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Brain Drain: Are Tax Laws Driving R&D Operations Overseas?

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Back in the early 1980s, the United States was one of the first nations to encourage private-sector research and development through tax credits. A number of studies have shown that every tax-credit dollar stimulates anywhere from \$1 to \$3 in additional R&D investment on the part of U.S. companies. And we know that R&D spurs innovation, creates jobs, and bolsters our country's global competitiveness.

But today, as we wait for the R&D tax credit to be enhanced and made permanent, instead of being constantly extended, the United States finds itself trailing 16 other Organisation for Economic Co-operation and Development member nations when it comes to R&D incentives.

This means that even though we devote 2.5 percent of our GDP to R&D, companies are relocating R&D facilities and operations to other countries—such as Australia, Canada, China, France, India, Japan, Portugal, Spain, and the United Kingdom. Asia, in particular, has pushed hard to make its R&D incentives permanent, and that's one of the reasons it's been successful in attracting some of the best and brightest research teams in recent years.

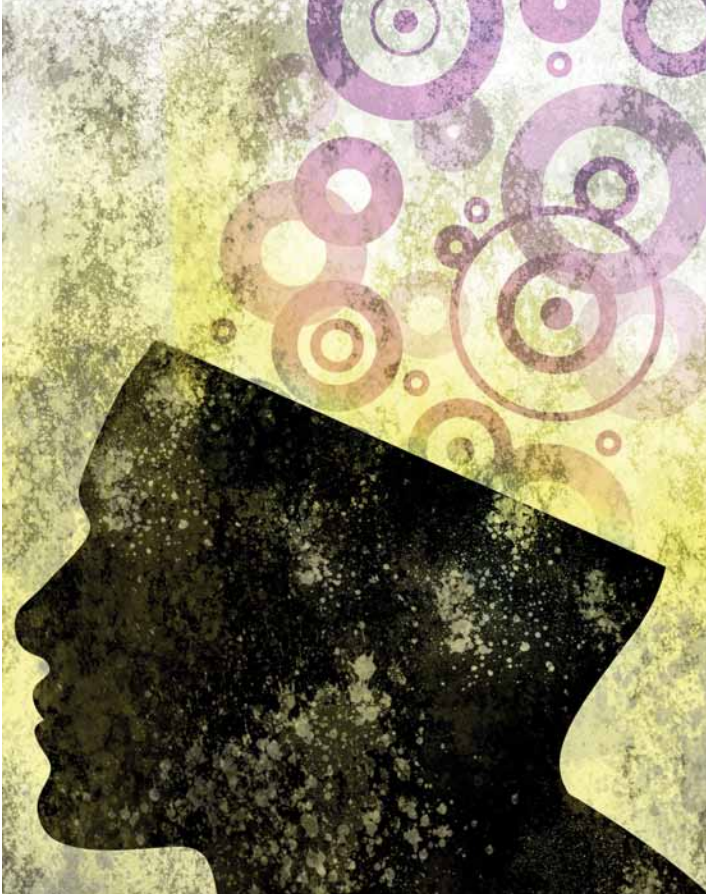
Despite the global competition for R&D talent, there probably isn't a perfect country for this critical business function. Indeed, each has advantages and disadvantages in terms of what it can offer a company's R&D division.

So, in addition to R&D tax credits, companies must assess all the tax-oriented incentives—including current deductions, enhanced deductions, and R&D grants—when considering relocating their R&D operations. The country's effective tax rate, duties, tariffs, value-added taxes, withholding taxes, the application of tax treaties, transfer taxes if the R&D facility is moved—all of these must be taken into account.

Then there are a host of nontax factors that are important when deciding whether—and where—to move an R&D facility. The key questions to ask in this process are:

- Are there qualified research institutions nearby?
- What's the education level of the workforce?
- What are the costs of resources, facilities, equipment, and materials?
- What's the proximity of the R&D operation to other company functions?
- What are the intellectual property laws, from a protection and ownership point of view?
- Does the country offer political stability?

Some countries permit cost-sharing arrangements for R&D operations, allowing several entities to pool their R&D expenditures. And a number of countries are very demanding about arm's-length transfer pricing, which requires an R&D division to charge another division within a company the accepted market rate for its services.



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Understanding and analyzing all these issues can help companies choose the right country for their R&D operations. But still more due diligence is required—especially in the area of structuring the R&D organization.

A recent high-profile legal case made this perfectly clear. The proceedings show that a U.S. company with a branch in India

set up two separate business units there—an R&D department and a sales operation. The company's head office back in the United States took on the costs of the Indian R&D department, which generated no profits. As a result, the company assumed it wouldn't have to pay taxes for the R&D department in India.

Unfortunately, it was wrong. The Indian government ruled that the R&D department was linked to the sales operation and was helping to generate revenues, so the R&D department had to be taxed in India.

There are many instances like this in today's peripatetic world of global R&D, and the risks can be avoided—or at least hedged—with thorough and thoughtful planning up front.

But the real essence here, especially for U.S. companies, is that we haven't yet committed to a seamless and substantive R&D tax credit, and that's forcing firms to look abroad for new R&D locations offering greater incentives.

It doesn't have to be this way. The federal subsidy for the R&D tax credit was slightly less than \$6 billion in fiscal year 2009—a drop in the bucket compared with the value of the innovation that stemmed from this tax benefit. Meanwhile, several analyses show that if we were to increase the R&D tax credit rate from 14 percent to 20 percent, for example, we'd create approximately 200,000 valuable and much-needed new jobs that could help stimulate growth and prosperity from coast to coast.

There's an old maxim: Brain drain leads to profit drain. If we don't find a workable solution for the R&D tax credit in our country, many more companies will move their R&D operations offshore, and we'll then fall even further behind in the race to the 21st century's finish line.

