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Towards a more effective use of tax incentives in favour of R&D

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INTRODUCTION

In the Lisbon strategy¹, Member States committed to making structural reforms to their economies. Within this context, the European Council called for R&D investment to approach 3% of GDP by 2010, of which 2% should come from the private sector. The Communication "*Investing in research: an action plan for Europe*"² highlighted that R&D plays a key role in achieving productivity gains and economic growth, but the social return of the investment is often higher than the private return to the investing firm. This market failure can be addressed through a combination of different public support measures to increase private R&D investment, such as grants, tax incentives and risk-sharing mechanisms, taking into account the specific contexts and objectives of different Member States.

Recently, tax incentives have grown to become one of the major instruments used by many Member States to increase business R&D. In parallel, industry is embracing the open innovation model and cooperation across borders is becoming commonplace, in particular in the high tech sector. However, the diversity of schemes introduced has resulted in an increasingly complex landscape for R&D tax treatment in Europe hindering trans-European collaboration.

In line with Europe's commitment to become a more attractive place for business R&D, the Commission announced in 2005, in its Communications on the contribution of taxation and customs policy to the Lisbon Strategy³ and on a common approach for research and innovation⁴, its intention to promote a more consistent and favourable tax environment for R&D, while recognising Member State competence for national tax policy. This approach to R&D tax incentives is confirmed as a priority in the Communication on putting knowledge into practice⁵.

To this end, this Communication provides guidance to help Member States improve their R&D tax treatment and to help develop mutually consistent solutions to common problems by:

- clarifying the legal conditions for Member State R&D tax incentives arising from EU law, notably relevant European Court of Justice (ECJ) jurisprudence on the EU Treaty freedoms and State aid rules;
- highlighting general design features for R&D tax treatment and incentives based on expert analysis of good practices;
- presenting for discussion a number of possible future initiatives aimed at addressing issues of common interest in a consistent way.

The accompanying Annex presents more detailed guidelines on the design, implementation and evaluation of R&D tax incentives.

¹ COM(2005) 24.
² COM(2003) 226
³ COM(2005) 532
⁴ COM(2005) 488
⁵ COM(2006) 502

1. EU LAW AND R&D TAX INCENTIVES

Most existing R&D tax incentives offered by Member States are open to all firms irrespective of size, sector of activity or location, and are therefore considered to be general measures from an EU law perspective. However, some R&D tax incentives target particular types of companies, sectors or activities. This section focuses on the legal parameters for all R&D tax incentives and provides guidance on the design features of such incentives to avoid incompatibility with EU law due to territorial restrictions. The factors leading to an incentive being deemed territorially restricted can be either explicit or implicit. In the latter case, the incentive generally includes design features that, de facto, result in favouring domestically performed R&D over that performed elsewhere in the EU.

All R&D tax incentives implemented by Member States must conform to the fundamental Treaty freedoms and the principle of non-discrimination. In particular, any R&D tax incentive imposing restrictions on where the R&D is performed (*territorial restrictions*) has to be scrutinised to verify compatibility with EC Treaty Articles 43 (freedom of establishment) and 49 (freedom to provide services). The Commission is currently examining the compatibility of Member State legislation in this respect and has identified a number of problematic cases that have been, or are being, discussed with Member States. The territorial restrictions of one Member State's R&D tax incentives are currently before the ECJ⁶ (*Commission vs Spain*). In others (e.g. France, the Netherlands, Belgium), Commission initiatives have already prompted Member States to amend their tax legislation or practice.

It is important to note that this section contains the Commission's view of the existing ECJ case law regarding R&D tax incentives. Moreover, it should be underlined that assessment of the compatibility of a specific R&D tax incentive with EU law depends on the circumstances of the case.

1.1. Compatibility with fundamental freedoms

When analysing an R&D tax incentive, the Commission considers both explicit and implicit territorial restrictions to be incompatible with EU Treaty freedoms. An example of an explicit restriction is a legal provision which restricts the benefit of an R&D tax incentive to activities performed domestically. Territorial restrictions infringe upon the freedom of establishment by excluding companies from conducting or outsourcing their R&D elsewhere in the EU.

Explicit territorial restriction was the central issue in the *Laboratoires Fournier* ECJ case (C39/04), in which the ECJ ruled against the legality of the French “*Credit d’Impôt Recherche*” in force at the time. Under the French “*Code Général des Impôts*”, industrial, commercial or agricultural undertakings received a tax credit only for expenditure on R&D activity in France. The ECJ ruled that legislation restricting the benefit of a tax credit to R&D carried out in national territory infringes the principle of freedom to provide services. According to the ruling, by introducing discrimination regarding the place of establishment of the service provider, this legislation was liable to restrict cross-border activities and was directly contrary to the objective of Community R&D policy, which is to fully exploit the potential of the internal market through the removal of legal and fiscal obstacles to

⁶ C248/06

cooperation between undertakings. The French tax incentive was rapidly modified to comply with the ruling.

