R&D incentives continue to draw government favor

Reflections from EY’s The outlook for global tax policy in 2018
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Tax competition is an inherent aspect of tax policy, as tax is a tool of economic policy and governments compete to attract economic activity to their jurisdiction. It is the increase in tax competition that, alongside changes to the very concept of value (how it is created, valued and ultimately taxed) has given rise to many of the tax changes occurring today.

While EY’s The outlook for global tax policy in 2018 signals a consistent picture of tax competition across many measures, new activity demonstrates the continued focus on sustaining existing investment and attracting new ventures. This is perhaps most apparent within the research and development (R&D) incentives category than in any of the 13 other business tax categories tracked in that publication, from which the information set out below is drawn.

Of the 41 jurisdictions we surveyed, 14 (or 34%) are forecasting new or more generous R&D incentives in 2018 (2017: 22%). This is a consistent theme year-on-year, with 9 of the 14 who are enhancing their R&D incentives having also done so in 2017.

The focus on R&D incentives could be explained by the fact that countries find their choices constrained by the base erosion and profit shifting (BEPS) recommendations, and nevertheless want to remain competitive. As a result, focus shifts onto improving or creating “acceptable” incentives. Companies, as beneficiaries, should be aware of this trend.
It’s not just BEPS

A further stimulant for competition is the US tax reform package, a key component of which focuses on the development and exploitation of IP assets. Competitor countries are therefore actively studying (and implementing) ways to attract higher levels of FDI in the knowledge economy.

Looking deeper into the data, the size of the changes is remarkable. While the 2015-2017 period saw countries introduce relatively minor changes to their incentives (“tweaking at the edges”), 2018 sees more significant, sizeable enhancements being adopted. Singapore, for example, increased its tax deduction for labor costs and consumables incurred on qualifying R&D projects performed in Singapore from 150% to 250%; likewise, Poland has increased its similar deduction from 100% to 200%, effective 1 January 2018.

The number of entirely new R&D incentives further illustrates the strength of this trend; Denmark, Hong Kong and New Zealand have or are contemplating introducing completely new R&D incentives among these 14.

Not all changes are positive for taxpayers

Not all countries are improving their R&D incentives in favor of taxpayers, though; in common with recent years a smaller subset of nations (Australia, the Czech Republic, Russia and Vietnam in 2018) continue to target their R&D incentives more tightly, attempting to ensure that government funds are put to the perceived best use. Here, two trends are apparent:

• curtailing the overall benefits available to multinational companies in favor of more focused efforts designed to benefit small and medium-sized enterprises (as has been recommended by the OECD in recent years).

• targeting their R&D incentives more closely at particular sectors, sub-sectors or specific activities.

In this second area, one angle merits further (and continued) investigation by companies, with many nations now targeting their incentives toward the development of digital activities.

Patent and innovation boxes

Patent and innovation boxes continue their global spread, a trend validated by their adoption by non-European nations including Singapore, Switzerland’s long-awaited tax reform package, which proposed a patent box (which will be mandatory at cantonal level), was passed as recently as 28 September 2018, while Poland issued draft legislation for an innovation box on 24 August 2018.

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Not all regions are equally active

Our research indicates that in 2018, few Americas nations have thus far amended their R&D regimes; Latin America (barring Argentina) indicates relative tax stability in 2018, relative to other regions. This situation may change, however. The Canadian Government will likely come under increased pressure to enhance its overall tax competitive position in relation to the United States.

In Mexico, the Secretary of Finance and Public Credit and the head of the Business Coordinating Council have stated that both groups have been holding meetings to define what short-term measures may be adopted to counteract the effects of US tax reform on the Mexican economy. Although it there has been speculation that some tax incentives may be established, there has been no specific position by the Mexican Government as to the specific details of this measures.

More widely, there have also been discussions as to whether US tax reform may trigger more comprehensive tax reform in Mexico; however, due to the current political climate in Mexico, this remains uncertain. As the 2018 election resulted in a significant victory for the opposition party, we may well see a shifting tax policy stance by the new administration.

