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Tax incentives on Research and Development (R&D)

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Summary and conclusions

France is leading the general tax cut trend across Europe by offering a range of new incentives and broad tax exemptions for corporations interested in undertaking research and development (R&D) in France. The exemptions include attractive regimes for holding companies, capital gains and dividend exemptions, and usually no withholding tax on royalties or interest. The following report analyses most of these tax incentives, such as the research tax credit or the incentive regime for innovative businesses.

Today the French state “refunds” most business expenditure on R&D. R&D “reimbursements” are not taxed, while R&D expenditure is tax deductible, thereby allowing a tax exemption on profits. France’s extensive definition of research includes both fundamental and applied research, as well as experimental development. Moreover, the research does not need to be patented to qualify for tax credit. For instance, creation of a fashion collection is included in the definition of research. Software is also considered research as long as it shows substantial innovation.

The tax credit basis includes gross salaries and social security contributions, together with a 50 per cent lump sum for operating costs. Depreciation and patent expenses are also included. The French state refunds 30 per cent of the above, up to 100 million euro per annum, and 5 per cent for amounts exceeding this ceiling. The total tax credit basis is doubled when hiring candidates with doctorates or equivalent qualifications. Subject to certain conditions, expenditure in Europe or in European Economic Area (EEA) countries is included in the tax credit basis. International groups may benefit from this tax credit system and still transfer research results to a foreign country. This foreign country (e.g. the United Kingdom) may offer further advantages for R&D, or low taxation on royalty contracts (e.g. Switzerland).

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The tax incentive regime for innovative businesses allows total or partial tax exemption for businesses with at least 20 employees that have increased their workforce by at least 15 per cent during the preceding two years.

1. R&D incentives under domestic tax law

1.1. Introduction

French R&D incentives may take the form of direct funding through subsidies, or indirect stimuli, such as tax incentives. Focusing on these last stimuli, France offers a large variety of measures to encourage R&D, which makes France a "worldwide champion". Specifically, the French R&D tax credit has become the most generous R&D tax incentive of OECD members in terms of the percentage of GDP (0.26 per cent of GDP in 2011).[1]

1.2. Brief overview of business income taxation

Business income taxation in France is built upon one main distinction: the business income of individuals (or pass-through entities) and the business income of corporations. The business income of individuals is usually taxed at graduated rates (up to 45 per cent, plus so-called "social taxes" and a surtax for high-income individuals) in the "industrial and commercial profits" category of individual personal income tax. The business income of corporations is subject to corporate income tax (CIT) at a standard rate of 33.33 per cent (plus applicable surtaxes for large companies – 34.43 per cent or 38 per cent).

Unlike most countries adopting a worldwide scope, French CIT is territorial and therefore only levied on earnings from companies engaged in business in France and those earnings attributed to France by a tax treaty. The earnings of companies incorporated in France and engaged in business abroad are not subject to French CIT, even if their accounts are maintained in France. This territorial rule also applies to losses. The losses of a French company tax entity incurred in a foreign enterprise are not deductible from its French source earnings. Foreign legal entities are subject to French CIT on any earnings from their French business operations.

Companies are required to take into account at the end of their financial year all accrued income and incurred expenses. In addition, the company will be deemed to realize during a given financial year any profits or capital gains to which it is entitled, even if the actual payment has not been made. Each financial year is considered absolutely independent from the preceding and subsequent financial years.

1 OECD (2009), *OECD Science, Technology and Industry Scoreboard 2009*, OECD, Paris; France is ranked third in terms of tax incentive for one euro spent of R&D (according to B-Index, an OECD indicator to measure the value of R&D tax treatment in OECD countries: see J. Warda, "Measuring the Value of R&D Tax Treatment in OECD Countries", *STI Review*, no. 27 (2001): Special Issue on New Science and Technology Indicators, OECD Publishing).

Local governments levy local direct taxes, of which the main one is the territorial economic contribution (TEC).

1.3. Tax policy considerations relating to R&D incentives

1.3.1. General tax climate for R&D

The general tax climate in France is favourable to R&D. It primarily consists of specific measures promoting R&D, which are not too adversely affected by general rules limiting carryforward of losses.

