Opinion of the European Economic and Social Committee on the ‘Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee — Towards a more effective use of tax incentives in favour of R&D’

COM(2006) 728 final

(2008/C 10/21)

On 22 November 2006 the European Commission decided to consult the European Economic and Social Committee, under Article 262 of the Treaty establishing the European Community, on the abovementioned communication.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee’s work on the subject, adopted its opinion on 21 June 2007. The rapporteur was Mr Morgan.

At its 438th plenary session, held on 26 and 27 September 2007 (meeting of 27 September), the European Economic and Social Committee adopted the following opinion by 134 votes to 2 with 5 abstentions.

1. Conclusions and recommendations

1.1 This Communication forms part of the Commission’s programme in support of the Lisbon objective that the value of EU R&D expenditure should be equal to 3 % of GDP by 2010, of which 2 % should come from the private sector. The focus of this Communication is on the methods used by Member States to incentivise company R&D through the tax system. The purpose of the Communication is to clarify the legality of R&D tax incentives in the context of EU law and to give advice to Member States regarding best practice. This Communication is a welcome response to the EESC request that ‘the Community should work to encourage Member States to frame their tax and liability laws so that they do more to provide incentives for industry to invest in Research and Development’.

1.2 Some examples of best practice are described in Section 3 of the Opinion. It is, however, necessary to recognise that there are limitations to the incentives which can be provided through the tax system. The higher the rates of corporate taxation, the higher the incentive while lower rates provide less incentive. The higher the social charges, the more the incentive to give relief from them. If companies are not profitable there is less scope, since the general concept is to provide relief from taxes on profits. Finally, it goes without saying that relief must be based on actual R&D investment made and not in respect of future plans.

1.3 The recommendations for the establishment of an incentive system include the requirement that the effectiveness of each scheme should be measured. This is clearly important in the case of large profitable companies which could very well carry any tax rebates into the bottom line instead of the R&D budget. To avoid this moral hazard some countries only allow incentives on incremental R&D expenditure but this may be self defeating because an important effect of these incentives is to retain R&D activity in the EU and prevent it going off shore. Accordingly an effective measurement system for large companies is likely to be more beneficial than restricting relief to incremental expenditure.

1.4 By far the most important impact of these programmes is the way in which they can support the development of R&D focussed SMEs during the early years of their existence. The recommendations include a powerful range of incentives which provide extra tax relief as a multiple of R&D investment, refunds in the absence of profits and relief from social charges. Given the strategic role of SMEs in the EU economy, the EESC recommends that each Member State uses an optimum mix of possible tax incentives to facilitate the survival and growth of SMEs in its economy.

1.5 In this context, the Committee is surprised that the Communication makes no reference to tax relief designed to help the formation of capital for new companies. This point is further developed in paragraphs 4.9 to 4.12. The EESC recommends that the Communication be expanded to include capital formation.

1.6 A further issue of great importance to SMEs is the treatment of patents and licences. The law is not clear and there is an element of competition between Member States in respect of the tax treatment. The EESC recommends that the Communication be extended to cover patents and licensing.

1.7 The Communication raises questions about a number of related issues on which action could be taken. The EESC recommendations are as follows:

1.7.1 Member States should improve the use of R&D tax incentives for industrial participants in transnational research projects.

(1) See the Opinion of the EESC on Unlocking and strengthening Europe's potential for research, development and innovation, OJ C 325 of 30.12.2006, p. 5, paragraph 3.5.
1.7.2 Member States should explore ways in which state imposed costs can be lowered for young R&D businesses following the example of the very successful French Young Innovative Enterprise (YIE) regime.

1.7.3 In respect of public benefit private sector research organisations, Member States should develop a common approach so that both donations and research funds can flow freely within the EU.

1.7.4 The cross border mobility of researchers should be encouraged by Member State agreements to prevent double taxation on short term assignments.

1.7.5 The Commission is encouraged to develop a common structure for the mutual recognition of R&D certificates for those countries which use them. At the same time the Commission might consider whether such certificates are needed in the single market.

1.7.6 The Committee welcomes the Commission’s proposal to simplify and modernise the rules for the recovery of VAT by private entities on R&D expenditure incurred in public/private projects.

1.7.7 It is essential to the debate on tax incentives and R&D to seek an EU wide tax definition of R&D and innovation. This will be a further step towards the creation of the Single Market.

