

Review of Global
R&D Tax Incentives ©

July 2010



Table of Contents

1. INTRODUCTION..... 1

2. COMPARISON OF TAX IMPACT OF R&D INCENTIVES IN SELECTED COUNTRIES..... 2

3. OTHER FACTORS FOR CONSIDERATION 3

4. IMPORTANCE OF ARM’S LENGTH TRANSFER PRICING..... 4

5. CONCLUSIONS..... 6

APPENDICES 7

APPENDIX 1 – REVIEW OF GLOBAL R&D TAX INCENTIVES 8

APPENDIX 2 – DETAILS OF R&D EXPENDITURE 9

APPENDIX 3 – CORPORATION TAX DEDUCTIONS 10

APPENDIX 4 – CALCULATION OF R&D TAX CREDIT OR ADDITIONAL DEDUCTION..... 11

1. Introduction

- 1.1 In February, the Global Tax and Fiscal Group of Mazars (and our alliance Partners Praxity) met in London to discuss global incentives and tax considerations involved with determining an optimal location for a research and development (R & D) department
- 1.2 The focus of this review is to provide finance executives with a process to analyze the after-tax cost of an R & D investment
- 1.3 The various tax and non-tax incentives, as well as of the regulatory requirements to obtain such benefits, were examined in 20 countries around the globe. While the benefits and qualification requirements varied widely, there was a remarkable similarity in the definition of R & D. The countries reviewed were:

Australia	China	Israel	Malaysia	Sweden
Belgium	France	Italy	Malta	Tunisia
Cameroon	Germany	Ivory Coast	Netherlands	UK
Canada	Ireland	Japan	Russia	US

- 1.4 This review summarises the benefits available in the above countries and this can be found at Appendix 1. The table is not intended to be all inclusive, but it does present an overview of the various types of benefits available in the above countries.

2. Comparison of tax impact of R&D incentives in selected countries

- 2.1 While it was recognised that determining the cost of an R & D department net of incentives and benefits can be an overwhelming task for tax and finance directors, tax professionals can help to play a key role in the R & D location decision making process. Accordingly, it was decided to prepare an analysis based on a representative number of countries to help put matters into perspective
- 2.2 The countries selected were illustrative of those with attractive R&D tax regimes, specifically Australia, Canada, France, Ireland, Israel, the Netherlands, UK and the USA
- 2.3 A tax computation was completed for each country to determine the after tax cost of a given level of R&D expenditure so as to arrive at an effective tax rate. This is shown at Appendix 3. It is based on a given set of trading results that included elements of R&D expenditure as detailed in Appendix 2
- 2.4 The tax computation for each country gives effect to the particular methods of incentivising R&D expenditure (mostly by way of tax credit) in arriving at the tax charge. Relating this tax liability to taxable profits threw up an effective tax rate for each country. The report only focuses on corporation tax. The results can be summarized as follows:

Country	Taxable Profits €'000	Net Tax €'000	Effective tax rate
Australia	4,550	433	10%
Canada	4,755	544	11%
France	4,550	914	20%
Ireland	4,550	57	1%
Israel	5,572	(381)	-
Netherlands	4,827	1,135	24%
UK	3,156	883	19%
USA	4,550	1,475	32%

3. Other factors for consideration

It is acknowledged there are many non-tax factors to consider when determining an optimal location for a multinational group's R & D activities, and these non-tax considerations are likely to be significantly more important than tax considerations.

Critical non-tax factors to consider include the following:

1. Availability of qualified research institutions
2. Education level of available workforce
3. Cost and availability of resources, facilities, equipment and materials
4. Proximity of the R & D location to the multinational group's existing operations
5. Country's intellectual property (IP) laws regarding ownership and protection of IP
6. Country's political stability
7. Tax rate applicable to the income from the exploitation of the R&D.

In addition to the various incentives available for R & D activities, multinationals need to consider other tax items, such as duties, tariffs, value-added tax, withholding tax and the application of tax treaties. Businesses also need to consider the tax costs associated with relocating an R & D department cross border, as many countries will require a toll-charge in connection with transferring an R & D department and related IP overseas.

