How to YIC

The YIC Status Handbook for Policy Makers

YIC (Young Innovative Company) status is a special tax category that allows access to State aid through tax incentives for R&D intensive start-ups.

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Foreword

Tax incentives for business R&D are widely regarded as an important policy tool to stimulate private investment in the life sciences and in innovation generally. The OECD reports that in 2005, 70% of member countries had tax incentives including the US, Canada, Japan and Australia. The figure compares to only 50% of OECD countries in 1996, highlighting the growing popularity of this policy instrument.

The overall picture is that tax incentive programs have catalysed investments in R&D which support innovative companies and create new job opportunities. Today several EU Member States have adapted their tax systems to stimulate R&D intensive companies in areas like the life sciences.

This handbook is a how-to guide for policy-makers looking to implement a tax incentive package for young and innovative companies and is one deliverable of the project "Realisation of Young Innovative Company Status, YIC, for biotech companies" supported by the European Commission (Contract No. LSSB-CT-2005-018768). Many of the background documents to this handbook are publicly available at http://www.yicstatus.com. The participants in this project include five national associations: SwedenBIO, Chemical Industry Federation of Finland, Estonian Biotechnology Association, Federation of Norwegian Industries and France Biotech. Further members are the European Association for Bioindustries and the coordinator is the Swedish Institute for Food and Biotechnology.

How to design tax incentives?

Policy-makers need to invest time and effort in designing tax incentives for Research and Development in order to create the desired effect and to avoid bureaucracy. It is important to take a lesson from the best practices currently in place, in order to improve existing schemes and to avoid mistakes in designing new programs.

Based on policy documents, papers and discussions with industry representatives, five characteristics have been identified for any tax incentive program. They are:

- Generous enough to influence investment decisions
- Predictable enough to enable long-term investment planning based on the incentives
- Simple enough to ensure that companies understand the programs
- Low administrative burden to encourage even small companies to claim the benefits
- A clear targeting profile to concentrate resources to where they have the greatest effect.

Qualifying R&D Expenditure

Costs that qualify for tax incentives can be considered under the following categories:

- Salaries. Most countries include salaries and social charges for R&D employees in their tax incentives. The incentive reduces the cost of hiring research personnel and stimulates the business to invest in new job opportunities.
- Current expenses. Current expenses besides salaries include materials, fuel, power, software and much else related to the R&D.
- Capital costs. Some countries allow inclusion of capital costs related to R&D in calculating the expenditure.

Outsourcing of R&D. Subcontracting of R&D activities and external salary costs are treated in different ways by tax incentive schemes.

Targeted incentives

Many countries have decided to target tax incentives to SMEs and/or research intensive companies. The Young Innovative Company system in France, for example, targets young companies that devote at least 15% of their outlay to R&D. Belgium, the UK, Canada, the Netherlands and Norway are other examples of countries that have a more generous treatment of SMEs than of larger companies.

The rationale for targeted incentives is to give an extra boost to R&D investments in a specific category of companies. These companies may be of particular interest to policy-makers or be more likely to suffer from market failures and information constraints that cause them to under invest in R&D. Targeted incentives to SMEs are motivated by SMEs possessing the highest potential to generate growth but being restricted by their financial instability and high risk, which makes it difficult to attract investors.

Tax Allowances

R&D expenditure represents an investment for the future; almost all developed countries allow complete deduction of current R&D expenditure, such as costs of materials and salaries for researchers. A number of countries allow immediate or accelerated write-off of capital expenditure such as machinery (e.g. Spain, Denmark, Canada and Ireland) and other countries provide accelerated write-off for buildings associated with the R&D work (e.g. the UK). More importantly, many countries provide tax allowances for R&D outlay. Companies investing in R&D can deduct the costs to above their actual value. This reduces the taxable profit and lowers the cost of the R&D investment. Australia, Austria, Belgium, Denmark and the UK are examples of countries that provide tax allowances. The value of these allowances for the company will depend on the level of income tax that the company is facing.