1.8 The Lisbon objective of 3 % was set by reference to the R&D investment made by competitor regions. It is a feature of the EU economy at the macro-sector level that it is not as involved in highly R&D intensive industry sectors as competitor countries such as Japan and the USA. Therefore, in addition to stimulating private sector R&D, it would make sense to increase public sector investment in universities and State funded research institutes. Environmental projects should provide an appropriate stimulus.

2. Introduction

2.1 The context of this Communication is the Lisbon strategy which calls for R&D investment in the EU to approach 3 % of GDP by 2010, of which 2 % should come from the private sector. In 2005 the Commission announced its intention to promote a more consistent and favourable tax environment for R&D, while recognising Member State competence for tax policy. (COM(2005) 488 and COM(2005) 532).

2.2 Within this Lisbon framework there have been a series of Commission initiatives aimed at increasing EU R&D spend to the target of 3 % of GDP while at the same time developing the European Research Area. There has been a drive to unlock Europe’s potential for research development and innovation culminating in the 7th Framework Programme. In its Opinions the EESC has consistently urged the Commission and the Member States to remove the barriers which hold back both the quantity and quality of R&D in Europe while at the same time taking organisational, institutional and financial initiatives to promote a sufficient critical mass of R&D activity in Europe.

2.3 The Communication provides guidance to help Member States improve their R&D tax treatment and to help develop mutually consistent solutions to common problems. Therefore it is not a EU programme targeted at specific R&D projects or objectives. It is a programme for Member States to promote R&D in the private sector and it will work to the extent that the private sector, company by company, is incentivised to undertake R&D. The Communication aims to help Member States in three ways:

— clarifying the legal conditions for Member State R&D tax incentives arising from EU law;

— highlighting general design features for R&D tax treatment and incentives based on expert analysis of good practice;

— presenting for discussion a number of possible future initiatives aimed at addressing issues of common interest in a consistent way.

2.4 The Open Method of Coordination applies to this policy domain. The decisions lie with Member States. The guidelines provided in the Communication are derived from best practice by Member States. A critique of Member State policies lies outside the scope of the Opinion. The Opinion is therefore confined to observations on the guidelines and comments on the possible future initiatives highlighted in 2.3 above.

3. Gist of the Commission’s Communication

3.1 All R&D tax incentives implemented by Member States must conform to the fundamental Treaty freedoms and the principle of non discrimination. The Commission considers both implicit and explicit territorial restrictions to be incompatible with Treaty freedoms. There is ample and consistent evidence that territorial restrictions on the application of R&D incentives are unlikely to be accepted by the ECJ.

3.2 In principle, State aid rules apply regardless of the form of the aid so R&D tax incentives could constitute State aid. However, an R&D tax incentive which is not selective, i.e. one that applies irrespectively to all shapes and sizes of company in any sector would not be seen as selective and so would be treated as part of general corporate taxation.
3.3 Article 87(3)(c) of the Treaty states that the following may be considered to be compatible with the common market: 'aid to facilitate the development of certain economic activities ... where such aid does not adversely affect trading conditions to an extent contrary to the common interest'. The Commission has adopted an RDI Framework to cover selective tax incentives which might qualify under this Article. The framework has been developed in the public interest to correct what is perceived as market failure in the R&D sphere.

3.4 In applying the framework the Commission will take into account the following framework elements:

— the R&D category, whether fundamental, industrial or experimental;

— the application of the incentive to eligible costs;

— the limitation of the aid intensity to the maximum threshold.

Furthermore the Commission will assume, on the basis of the case made by the Member State, that the incentive will address market failure by stimulating higher R&D spending by companies.

3.5 The European Council has called for the Open Method of Coordination to be used in support of research policy making and the Council subsequently invited the Committee for Scientific and Technical Research (CREST) to oversee this method of support. In this Communication the Commission has relied heavily on the report ‘Evaluation and design of R&D tax incentives’ produced by CREST in March 2006.

3.6 Due to varying economic and industrial structures, R&D capacity, level of R&D spending and overall tax environment, the mix of R&D and innovation policy instruments vary greatly between Member States. The majority of the existing schemes are general in nature and about half of these have an upper limit or cap. This works to the advantage of SMEs as their level of expenditure is not usually affected by the cap. About one third of tax incentives provide specific benefits for SMEs and a growing number of schemes cater specifically for young innovative SMEs.

