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MEETING DOCUMENT

From:	Presidency
To:	Working Party on Tax Questions (Direct Taxation – CCTB)
Subject:	Super deduction for Research and Development (R&D): way ahead – Article 9(3) CCTB

Delegations will find attached a document from the Presidency on Article 9(3) (Super deduction for Research and Development (R&D): way ahead), in view of the meeting of the Working Party on Tax Questions (Direct Taxation - CCTB) on 23 March 2017.

Common Corporate Tax Base (CCTB) - Article 9(3)

Super deduction for Research and Development (R&D): way ahead

1. On 6 December 2016, the ECOFIN Council (doc. 15315/16) invited Member States to, as a start, "*concentrate their efforts on the rules for calculating the tax base and, in particular, on the new elements of the relaunched initiative (chapters I to V)*".

2. At the last WPTQ meeting on 16 February 2017, the new elements of the relaunched CCTB proposal were examined article by article, including paragraph 3 of Article 9 relating to the super deduction for research and development (R&D). Paragraphs 1 and 2 remain indeed broadly similar to the latest state of play in Council deliberations (end 2014).

3. At this occasion and in subsequent bilateral contacts, delegations raised a number of comments:
    a. one delegation questioned the supplementary deduction going beyond actual expenditures, whilst others questioned the percentages chosen;
    b. some delegations expressed a preference for a tax 'credit' approach considering that the deductibility approach favours those already profitable;
    c. some delegations criticised the approach chosen by the Commission and requested to keep national flexibility in this field, i.e. to delete the provision.

4. The Maltese Presidency intends to stabilise the text of this Article by the end of June 2017, but prior to this, it would be useful that Member States decide on some policy directions. The range of alternative options is indeed at this stage too wide for putting a compromise text on the table.

5. Against this background, this room document aims to present the main policy options for the work ahead, as well as to tackle some more technical issues raised by delegations in the last meeting and in bilateral contacts. This will help the Presidency prepare a preliminary compromise text for this Article and present it at the subsequent WPTQ meetings.

I / POLICY OPTIONS FOR THE WORK AHEAD

6. As developed in the Commission's impact assessment, R&D tax incentives can either impact on the tax base by granting a deductible allowance or take the form of a tax credit and directly reduce the tax liability. Support measures can also involve the income generated through the use of an asset that is the result of successful R&D activity, e.g. a patent. Indeed, patent box / intellectual property (IP) regimes usually provide for reduced tax rates on income deriving from such assets[1].

7. Recent OECD research[2] shows that countries operate a wide variety of R&D tax incentives, which does not facilitate harmonisation. The diversity of schemes could result in an increasingly complex landscape for the R&D tax treatment in Europe hindering trans-European collaboration.

a. Tax credits

8. The Commission's impact assessment (page 29) underlines that tax credits and additional allowances (i.e. deductions of R&D expenditure from the tax base) are "*economically very similar*". The OECD concurs on this issue: "*the choice between credits and allowances is largely a formal one, as they can be converted and made equivalent*"[3]. The only operational difference is that tax credits reduce directly the tax bill and therefore do not vary with the national tax rate.

9. The Commission however argues that a tax credit would go beyond the material scope of the Directive on a common tax base. The rules of the Directive are confined to computing the base. Taxpayers are then called upon to calculate their tax liability based on their national rules by applying the rate and possible credits against the resulting amount of tax.

10. Member States would give a tax credit for R&D against a taxpayer's tax liability. In its impact assessment, the Commission noted that a tax reduction would not ensure a level playing field for R&D in the EU and this could induce harmful competition between Member States. Therefore, this option was not retained.

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[1] Technically, in several Member States the taxable income in the patent box is reduced by a percentage (e.g. 50% or 80%) which de-facto results in a lower tax rate for this income category, while the general tax rate is applied on the adjusted box income.

[2] http://oe.cd/rdtax, February 2017 .

[3] http://www.oecd.org/sti/RDTaxIncentives-DesignSubsidyRates.pdf (page 10)

11. The Presidency notes that the separation of the CCCTB project in two legislative proposals (CCTB and CCCTB) was presented as an essential element of the project's "relaunch" and that this separation should mean that the CCTB proposal is able to live, at least temporarily, as a stand-alone proposal. The Presidency furthermore recalls that ECOFIN Council of 6 December 2016 supported the view that work should focus as a priority on the elements of a common tax base (doc. 15315/16). The approach chosen for the treatment of R&D should thus be such to cater for a workable (yet attractive) CCTB whilst not hindering the move towards consolidation at a subsequent stage.

12. As regards the possible harmful tax competition between Member States that such approach could give rise to, the Presidency would like to hear the views of the delegations, including on possible ways to mitigate it, for instance taking inspiration from the final report on OECD BEPS Action 5.

13. According to Annex IX of the Commission's impact assessment, 15 Member States currently use a tax credit approach for R&D incentives.

b. Deduction against the tax base

14. This is the approach proposed by the Commission in Article 9. Under this approach, R&D expenses are fully (100%) deductible in the year that they are incurred as a one-off cost, except for R&D costs related to immovable property, which are subject to depreciation. In addition, there are extra allowances (additional 50% for the first EUR 20 000 000 of R&D costs (N.B. 100% extra for start –ups); and 25% for the balance of R&D deductible expenses).

15. Several Member States however noted that they abandoned this approach at national level due to other limitations. In particular it only benefits companies that make profits (i.e. if a company is loss-making, it does not have to pay tax and therefore, there is no base against which to apply the deduction).

