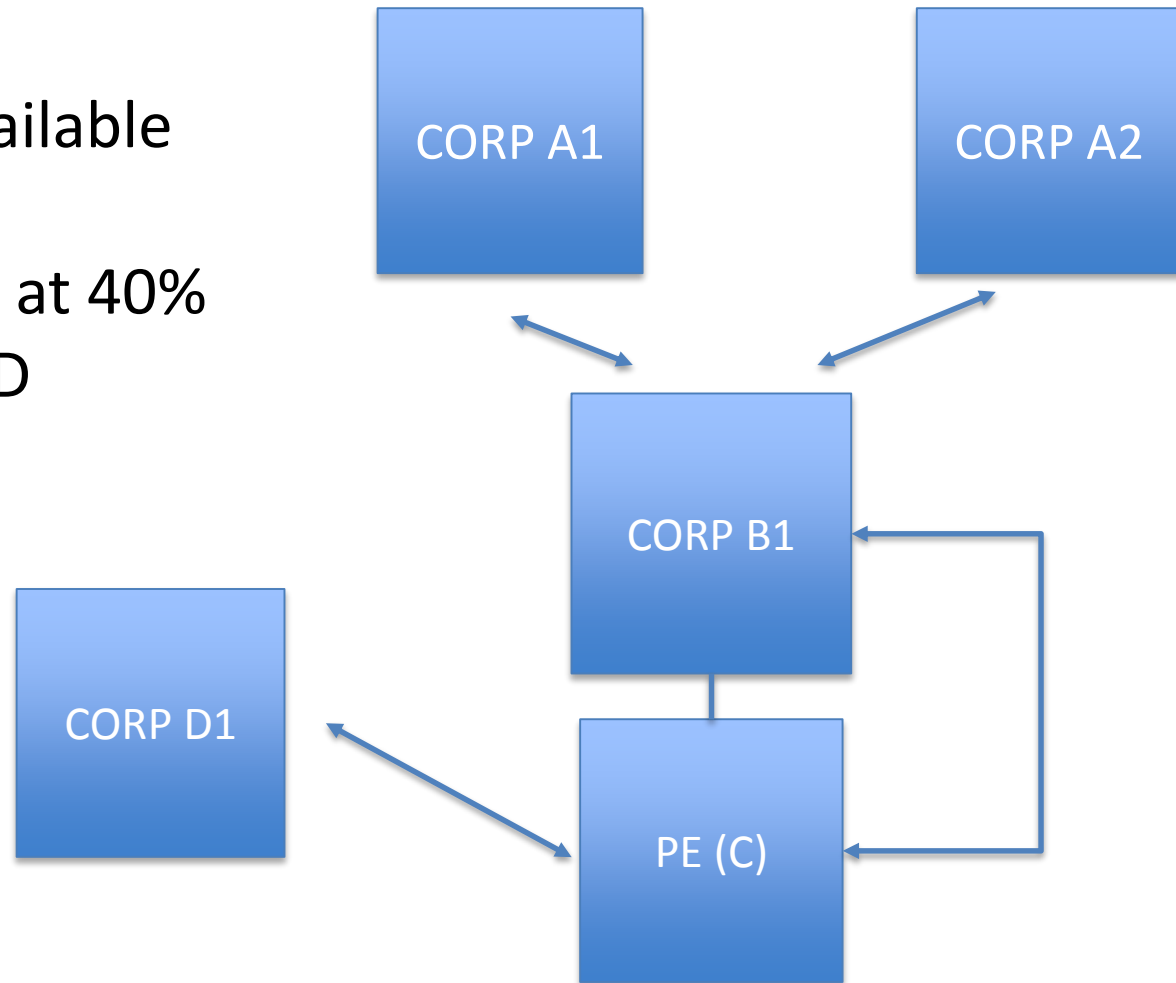
## Case Study B: Tax Efficient IP Structure – Pre-BEPS

- Corp B1 has a ruling that 10% of PE income attributable to B1 home office
- WHT from D at 10% from Treaty B-D



## + Post-BEPS – What results?

- No ruling available for B1
- WHT from D at 40%  
no Treaty B-D applicable



## + Panel Summary

## + Panel Summary

- R&D policy not limited to taxation; challenges to assure that R&D incentives are effective in incentivizing R&D activity and avoiding windfall.
- General Report highlights importance of neutrality and proportionality principles for R&D incentive to be effective
- Treaty nondiscrimination article has limited effect on incentives, but supports neutral policy
- EU law supports R&D activity within single market; coordination and BEPS compatibility challenges remain.

## Panel Summary

- Case Study A highlights challenges of designing effective R&D tax incentive for legitimate business that does not result in windfall revenue loss
- Case Study B highlights that pre-BEPS planning can be more generous than patent box; post-BEPS is uncertain but if BEPS is successful it may shift tax competition from intermediary to activity countries.

## + Questions and Interventions from the Floor