

The Emergence of R&D Tax Regimes In Europe

by Wolfgang Kessler and Rolf Eicke

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FEATURED PERSPECTIVES

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International tax law is going through a period of remarkable change. Trends come and go frequently; however, three trends have been steady and durable in the last years.

First, industrial countries (except for the United States and Japan) have been reducing their statutory corporate income tax rates while broadening the tax base.

Second, many industrial countries tightened their antiabuse regimes, which include measures such as general antiavoidance rules, anti-treaty-shopping, limitation on benefits, and change of ownership rules. In fact, the United States and the United Kingdom introduced and later tightened disclosure rules for tax avoidance schemes. (See “Legal, but Unwanted,” *Tax Notes Int’l*, Nov. 5, 2007, p. 577, *Doc 2007-23126*, or 2007 *WTD 219-9*.)

Third, industrial countries have bestowed preferential treatment on special sources of income. Examples include Switzerland’s so-called holding privilege, which only lightly taxes dividends, interest, and royalties; and the dual income tax system of countries such as Finland and Sweden that favors capital income over labor income for tax purposes. Those examples inspired Germany to introduce a special regime for private capital income that will be effective from 2009 (*Abgeltungsteuer*; see “Welcome to the German Dual Income Tax,” *Tax Notes Int’l*, Aug. 27, 2007, p. 837, *Doc 2007-17722*, or 2007 *WTD 169-7*.)

Yet this category of trends has another offspring: The preferential treatment of research and development

activities and the income derived from patents and other forms of intellectual property (IP).

Patents

Patents and other forms of IP are in some ways like diamonds — exclusive, unique, and often brilliant. Even though patents are not, like diamonds, forever, they are as valuable. Patents are the lifeblood of society, the wealth of nations. For countries lacking natural resources, patents are the crude oil of the mind: predominantly onshore and rarely wasted. Patents are an intangible property, the only property that can be reproduced indefinitely.

No wonder states attempt to attract and promote the creation of patents by introducing R&D tax regimes. Several European countries have introduced special tax incentives and sparked a new round of global tax competition.

Competition enhances the free movement of best practices, not only for tax planning opportunities but also for tax legislation. Once a legislative measure turns out to be successful in attracting investment, other countries use that legislative measure. Many decades ago, the Netherlands was on the cutting edge because it introduced a comprehensive participation exemption regime to attract holding companies. Many nations have since copied this regime, thus depriving the Netherlands of a unique selling point. Yet, the Netherlands has continued to produce innovative tax legislation, the latest of which is the patent box regime, in which patent income is taxed at a lower rate than other sources of income.

Incentive Regimes

Netherlands

The Dutch 2007 corporate income tax reform introduced a patent box to stimulate R&D in the Netherlands (article 12b CITA). It applies to both Dutch patents and foreign patents held by a Dutch taxpayer that were first registered on or after January 1, 2007, either in the Netherlands or abroad. The patent income is subject to an effective tax rate of 10 percent if the royalties are derived for more than 30 percent of the patent. The taxpayer can elect to be taxed on a per-patent basis on all income related to the patent, including profits from products produced with the patent, royalty income, and capital gains. Patent income is defined as benefits minus related R&D expenses, other charges, and amortization of the IP. The maximum eligible patent income is four times the expenses made for the creation of all patents. Income beyond this amount is taxed at the normal tax rate. Since the developing costs of all intangible assets are taken into account, the patent box may still be applied if the income on an intangible asset exceeds four times the development costs of the patents but does not exceed the development costs of all of the patents. Conversely, if the development costs of an unsuccessful patent are so high that it exceeds the overall income from other patents, the other patent income is subject to the normal tax rate until the overall income of the other patents exceeds the costs for the expensive unsuccessful patent. The favorable 10 percent rate will apply only after all development expenses have been recaptured. Once elected, the choice for the particular patent is final.

Belgium

Effective from January 1, 2008, Belgium introduced an 80 percent patent income deduction (PID), based on the Dutch patent box. The 80 percent PID is applicable to income derived from licensing of patents or the use of patented products, for a total tax burden of 6.8 percent. It applies only to new patents and not to other IP such as trademarks or know-how. The preferential treatment does not require an application or an advanced ruling. The PID regime can be combined with the notional interest deduction.

France

The French R&D tax regime served as a model for the Dutch and Belgian rules. Since January 1, 2008, the French rules are even more attractive. The rules provide for a tax credit of 30 percent of the annual research expenses, capped at €100 million, and a tax credit of 5 percent of annual research expenses above €100 million. Moreover, income from royalties and capital gains from patent transfers are taxed at a preferential rate of 15 percent. The French regime also provides for a simplified advanced ruling system. If the

tax authorities do not react within three months after filing for the R&D project, it is deemed granted.

Ireland

In Ireland patent income derived from qualifying patents by Irish resident taxpayers is exempt from taxation. The Finance Act 2007 imposes a maximum on the patent income exemption of €5 million for a company in any calendar year. A qualifying dividend is defined as a patent in which the research, planning, processing, experimenting, testing, devising, designing, developing, or a similar activity leading to the invention is carried out within the European Economic Area. Under some conditions, the exemption covers dividends or distributions paid by a company out of exempted patent income.