The following are examples of implicit territorial restrictions: (1) a tax incentive covering R&D costs incurred anywhere in the EU, but subject to administrative approval favouring domestic R&D performers over non-residents wishing to provide R&D services, e.g. when such approval is needed only for R&D costs incurred abroad, or when the administrative burden is heavier for non-resident companies; (2) a tax incentive covering the costs of subcontracted R&D, but limiting the proportion of R&D that can be subcontracted to non-resident entities. However, a tax incentive limiting the proportion of R&D that can be subcontracted without making any distinction between resident and non-resident subcontractors would be acceptable.

In principle, the ECJ has recognised that restrictions on the scope of tax incentives could, under certain specific circumstances, be justified, either by an exemption expressly provided for by the Treaty⁷ or on other grounds recognised by the ECJ as *overriding requirements in the general interest*. However, the ECJ accepts such a restriction only where it is certain that the aims sought cannot be achieved using a less restrictive measure (principle of proportionality). In the past, Member States have sought to defend territorial restrictions before the ECJ on the basis of several arguments:

a) Fiscal supervision

Member States have argued that the need for effective fiscal supervision is an overriding requirement in the general interest, justifying a territorial restriction. The ECJ has held that, in principle, a Member State has the right to apply measures to ascertain clearly and precisely the amount of costs deductible as research expenditure (Baxter⁸, Fournier). It may also require a non-resident taxpayer to demonstrate clearly and precisely that the losses he claims to have incurred correspond, under domestic rules governing the calculation of income and losses, to the losses actually incurred (Futura and Singer⁹). However, the ECJ has so far concluded (Baxter, Futura and Singer and Fournier) that the restrictions in these specific cases are not proportionate to the aims sought. For example, in Baxter and Fournier, the ECJ concluded that national legislation that does not accept evidence submitted by a taxpayer as valid for R&D carried out in other Member States cannot be justified by the need for effective fiscal supervision. In these cases, reference is made to the Mutual Assistance Directive¹⁰ and the fact that Member States should be able to obtain the relevant and necessary information under that Directive or through bilateral tax treaties¹¹.

b) Loss of tax revenue

⁷ EC Treaty Art 46 & 55

⁸ C254/97

⁹ C250/95

¹⁰ Council Directive 77/799/EEC as amended by 2004/56/EC

¹¹ Vestergaard C 55/98, Futura & Singer C 250/95, Danner C 136/00

Member States have argued in several cases that preventing the loss of tax revenue could justify the imposition of a restriction. However, the ECJ has so far been very clear that budgetary arguments are not acceptable as such¹².

c) Prevention of tax avoidance

The ECJ has, in principle, recognised that the prevention of tax avoidance could justify restriction of the fundamental freedoms. However, existing case law suggests that the ECJ would not accept a general territorial restriction, but would rather favour legislation aimed at preventing, on a case-by-case basis, wholly artificial arrangements¹³. Furthermore, to prevent tax evasion, the ECJ has also referred to the possibility for a Member State to use the Mutual Assistance Directive.

d) Promoting national R&D and competitiveness

In the Fournier case, the ECJ stated that promoting R&D may be considered an overriding requirement relating to public interest which may justify a restriction on the exercise of fundamental freedoms. It noted, however, that the refusal by a Member State to grant R&D tax relief on the basis that the R&D was carried out in another Member State is contrary to the objectives of Community R&D policy, which, according to Article 163(1) of the EC Treaty, includes *strengthening the scientific and technological bases of Community industry and encouraging it to become more competitive at international level*.

Summarising existing case law, there is ample and consistent evidence that territorial restrictions on the application of R&D tax incentives are unlikely to be accepted by the ECJ. Thus, when designing R&D tax incentives, Member States should take into account that any explicit, and in some cases implicit, form of territorial restriction would not be considered to be in accordance with the EC Treaty. This does not however preclude territorial restrictions which simply reflect the territoriality of the tax competence of Member States. For example, a wage tax or social security incentive for R&D personnel might by its nature be limited *de facto* to persons performing R&D activities in the Member State in which they are taxed or pay social security contributions.