Wider capital investment incentives

Likewise, other business incentives – which includes depreciation, amortization and capital allowances – also continue to foster high levels of attention, with 14 of 41 jurisdictions (again, 34%), forecasting a lower burden due to new or improved changes in this area – slightly higher than in 2017, when the figure was 30%. Six jurisdictions (China (mainland), Denmark, Germany, Hong Kong, Italy and Singapore) are enhancing both R&D and other business incentives in 2018.
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A summary of 2018 R&D changes

The following changes are drawn from EY’s The outlook for global tax policy in 2018; as such, coverage is limited to the set of 41 jurisdictions covered in that publication and not to all countries of the world.

Austria

As stipulated in the government program for 2017/18, the Austrian Parliament approved an increase in the research tax credit by an additional 2%, effective 1 January 2018.

Regardless of their size, companies conducting research may already claim a tax credit amounting to 12% of their R&D expenditures. Starting in 2018, 1% of R&D costs will be refunded either as a cash payment or as a tax credit.

Most recently, the research tax credit (or research premium) was raised from 10% to 12% at the beginning of 2016. This tax incentive is complemented by a wide range of direct funding programs as well as bureaucratic relief for startups and companies driving innovation.

China (mainland)

On 8 November 2017, China’s State Administration of Taxation (the SAT) released Public Notice [2017] No. 40 (PN 40), which expands the scope of qualifying R&D expenses eligible for a super deduction, and to clarify certain related issues. The super deduction results in an additional 50% deduction of actual R&D expenses. The expanded scope of qualifying R&D expenses includes the following:

- Equity incentives granted to R&D personnel
- Personnel expenses such as salaries and wages included in a payment made to contract a human resource agent that provides R&D personnel
- Employee welfare expenses, supplementary pension funds and supplementary medical insurance premiums
- R&D expense incurred for “failed” projects
PN 40 also clarifies that for outsourced R&D projects, the R&D expenses of the principal and not the subcontractor will be eligible for the super deduction.

PN 40 applies to annual corporate income tax returns for taxable years beginning in 2017. PN 40 is also applicable to any new and pending cases to which retroactive preferential tax treatment is available.

More recently, on 20 September 2018 China’s Ministry of Finance (MoF), the State Administration of Taxation (SAT) and the Ministry of Science and Technology jointly issued Circular [2018] No. 99 which increases the super deduction for R&D activities. According to the circular, costs and expenses incurred on eligible R&D activities may be increased by 75% in determining the deduction that may be claimed, when determining the enterprise’s profits if the R&D activities have not yet resulted in the creation of an intangible asset. In cases where such R&D has resulted in the creation of such an asset, the amortization base of that asset may, during the 1 January 2018 to 31 December 2020, be increased by 175% for income tax purposes.

Denmark

On 26 February 2018, the Danish Minister of Taxation published draft legislation that would gradually increase the allowable tax deduction for R&D expenses from 100% to 110% as follows:

- Income years 2018 and 2019: 101.5%
- Income year 2020: 103%
- Income years 2021 and 2022: 105%
- Income years 2023-2025: 108%
- Income years 2026 and onwards: 110%.

Taxpayers are currently entitled to claim a 100% deduction of R&D expenses.
Germany
On 7 February 2018, the leadership of the Christian Democratic Union and the Social Democratic Party agreed to form a new government, with Angela Merkel as the Chancellor, for the legislative period 2017-2021. In Germany, the multiparty government is based on a coalition agreement, which is in essence a politically binding work plan for the future government. The 180-page document also includes a small summary of planned tax legislation projects, including the adoption of tax incentives for R&D activities, in particular for small and medium-sized enterprises, which are based on personnel and project cost. The entire budget forecasts 2018-2021 financial support for R&D activities of €2b, but only a portion of that will be apportioned to tax incentives.

Hong Kong
In March 2018, Hong Kong's Financial Secretary announced that draft legislation will be presented to the Legislative Council as soon as possible on proposing super tax deductions for expenditures on qualifying R&D activities. Under the proposal, the first HK$2m (about US$256,000) of eligible R&D expenditures will enjoy a 300% tax deduction and the remainder, a deduction at 200%.
It is understood that the proposed super tax deductions would only apply to expenditures incurred for R&D activities undertaken in Hong Kong. It may not cover R&D activities that have been subcontracted out, whether performed inside or outside Hong Kong.