Tax Credits

A tax credit is applied directly to the tax that is being paid. It is specified as a percentage of the R&D expenditure (e.g. 20% of R&D outlay) and this credit reduces the tax payable. An important difference between credits and allowances is that credits do not depend on the level of corporate tax. Canada, France, Spain, Ireland and Norway are all countries that offer tax credits for R&D, and among the OECD countries, credits are generally used more often than tax allowances.

Extended Incentives

Constructing incentives for unprofitable firms requires special solutions. One alternative is to allow companies to carry tax credits and allowances back or forward in time, to set against profits in better years. However, carrying a tax credit forward makes it less valuable since time erodes its value. It is important to realise that young R&D-intensive firms are more in need of immediate cash flow than of reduced tax bills in the future. To support these companies, some countries provide tax incentives through an immediate cash payment. This is current practice in Canada, France, the UK and Norway, for example, with variations in implementation.

Another option is to relieve the companies of social costs related to the R&D expenditure. Because unprofitable businesses also pay social costs for their employees, this measure provides general support to companies performing R&D. The main benefit of the YIC system, in place in France and Belgium, is relief from social costs. French companies qualifying for YIC status are exempt from paying social costs for all researchers and technicians, but also for employees in other roles such as managers and employees in charge of intellectual property and judicial matters.

Volume or Incremental Change as the Basis of Support

Volume or incremental change as the basis for calculating tax incentives is another possibility. Fiscal incentives based on volume define the support as a percentage of the total amount of R&D that the company is undertaking. This can lead to a situation whereby governments support R&D that would also have been carried out without the incentives. To encourage an increase in R&D spending, some countries (e.g. France, the US and Spain) base at least part of the support on the increase in R&D volume. The credit is calculated as a percentage of the year-to-year change in R&D expenditure.

Some governments provide tax relief to increase R&D investments; thus, basing the support on the incremental volume change in R&D is appealing. However, the theoretical advantage must be weighed against the relative complexity of an incentive based on incremental change compared to one based on volume. A special solution is needed to handle a decrease in R&D costs. The tax relief may also be very volatile from one year to another in an incremental system, which creates uncertainty. Most countries therefore prefer a volume-based incentive program.

YIC - France Case Study

France is a forerunner when it comes to stimulating business R&D through tax incentives. The main program, "Crédit d'impôt recherche" (Research tax credit - CIR) was launched in the 1980s and focuses on companies of any size and in any industry. "Jeune Entreprises Innovantes" (Young Innovative Companies - YIC) is a supplementary program that was introduced in 2004. YIC embodies a range of measures targeting the creation and growth of young research intensive companies in France.

The Young Innovative Company status is a measure to strengthen the growth of young and innovative companies. To obtain YIC status, companies must be maximum 8 years old and must be investing at least 15% of their expenditure in R&D. Public companies (listed on a stock exchange) are excluded from support.

Businesses that qualify for YIC status profit from a battery of different support measures. They are exempt from social costs for all employees in R&D-related activities (approximately 25% of gross salary costs). The definition of R&D-related activity is liberal and researchers, technicians, patent attorneys, and people working with testing are all included, as well as managers (including the CEO).

YIC companies are also relieved from corporate income tax for the first three years and pay 50% of normal taxes for the following two years, up to a maximum of 100,000 EUR in support. They can also be relieved from local taxes related to the value of properties and buildings.

Support targets

YIC has an obvious focus on SMEs, and specifically on young, innovative companies.

Administration and claim procedure

For YIC, companies apply for the status in advance. Once they have been approved, their monthly payments of social costs are reduced for all qualifying employees. YIC therefore immediately improves the cash flow of the company by lowering costs for personnel.

The YIC status applies to social costs for everyone working in R&D plus a number of other positions. In one French company with 42 employees, 39 of those qualified for relief from social costs, which indicates the generous definition of an R&D employee under YIC.

Results

In 2004, the first year that YIC status was available, 862 companies gained this status – which involved a total of 4,880 employees (Ministère délégué à la Recherche, 2005). 1600 companies have gained YIC status since the introduction of the scheme. Such companies are by definition research-intensive, and many are active in the life sciences (20%). The total cost of the YIC program has been about € 40 Million per year, but is expected to increase to € 120 Million in 2006.

With the addition of YIC status, France has considerably strengthened the incentives for innovation.