1.2. Compatibility with State aid rules

R&D tax incentives in Member States are not only subject to the legal constraints imposed by the Treaty freedoms, but also need to be in line with Community State aid rules. According to Article 87(1) of the EC Treaty, “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market”. In principle, State aid rules apply regardless of the form of the aid. Thus, R&D tax incentives could constitute State aid if the relevant criteria under Article 87(1) and the jurisprudence of the ECJ regarding the conditions under which R&D fiscal measures qualify as State aid are fulfilled, and the aid does not fall under the *de minimis* regulation¹⁴. A comprehensive assessment of these conditions is

¹² Danner & X & Y, ICI C 264/96, De Groot C 385/00, Bosal C 169/01, Saint-Gobain C 307/97 and Skandia C 422/01

¹³ X & Y C 436/00, Danner C 136/00

¹⁴ Commission Regulation 69/2001 or any successor thereof.

provided in the 1998 Commission notice on the application of the State aid rules to measures relating to direct business taxation¹⁵, which also provides specific guidance. One of the main criteria is the selectivity of the R&D tax incentive. An R&D tax incentive is considered selective if its potential beneficiaries are restricted notably in terms of size (e.g. to SMEs), location or sector and as such is likely to constitute State Aid.

Indeed, the Stockholm and Barcelona European Council conclusions called for continued efforts to reduce the general level of State aid and the need to redirect aid towards horizontal objectives of common interest, including economic and social cohesion, and target it towards identified market failures.

Furthermore, direct tax measures that pursue general economic policy objectives by reducing the tax burden related to certain production costs (including R&D costs) normally do not constitute State aid if they apply without distinction to all firms and to the production of all goods and services. Moreover, the fact that some undertakings have higher levels of R&D spending than others and thus benefit from R&D fiscal measures, notably those active in R&D-intensive sectors, does not necessarily mean that the measures are selective.

In certain cases, R&D tax incentives that constitute State aid may be compatible with the Treaty on the basis of Article 87(3). The Commission has also adopted a new revised Community Framework for State aid for research, development and innovation (*the Framework*)¹⁶, under which the Commission will assess State aid measures for R&D&I notified to it, including measures in the form of R&D tax incentives.

When designing R&D tax incentives, Member States should take into account the above-mentioned notice and Framework. The first step is to determine whether an R&D tax incentive can be considered a general measure. In most cases, R&D tax incentives that are open to all firms irrespective of size, sector or location are considered to be general measures that do not fall under the Framework.

When assessing an R&D tax incentive that constitutes State aid in accordance with Article 87 (1) of the EC Treaty, the Commission will look particularly at the following elements :

- The R&D tax incentive applies to one or more R&D categories defined in the Framework (i.e. fundamental research, industrial research and experimental development);
- The R&D tax incentive relates solely to certain eligible R&D costs listed in the Framework; and
- The aid intensity of the R&D tax incentive can be established and does not exceed the maximum threshold established in the Framework.

The R&D&I-framework furthermore states that when doing so, the Commission will assume that on the basis of evaluation studies presented by Member States, R&D tax incentives have an incentive effect by stimulating higher R&D spending by enterprises.

Account must also be taken of the relevant cumulation rules which determine whether a company may receive aid under different measures.

¹⁵ OJ C 384, 10.12.1998, p 3

¹⁶ RDI Framework

It must also be assessed whether fiscal measures fall under block exemption regulations.

2. GOOD DESIGN FEATURES FOR R&D TAX TREATMENT AND INCENTIVES

In recent years, a growing number of Member States have adapted or introduced R&D tax incentives to foster investment in R&D¹⁷. Currently, 15 Member States use them as part of their mix of public support instruments. Under the Open Method of Coordination, CREST¹⁸ expert reports¹⁹ provide an overview and analysis of the various R&D tax incentives in Member States and other relevant countries. The reports highlight the variety of types and design characteristics of tax incentives, reflecting the diversity of situations in the countries concerned (general tax policy, industrial structure, private sector R&D performance). There is no single answer as to how R&D tax incentives should be designed, implemented or evaluated.

Nevertheless, based on expert analysis of the various schemes and existing evaluations, a number of guiding principles can be defined for the main design options, features and relevant contingency factors and may be found in the Annex²⁰. For example, these guiding principles include the need for tax incentives to:

- reach more firms, maximising the potential increase in BERD and minimising market distortions, general measures are best used;
- include all current expenses and consider certain types of R&D-related capital expenditure;
- focus on ascertaining the direct additionality of tax incentives and their behavioural additionality;
- consider evaluation criteria and data from the design stage;
- test whether tax incentives have met their specific objectives, whether their delivery/administration mechanism was efficient and their wider societal effects.