16. Deductible R&D expenses in a loss-making company (critical for start-ups) will increase the amounts of losses to be carried forward for offset against profits in future years. On the other

hand, the carry-forward of unused tax credits requires the creation of a special pool to track unused credits.

17. According to Annex IX of the Commission's impact assessment, there is an equal split between Member States that apply an enhanced allowance/deduction and/or tax credits for R&D incentives. Many countries apply more than one incentive schemes for R&D, which may or may not be combined.

c. Patent/IP box approach

18. Within the Commission's impact assessment, the Commission is of the view that based on empirical evidence,[4] incentives that focus on R&D expenses are more effective than patent/IP boxes in stimulating R&D investments.

19. The main arguments put forward by the Commission in this regard are as follows:
    a. Patent/IP boxes have resulted in a considerable decrease in effective tax rates that multinational groups can achieve[5];
    b. Patent/IP boxes do not create incentives for R&D activity[6];
    c. Patent/IP boxes do not address the high risk of failure inherent in R&D in contrast to expense-based R&D tax incentives that apply to R&D costs whatever their result. Instead, IP boxes reward additional tax benefits to a successful innovation that already enjoys intellectual property protection and thus monopoly rights. Research efforts that are not patentable with potentially higher social spill-overs are less attractive and thus become indirectly discriminated.

20. The modified nexus approach agreed under OECD BEPS Action 5 for IP regimes is aimed to mitigate the above-mentioned concerns. Contrary to old patent box regimes, the modified nexus compliant regimes will have to create a link between the income qualifying for tax benefits (output) and the core activities necessary to earn the income (input). In this way, it should be expected that the patent box regimes support carrying on with R&D activity. It would however

[4] CPB (2014), A study on R&D tax incentives: Final Report, Taxation Papers No 52, DG Taxation and Customs Union, European Commission.
[5] ZEW (2016c), The impact of tax planning on forward-looking effective tax rates, Taxation Papers No 64, DG Taxation and Customs Union, European Commission
[6] Alstadsaeter et al. (2015), Patent boxes Design, Patents Location and Local R&D, Taxation Papers No 57, DG Taxation and Customs Union, European Commission

continue to be the case that efforts focus on achieving patentable outcomes, rather than on research more broadly.

21. According to Annex IX of the Commission's impact assessment, at the time of the impact assessment, 13 Member States[7] had a patent/IP box.

d. No common R&D tax incentives

22. Some delegations suggested to delete the proposed R&D tax incentive and leave complete freedom to Member States in this field, given the divergence of approaches to R&D support within the EU.

23. This would however entail that the harmonisation of the tax base is only partial and it would lead to situations whereby in the context of consolidation, some Member States would share the costs of R&D incentives given by others. For instance, if a Member State gave a super-deduction for R&D to a company in a group, the relevant deductible amounts would directly reduce the company's taxable share (as apportioned through the formula) without interfering with the consolidated revenue.

QUESTIONS

- *If delegates could support in principle the R&D deduction (as proposed), what measures could be introduced to enhance its operation with a view of being more acceptable?*
- *Should there be a departure from the approach presented by the Commission in its proposal, which policy option do delegations favour, and why would this be considered as superior for the purposes of the CCTB?*

[7] BE, IE, EL, ES, FR, IT, CY, U, HU, MT, NL, PT and UK.

II / OTHER ISSUES

a. Targeted R&D incentives for innovative start-ups

24. Several delegations raised concerns about how to effectively support new companies (start-ups), which typically do not record profits and have liquidity issues.

25. The Commission's proposal with regard to start ups is an additional 100% allowance, leading to a 200% deduction for costs up to 20 million euros. However, such deduction would only be possible once the start-ups are actually profitable given the deductibility approach. Furthermore, SMEs are effectively excluded from the mandatory scope of the CCTB due to the requirement for being part of a group with a consolidated turnover, for accounting purposes, of more than EUR 750 million.

26. Possible features that would offer innovative start-ups more flexibility and reduce the uncertainty associated with investment decisions include:
    a. Providing for some form of carry-over provisions for unused benefit.
    b. cash refund provisions (as in seven EU Member States[8]): a tax credit becomes refundable when any credit surplus can be paid in full or in part to the taxpayer.
    c. Tax relief redeemable against payroll taxes and related social security contributions (as in six Member States[9]): this may provide an alternative means to address the limited income tax liability problem

QUESTION

- *With respect to the deduction contemplated for start-ups do you think that it is effective, and if not, what changes could be made to achieve the desired results/outcomes?*

[8] AT, BE, DK, FR, IE, ES and UK.
[9] BE, FR, HU, NL, ES and SE.

b. Anti-abuse provisions

27. Some delegations also complained about the narrow definition proposed for start-ups in points a) to d) of Article 9.3. The Commission however indicated that this derives from the EU state aid rules (block exemption regulation (GBER).

28. One delegation noted that the limitation to mergers in point c) is too narrow, and would appear to warrant a wider definition to cover SMEs formed from other forms of corporate restructuring.

29. Some delegations questioned the concept of "movable" assets and have found this somewhat confusing. One delegate within the written submissions also raised issues of interrelation with GBER, particularly on how would the limits under GBER be respected/controlled in context of the CCTB considering that the effective aid granted will vary across different Member State (in view of different rates)

QUESTIONS

- *Would delegates agree that the approach taken (of working within the parameters of GBER) would provide Member States with a practical approach in giving effect to this article of the CCTB?*
- *In addition to points already reflected under this section, do delegates have further comments in relation to the drafting of Article 9(3), and whether any other conditions or anti-abuse rules ought to be inserted?*