Italy
Under Budget Law 2017, which was effective as of 1 January 2018, Italy's R&D tax credit has been extended to FY 2020. Italian taxpayers (including a network of companies, permanent establishments of nonresident companies and associations of companies) investing in R&D activities are entitled to a tax credit to offset tax liabilities. The R&D credit has also been extended to include R&D expenses incurred in connection with agreements entered into with non-Italian providers residing in the European Union (EU), European Economic Area and “white list” countries. Therefore, R&D expenses outsourced by foreign entities to Italian companies are now eligible for the tax credit.
The tax credit equals up to 50% of the annual increase of the average R&D expenses carried out during FY12-FY14. Eligibility for the benefit depends on a minimum annual investment of €30,000. Specific provisions are established for companies with less than three FYs of activity.
The maximum annual credit for each beneficiary is set at €20m. All taxpayers irrespective of their juridical form, accounting system adopted, activity or turnover may benefit from the R&D tax credit.

Luxembourg
On 7 August 2017, Luxembourg's Minister of Finance introduced in Parliament a long-awaited draft law n°7163 (Draft Law) on the new intellectual property (IP) regime, following the abolishment of the old IP regime by the 2016 Budget Law. The draft law sets out that R&D expenditures incurred by a permanent establishment may be treated as qualifying expenditures, provided that:
• The permanent establishment is located in a jurisdiction that is party to the Agreement on the European Economic Area (EEA Agreement) other than Luxembourg
• The permanent establishment is operational at the time of the realization of the eligible income
• The permanent establishment must not benefit from a similar IP regime in the jurisdiction of its location

New Zealand
The New Zealand Government intends to reintroduce some form of tax credit for R&D expenditure, most likely 12.5% of qualifying expenditure, although the implementation date is not yet known.
Poland

With effect from 1 January 2018, Poland’s R&D deduction has been increased to 200%, providing for a saving of up to 38%, given Poland’s 19% CIT rate.

R&D tax relief allows for an additional decrease in taxable income by certain categories of R&D expenses already borne by a taxpayer undertaking R&D activities. The deduction is calculated with reference to the amount of costs incurred for conducting R&D.

If the additional deduction exceeds the company’s tax base for a given year, the excess may be carried forward for six consecutive years after the year in which costs were incurred; however, the additional deduction is not available if a taxpayer carries out activity in Poland’s Special Economic Zones (SEZ) under a permit in the given year.

Singapore

Singapore’s annual budget held on 9 February 2018 saw the tax deduction for labor costs and consumables incurred on qualifying R&D projects performed in Singapore increased from 150% to 250%. This change will become effective from YA 2019 to YA 2025. This is but one of multiple R&D-related changes in Singapore’s annual budget, the remainder of which are discussed in an EY Global Tax Alert.²

Thailand

The rollout by the Board of Investment (BOI) of the Royal Thai Government’s Eastern Economic Corridor (EEC) plan, which covers Rayong, Chonburi and Chachoengsao provinces and would allow maximum incentives for qualified investment projects of which, among others, include the exemption of corporate tax.

For BOI-promoted projects, tax holiday period is extended from 8 years to 13-15 years in accordance with the Amendment of BOI Act and the Competitiveness Enhancement Act with certain conditions.

Ukraine

On 1 January 2018, Ukraine made amendments to its existing R&D incentive regime, including expanding the scope of R&D activities related to the development of computer software, which are eligible for temporary VAT exemption.

