

Tax incentives for R&D and innovation

Rationale and objectives

Public support for business R&D is justified as a means of overcoming market failures that depress the level of R&D and innovation activity in an economy. R&D tax incentives aim to encourage firms, which are the main intended beneficiaries, to invest in R&D by reducing their effective costs (OECD, 2010). Compared with most types of direct subsidies, R&D tax incentives tend to be designed to allow firms to decide the nature and orientation of their R&D activities, on the assumption that the businesses are best placed to identify research areas that can be brought to the market. R&D tax incentives are in principle more market-friendly and neutral than direct support instruments. In addition, direct subsidies under international trade and competition rules are subject to conditions that are less stringent or do not apply in the case of indirect forms of tax support, provided the relief remains non-discretionary and different types of firms and sectors are not automatically excluded (OECD, 2014).

Potential downsides of R&D tax incentives include their limited scope for identifying and supporting projects with the highest expected additionality - i.e., those inducing R&D and related outcomes compared to what would have been realised in the absence of relief. If inadequately monitored, tax incentives for R&D and innovation may actually support downstream activities for which there is less of rationale for support, displacing activity by other firms. The widespread use of tax incentives by different countries in order to attract the R&D activities of multinational corporations (MNEs) may also lead to a form of tax competition where the effects of national R&D tax incentives can be nullified by those introduced abroad for R&D, resulting in a global loss of tax revenues with little or no added impact to R&D levels (Appelt et al., 2016).

Major aspects and instruments

Types of tax support instruments

Tax incentives for business R&D can represent either advantageous tax treatment of R&D expenditure (expenditure-based provisions) or preferential treatment of incomes from licensing or asset disposal attributable to R&D or patents (income-based provisions).

Expenditure-based R&D tax incentives are widely available to businesses across most OECD countries and many other economies. Within the OECD, only Estonia, Germany and Switzerland do not currently offer specific tax relief for R&D at central or federal level. Tax relief is also available to individuals acting as companies in most of these countries, and some (e.g. Colombia, Denmark, Korea, Turkey) also provide direct relief to individuals for their earnings as employees, for example, to encourage inward mobility of highly qualified personnel and reduce indirectly the costs incurred by firms or other organisations to attract those individuals. Tax relief for charitable giving by individuals and corporations often refers explicitly to donations intended to support research and related activities (e.g. Denmark and Hungary).

Income-based incentives are currently less widely used than expenditure-based schemes but, in recent years, their adoption rate has increased within and outside the OECD area. Recent examples include the “patent box” introduced in Italy, Ireland’s Knowledge Development Box regime and the “Tax Exemption for Income from Technology Acquisition” scheme introduced by Korea in 2015 as a temporary incentive for SMEs and “high potential enterprises”. The OECD Action Plan on Base Erosion and Profit Shifting (BEPS) seeks to limit the potential harmful effect of such provisions by setting a number of rules that limits their use and links the relief to the existence of substantive knowledge development activity (OECD, 2015a). A discussion of the rationale and emerging evidence on the effectiveness such schemes is available in Appelt et al. (2016).



The distinction between expenditure and income-based incentives can also apply to innovation activities in general and the outcomes of such activities. A few countries such as France and Spain provide explicit forms of tax relief for companies that engage in innovation activities other than R&D. Overall, it is more difficult to identify schemes as being innovation-oriented because they tend to adopt very different perspectives for the eligible innovation activity for which relief is provided. The range of tax support measures with potential incentive effect on innovation is significantly broader, especially in relation to the treatment of capital gains or start-up business activity.

Tax incentives for R&D and innovation may be implemented via income tax, payroll withholding taxes and social security contributions, value-added tax or other consumption, land and property taxes, etc. (OECD, 2015b). From the perspective of business, corporate income taxes are the most widely used instruments, followed by tax relief on wage taxes and social security contributions. Other instruments, e.g. preferential import and value-added tax rates are also applied for the import of science and technology (S&T) equipment in Colombia and the Russian Federation. Tax relief on land and property is also applicable in some cases, e.g. for specific types of firms (France) or special geographic economic zones (Russian Federation).

As shown in Table 1, tax relief can be provided as an allowance, exemption, deduction or credit. Tax allowances, exemptions and deductions effectively subtract from the tax base before the tax liability is computed. A tax credit is an amount subtracted directly from the tax liability due from the beneficiary unit after the liability has been computed (OECD, 2015b). Most countries providing tax incentives for R&D use either a tax credit (e.g. Australia, Canada, France, Ireland and Norway) or tax allowance (e.g. Brazil, China, Netherlands, United Kingdom) that is applicable on the volume of R&D expenditure undertaken. Other countries target tax credits (e.g. United States) to R&D expenditures over and above of a pre-defined baseline amount. Using a volume-based scheme has the advantage, for firms claiming incentives, of being simple, predictable and generous. From the government perspective, this approach might be costly as a substantial fraction of support goes to subsidise R&D that would have been performed without any R&D tax incentives. However, incremental approaches are not guaranteed to address the deadweight problem and may induce volatility in R&D performance (Appelt et al., 2016).