The Annex provides detailed guidance on generic design and implementation principles such as those described above, but also on the different types of regimes and relief, and eligible R&D costs. It presents options for improving the tax treatment of R&D in different policy contexts, addressing in particular the influence of the wider policy mix, the relative merits of a generally R&D-friendly tax environment versus the use of general corporate tax incentives or selective support for young innovative SMEs. Member States are invited to take these guidelines into account when introducing new or adapting existing R&D tax incentives.

Systematic and consistent evaluation of their impact, both at individual firm level and on the economy at large, is crucial for a more effective use of R&D tax incentives. However, the relatively few evaluation studies that currently exist often use different methodologies, making their results difficult to compare. Member States are invited to adopt a systematic and consistent approach for their evaluation along the lines defined in the Annex.

¹⁷ IBFD 2004 report on the tax treatment of R&D expenses

¹⁸ The scientific advisory committee to the European Council and the Commission

¹⁹ CREST Reports

²⁰ SEC (2006) XXX

The approach proposed includes an ex-ante analysis of the expected impact of R&D tax incentives and the preparation of ex-post evaluation at the design stage. The Commission will promote the sharing of experience and good practices by setting up a network of national experts.

3. ORIENTATIONS FOR MEASURES OF COMMON INTEREST AND MUTUAL BENEFIT

To enhance the effective use of R&D tax incentives and improve R&D tax treatment in the EU, there are a number of other specific tax issues that need to be addressed in a consistent way, on top of the basic design principles outlined above (i.e. compliance with EU law and learning from Member State good practices). Some of these issues are research-related aspects of the general taxation system while others concern R&D issues of common interest.

The common aim of the initiatives proposed in this section is to ensure that tax policy contributes more to achieving the knowledge economy by establishing a consistent framework conducive to more investment in R&D and improving the functioning of the Internal Market.

Member States are invited to discuss the initiatives proposed in this section at EU level and consider them when reviewing their tax policy.

3.1. Supporting large-scale trans-national R&D projects

Increasing globalisation of knowledge and internationalisation of research and innovation is an important current trend. This development is supported by advances in ICT as well as realisation of the significant value added to the knowledge production and dissemination that globalisation and international partnerships have to offer. The experience of Eureka and other multinational research initiatives has shown that large-scale transnational projects face major difficulties in ensuring timely and synchronised multi-annual public funding from several Member States, often linked to the distinct approval procedures used. Consequently, whilst transnational projects should ideally be encouraged due their high productivity, beneficial learning and knowledge transfer impacts, they may in fact be discouraged. To resolve these issues, it may be appropriate to also use specific R&D tax incentives for their timeliness and predictability over the duration of a research project instead of solely funding such projects through grants.

Therefore, Member States are invited – together with the European Commission – to address the obstacles for transnational research projects by, for instance, improving the use of and co-ordination of tax incentives for industrial participants in large-scale transnational R&D projects or by applying common R&D definitions.

As such public support is selective by design, it constitutes State aid and must comply with the provisions of the revised Framework and be compatible with the EC Treaty under Art. 87 (3) regarding important projects of common European interest.

3.2. Young Innovative Enterprises

Tax incentives targeting Young Innovative Enterprises²¹ as introduced by some Member States can have a positive effect on R&D activities and said companies' growth. They can take the form of a corporate tax exemption or a time-limited exemption on social security payments associated with the employment of highly qualified personnel (e.g. researchers and experts), thereby lowering the costs for young R&D-based businesses. Member States are invited to consider offering specific tax incentives for this strategically important category of enterprises.

3.3. Promoting philanthropic funding of research

A further way of promoting European R&D investment could be to improve the tax treatment of philanthropic entities funding research, e.g. foundations and charities (*research foundations*). Research foundations are private entities with the aim of enhancing scientific knowledge by funding R&D activities in public-benefit organisations, typically universities and public research centres. However, although some large research foundations²² exist, this source of funding is under-exploited in Europe when compared to the US, and certain formal and informal obstacles appear to inhibit both donations by individuals and corporations on the one hand and the flow of funds to research on the other.

There is therefore a need to improve the tax conditions for cross-border donations and foundation activities to create a level playing field in the EU. Agreeing upon a common definition of public-benefit purposes, or a move towards the mutual recognition of public-benefit organisations entitled to tax relief, would be an important step to facilitate cross-border funding. Such an approach can be found in the European Foundation Centre's proposal for a European Foundation Statute, which also advocates a non-discriminatory approach to the tax treatment of such foundations and their donors and beneficiaries.