(a) A first rule indirectly promoting R&D is taxation at a reduced 15 per cent CIT rate of income or gain deriving from the licence, sublicence, sale, or transfer of qualified intellectual property (IP) at a reduced CIT rate of 15 per cent (plus applicable surcharges for large companies).[2] Second, companies engaged in research activities could benefit from temporary TEC relief if their head offices are located in specific geographical areas.[3] Third, small and medium-sized enterprises (SMEs) are subject to CIT at a reduced rate of 15 per cent on the first 38,120 euro of profits and at the standard rate on any excess. This reduced rate could encourage SMEs to be engaged in R&D activities. SMEs are defined as enterprises that have an annual turnover of less than 7,630,000 euro, entirely paid up capital and at least 75 per cent of the shares continuously held by individuals or by one SME. Fourth, accelerated amortization of equipment and tools used for R&D operations[4] supports R&D activities.[5] Fifth, the French tax consolidation regime could indirectly promote R&D through the possibility, for instance, of offsetting losses (relating to R&D) incurred by a company against the profits of another 95 per cent held company.

(b) Among the rules adversely affecting promotion of R&D is the limitation on carrying forward or carrying back losses. This recently introduced limitation was aimed to align the French loss regime with that of other EU countries. France allows both loss carryforward and loss carryback. Losses may be carried forward indefinitely. The carryforward of losses is limited to an amount of 1 million euro plus 50 per cent of the profit above 1 million euro. Also, any unused losses can be carried forward indefinitely. Moreover, the French tax law limits loss carryforward for companies which terminate their business activities, sell their operations, take part in company reorganization, or are under a court order to liquidate their business.

1.3.2. Reasons for introducing R&D incentives

The reasons for introducing R&D incentives are twofold: to encourage economic growth and to sustain private R&D in the open competition sector. First, empirical

2 French Tax Code (FTC) s. 39 *terdecies*.
3 FTC, s. 1465.
4 In this tax measure, R&D operations are operations defined in the FTC (FTC, s. 49 *septies* F).
5 FTC, s. 39AA *quinquies*.

studies reveal that an increase in R&D expenditure affects economic growth.[6] In 2008, the French Treasury Department[7] considered that R&D incentives could lead to a 0.3/0.6 point GDP increase in the following 15 years.[8] Using economic analysis to assess R&D has always been useful.[9] Second, public R&D incentives were introduced or reformed in order to offset the weakness of private R&D expenditure and the lack of corrective public intervention. Indeed, private R&D activities are a risky business for companies which may just not have enough financial base to recover their costs.[10] Between 1998 and 2008, French business enterprise expenditure on R&D (BERD) decreased from 1.33 per cent of GDP to 1.27 per cent of GDP.[11] Comparatively, French BERD was lower than the average of OECD members during that period: from 1.45 per cent of the GDP rate in 1998 to 1.65 per cent of GDP in 2008.[12]

France cumulates two forms of public aid to promote R&D: direct funding and tax incentives. According to the OECD,

> "direct government funding includes grants, loans and procurement. Government indirect R&D funding includes tax incentives such as R&D tax credits, R&D allowances, reductions in R&D workers' wage taxes and social security contributions, and accelerated depreciation of R&D capital."[13]

The share of tax incentives in the global amount of R&D aid has increased since the 2008 R&D tax credit reform.[14]

The 2011 budget for R&D tax credit equals 5.17 billion euro[15] vastly exceeding the amount of other aid, which is three times lower.[16] It is expected that the amount of the R&D tax credit will be 5.8 billion euro in 2014.[17]

6 French Senate's information report no. 391, 2003–2004, pp. 17–20 available at http://www.senat.fr/rap/r03-391/r03-3911.pdf; Robert M. Solow, "A Contribution to the Theory of Economic Growth", *The Quarterly Journal of Economics*, vol. 70, no. 1 (February 1956), pp. 65–94.

7 P. Cahu, L. Demmou and E. Massé, "Les effets économiques de la réforme du crédit d'impôt recherche de 2008", *TRESOR ECO*, January 2009, no. 50.

8 From 2008 to 2022.i

9 H. W. Friederiszick and L.-H. Roller, "Using economic analysis to assess R&D&I state aid measures", *E. St. A.L.* 2007, 6(4), 592–604.

10 French Ministry for Higher Education and Research, *Report to Parliament on the R&D Tax Credit* (in French), March 2010, p. 10.

11 OECD, Main Science and Technology Indicators Database, March 2010, chapter 4, p. 76, available at http://www.oecd.org/site/innovationstrategy/45188105.pdf.

12 *Ibid.*

13 *Ibid.*

14 French Court of Auditors (*Cour des comptes*), *Les aides aux entreprises en matière d'innovation et de recherche: la cohérence des dispositifs fiscaux et budgétaires*, Public Report, October 2011, p. 7.

15 *Cour des comptes*, *L'évolution et les conditions de maîtrise du CIR*, July 2013, p. 9.

16 *Cour des comptes*, *Les aides aux entreprises en matière d'innovation et de recherche: la cohérence des dispositifs fiscaux et budgétaires*, Public Report, October 2011, p. 7.

