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## Using methods of tax incentives in innovation

**Shteinberg Konstantin Konstantinovich**

Postgraduate student,  
Chief Expert of the Department of  
international experience analysis in tax administration,  
State University of Management,  
P.O. Box 109542, Ryazanskii ave., No. 99, Moscow, Russian Federation;  
e-mail: mns10112@nalog.ru

### Abstract

The directions of the use the accelerated depreciation and tax credit for THE stimulation of innovative activity of enterprises is grounded in the article.

Foreign experience of the use of tax stimulation methods of innovative activity is considered, the basic types of tax incentives being used in foreign countries are defined.

### Keywords

Tax deductions, innovative activity, tax stimulation, accelerated depreciation, tax credit.

## Introduction

Developing and introducing state regulatory policies to support innovation is an important prerequisite for economic development. A special role in the implementation of this strategic task belongs to the efficient use of tax incentives methods.

In scientific works of foreign and local experts a lot of attention is paid to the issues of tax incentives as an instrument of state regulation aimed at enhancing innovation.

Problems of tax incentives has been considered by many foreign experts: W. Petty, A. Smith, M. Friedman, A. Shekle, A. Marshall etc., as well as

by national economists: A.Z. Dadashev<sup>1</sup>, N.V. Milyakov<sup>2</sup>, A. N. Karetin<sup>3</sup>, S.V. Fedoraev<sup>4</sup>, A.M. Mukhamedyarov<sup>5</sup> etc.

At the same time there is a need for continuous development of theoretical and practical aspects of tax incentives to enhance innovation in terms of the global tax reforms. This makes it necessary to choose the most effective areas of innovation.

- 1 Dadashev, A.Z. (2008), "Formation of tax mechanism of investment stimulation in the fixed assets" ["Formirovanie nalogovogo mekhanizma stimulirovaniya investitsii v osnovnoi capital"], *Investitsii i nalogooblozhenie*, No. 4, pp. 10-25.
- 2 Milyakov, N.V. (2003), *Taxes and taxation: practical textbook. 3rd ed., rev. and enl.* [*Nalogi i nalogooblozhenie: praktikum. 3-e izd., pererab. i dop.*], INFRA-M, Moscow, 380 p.
- 3 Karetin, A.N. (2010), "Government policy in the field of management innovation: problems and prospects" ["Gosudarstvennaya politika v sfere upravleniya innovatsiyami: problemy i perspektivy"], *Menedzhment innovatsii*, No. 1, pp. 84-86.
- 4 Fedoraev S.V. (2010), "Mechanism of tax stimulation of science and innovation in Russia: baseline conditions and prospects of development" ["Mekhanizm nalogovogo stimulirovaniya nauki i innovatsii v Rossii: sovremennoe sostoyanie i perspektivy razvitiya"], *Menedzhment segodnya*, No. 5, pp. 226-275.
- 5 Mukhamed'yarov, A.M. (2008), *Innovation management: study guide. 2th ed.* [*Innovatsionnyi menedzhment: Ucheb. posobie. 2-e izd.*], INFRA-M, Moscow, 176 p.

This article aims to study foreign experience of tax incentives and analysis of domestic preconditions in order to introduce efficient and effective methods of tax incentives for innovation.

## **Tax incentives and innovation activities**

In world practice by stimulating innovations direct and indirect methods are used.

Direct stimulation provides for allocating budget funds to conduct research and development. Indirect incentives are provided by tax deferments, tax allowances, profit tax relief and other tax incentives. Changing the conditions of taxation aims to enhance innovation.

International experience of using tax incentives methods shows that in recent years there is a transition from direct government funding of innovation enterprises to indirect methods based on the use of tax leverage. Thus, if in 2005 direct government funding amounted to average 7% of business spending, compared with 11% in 1995.

In recent years number of countries offering tax incentives for innovation has increased. Thus, in 2008, 21 countries-members of OECD provided tax breaks to companies in the innova-

tion sphere (compared with 18 countries in 2004 and 12 – in 1995)<sup>6</sup>. Favorable innovation environment is created in the states in different ways. For example, Canada and the Netherlands used the mode of tax incentives with respect to small businesses. Brazil, India, South Africa and China are establishing a competitive tax environment for innovation<sup>7</sup>.

In foreign countries the following methods of tax incentives are widely used:

- Preferential tax rates: for example, in the UK, a special rate for small businesses is used;

- Favorable conditions for the payment of tax liabilities and simplified reporting procedure are used in Italy, Spain;

- in countries such as the UK, Sweden and other countries businesses with a small turnover do not need to be registered as VAT-payers;

- Using the tax rates that depend on the value of the turnover in countries such as the United States and Switzerland;

- Preferential reporting deadlines in France, Italy, Sweden, Spain;

- Reduction of taxable income in terms of local income tax on 50% for companies with low turnover, for example, in Italy.

The indicator of tax benefits is most commonly used in the world to assess the country's tax incentives for innovation<sup>8</sup>. Value of the index indicates a significant amount of effective incentives implemented by the state to support innovation. In particular, in 2008 such countries as France, Spain, Portugal, Czech Republic and India had the highest rates of tax benefits for \$ 1. spent on innovation.