Member States are invited to support a common approach regarding i) the tax treatment of the foundations themselves, irrespective of where they are established in the EU, and ii) the definition of public-benefit organisations.

The Commission will support the establishment of a "*European Forum on Philanthropy and Research Funding*", a permanent mechanism for sharing experience, reviewing best practices and promoting cooperation.

3.4. Cross-border mobility of researchers

To facilitate the mobility of researchers within the EU, for both long stays in another Member State and for shorter professional missions, Member States are invited to make administrative tax compliance easier for researchers and hiring institutions and to provide tax-free allowances to cover the actual cost of mobility (e.g. travel expenses).

Furthermore, both the Member States and the hiring institutions should make an additional effort to improve transparency regarding specific tax incentives that might be available to researchers as well (e.g. expatriate tax benefits). Member States are also invited to identify under which circumstances researchers could be allowed to maintain their fiscal residence in

²¹ See RDI state aid framework definition

²² The Wellcome Trust, Volkswagen Stiftung, Fondazione Cariplo, Champalimaud Foundation

their country of origin for a limited period of time. In any event, Member States should avoid situations of double taxation, e.g. by improving transparency on provisions in bilateral tax treaties and domestic legislation which are relevant for cross-border researchers.

3.5. Facilitating cross-border outsourcing of R&D

Some Member States (e.g. France, Spain) allow firms to request a certificate recognising their capacity to perform R&D. Such certificates facilitate the application of R&D tax incentives and are valid for several years. They are used by tax authorities to streamline the processing of tax relief claims. To avoid territorial discrimination in cases of cross-border outsourcing of R&D, Member States implementing such processes are invited to extend them to R&D-performing firms established in other Member States.

Interested Member States are invited to agree on the content of such certificates to facilitate their mutual recognition and decrease administrative burdens for firms across the EU. The Commission will present a possible structure for such certificates to stimulate discussion.

In some Member States, public entities performing R&D are automatically granted such certificates. To avoid territorial discrimination in cases of cross-border R&D outsourcing, equivalent public entities established in other Member States should be treated in the same way as national ones. The Commission has drawn up a list of R&D performing public entities established in the EU, based on their participation in the research framework programme. This list will be available online and can help interested Member States implement their R&D tax incentives in a non-discriminatory way. The Commission intends to update this list regularly and invites all Member States to review it and, where appropriate, provide information on other entities to be included.

3.6. R&D and VAT

VAT on R&D costs incurred by taxable persons is deductible where the goods and services in question are used for VAT-taxable transactions. The current rules of the 6th VAT Directive concerning exemptions, public authorities and subsidies may affect this deductibility and hence place an unnecessary burden on certain research activities. The Commission has committed itself to reviewing these three issues²³, which need to be modernised. When reviewing the legislation, the Commission will critically examine the restrictions on the recovery of VAT on R&D expenditure. It will also consider to what extent the current rules on public authorities and subsidies hamper the creation of public-private partnerships and cost-sharing arrangements, including in the research field where such structures are increasingly being used to conduct R&D efforts requiring the pooling of resources from public and private entities or the outsourcing of research by private entities to public ones (contract research). The application of current VAT rules to public entities is complex and leads to inconsistent results across the Community. Furthermore, the difference in VAT treatment between public and private entities causes distortions of competition, produces economic inefficiencies and encourages tax avoidance schemes. The Commission will examine ways of simplifying these rules and facilitating their more uniform application throughout the Community in order to secure a level playing field in those sectors of activity where both public and private entities intervene, e.g. the provision of contract research.

²³ COM(2000)348

The closely related problems of exemptions, public authorities and subsidies will be treated as a package and the social and economic impacts of any possible legislative proposal will be assessed before a proposal is presented in 2008.

3.7. R&D treatment in the common consolidated corporate tax base

In the longer term, it is desirable to seek an EU-wide tax definition of R&D and innovation and to give such expenditure favourable tax treatment in the common consolidated corporate tax base (CCCTB). The Commission will include this in the relevant working group discussions with Member States, with a view to defining a coherent and well-balanced solution in line with other possible incentives within the CCCTB.

4. CONCLUSION

The Commission acknowledges the recent trend in many Member States to provide more favourable tax treatment for R&D and welcomes these efforts to raise R&D business expenditure. The growing diversity of R&D tax incentives risks further fragmenting the European corporate fiscal landscape and could lead to their less than optimal cross-border use. Therefore, a certain degree of coordination is needed to foster the effective use of R&D tax incentives across the EU and improve trans-national research cooperation given the increasing globalisation of R&D activities. This Communication and the accompanying Annex set out the legal conditions and design options to help Member States improve their R&D tax treatment.