17 Appendix to the 2014 Finance Bill, Evaluation of Ways and Means, vol. II, Tax expenditures.

1.3.3. R&D incentives, equality of treatment and ability to pay

The French tax system is subject to a constitutional framework requiring tax law to achieve equity and fairness. Precisely, the French tax law provisions are subject to the principles of equality of taxation[18] and the ability to pay.[19]

R&D tax incentives can be considered as creating a distortion, since they are only granted for a specific type of activity (R&D). However, no debate on this issue was really settled by the lawmaker since this tax incentive is justified for reasons of public interest. Indeed, the R&D tax credit entered into force in 1983 to increase the competitiveness of businesses on the global market and to encourage businesses to develop scientific and technical research.[20]

R&D tax incentives in French tax legislation have been designed without neglecting the obligation for these incentives to be in accordance with the constitutional framework, in particular the principles of equality of taxation and the ability to pay.

1.3.4. Subjective scope

The subjective scope depends on the tax incentive: all businesses are eligible for the R&D tax credit regardless of their nationality or their size, except those involved in a liberal professional activity.[21] For "young innovative company" status, any company regardless of its form is eligible if the cumulative conditions set by the FTC related to its size, its age, its volume of expenditure, its capital component and the activity are met.[22] In short, the status is reserved for SMEs spending at least 15 per cent of their expenditure on R&D. For tax competitiveness centres, no specific company form is required as long as the company is based in an R&D zone of competitiveness and participates in an R&D project approved by the French Ministry.[23] Therefore, the subjective scope is relatively large as most taxpayers are eligible to claim R&D fiscal incentives.

Foreign taxpayers are eligible to claim R&D tax credit under the same conditions as domestic taxpayers. However, to be eligible expenses must satisfy the following two conditions: (a) they are taken into account for the determination of French CIT, under territoriality rules that apply to the latter tax (see section 1.2), and (b) they are incurred in the EEA. As a consequence, a foreign company can only include in the basis of the R&D tax credit expenses which have been borne in France by its enterprise or permanent establishment. Another consequence is that a French company can include in the basis of its R&D tax credit expenses incurred outside France, where such expenses have been incurred in the EEA and are part of the company's income subject to French CIT.

18 Declaration of the Rights of Man and of the Citizen, 26 August 1789, s. 6.
19 *Ibid.*, s. 13.
20 Law no. 82-1126, 29 December 1982, s. 67.
21 FTC, s. 244 *quater* B, Jurisclasseur Brevets, fasc. 4965 Crédit d'impôt recherche, §4.
22 FTC, s. 44 *sexies*-0 A.
23 French Administrative Guidelines, BOI-BIC-CHAMP-80-10-40-20130205.

1.3.5. R&D incentives: multinational enterprises (MNEs) versus SMEs?

MNEs generally have a competitive advantage over SMEs in obtaining very high levels of tax relief in general. This has been repeatedly discussed in the French National Assembly[24] or Senate.[25]

In order to offset such an advantage, certain tax reliefs or benefits are only available to SMEs. As an illustration, in addition to the R&D tax credit, SMEs characterized as such under European law[26] can be eligible for the innovation tax credit. The innovation tax credit basis consists of operating costs relating to prototypes/ design or pilot-plants for new products that have not already been launched in the marketplace.

1.3.6. Definition of R&D for tax purposes

The French tax administration (FTA) definition of R&D coincides closely with the interpretation favoured by the Frascati Manual. Indeed, the definition of R&D expenditure eligible for the French R&D tax credit refers to (a) basic research, (b) applied research and (c) experimental development, as defined in the Frascati Manual.[27] Also, administrative guidelines expressly quote the definition of these three subdivisions of R&D as they appear in the Frascati Manual.[28] Moreover, the FTA distinguishes R&D from related activities by the presence of an "appreciable element of novelty" and "the resolution of scientific and/or technological uncertainty" by reference to the Frascati Manual. R&D does not usually include activities aiming at increasing productivity, reliability, ergonomics, IT portability, or upgrading basic and application software. Only operations aiming at removing scientific and/or technological uncertainties are taken into account.

However, it should be mentioned that the terminology of the Frascati Manual definition of R&D expenditure is slightly different from that of the FTA definition.[29]

1.4. R&D input incentives

1.4.1. General overview of R&D input incentives

The French government has introduced several types of input R&D tax incentives:
(a) tax credit for R&D expenditure;
(b) innovation tax credit;
(c) cash grants for collaborative R&D projects;

24 E.g. National Assembly, question no. 31793 (Official Journal dated 1 April 2014, p. 2995) – tax evasion/optimization of tobacco MNEs.