United Kingdom

The rate of R&D expenditure credit has increased from 11% to 12% in order to encourage business investment. Furthermore, incentives have been introduced for companies to invest in green technologies through capital allowances including:

- Extending for five years, the first-year tax credit for loss-making businesses purchasing designated energy-efficient or water-saving technologies
- Extending for three years, the 100% first-year allowance for companies investing in zero-emission goods vehicles and gas refueling equipment
- Updating the list of technologies and products covered by the Enhanced Capital Allowances scheme, which provides a 100% first-year allowance on qualifying expenditure

United States

One of the overarching goals of the US tax reform legislation was to encourage companies to invest and create jobs in the United States. While substantive changes were not made to the research and development (R&D) credit, other tax reform changes will increase the tax value of the credit and incentivize taxpayers to relocate R&D activities to the United States. With the lower corporate income tax rate under the law, the Section 41 R&D credit has greater value, since it is a dollar-for-dollar tax liability offset (including for tax liability generated by the Section 965 transition tax). Also, most businesses subject to the corporate AMT under prior law could not use the research credit to offset the AMT. With its repeal as part of tax reform, these taxpayers have an opportunity to reevaluate the benefits of claiming the R&D credit.

Tax reform significantly changed how qualifying research and development expenditures are treated from a tax accounting perspective; beginning in 2022, a taxpayer must capitalize and amortize Section 174 research and experimentation expenditures and all software development costs over five years (for US R&D) or 15 years (for foreign R&D). This differential in recovery period could incentivize taxpayers to relocate R&D activities in the United States.

Taxpayers can elect under Section 280C to keep all of their Section 174 deductions for the year, but with a reduction in the R&D credit. This reduction, or “haircut,” equals the applicable tax rate, and so will be smaller under the new law than in prior years (21% in 2018 vs. 35% in 2017). If taxpayers do not make a Section 280C election, they must reduce the Section 174 deduction amount, so taxpayers will need to determine whether it is more advantageous to have a larger credit (to offset current-year tax liability or carry forward a larger credit amount) or more Section 174 deductions. Other changes in the tax reform law, including the new base erosion and anti-abuse tax (BEAT), could add greater complexity and new timing considerations to decisions around R&D tax incentives.

Recent months indicate further change

In fact, since the 2018 Global outlook for tax policies was published in March 2018, many jurisdictions continue to publish changes to their R&D tax laws. These include:

- Australia’s 2018-19 Federal Budget, issued in May 2018, delivers changes to the tax treatment of R&D expenditure. Changes include:
  - Increasing the R&D expenditure threshold from $100m to $150m and making the threshold a permanent feature of the law
  - Linking the R&D tax offset for refundable R&D tax offset claimants to claimants’ corporate tax rates plus a 13.5 percentage point premium
  - Capping the refundability of the R&D tax offset at $4m per annum (with a clinical trials exemption)
  - Increasing the targeting of the Incentive to larger R&D entities with high levels of R&D intensity
R&D incentives continue to draw government favor.
• Extending the general anti-avoidance rules in the tax law to R&D tax offsets directly
• Claw back provisions allowing for removal of double benefit situations
• Disclosure and reporting frameworks for R&D claimants, along with broadening powers ISA powers to allow administration.
• China has expanded the scope of eligible services for companies to qualify as a Technology Advanced Service Company (TASC) nationwide. A TASC is eligible for a reduced 15% corporate income tax rate, and Circular 44 is retroactively effective as of 1 January 2018.
• Japan's 2018 tax reform bill, enacted on 28 March 2018, limits the take-up of Japan's R&D tax credit, which will no longer be available to large corporations if all the following conditions exist:
  • Current taxable income exceeds the prior year's taxable income
  • The average salary paid by the company to the employees is equal to or less than the average salary paid during the previous fiscal year
  • Domestic investment in depreciable assets is equal to or less than 10% of depreciation

This revision applies to fiscal years starting on or after 1 April 2018 and ending on or before 31 March 2021.

• Poland: As noted on page 2, 24 August 2018 saw Poland’s Ministry of Finance (MoF) release a draft bill introducing significant changes to the tax law beginning 2019. These changes include the introduction of an innovation box, whereby profits from qualifying IP rights may be taxed at a preferential 5% tax rate. The box is based on the OECD BEPS Action 5 guidelines regarding the modified nexus approach.