4. Importance of arm's length transfer pricing

- 4.1 A multinational group must devote particular attention to arm's length transfer pricing on transactions among group members including R & D activities. Transactions among related companies, must, generally, be charged at arm's length prices, and most developed countries have regulations with pricing methodologies for use in verifying arm's length pricing. In addition, businesses must maintain substantial documentation when analysing the group's transfer pricing transactions
- 4.2 S Some countries permit cost-sharing arrangements (CSA's). A CSA is based on the idea that a group of companies may gather together and share expenditures involved in researching and developing new ideas. Generally, by sharing the costs, each participant in the arrangement obtains the rights to use the R & D. There are significant legal and tax issues to navigate through in connection with the implementation of a CSA, and the rules vary widely throughout the globe
- 4.3 A recent example of the importance for the need to carefully structure and document R & D arrangements can be found in the Delhi Income Tax Appellate Tribunal ruling, on 24 December 2009, in *Pioneer Overseas Corp. v DDIT*. Pioneer, a U.S. company that develops and sells hybrid seeds around the globe, had a branch-office in India which

operated two separate business units. One unit conducted R & D activities, and the other conducted commercial seed production and distribution activities to related parties. The income statement of the Branch included the sales and costs of the seed production and distribution unit. The costs of the research unit were fully reimbursed, at cost, by the U.S. head-office. The results of R & D were considered to be owned by the U.S. head office, with no profit being associated with the R & D activities that were allocated to the Branch, *i.e.*, the R & D unit had no profit or loss

- 4.4 During an audit of the Branch's tax return, the Indian tax officer took the position that the R & D and production and distribution activities were linked. The R & D activities created a permanent establishment (PE) under Article 5 of the U.S. and India income tax treaty, and the profits of the Branch were taxable in India. The benefits of the R & D activities from commercial exploitation of the IP were also available to Pioneer's branches
- 4.5 Pioneer unsuccessfully argued that the Branch activities were preparatory and auxiliary in nature and, that therefore, the company was eligible for the PE exclusion under treaty Article 5(3). The tribunal ruled in favour of the Department of Revenue regarding the PE issue, but determined the tax officer's methodology in calculating the profits of the R & D unit to be incorrect and asked the officer to give Pioneer the opportunity to examine whether a cost, plus basis, can be adopted to determine the profits of the R & D unit
- 4.6 The Indian ruling demonstrates the importance of structuring R & D arrangements in a manner to ensure the benefits of exploiting IP are contained in a desired group entity and the importance of adopting arm's length transfer pricing methodologies regarding related party transactions.

5. Conclusions

- 5.1 In summary, multinational companies need to consider tax and non-tax factors when determining where to locate R & D activities. There are widespread R & D incentives and benefits around the globe, and multinational companies need to evaluate the cost of R & D activities, taking into account such benefits and incentives
- 5.2 In order to make a meaningful comparison, it is essential to work off a given set of revenues and costs. The precise level of R&D support available from tax incentives can only be determined by making detailed cross country comparisons that take into account not only costs but also the tax treatment of R&D related income.

APPENDICES

Appendix 1 – Review of Global R&D tax incentives

Global R & D						
Country	Current Deductions	Enhanced Deductions	Tax Credit	R & D Grants	Other Benefits	Cost Sharing Allowed
Australia	X	X	X	X	X	X
Belgium	X		X	X	X	X
Cameroon	X		X			
Canada	X		X	X	X	X
China	X	X			X	
France	X		X	X	X	X
Germany	X			X	X	X
Ireland	X		X	X	X	X
Israel	X			X	X	X
Italy	X		X	X	X	X
Ivory Coast	X		X		X	Unknown
Japan	X		X	X	X	X
Malaysia	X	X		X	X	X
Malta	X	X	X	X	X	X
Netherlands	X	X	X	X	X	X
Russia	X	X	X	X	X	
Sweden	X					X
Tunisia	X		X	X	X	
UK	X	X	X	X	X	X
US	X		X	X	X	X

Appendix 2 – Details of R&D Expenditure

X Limited							
Income statement for the year ended 31 December 2010							
Sales						25,000,000	
Cost of sales							
R&D directors and staff							
salaries				1,000,000			
social welfare				100,000			
pension				50,000			
						1,150,000	
Other directors and staff						5,000,000	
R&D related %, say 6%							
Selling, distribution and admin costs, incl. depreciation						14,000,000	
R&D related % say 3%							
Outsourced R&D to university						300,000	
R&D related plant and machinery, 160,000							
						20,450,000	
Net income before tax						4,550,000	