25 Senate Finance Committee, Interviews of T. Madiès, G. Monsellato, O. Passet and R. Russo dated 9 April 2014.

26 Companies with less than 250 employees and where either their annual gross income is not more than 50 million euro, or their total balance sheet is not more than 43 million euro.

27 FTC Annex III, art. 49 *septies* F.

28 French Administrative Guidelines, BOI-BIC-RICI-10-10-10-20-20120912 §1.

29 OECD, Frascati Manual 2002, p. 266, available at http://www.uis.unesco.org/Library/Documents/OECDFrascatiManual02_fr.pdf.

(d) reduced tax rates for young innovative companies;
(e) TEC tax holidays;
(f) accelerated depreciation on qualifying R&D assets.

1.4.2. Privileged R&D expenditure

The FTC does not provide a definition of R&D expenditure but its article 244 *quater* B describes R&D expenditure eligible for the R&D tax credit and the innovative new company status.[30]

R&D expenditure eligible for French tax credit are the following:

- depreciation allowances;
- R&D staff costs;
- operating costs;
- subcontracting expenses;
- expenses linked to patents;
- technological monitoring and standardization expenses;
- public subsidies;
- consultancy fees.

Apart from this specific provision, R&D expenses are deductible unless they are related to the value of an asset in which case it is depreciated.[31]

1.4.3. Tax credit versus allowance

The French public authorities have chosen to introduce an R&D tax credit in order to support companies in their R&D investment. The R&D credit 2008 reform has ranked France well in the international arena of fiscal R&D incentive mechanisms.[32]

The R&D tax credit depends on the calendar year or the closing date of the financial year. The R&D tax credit is assessed on a percentage of the eligible expenses identified and valued:

- 30 per cent of eligible expenses, up to a yearly 100 million euro threshold of expenses;
- 5 per cent of eligible expenses beyond this yearly threshold.

An "introductory bonus" was available for companies applying for research tax credit for the first time, or for those that have not received the tax credit within the past five years. This specific relief was repealed by the Finance Act for 2013.

30 Young innovative company eligible R&D expenditure is expenses described by reference to FTC, s. 244 *quater* B II(a) to (g).

31 Upon taxpayer election, FT, s. 236-I extends to R&D expenses the favourable regime applicable to start-up expenses. Consequently, a taxpayer is allowed to deduct in the financial year incurred the R&D expenses insofar as he or she did not, for accounting purposes, add a new element to the balance sheet or increase the value of an existing fixed asset. As a result, a self-developed patent may have a nil asset value where the taxpayer elected for immediate deduction of the related R&D expenses. A similar regime was extended to expenses related to software and website development. Therefore, a company may either expense the amount incurred, or capitalize it and amortize the expense over a maximum period of five years. There is, however, a limitation to this flexibility: the tax treatment must be the same as the accounting treatment followed by the taxpayer.

32 See above section 1.1.

Companies can outsource R&D work to either a private organization or to an individual expert. In both cases, the subcontractor is required to possess a certificate of approval from the Ministry of Research and Higher Education. Ceilings apply to expenses charged by subcontractors.

Companies can offset the R&D tax credit against their corporate tax liability of the financial year in which expenses are incurred or of the three following financial years in the case of tax losses. The remaining unused part of the R&D tax credit is reimbursed.

The young innovative company status involves relief from income tax or corporation tax of 100 per cent over the first three years or three profitable years and 50 per cent for the two following profitable years. Other fiscal measures include exemption from social charges for researchers, technicians, R&D managers and legal experts on industrial protection.

1.4.4. Territorial scope

Before 2005, the FTC reserved the benefit of the R&D tax credit to research operations performed in France.[33] This restriction was held to be in violation of article 49 EC.[34] Research activity performed in the European Union, in Norway or in Iceland is now eligible for the R&D tax credit if its earnings and expenses are taken into account for the purposes of the determination of the company's income taxable in France.[35]

1.4.5. Anti-avoidance provisions

The FTC contains general anti-abuse rules, with the renewed notion of abuse of law allowing the FTA to challenge any operation which is either fictitious or genuine, but designed solely to avoid or evade the tax liability that would normally have been borne. The FTC also contains specific anti-abuse rules to prevent international abusive transactions. They do not specifically target R&D, although they include transfer pricing rules, thin capitalization rules, or rules concerning payments in a low-tax jurisdiction. Finally, the French controlled foreign company (CFC) regime[36] will gain more application in a tense budgetary situation.