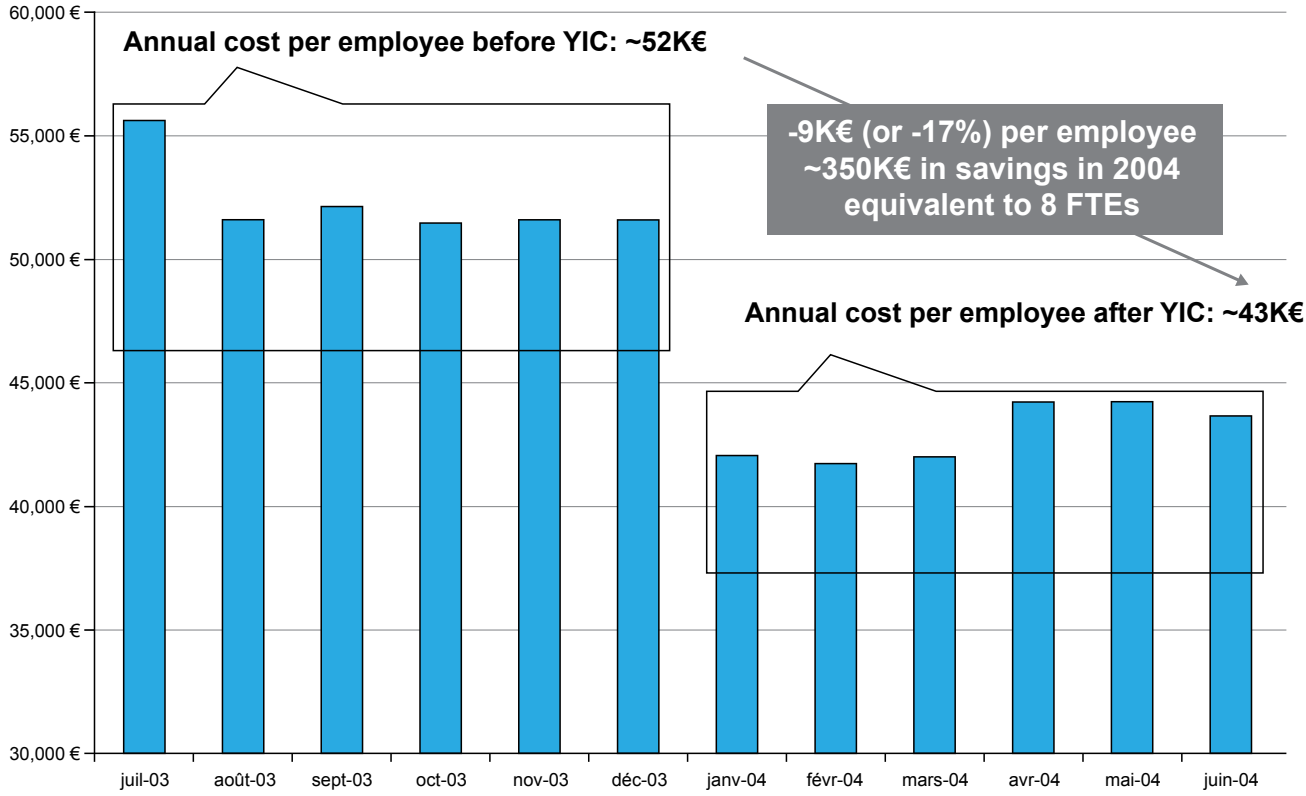

Table from the presentation 'Young Innovative Company Made in France', by France Biotech in Stockholm, 28 Feb 2007

Future directions

France has considerably strengthened the incentives for innovation over the last few years and there is no reason to believe that this trend will not continue. One issue is an extension of the YIC status to include also companies that have been through an Initial Public Offering (IPO) and are listed on a stock exchange. YIC status is currently only available to privately held companies, which is a disincentive to take high-tech companies to the stock market.

YIC Status & the EU

The European Commission's new State aid rules recognize Young Innovative Companies (YIC) status as an eligibility criterion for state aid. This will enable Member States to provide extra public funds like tax and other financial incentives to their young innovative biotechnology companies without running into trouble with EU competition rules. The new EU rules enable governments to give extra incentives to companies that are less than 6 years old and spend 15% or more of their revenues on R & D. As of 1 January 2007, the EU rules, which are not sector specific, have opened the path to benefit research, development and innovation across Europe.