3.7 The three basic types of tax relief are tax deferral, tax allowance and tax credit. The impact of the incentives used by each Member State is a function of the overall tax system. Depending on the purpose of the incentive, some schemes apply to total R&D expenditure, others apply only to incremental expenditure resulting from the scheme. In other cases both classes of expenditure are relieved, but at different rates. The generosity of the incentives varies considerably across Member States. As a relief of tax, it is also affected by the prevailing levels of corporation tax.

3.8 Tax deferral generally means the 100 % deduction of R&D expenditure from taxable profits. In this scheme, every Euro of R&D expense can be claimed in full against tax. Where the R&D expenses are not 100 % deductible, they can usually be capitalised and subsequently be depreciated. In particular, this will be the case for capital expenditure.

3.9 Tax allowances are used to allow more than 100 % of R&D expenditure to be relieved. Where allowances apply, the uplift is usually between 125 % and 300 %. For example, with a general corporation tax rate of 30 %, a company would be able to claim EUR 3 000 tax relief on every EUR 10 000 of R&D expenditure. With an uplift of 50 %, the company could claim EUR 4 500 relief on every EUR 10 000 of R&D spent.

3.10 When the incentive is given in the form of a tax credit, it takes the form of a tax or cash refund. The credit is usually given on the amount of tax payable, but where no tax is payable the credit may be calculated as a percentage of the R&D spend. A credit in cash payable where a company is not making profits can provide a very welcome injection of funds for early stage companies.

3.11 While most schemes, as described above, are related to corporation tax, other schemes target wage tax and social contributions, or personal income tax. These options decrease research staff costs with immediate effect, thus reducing the most important component of R&D expenses. These options will have most effect where social charges are high.

3.12 For targeting loss making firms, such as young innovative SMEs, design options range from wage tax exemption to corporation tax refund to R&D tax credits to unlimited carry forward of losses incurred for future corporation tax relief.

3.13 In 2004 France was the first EU country to introduce a tax incentive specifically to support Young Innovative Enterprises (YIE). The aim is to stimulate private sector research and create real growth by reducing the start up costs of new businesses oriented towards research and innovation. The incentives include corporation tax exemption for the first three profitable years followed by a 50 % exemption for the next two years. In addition, social security payments for highly qualified personnel are exempted for eight years. Eligibility criteria apply to the YIE scheme.

3.14 Based on the experience of the application of R&D tax incentives in fifteen Member States, the Communication concludes that Member States should:

— use general measures as far as possible because these will reach more firms, maximising the increase in R&D and minimising market distortion;
allow full deductibility for all R&D expenses (no capitalisation or accelerated depreciation of these expenses) with adequate carry-forward and carry-back provisions for losses incurred.

3.15 As far as the design of schemes is concerned, Member States should clearly define their objectives:

— focus on the additional R&D spend to be achieved;
— focus on the behavioural change in firms;
— evaluate the wider societal effects of these changes;
— consider evaluation criteria from the design stage;
— test whether specific criteria meet their objectives.

3.16 Beyond the scope of R&D incentives for companies, the Communication also raises a number of issues affecting described as orientations for measures of common interest and mutual benefit: The EESC position on these issues is given in section 5 below.

4. Observations on the guidelines

4.1 The guidelines provide a wide range of options for the promotion of R&D via tax incentives. The EESC encourages all Member States to adapt these guidelines to their particular circumstances to create an R&D friendly regime. The Open Method of Coordination, facilitated by CREST, and driven by the Lisbon agenda should give all Member States the opportunity to apply best practice.

4.2 The impetus provided by R&D tax incentives will vary according to the size of the enterprise, whether, large, SME or start up.

4.3 In many Member States, tax incentives for R&D investments are relatively recent and the effect on large companies cannot yet be accurately tracked. It is possible that in some cases the tax savings will be reflected in the bottom line rather than the R&D department. Hence the interest in certain Member States to give greater incentives for incremental investment. At the same time Member States have an interest in retaining domestic R&D presence and straight forward incentives will encourage enterprises to keep their R&D activities where they are.

4.4 Larger firms have a greater critical mass of engineers and scientists and consequently they are well placed to send work off-shore. If, for example, Member States decide to use R&D incentives to retain software engineering jobs on shore, the most powerful incentive could be to make the associated costs 100 % deductible as per 3.8 above.

4.5 SMEs do not have the resources of larger companies and so their finances may be under relatively greater pressure. Options adopted by some Member States to give larger allowances so SMEs and set scheme upper limits beyond the scale of SMEs will give SMEs relatively more financial flexibility for R&D investment.