One can, however, identify measures trying to prevent double deductibility of expenses. As mentioned,[37] the French R&D tax credit allows companies to take into account the amount of subcontracting R&D expenditure in their eligible expenditure regime. Initially, this regime only included R&D expenditure paid to French companies, but due to the ECJ judgment[38] the French legislator amended this regime to include R&D French expenditure paid to EU established companies. But in order to avoid tax fraud and the use of "letter-box" companies, the French

33 S. 49 *septies* H was then repealed by s. 45 of Law no. 2004-1485 dated 30 December 2004.

34 ECJ, 10 March 2005 case no. C-39/04, *Laboratoires Fournier*, Dr. fisc. 2005, no. 18-19, com. 399, note B. Boutemy and E. Meier, RTD eur. 2005, no. 4, p. 867 s. note C. Prieto; RTD com. 2005, no. 2, p. 434 s. note G. Jazottes; Europe 2005, no. 5, p. 20, note L. Idot.

35 See above section 1.2.

36 FTC, s. 209B.

37 See section 1.4.3.

38 See section 1.4.4.

legislator introduced two anti-abuse provisions in the matter of subcontracting R&D expenditure:

- a first expenses cap (fixed limitation):[39] French companies cannot take into their tax credit basis an amount over 2, 10, or 12 million euro depending on the case;
- a second expenses cap:[40] French companies should not take into their tax credit basis an amount of subcontracted R&D expenditure more than three times their own R&D expenditure.[41]

1.5. Output R&D fiscal incentives (patent box or similar incentive)

1.5.1. General overview of output incentives

The French public authorities have implemented an output incentive in the form of the so-called "patent box". FTC, section 39 *terdecies* describes the terms and conditions applying to the French patent box. There is no other output R&D tax incentive applying in France.

1.5.2. Definition of privileged IP rights

The FTA restricts the benefit of the output tax incentive to patents, patentable inventions and improvements made to them.[42] Also, industrial manufacturing processes that are the continuation of patents or patentable inventions benefit from the French patent box. The French approach to privileged IP rights could be qualified as a "narrow approach".[43] Indeed, processes and technologies were removed in 1991 from the scope of the favourable regime because some companies interpreted those concepts too liberally including with the favourable regime payments received in return for usual services with no intellectual creativity input.[44] This amendment was considered as having no adverse impact on the capacity of companies to carry out research.

1.5.3. Acquired IP

The French patent box is extended to IP acquired from a third party. If IP rights are acquired, they must be held (i.e. fixed assets on the company's balance sheet) for at least two years before qualifying for the French patent box regime.[45]

Where IP is transferred from one taxpayer to another, the benefit of the incentive is not granted to both the seller and the acquirer. Precisely, the transferor is the only one benefiting from the incentive, provided that the conditions mentioned

39 FTC, s. 244 *quater* B(d) *bis* and (d) *ter*; French Administrative Guidelines, BOI-BIC-RICI-10-10-20-30-20140404 §250 *et seq.*

40 Finance Act for 2011.

41 FTC, s. 244 *quater* B(d) *bis*; French Administrative Guidelines, BOI-BIC-RICI-10-10-20-30-20140404 §300.

42 FTC, s. 39 *terdecies*.

43 S. 100, Finance Act for 1992.

44 French National Assembly Report no. 2458, p. 117.

45 FTC, s. 39 *terdecies*.

above are met. The same reasoning is applicable to the transfer by the transferee of the acquired IP right to another taxpayer, provided that the same conditions are met. Further, the tax incentive is not available if the transferor and the transferee are related entities. If the transfer is a purchase for selling, the acquired IP right is not considered as a fixed asset and consequently the incentive cannot benefit from the tax incentive.

1.5.4. Pre-existing IP

A 1939 tax regime exonerated capital gains on the sale of patents and gains deriving from licences subject to reinvestment conditions. This regime was considered too complicated. The current French patent box is the result of amendments passed in a 1965 statute[46] setting up the short- and long-term capital gains regimes, depending on whether the holding period is more or less than two years.

1.5.5. Development condition

The law sets no development condition. It must, however, be noted that where the IP rights that are licensed or sold were acquired by the licensor or seller, the reduced 15 per cent CIT rate may not apply in the first two years which follow the acquisition.

1.5.6. Privileged IP income

(a) Net royalty payments received under licence and sublicence agreements (either exclusive or non-exclusive, covering a portion or all of the qualified IP rights) benefit from the patent box regime. In the case of sublicence, the reduced CIT rate applies only if the licensor does not benefit from this tax incentive: this is the case, for example, if the licensor is a foreign company, not subject to CIT in France. A net capital gain reported by the seller in the case of the transfer (sale, contribution in kind, transfer of business, etc.) of qualified IP also benefits from the patent box regime.