Finally, and most recently, Poland also issued the executive regulations related to several investment incentives for new investments into the country. Under a new law on “Polish Investment Zones” that entered into force on 5 September 2018, companies may now apply for a corporate income tax (CIT) exemption for a new investment to be placed at any location in Poland. On 5 September, the executive regulations (by-laws) which provide for detailed, but important mechanics related to obtaining such an incentive became a binding law.

• As noted, Switzerland's tax reform package was approved on 28 September 2018. A core element is the introduction of a patent box regime in accordance with the OECD standard. In the box, net profits from domestic and foreign patents and similar rights are to be taxed separately with a maximum reduction of 90% (rate at cantonal discretion). Before the patent box can be applied for the first time, the corresponding tax deducted research and development (R&D) expenditures must be recaptured and taxed.

The introduction of an R&D super deduction of maximum 50%, optional at cantonal level for domestic R&D is Switzerland’s commitment to be recognized as an attractive location for R&D. For administrative reasons, the maximum deduction of 50% (rate at cantonal discretion) is limited to personnel expenses for R&D plus a flat-rate surcharge of 35% for other costs and 80% of expenses for domestic R&D carried out by third parties or group companies.

• In Uruguay, 24 April 2018 saw the Uruguayan Executive Power proposed a bill for consideration by the Parliamentary General Assembly that would change the corporate income tax (CIT) regime and establish new benefits for taxpayers. The bill, which remains as a draft at this stage, would amend the article in Law No. 19,535 that established CIT exemptions for R&D activities in the areas of biotechnology, bioinformatics and software production. It would establish a new method for calculating the CIT exemption for the development of such activities, provided that the resulting assets are covered by the intellectual property rights regulations. Additionally, the bill would allow income from services related to these areas to be fully exempt from the CIT if those services are performed in Uruguayan territory. More than 50% of expenses and costs must be incurred in Uruguay in order to qualify.
Europe: a word of caution

While the overall picture painted by these changes is positive for companies, there may be some storm clouds gathering in Europe.

In late June 2018, France and Germany published significant amendments to the proposed directive for a common corporate tax base (CCTB) among European Member States (MSs). The proposed CCTB changes are wide-ranging and focus on a number of key areas, including an important R&D change. In this area, both countries are opposed to providing tax incentives for either R&D activities or for equity financing, while the existing proposal includes both a notional interest deduction and a super deduction for R&D expenses. France and Germany will now present their CCTB proposal to other MSs, seeking swift agreement, although the directive will require unanimity among MS if it is to pass into legislation. Use of the enhanced cooperation mechanism is a future possibility, but its use is not currently foreseen.

The Franco-German proposals would substantially modify the substance of the existing Directive – not least that it suggests making use of a CCTB mandatory for all companies (the current EU proposals from under the Commission’s attempt to relaunch the CCCTB under a two-phased approach make it mandatory only for groups with consolidated worldwide revenues greater than €750m in the preceding year). From a procedural viewpoint, the joint proposal raises the question of whether these changes will necessitate a complete relaunch of the Directive and whether the deletion of the major tax incentives lead to a willingness of smaller Member States to welcome these developments.

Where to next?

Notwithstanding the above, nothing we hear in conversations with policymakers around the world indicates that the trend of improving R&D incentives in the favor of taxpayers will either slow or cease in the short term. Indeed, US tax reform is spurring many governments to review their tax regimes, and we expect this area to be one which would serve as a benefit, should responses be put in place.

Against such positive developments, we see an uptick in related activity by companies, working to ensure that their processes to identify, secure and maintain incentives take these important changes into account.

For many companies, securing an R&D incentive may be seen as a single-step process. This is a sub-optimal approach to take, as other issues — continued compliance with the original rules, for example — must also be taken into account. Companies benefitting the most will be those that seize the opportunity and take advantage of this unusual up-tick in the availability and quality of incentives. That means addressing incentives management in a more joined-up way, coordinating between different geographies and different business functions in a more effective manner. Generally speaking, the opportunity for tax to contribute to business objectives in an even more meaningful way is increasing as a result of these changes. That provides a good opportunity to revisit an issue that may not have been refreshed in quite some time.
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