4.6 It is for start ups that tax incentives have the greatest potential leverage and this is important because such companies are vital elements in the promotion of enterprise and innovation. Innovations in the service economy, as well as in science and technology very often emerge via start up companies. The R&D departments of established enterprises often seem better adapted to product replacement and product improvement rather than break through invention. New companies exploiting inventions in science and technology are vital because if they can survive the difficulties of the start up phase (unfortunately most small companies do not survive), they may either develop into wealth creating SMEs or become a valuable acquisition for a larger enterprise. The M&A budgets of many technology enterprises may be of no less importance than the R&D budgets of those same firms. Indeed, many large technology enterprises have established investment arms modelled on venture capital.

4.7 Since the acquisition of small companies by large is a feature of the enterprise economy, it makes sense that the transactions should be as tax transparent and tax neutral as possible. This means that exit taxes for founders and entrepreneurs should be minimised while distorting penalties should not be imposed on acquiring companies.

4.8 While R&D incentives may be appropriate for YIEs in the technology sector, general incentives for start up companies are equally important. This is because such incentives will encourage new business formation in all industry sectors, thus contributing to the overall growth of Member State economies.

4.9 In the context of general tax incentives to encourage new business formation, the Communication is strangely silent on capital taxes. The problem for a start up business is to secure its initial funding. So called venture capital is not eager to be involved in early stage businesses and so the seed money usually has to come from private investors, business 'angels' and the friends and family of the founder(s). The capital tax regime which applies to these investors is a vital ingredient in business formation.
4.10 The UK has a reasonably well developed system of tax incentives in this area which may serve as an example. Investment may be made directly via the Enterprise Investment Scheme (EIS) or via a Venture Capital Trust (VCT) which is a collective investment vehicle quoted on the Alternative Investment Market (AIM). Companies qualifying for either scheme have to meet relevant eligibility criteria.

4.11 In each scheme, income tax relief is available on the sum invested at 20% (EIS) or 30% (VCT). No capital taxes are payable on gains after a qualifying period. No income tax is payable on VCT dividends and no death duties are payable on VCT holdings in the investor’s estate. While tax advantages should never be the reason for making an investment, these schemes do significantly mitigate the risks of investing in start up companies. They have succeeded in their objective of making it easier for British entrepreneurs to raise the money.

4.12 An important omission from the Communication is any guidance on the treatment of patents and licensing. There is confusion in respect of the law and evidence of competition between Member States in the tax treatment available in respect of patents. The EESC proposes that the Communication be expanded to include patents and licensing.

5. **Orientations for measures of common interest and mutual benefit**

5.1 The Committee supports the proposal that Member States should address the obstacles in the way of transnational research projects by, inter alia, improving the use of R&D tax incentives for industrial participants.

5.2 The Committee encourages Member States to explore ways in which state imposed costs can be lowered for young R&D businesses following the very successful French example of the YIE regime.

5.3 The Communication notes that while there are in the EU a few private sector public benefit research foundations which aim to enhance scientific knowledge by funding research, typically in universities, other regions such as the USA have very many more. Formal and informal obstacles appear to inhibit both donations by individuals and corporations (which should qualify for income and corporation tax relief) and the subsequent flow of funds to research. The Committee endorses the proposal that Member States develop a common approach so that both donations and research funds can flow freely within the EU.

5.4 The cross border mobility of researchers should be encouraged by Member State agreements to prevent double taxation on short term assignments. Member States are also encouraged to extend these arrangements to countries within the EU orbit such as the Ukraine, Israel and Turkey which are involved in a significant R&D exchange with the EU.

5.5 Some Member States allow firms to request a certificate recognising their capacity to perform R&D. In some Member States, public entities performing R&D are automatically granted such certificates. In order to facilitate mutual recognition of these certificates, the Commission will propose a possible common structure. This seems a sensible step for Member States which rely on these certificates.

5.6 The Commission has identified concerns where public and private firms interact in the R&D arena because of the problems created for the recovery of VAT on R&D expenditure by private entities. The Commission’s proposal to simplify and modernise the rules and their application is very welcome.

5.7 Finally, the Communication states that in the long term it is desirable to seek EU wide tax definition of R&D and innovation and to give such expenditure favourable treatment in the common consolidated corporate tax base. This would be a further step towards the completion of the single market.