The primary objective of this new framework is to:

- To increase Research, Development and Innovation spending to 3% of European gross domestic product by 2010
- Help Member States invest more in R&D&I and increase the share of aid for R&D&I as a percentage of total State aid budgets; and
- Use better economics to help Member States target State aid on the right projects, so that distortions of competition and trade are minimised and public spending efficiency maximised.

The new rules on Research, Development and Innovation contain a flexible package of measures which can be used by Member States to tailor their support to R&D&I according to their national preferences, needs and specificities. On the basis of economic analysis a series of measures are offered to Member States to grant aid, to help them direct more aid to R&D&I than currently the case and to better target their funds to measures that are on balance beneficial to the common interest.

New measures on support for innovation were introduced. They include:

- aid for young innovative enterprises
- aid for projects covering fundamental and industrial research and experimental development
- aid for technical feasibility studies
- aid for industrial property rights costs for SMEs
- aid for process and organisational innovation in services
- aid for advisory services and innovation support services
- aid for the loan of highly qualified personnel
- aid for innovation clusters.

Exploring YIC Status potential

Currently the only European countries that have YIC Status are France and Belgium. Four European countries took part in this project and examined their biotechnology industries and the potential impact that YIC Status could have on their country. The evaluations and proposals for YIC Status in Estonia, Finland, Norway and Sweden are mentioned briefly below and can be consulted in more detail in 'Improved Conditions for Young & Innovative Companies', available at http://www.yicstatus.com/.

Estonia

Estonia's biotech industry

The Estonian Biotechnology Sector has approximately 40 companies, out of which around a dozen could be considered "core" biotechnology companies. The total turnover of biotechnology enterprises reached 9.6 million euros in 2005. There are around 15 research institutions working in the field of biotechnology. 500 people are employed in this sector, while about 450 people with the relevant education entering the job market annually. The main competences of Estonian biotechnology lie in red biotech – drug development, diagnostics etc. White biotechnology is also common in research as well as companies.

Summary of Estonia's YIC potential

Estonia's fledgling biotech industry could benefit immensely from tax incentives. YIC status would provide the SMEs with better conditions for private funding, to attract venture capitalists, by providing a more growth friendly tax environment.

Estonian SMEs have difficulties attracting venture capitalists. There is very little real venture capital funds available in Estonia and lack of capital has been underlined as the major obstacle in Estonian R&D, as the existing support instruments (grants, direct funding schemes) and research funding are hardly enough to cover the R&D labour costs. This leaves no resources for buying equipment, and materials for experiments, ongoing maintenance, telephone and electricity etc.

The YIC proposal in Estonia is to implement a 50% social tax reduction (from 33% to 16.5%) of R&D labour in SMEs who are 8 years old or younger and invest at least 15% of their yearly budget in R&D. The new scheme would lead to an increase of government direct and indirect support of business R&D from 43.5% to 44.5%.

Finland

Finland's biotech industry

Finland has an advanced infrastructure and is technology-friendly society. There are about 100 core biotechnology companies, of which there are 25 "young innovative biotech companies".

Biotech companies are most common in diagnostics, drug discovery and food and feed. There are also a smaller number of companies involved in biomaterials, enzymes and bioinformatics.

Due to a lack of venture capital in the biotech industry in recent years (2002 – 2006), there have been only a small number of new companies founded with a slow development of projects and few IPO's.

Summary of Finland's YIC potential

Although there is no data to prove that tax incentives can boost the Finnish biotech industry, tax incentives could support the 'business angels' of today. They could bring a longer period to utilise cumulative losses which would be positive for valuation. As the companies grow there is more potential for value, increasing attractiveness to venture capital and the professional competences that go with it.

The YIC proposal for Finland is to amend the present tax law so that YICs, as defined by the EU State aid rules (SMEs, 6 years or younger that invest at least 15 % of the yearly budget in R&D) would receive a tax credit in the form of a reduction of the payroll tax levied on administrative, marketing and business personnel. Under such a scheme a YIC could receive a maximum tax relief of 1 (or 1.25 or 1.5) million EUR over a three-year period.