The analysis of foreign experience and trends in the state sphere of innovation support requires thorough research of the background, as well as the development of specific tax tools to be used in Russia.

Tax breaks as a part of the tax regulation mechanism, including various forms, types and tools are aimed to increase (*ceteris paribus*) the profitability of business entities, the volume of their own financial resources. The greatest potential for the regulatory impact on the pace, scope and direction of investment activities include

6 "OECD Science, Technology and Industry Outlook, 2009", available at: <http://www.oecd.org>

7 OECD Science, Technology and Industry Scoreboard, 2010", available at: <http://www.oecd.org>

8 Warda, J., "An Update of R&D Tax Treatment in OECD Countries and Selected Emerging Economies, 2008-2009", available at: <http://www.oecd.org>

direct taxes; corporate income tax may be allocated among them as well.

An integrated approach to the calculation of income tax and depreciation costing is an effective method of tax incentives. Using this method allows businesses to increase the volume of their financial resources that can be used to provide further strengthening of investment potential and innovation development.

Tax breaks for businesses existed until 2002, as far as the procedure provided for enterprises' using investment tax breaks on profits of enterprises and organizations, which allowed to allocate up to 50% of taxable profits to finance capital investments, were applied. Subsequently this incentive was abolished by reducing the income tax rate and introducing a new depreciation policy.

Tax burden has been steadily declined, in particular from 1 January 2002 due to the promulgation of Sec. 25 of the Tax Code the tax rate was reduced from 35% to 24%, and since 2004 the VAT rate has been reduced from 20 to 18%; moreover, the sales tax was abolished to take measures to reduce the tax burden on the economy. These measures have contributed to a corresponding increase in companies' equity investments in innovation to a certain extent.

From January 1, 2002 the investment income tax credit for enterprises and organizations was abolished, but a new mechanism for calculating and using depreciation was introduced. The current depreciation policy is still used ineffectively in the tax regulation of the Russian economy. In the industrialized states the share of depreciation in terms of the total value of investment financing in fixed assets amounts to average 65%, at the same time it does not exceed 20% in Russia.

As far as this issue is concerned, increasing investment activity and renewing fixed assets based on the effective depreciation policy is of highly importance. Including depreciation, as well as other production costs in the composition of expenses reduces the amount of profit specific to tax payers and, accordingly, reduces the amount of corporate tax they pay. Compared to other production and distribution costs depreciation charges turn into an additional source of financial resources for the taxpayer. Therewith these funds are aimed to renew fixed assets, to introduce technical and technological innovations.

Thereby adopting requirements for innovations at the normative level becomes of special importance, with these innovations being subject to accelerated depre-

ciation benefit. With a decrease of budget revenues in terms of corporate income tax one must take into account the fact that the state guarantee is required in respect of additional financial resources received by taxpayers that should be used to develop innovation and investment sphere.

In this regard when calculating and paying corporate tax it is of vital importance to include depreciation in actual expenses, which is actually used to finance investment.

These funds should be used not only for direct investment in fixed assets, but also for research and development.

As far as innovation stimulation is concerned, along with depreciation and targeted tax incentives the use of investment tax credit by an enterprise is of particular importance.

In turn, the global experience of applying innovative tax credits indicates that the mechanism of its provision provides for not a deferral of tax liability for income tax at a later date (which would lead to making a large amount of payments to the budget at the end of the investment (innovation) project and thus to a significant impact on the financial condition of active innovation enterprise), but rather for a reduction of the tax assessed by a certain percentage – from 4 to 30% of total expenditure on innovation

and (or) from 20 to 50% of their average growth over a particular period of time.

## **Conclusion**

In summary, the foreign experience of innovation stimulation shows that there is a gradual transition from direct public funding of innovation enterprises to indirect methods of their stimulation. This requires the use of new and improvement of existing tax mechanisms to stimulate innovation. In this regard tax tools are being improved to stimulate innovation, favorable and competitive tax environment is being established for investment in innovation.

Analysis of domestic prerequisites for innovation stimulation shows that when accelerating innovation of enterprises use of such tax benefits as depreciation policy and the tax credit is of particular importance.

Improving tax incentives for innovation will facilitate the transition of the domestic enterprises to innovative path of development.

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## **Использование методов налогового стимулирования в инновационной деятельности**

**Штейнберг Константин Константинович**

Аспирант, главный специалист-эксперт

Отдела анализа международного опыта налогового администрирования,

Государственный Университет Управления,

109542, Российская Федерация, Москва, Рязанский просп., 99;

e-mail: [mns10112@nalog.ru](mailto:mns10112@nalog.ru)

### **Аннотация**

Обоснованы направления использования ускоренной амортизации и налогового кредита для стимулирования инновационной деятельности предприятий.

Рассмотрен зарубежный опыт использования методов налогового стимулирования инновационной деятельности, определены основные виды налоговых стимулов, используемых в зарубежных странах.

### **Ключевые слова**

Налоговые льготы, инновационная деятельность, налоговое стимулирование, ускоренная амортизация, налоговый кредит.

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