Luxembourg

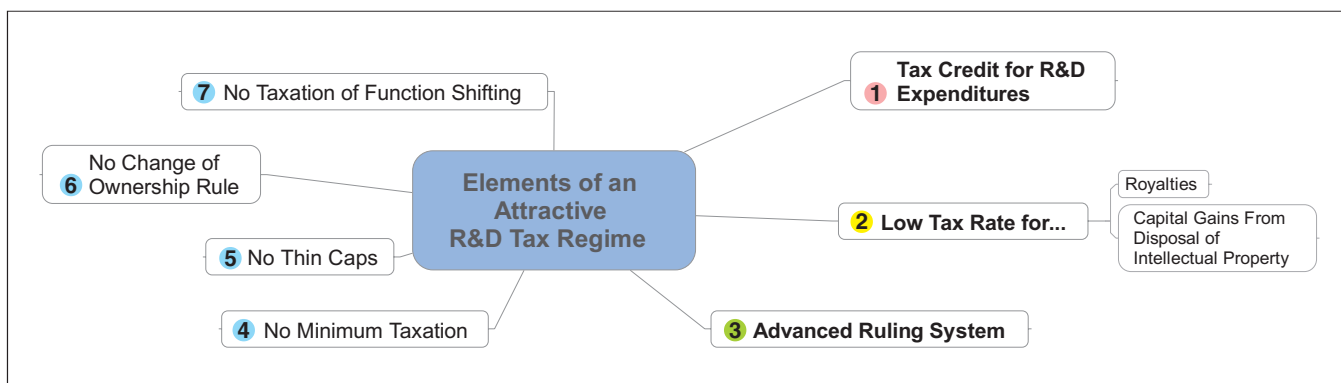
Effective from January 1, 2008, a partial exemption of 80 percent applies to net income and capital gains deriving from software copyrights, patents, trademarks, designs, and models acquired or constituted after December 31, 2007. The IP regime results in an effective tax rate of 5.93 percent of the net income and capital gains from the disposal of the qualifying IP.

Blueprint for Germany?

Germany is one of the few industrial countries that has not enacted a tax incentive for R&D activities. Because of the intense global tax competition, for Germany not to offer its own regime is not only dangerous but shortsighted.

Recently, we presented a blueprint for an R&D tax regime in Germany that includes a 30 percent tax credit for R&D expenditures and a preferential tax rate of 15 percent for royalties and capital gains from patents and other IP.¹ The blueprint also states that the incentives are null and void if not accompanied by legal certainty. This includes the administrative reliability that the tax incentive will actually be gained. An attractive regime must include a user-friendly advanced ruling system that automatically grants an incentive under the circumstances described in the application unless the application is rejected within three months after the application was filed. Finally, a state must refrain from applying restrictive thin capitalization, change of ownership, or function shifting rules as well as from implementing a minimum taxation that taxes even in case of losses because high losses are usually generated in the beginning stages of a new project. (See figure.)

¹ See *Der Betrieb* 2007, p. 1172.



EU Is the Engine

R&D incentives generate a wide range of reactions in the European Union — from condemnation as forbidden state aid, to cheers for promoting welfare and growth. In fact, selective incentives are likely to be targeted by the European Commission as forbidden state aid. However, if the incentives are general and accessible to all companies, the measure should be embraced by the EU.

In the Lisbon Strategy in March 2000, the European Commission aspires to create the most competitive and dynamic knowledge-based market in the world. One of the key milestones is to increase spending for R&D activities to 3 percent of the GDP in 2010. EU member states agreed to come up with one-third of those expenditures and the companies agreed to provide the remaining two-thirds.

The Lisbon Strategy is based on the idea that increasing the expenditures for R&D stimulates innovations, improves competitiveness, and adds value to companies. Across Europe, governments and corporations agree that the more money that is invested in R&D, the higher the productivity will be.

However, one drawback about R&D investments is that the benefits for the general public are higher than the benefits for the investing company. This can result in a partial or even complete market failure, which would require public investment. Hence, it makes sense that the Lisbon Strategy provides for governments and corporations to split the expense bill.

Today's Options, Tomorrow's Jobs?

To calculate the 3 percent GDP goal, all direct contributions and indirect promotions (tax incentives) must be taken into account. The example of Germany shows that there is a long road ahead to reach this goal. Historically, 2.5 percent of the GDP is spent on R&D. To reach the 3 percent level, the value of the direct and indirect measures must be increased from €55.8 billion in 2005 to €76.2 billion in 2010 — a task hard to accomplish in times of severe budget restraints. However, because of global competition, Germany must be willing to spend this money directly, or indirectly, through tax incentives to create jobs for tomorrow — or else corporations will shift investments to countries that have successfully implemented an R&D tax regime, putting today's jobs in jeopardy. ◆

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