Norway

Norway's biotech industry

For many years, the Norwegian biotechnology industry consisted of a few large, partly profitable companies dominating the sector and many small companies, with significant research and investment needs. The industry is mainly concentrated on pharmaceuticals, but is looking to extend into marine environments. In 2006, Norway's biotechnology industry was made up of some 75 companies, of which five are listed on the Oslo stock market, representing an estimated 0.3 % of the total market value. However, the majority of the companies are small and short on capital.

Support from SkatteFUNN, a tax credit program through which companies can have up to 20% of their R&D expenditure financed, is distributed to a very large number of companies in all sorts of industries, but the injection given to each company is moderate in size. By restricting the overall support, SkatteFUNN has only a marginal effect on R&D intensive companies that have passed the start-up phase and need large R&D investments. The system is therefore not particularly friendly to the biotechnology sector.

Summary of Norway's YIC Programme

There is an inadequacy in the present tax-incentive-system in Norway and there is a need for reforms. The system is not tuned to the needs of growing companies with tax-incentives that are insufficient for biotech start-ups; SkatteFUNN should narrow its focus and direct more support to fewer companies.

The YIC proposal for Norway is to amend the present SkatteFUNN scheme so that SMEs which are 8 years or younger and invest at least 15 % of their yearly budget in R&D, will receive a tax credit of 30 % of R&D costs, with a cap set for the amount of R&D taken into consideration at NOK 45 mill.

Sweden

Sweden's Biotech Industry

Sweden has about 800 life science companies. The Swedish life science companies are focused on development of pharmaceuticals, medical devices and platform technologies; the drug development pipeline has a many projects in clinical trials. Currently, about 40 000-50 000 people in Sweden are employed in the life science industry and it has had the most rapid growth of all sectors in Sweden during the last 10 years. Over 90% of the life science companies in Sweden have less than 100 employees.

These R&D intensive companies need tax relief to reinvest social fees into expanding faster, accelerating development and hiring personnel. This would also contribute to increasing their competitiveness in the global market place.

Summary of Sweden's YIC potential

In 2001 the Swedish Corporate tax was below EU average – Today it is above. One Euro of R&D costs in Sweden costs only 70 cents in France and Canada. A R&D tax incentive would stimulate new jobs and product development. Time is critical and the Swedish government is advised to implement a R&D tax incentive as soon as possible.

The YIC proposal for Sweden is a reduction of the payroll tax for research personnel employed by YICs, defined as companies that invest 15% or more of their budget in R&D. The payroll tax is presently slightly higher than 32% of wages. The size of the reduction and the definition of research personnel are subject to further considerations.

Conclusion

Simplicity, predictability and liquidity are keys in a well-designed YIC program. New State aid rules at EU level accept YIC status as a legitimate category for State aid. Governments considering tax incentives for Young and Innovative Companies are recommended to have a well-defined the goal and ambition for the system. These programmes should include a payable credit option for unprofitable companies to let the money reach the company as soon after the R&D outlays have occurred as is practically possible. However, policy-makers must note that avoiding excessive bureaucracy is important for an effective tax incentive system. Self-assessment of R&D outlays by companies effectively manages the level of bureaucracy.

Governments should outline the tax relief in close collaboration with industry and plan early for continuous evaluation of the program together with industry. Once a system is in place, major changes to programmes should be avoided as predictability is a virtue.

The final messages:

- Europe must fully embrace innovation to meet global competition along the value chain.
- New jobs and growth will come in sectors like life sciences and biotechnology and State aid through tax incentives to young and innovative companies helps achieve growth –without lowering social security and creating problems in other sectors.
- The EU Commission's new State aid rules facilitate the setting up of a YIC Status for State aid in Member States.
- Implementation of YIC Status is the responsibility of Member State governments, who need to act to allow innovation and growth to thrive.

Project partners

SIK, the Swedish Institute for Food and Biotechnology (co-ordinator)

SwedenBIO Service AB

Estonian Biotechnology Association

Federation of Norwegian Industries

Chemical Industry Federation of Finland

EuropaBio, The European Association for Bioindustries

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