Appendix 3 – Corporation tax deductions

Corporation Tax Computation								
	Australia	Canada	France	Ireland	Israel	Netherlands	UK	USA
Net income	4,550,000	4,550,000	4,550,000	4,550,000	4,550,000	4,550,000	4,550,000	4,550,000
Depreciation	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000
Capital allowances	-20,000	-20,000	-20,000	-20,000	-20,000	-20,000	-20,000	-20,000
R&D expenditures		2,020,000						
R&D pool deductions		-1,815,300						
R&D grants					1,022,500			
Reduction R&D wage tax						277,400		
Federal tax credit								
Additional deduction							-1,393,750	
Excluded income (<i>Note 3</i>)						-329,528		
Net income before tax	4,550,000	4,754,700	4,550,000	4,550,000	5,572,500	4,497,872	3,156,250	4,550,000
Corporation tax	30%	29.90%	33.33%	12.50%	11.50%	<i>Note 6</i>	28%	35%
Corporation tax	1,365,000	1,421,655	1,516,515	568,750	640,838	1,135,957	883,750	1,592,500
Tax credit	932,000 (<i>Note 1</i>)	877,560	603,000	511,250	0			117,325
Tax Grant					1,022,500			
Net corporation tax	433,000	544,095	913,515	57,500	(381,663)	1,135,957	883,750	1,475,175
Effective corporate tax rate	10%	11%	20%	1%	-6%	24%	19%	32%
		<i>Note 2</i>			<i>Note 5</i>		<i>Note 4</i>	

Appendix 4 - Calculation of R&D tax credit or additional deduction

	R&D Credit/additional deduction							
	Australia	Canada	France	Ireland	Israel	Netherlands	UK	USA
R&D directors & staff								
Salaries	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000		750,000	1,000,000
Social welfare	100,000		100,000	100,000	100,000		75,000	100,000
Pension	50,000		50,000	50,000	50,000		37,500	50,000
Other directors & staff								
R&D related, 6%	300,000	300,000	0	300,000	300,000		225,000	300,000
Proxy overhead on labour costs		845,000						
Selling, distribution and admin								
R&D related, 3%	420,000	420,000	420,000	420,000	420,000		0	0
Outsourced R&D to university	300,000	300,000	300,000	15,000	15,000		146,250	195,000
R&D plant and machinery	160,000	160,000	140,000	160,000	160,000		160,000	160,000
Total R&D costs for tax credit	2,330,000	3,025,000	2,010,000	2,045,000	2,045,000	0	0	1,805,000
Other Deductions:								
Additional deduction							1,393,785	
Reduction R&D wage tax						277,400		
<i>Average annual gross receipts</i>								25,000,000
<i>Fixed base percentage</i>								3%
<i>AAGR* fixed base percentage</i>								750,000
<i>Qualified expenses - base receipts</i>								1,055,000
<i>Half of expenses</i>								902,500
<i>Lessor of above</i>								902,500
Tax credit	40%	29.01%	30.00%	25%				13%
R&D Grant					50%			
Federal tax credit		16.95%						
Quebec tax credit		12.06%						
Tax credit	932,000	877,560	603,000	511,250	0	0	0	117,325
Tax R&D Grant					1,022,500			

Notes

1. Australia – based on new R&D laws which will apply from 1 July 2010
2. Canada – The tax credit of €877,560 is made up of a Federal tax credit of €512,860 and Quebec tax credit of €364,700). The Federal tax credit of €512,860 is taxable in the following year and has the following impact on the total effective tax rate:

Federal tax credit	<u>512,860</u>
Corporation tax at 29.9%	153,345
Corporation tax charge in previous year	<u>544,095</u>
Total net taxes over two years	<u>697,440</u>
Total effective tax rate	14.67
3. Netherlands – an amount of €329,528 represents the excluded income relating to R&D sales. This incentive brings only 20% of R&D income into charge
4. United Kingdom – the effective tax rate is 19% which is calculated by taking the tax liability of €883,750 and dividing it by net income of €4,550,000 in order to factor in the additional deduction received for the R&D
5. The effective tax rate in the example for Israel will change according to the rate of the grants received in the particular R&D program and the corporate tax rate of the companies at priority zones in the same year
6. The actual tax rate for 2010 is 20% for the first €200,000 of taxable income and 25.5% for the excess amount.

The information published here is intended as a brief summary of selected, recent legal developments. It is not intended to provide consulting advice and should not be relied on for that purpose. For this reason, do not rely on this information as tax advice or formal opinion or regard it as a substitute for detailed advice about your particular situation. Contact your Mazars advisor for more detailed information.

Mazars Contact	
Name	Noel Cunningham
Position	Tax Partner
Address	Harcourt Centre Block 3 Harcourt Road Dublin 2
Telephone no.	01 449 4400
Email address	ncunningham@mazars.ie
Web address	www.mazars.ie



Dublin

Mazars
Harcourt Centre
Block 3
Harcourt Road
Dublin 2

email: mazars@mazars.ie
tel: +353 (0)1 4494400

Galway

Mazars
Mazars Place
Salthill
Galway

email: mt@mazars.ie
tel: +353 (0)91 570100

Belfast

Mazars
12b Clarendon Road,
Belfast BT1 3BG

email: mazarsnorth@mazars.ie
tel: +44 (0)28 90247188

mazars.ie