(b) Companies which self-exploit their IP cannot claim an “embedded royalty”. However, a similar result may be achieved within a group of companies, by way of a licence by the IP owner to an affiliate company, which manufactures and sells the goods in which the technology is embedded: while the licensing company is taxed at the CIT 15 per cent rate on its royalty income, the licensee deducts from ordinary income (taxable at the standard 33.33 per cent rate) payments made to the former company.

(c) The patent box regime applies on the net IP income or capital gain. The net IP income corresponds to the difference between the gross amount of royalties received and the related costs incurred (by the owner) to manage the qualified IP rights licensed. The net capital gain corresponds to the difference between the transfer price and expenses incurred by the transferor for the purpose of the transfer.

[46] Statutory instrument no. 65-566 dated 12 July 1965.

R&D expenses are not taken into account for the purposes of determination of net royalty payments or net capital gain.

(d) The output incentive takes the form of a privileged rate on income. Indeed, income or gain deriving from the licence, sublicence, sale, or transfer of qualified IP is taxed at a reduced 15 per cent CIT rate (plus applicable surcharges for large companies).

The reduced 15 per cent CIT rate applicable to royalty income was "neutralized" where a licence agreement existed between two related French companies. If the licensor company benefited from a 15 per cent tax rate, the licensee company would only be entitled to claim a reduced tax deduction for amounts paid under the licence (i.e. 15/33.33 per cent of the amounts paid). Therefore, there was no real benefit from this output incentive in a group context, unless the licensee company was located overseas. For this reason, the Finance Act for 2011 removed this capping of the tax deduction for licensee companies where the licensing agreement was entered into between related French companies. Therefore, in the case of a licensing agreement between affiliated French companies, the licensor will benefit from a reduced 15 per cent CIT rate on royalty income, while the licensee company will benefit from a 33.33 per cent tax deduction, provided that the licensee proves the reality and profitability of the licence agreement (see section 1.5.6(b)).

(e) The benefit stemming from the output incentive is not subject to any limitation, such as a certain percentage of the taxpayer's before tax profit, apart from the case in which (i) the licensor and the licensee are French related companies and (ii) the licensee cannot prove the reality and profitability of the licence agreement (see section 1.5.6(d)).

1.5.7. Anti-avoidance provisions

An anti-avoidance provision was introduced in 1991: when the licensor and the licensee are related entities, the licensor could not benefit from the favourable tax regime on the royalties received if the licensee could deduct this royalty at the standard rate. The aim of the 1991 amendments was to enhance the location of research activities in France, to develop French industry and encourage the competitiveness of industries which provide intellectual and knowhow services. This rule had been criticized by European Community counsel according to which it excessively encouraged locating patents in France. This anti-avoidance provision was removed by the Finance Act for 2002.[47]

1.5.8. Credit for foreign withholding taxes

Withholding tax on foreign source royalties is creditable against French tax liability, including royalties eligible for the patent box. A 33.33 per cent withholding tax is levied on the gross amount of patent royalties paid by resident companies to non-resident companies. This withholding tax is not final; it is credited against the CIT assessed under the general rules, where the latter tax is due under territoriality

[47] S. 54, Law no. 2001-1276 dated 28 December 2001 codified in FTC, s. 238-O A.

rules that apply to CIT. Any excess is not refundable. Double tax treaties (DTCs) may reduce, or even eliminate, this withholding tax. As of 1 January 2013, a 75 per cent withholding tax applies to royalties paid to companies situated in a non-cooperative state or territory,[48] unless the paying company proves that the payments do not have tax avoidance as their main motivation and effect.

1.6. Procedural requirements

For R&D tax credit, taxpayers can benefit from an FTA tax ruling on the eligibility of their R&D work. The application must be filed no later than six months prior to the filing of the tax return in which the relevant R&D expenses are registered. If the FTA has not replied within three months, the R&D work is considered as eligible for the tax credit. The ruling is enforceable during a subsequent tax audit. This ruling procedure has met with little success among companies.

The R&D tax credit is offset against CIT. Otherwise it is refunded to the taxpayer at the end of the third year. However, it can be immediately refunded to:

- innovative new enterprises (see section 1.3.4);
- newly created companies (immediate refund for the year of incorporation and the four subsequent years);
- companies which enter into the category of SMEs, as defined by European law (see section 1.3.5);
- businesses which were put into conciliation or safeguard proceedings or into receivership or judicial liquidation proceedings.

2. R&D incentives in an international context

2.1. Introduction

This second part places R&D incentives in an international context and allows the report to explore the following issues:

- the subjective and territorial scope of R&D incentives and their compatibility with several international tax rules (section 2.2);
- R&D incentives and harmful tax competition (section 2.3);
- intangible assets and selected base erosion and profit shifting (BEPS) situations (section 2.4).

