The role of tax incentives in corporate taxation

While business tax incentives are used widely, concerns have been raised in recent years regarding their effectiveness, their impact on public finances and whether they could potentially distort the EU single market. With important innovation challenges ahead relating to the green and digital twin transition, tax incentives are increasingly being used to boost investment in the area of research and development.

Tax incentives and reforms

While they come in many shapes and forms (accelerated depreciations, carry-forwards of losses, ...), tax incentives for businesses are generally introduced to support either wider economic objectives (growth, job creation, the need to attract foreign direct investment) or more specific policies (such as the energy transition). However, these tax measures have been criticised in recent years as they can be used or abused to lower the corporate tax payments of (large) enterprises significantly, thereby possibly causing a gap in overall tax revenue. In response, as part of the base erosion and profit shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD), policy-makers have initiated several reforms in order to counter tax incentive abuse. In particular, BEPS Action 5 reforms intellectual property regimes ('patent boxes') to ensure that tax relief is conditional upon a closer connection between the location of the income and the actual research activities. More recently, the OECD global agreement of 8 October 2021 on a minimum effective corporate tax rate ('Pillar Two') can ensure further that large multinationals cannot use tax incentives to significantly minimise their corporate tax payments.

At EU-level, since its creation in 1998, the Code of Conduct Group has brought together Member States to assess business tax measures. Although its guidance is not legally binding, Member States tend to undertake reforms on those measures that are deemed by the Group to constitute harmful tax competition. The Group also screens preferential business tax regimes in third countries, as part of the process relating to the EU list of non-cooperative jurisdictions for tax purposes.

Taxation of research and development

Preferential tax treatment for research and development (R&D) is among the best-known tax policy tools used by governments. With important challenges ahead in light of the green and digital transitions and the global race for innovation, the use of tax benefits for R&D has risen steadily over the past two decades (see Figure 1). Government tax relief for R&D in the EU was about 0.02 % of gross domestic product (GDP) in 2000, and increased five-fold to 0.10 % in 2018. The EU Member States with the highest R&D tax relief were France (0.29 %), Italy (0.20 %) and Austria (0.19 %).

Figure 1 – R&D tax incentives as a % of GDP

While the use of R&D tax incentives has expanded, views on their usefulness vary among academics. According to a 2017 European Commission study, R&D tax incentives are generally found to be effective in stimulating business investment in R&D, although their level of added value (i.e. whether the amount lost in tax revenue is offset by the amount of innovation generated) depends on the incentives' design and implementation.

More specifically, a distinction is drawn between tax allowances based on the inputs of innovation (i.e. expenditure, for instance researchers' wages), and those based on the outputs (i.e. income, such as the patent income). The OECD has noted that evidence on the effectiveness of R&D tax incentives appears 'more positive for input-based incentives than for output-based incentives'. For example, according to a study by the United States National Bureau of Economic Research, countries that offered output-based incentives (e.g. intellectual property regimes) were not found to have seen a significant increase in the number of inventions patented compared with countries that did not. On the other hand, research by the OECD demonstrated that one extra monetary unit of input-based tax support caused 1.4 extra units of R&D, with smaller enterprises in particular being more responsive towards these tax incentives in comparison with large companies. However, academics highlight that tax is just one of a series of factors for entrepreneurs when making R&D investment decisions, next to the availability of a skilled workforce, the macro-economic environment, the presence of local science hubs, well-functioning capital markets, etc.

Nevertheless, the tax treatment of R&D could change in the coming years, following the OECD agreement on Pillar Two. As Pillar Two would ensure a minimum level of corporate taxation of 15%, countries will be limited in the level of tax benefits they can provide to businesses (as other jurisdictions will be able to impose a top-up tax in cases of low-taxed profits). The OECD acknowledges that Pillar Two 'may reduce the effectiveness of certain tax incentives' in the area of innovation and economic developments but considers at the same time that countries will continue to have a great degree of flexibility in offering tax relief to attain these goals. Moreover, as Pillar Two covers corporate taxation exclusively, governments will be able to continue to provide relief in other areas (e.g. wages, social security contributions).

DEBRA

On 11 May 2022, the European Commission put forward a proposal for an EU-wide tax incentive in the shape of a debt equity bias reduction allowance or DEBRA. With debt being treated more favourably than equity in most national tax systems, the Commission argues that this incentivises companies to choose debt over equity, even when this is not the best option. In order to create a level playing field and to reduce the debt liability of the corporate sector, the Commission's DEBRA proposal would grant a tax allowance on new equity. The equity allowance would be computed on the basis of difference between net equity at the end of the current tax year and net equity at the end of the previous tax year, multiplied by a notional interest rate. While the pro-debt bias in taxation has existed for a long time, the Commission considers that the need to act has become more 'pressing' in the post-COVID-19 era, since companies' stock of debts has increased significantly.

While full EU-level harmonisation of a corporate tax incentive is a rare thing, the Commission believes it is necessary in this case. Six Member States (Belgium, Italy, Cyprus, Malta, Poland and Portugal) already have a tax allowance on equity in place, but these national measures are very different. On top of this, 21 Member States have no such system in place at all, leading to 'distortions to the function of the internal market and 'affect[ing] the location of investment in a significant manner'. While this proposal is not directly designed to foster innovation, the Commission argues that equity financing is particularly important for young innovative companies, which may have too high a risk profile to be accepted for a bank loan.