O.E.C.D. REACTION TO RESEARCH TAX INCENTIVES – ACCEPTANCE WITH A LIMITATION BLOCKING MOBILITY

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In recent years, the European Commission (the "Commission") has been criticizing arrangements between multinational companies and countries within the E.U. offering favorable tax treatment to certain income. Such arrangements required these companies to locate some of their business in the country offering the benefits and often required the hiring of local talent. One example would be the investigatin into arrangements between Ireland and Apple Inc., a U.S. corporation.[1]

Despite such actions and recent Commission decisions, which treat such arrangements as illegal State Aid and impose harsh economic penalties on a retroactive basis, the Organization for Economic Cooperation and Development ("O.E.C.D.") issued a working paper (the "Working Paper")[2] that recognizes that the encouragement of research and development ("R&D") is an essential part of the development, innovation, and growth of an economy. In a caveated breath of fresh air, the Working Paper acknowledges and accepts the importance of taxes as it recommends that "fiscal incentives, including tax policies, . . . be directed at specific barriers, impediments or synergies to facilitate the desired level of investment in R&D and innovations."

The Working Paper lists several issues affecting the recent decrease in global R&D, including the difficulty encountered to finance the activity, especially for small start-up companies, and the leakage of knowledge garnered from R&D activity. To overcome some of these issues, the O.E.C.D. acknowledged that governments should support R&D and offer incentives.

R&D tax incentives adopted in one jurisdiction have potential spillover into other countries' tax policies; however, as the Working Paper provides, such spillover is not necessarily positive and such activities may not result in an overall increase in global innovation. It may simply shift R&D activity from one country to another country. The Working Paper expresses a concern about the mobility of intellectual property ("I.P.") and the potential tax abuse that may follow by shifting income away from the country where the I.P. was created. To prevent harmful tax practices, the Working Paper recommends adoption of a "nexus" approach to R&D tax incentives, which allows the incentives in the country where the I.P. was created and possibly not elsewhere, especially if it is moved to a low-tax or no-tax country.

Fiscal incentives can be presented in several forms, including, but not limited to, grants, guarantees, and tax incentives. Tax incentives then can also take several forms, including tax credits, accelerated depreciation, or favorable capital gain tax

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1 On August 30, 2016, the E.U. published the results of the *Apple* case and concluded that Apple must repay Ireland €13 billion.

2 Thomas Neubig, et. al., "O.E.C.D. Taxation Working Paper No. 27, Fiscal Incentives for R&D and Innovation in a Diverse World," *O.E.C.D. Taxation Working Papers* 27 (2016).

rates. The Working Paper surveyed the practice of R&D incentives around the world and found that most countries focus the tax incentives on increased expenditures on R&D and that an increasing number of countries have adopted or are considering adopting income-based R&D tax incentives in addition to their expenditure-based R&D tax incentives. Due to the mobility of I.P. and the potential abusive result to a global tax base, the Working Paper recommends adopting a "nexus" approach as a threshold for R&D tax incentives in order to "avoid harmful tax practices."

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The Working Paper concludes that given the significant diversity of businesses and different type of R&D investments, more research is needed to determine the global effects of local R&D incentives that provide the biggest improvement in productivity.

U.S. TAX RESEARCH INCENTIVES

Absent special tax treatment, capital investment to create or purchase new tangible or intangible property produces a long-term asset so that the cost of such asset cannot be taken as an ordinary and necessary business deduction under Code §162. Rather, the cost of the asset may be depreciated under Code §167 or amortized under Code §197. The 15-year amortization of intangible property under Code §197 (a), however, is not allowed for self-created intangibles.[3]

To encourage investment in R&D, Code §174 offers two methods to obtain tax relief for R&D expenditures. One method provides a current deduction[4] and the other method provides for amortization.[5] Both forms of tax relief apply only to the extent that the amount claimed for R&D is reasonable under the circumstances.

Current Expense Deductions

Under the current expense deduction, taxpayers may treat R&D expenditures paid or incurred during the tax year in connection with their trades or businesses as expenses that are not chargeable to the capital account. This allows for current tax benefit for the amount expended.

If the current expense method is adopted by the taxpayer, it applies to all R&D expenditures of the taxpayer. Cherry picking is not allowed. Once adopted, the method must be followed in all subsequent tax years, unless the I.R.S. approves a change to a different method.

Amortization Deduction

The amortization deduction method allows the taxpayer to elect to treat qualified R&D expenditures as deferred expenses amortized ratably over a period of not less than 60 months, as selected by the taxpayer. Qualified R&D expenditures are those paid or incurred by the taxpayer in connection with a trade or business.[6]

Credit for Increasing Research Activities or Alternative Credit

Code §42 allows a credit for a portion of the costs of increasing expenses paid or

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3 Code §197(c)(2).

4 Code §174(a).

5 Code §174(b).

6 *Id.*

incurred for qualified research. Code §280C allows for an alternative credit that is not as favorable. Qualified research means research for which expenses may be deducted currently under Code §174. The research must be undertaken for discovering information that is technological in nature, and its application must be intended for use in developing a new or improved business component of the taxpayer. In addition, substantially all of the activities of the R&D activity must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality. The credit is claimed by filing Form 6765.

CONCLUSION

The O.E.C.D. has been leading the attack on tax incentives and uses of the tax system that are viewed by policy makers in Europe as abusive. While most new O.E.C.D. pronouncements have caused tax advisors to cringe, the recent O.E.C.D. Working Paper recognizes that R&D tax incentives are appropriate when tax relief is tied to the place where the R&D activity is performed. Financing R&D without activity by employees and officers is not sufficient to claim tax relief. The tax relief provided to innovation companies performing R&D activity is triggered at the time revenue is realized from the R&D. To date, the U.S. allows relief only when and as amounts are expended – either on a current basis or an amortized basis.