2.2. Subjective and territorial scope of R&D incentives

2.2.1. Compatibility with the non-discrimination provision of DTCs

French branches and French subsidiaries of a European parent company that incur R&D expenditure in France and are within the CIT territorial scope can benefit

[48] As of 1 January 2014, the British Virgin Islands, Botswana, Brunei, Guatemala, Montserrat, Nauru, Niue and the Marshall Islands are included in the French non-cooperative states or territories list.

from the R&D tax credit.[49] Therefore, there is no discrimination for branches established in France in comparison with subsidiaries regarding the R&D tax credit.

2.2.2. Compatibility with EU fundamental freedoms

The French legislator adapted the R&D incentive regimes to conform to EU fundamental freedoms and EU treaties. This line of reasoning applies both to input and output incentives.

- Concerning input incentives: before 2004, R&D outsourced expenditure paid in other Member States was not within the R&D tax credit basis, whereas domestic expenditure was within this basis. This difference of treatment between domestic expenditure and expenditure paid abroad was held to be a restriction on the free movement of services.[50] Therefore, the French legislator amended FTC, section 244 *quater* B: amending the Finance Act for 2004 allowed taxpayers to take into account R&D expenditure paid to an EU company.[51]
- Concerning output incentives: the 2003 Interest and Royalties Directive implemented under section 182B *bis* FTC guarantees the EU fundamental freedoms as it eliminates withholding taxes paid between two different EU Member State companies. Thus, EU companies exploiting patents from another EU member company are treated in the same way as relations between two domestic companies.

2.2.3. Compatibility with EU state aid rules

State aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities.[52] Therefore, subsidies granted to individuals or general measures open to all enterprises are not covered by this prohibition and do not constitute state aid. State tax aid is defined as a selective tax benefit which is not granted to all enterprises. Concerning French R&D incentives:

- R&D tax credit: this incentive is not regarded as a state aid as it does not meet the criteria of selection. Any enterprise that incurs eligible R&D expenditure is able to benefit from the French regime;
- innovation tax credit: this recently introduced incentive (2012) is an additional R&D tax credit which only applies to SMEs (see section 1.3.5).[53] It corresponds to 20 per cent of eligible expenditure, capped at 400,000 euro. According to the last subsection of 244 *quater* B-II, FTC, the R&D tax innovation credit is subject to the EU state aid rules. Nevertheless, it fulfils the exemption regulation conditions;

49 FTC, s. 244 *quater* B.
50 ECJ, 10 March 2005, case no. C-39/04, *Laboratoires Fournier* cited above.
51 Amending Finance Law 2004, no. 2004-1485, s. 45.
52 TFEU, ss. 107 and 108, available at http://ec.europa.eu/competition/state_aid/overview/index_en.html.
53 FTC, s. 244 *quater* B – Finance Act 2013, no. 2012-1509, s. 71.

- by contrast, many French tax credits have been characterized as state aids by the European Commission, such as the tax credit for the art sector or the tax credit for the textile field.[54]

2.3. Patent box regimes and harmful tax competition

2.3.1. Under the OECD BEPS action plan

According to the OECD, BEPS can occur as a result of aggressive government competition for a share of the tax base, including the introduction of favourable tax regimes targeted at activities such as IP. This is one of the issues being addressed as part of action item 5 of the BEPS action plan. An example of such a preferential regime is the UK patent box, which was introduced on 1 April 2013, and is to be phased in over five years in such a way as to ultimately permit income arising from patents and other qualifying IP to be taxed at the favourable CIT rate of 10 per cent. As mentioned above (see section 1.4.5), French companies can benefit from R&D tax credit if R&D expenditure is outsourced. However, they should not take into their tax credit basis an amount of outsourced R&D expenditure more than three times their own R&D expenditure.

2.3.2. Under EU state aid rules and the code of conduct for business taxation

Very much like France, the Netherlands or Ireland, many European states have enacted a patent box in order to attract foreign investors. Therefore, there is a risk that this may lead to a situation of low-tax overbidding in which every state will try to reduce its IP tax rate as much as possible to attract companies. As a result, a situation where many European states reduce their IP taxation to a rate of virtually nil could lead to the opposite result from the one expected: instead of reducing public debt by attracting taxpaying companies, this tax overbid could generate less tax revenue.

It has to be noted that even though concerns (relating to R&D incentives that could constitute a form of harmful tax competition) have been expressed in the recent OECD action plan concerning BEPS, the EU Commission has recently adopted new rules to facilitate the granting of aid measures by Member States in support of research, development and innovation (R&D&I) activities.[55] Precisely, the new R&D&I state aid framework sets out the conditions under which Member States can grant state aid to companies to carry out such activities. Also, the scope of measures that no longer need to be notified to the Commission for prior approval has been widened under the new general block exemption regulation (GBER).

The new state aid rules for R&D&I set out in the GBER and the R&D&I framework include the following key features:

- flexibility for implementing R&D&I measures. Precisely, the threshold amounts below which aid is exempted from notification to the Commission have been significantly increased;

54 French Administrative Guidelines, BOI-BIC-RICI-10-10-40-20120912, §370.
55 EU Commission, IP/14/586, 21 May 2014.

- the R&D&I framework will, for individually notified measures, allow aid up to 70 per cent of eligible costs for large companies and 90 per cent for small companies carrying out applied research;
- R&D projects that are co-financed by the EU will now be presumed to constitute necessary and appropriate state aid, in order to simplify the assessment of large aid amounts for project that are in the common European interest.

2.4. Intangibles and BEPS situations

2.4.1. Transfer of intangibles to low-tax jurisdictions

Profit shifting from a high-tax jurisdiction to a low-tax jurisdiction through payments for intangibles is a growing concern in France. Therefore, the French legislator has enacted new provisions and reinforced existing provisions to fight this tax evasion in the matter of transfer pricing especially:

- first, France limits the deductibility of payments made to entities located in tax havens. Under FTC section 238A, French companies that pay IP royalties to tax haven companies cannot deduct these royalty payments from their taxable income. In addition, the withholding tax is up to 75 per cent[56] if royalty payments concern a non-cooperative state or territory;[57]
- second, France deals also with IP transfer to low-tax jurisdictions with the French CFC regime;[58]
- third, the French legislator has strongly increased transfer pricing obligations:[59] French companies with a turnover of over 400 million euro or holding companies meeting this test must make a general report on their transfer pricing policy, a list of the main intangible assets owned and the changes that have occurred in the past year. They must also make a specific report providing a description of the activity and a description of any transaction over 100,000 euro performed with a related company;[60]
- fourth, the FTA would favour the profit split transfer pricing method during a tax audit.[61] This method would be adapted to MNEs that make profits throughout the world using strong intangible assets and locating these assets in low-tax jurisdictions. Using an economic approach to intangible assets rather than a legal approach allows a better allocation of profits based on the property right and, therefore, a fair allocation of taxation between states.

2.4.2. Royalty payments to intermediary IP companies

Erosion of the tax base through IP intermediary companies located in favourable tax regimes is a growing concern for European countries. Traditionally, the FTA

56 FTC, s. 182 B, III.
57 See above.
58 See above.
59 Book of Tax Procedure (LPF), s. L13AA.
60 Provision for combating tax fraud and serious economic and financial crime – FTC, s. 223 *quinquies* B.
61 *Feuillet rapide* no. 49/13, 11 November 2005.

follows two approaches to penalize French companies using intermediary IP companies by "treaty shopping". The first approach, based on the transfer pricing legislation,[62] allows the FTA to reassess royalty transactions paid by French companies to intermediary companies abroad. The second approach, based on the abuse of law concept,[63] aims at forbidding tax avoidance schemes by providing the lack of economic substance of the intermediary IP company.

More recently, the FTA has enhanced its tools in two different ways:[64]

- a preventive way through rulings: regarding MNEs, rulings may be a response to prevent tax avoidance. The French legislator has established two rulings concerning tax evasion concerns. First, the "permanent establishment" ruling confirms or denies the presence of a French permanent establishment for a foreign company.[65] Second, the "transfer pricing agreement" is a contract which is entered into between the taxpayer and the FTA concerning the transfer pricing policy used by the company in France for transactions that occur with related entities;[66]
- and an *a posteriori* repressive way: the Finance Act for 2014 tentatively introduced the obligation to declare tax planning scenarios to the FTA, looking like the UK disclosure of tax avoidance scenarios obligation. Contravening this obligation involves a fine equalling 5 per cent of the amount generated by the tax planning scheme. This obligation, however, was not upheld by the French Constitutional Court.[67] Similarly, the French legislator may well extend in 2015 the French "anti-hybrid rule" to IP royalties paid by French companies.

Recently, the FTA notified heavy tax reassessments against companies implementing these practices.

62 FTC, s. 57.
63 LPF, s. L 64.
64 French Senate Report, no. 673, Ph. Dominati, available on the internet at http://www.senat.fr/rap/r11-673-1/ r11-673-11.pdf.
65 LPF, 6°, s. L80B.
66 *Ibid.*
67 Case no. 2013-685 DC.

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