A specific form of R&D tax allowance concerns provisions for the accelerated amortisation of capital investments for R&D - e.g. machinery, equipment, buildings, and possibly also intangible assets - under more favourable conditions than for assets of the same class used in other contexts. By allowing for an accelerated depreciation of such assets for tax purposes, companies can deduct their acquisition costs at an earlier date with the associated benefit. These are used for example in the case of Belgium, Brazil, Denmark, Poland and the United Kingdom. Accelerated depreciation provisions may sometimes cover or extend to the amortisation of R&D-based knowledge assets, including those acquired from third parties.

One of the general features of tax based support is that the scope for fully benefiting from tax relief depends on the existence of a sufficiently large tax liability for the taxpayer, for otherwise support will be capped, possibly even to zero. Some countries address the limited incentive effect of standard types of tax relief instruments among firms with low or no profits by providing for the carry-over of tax benefits into other periods. Another solution is to allow for offsetting payments to be made by the tax authority to the firm on the relevant period, thus increasing the certainty of tax support. Refundability can be particularly beneficial for young, innovative firms, at the stage of investing in developing and launching their products. Most countries allow carry-forwards for firms whose tax bill is lower than their allowable R&D credit. Some provide refunding options for start-up firms and non-profitable firms.

Tax incentives that relate to R&D labour costs and that are applied on wage taxes and social security contributions provide greater scope for assuring taxpayers about the amount of support they stand to receive in a given period regardless of their overall financial performance, but they may be ultimately capped in order to ensure employees do not miss out with respect to their social security entitlements. These are used for example in the cases of Belgium, the Netherlands, France (young innovative firms), Spain and Sweden, among others.

Cross-country differences in the design of R&D tax schemes also include the definition of eligible expenditures (e.g. labour costs, capital costs, costs of intellectual property rights), the nature of eligible firms (in terms of size, age, domiciliation, sector of activity etc.), deductibility rates, caps and thresholds on qualified R&D expenditure or on the maximum amount of tax deduction (in absolute terms or as a percentage of firms' turnover, profit or tax liability), special provisions for collaborative R&D projects, or different technologies. These features reflect countries' own appreciation of priorities for allocating tax support and managing the uncertain impact on public sector budgets.



Table 1. Main features of R&D tax incentive provisions in OECD and selected non OECD economies, 2016

Expenditure-based R&D tax incentives			
Corporate income tax			Tax relief on wage taxes and social security contributions (SSC)
R&D tax credit		R&D tax allowance	
Volume	Incremental/hybrid		
<i>Taxable:</i> Australia, Canada, Chile, United Kingdom (large companies) <i>Non-taxable:</i> Argentina, Austria, Belgium (incompatible with allowance), Denmark (deficit only), France, Iceland, Ireland, Korea (investment), New Zealand (deficit only), Norway, Hungary	<i>Taxable:</i> United States (credit on fixed, indexed base and incremental for simplified credit) <i>Non-taxable:</i> Italy (Legge di Stabilit� 2015), Japan, Korea, Portugal, Spain	Belgium, Brazil, China, Colombia, Czech Republic (hybrid), Greece, Hungary, Latvia, Lithuania, Poland (R&D tax allowance, deduction for R&D Centres), Romania, Russian Federation, Slovenia, Slovak Republic (hybrid and volume-based), South Africa, Turkey (hybrid), Thailand, United Kingdom (SMEs)	<i>Taxable:</i> Belgium, France, Netherlands (merged with RDA scheme for non-labour related R&D expenditure), Hungary, Russian Federation, Spain, Sweden, Turkey
Treatment of excess claims			
Refund			
Australia (SMEs), Austria, Belgium (after five years), Canada (SMEs), Denmark, France, Iceland, Ireland, New Zealand, Norway, United Kingdom (large companies)	Spain (reduced, payable credit optional), United States (payroll tax offset for certain start-ups)	United Kingdom (SMEs)	<i>Automatic refund through wage system (limited to payroll tax and SSC liability)</i>
Carry-forward			
Australia, Belgium, Canada, Chile, France, Ireland, United Kingdom	Korea, Portugal, Spain (unreduced, non-payable credit), United States	Belgium, China, Czech Republic, Greece, Latvia, Lithuania, Poland, Romania, Russian Federation, Slovenia, Slovak republic, South Africa, Turkey, United Kingdom	<i>Not applicable</i>
Enhanced tax credit/allowance rates or more favourable terms			
SMEs			
Australia, Canada, France, Norway	Italy (innovative start-ups), Japan, Korea, Portugal (start-ups), United States (qualified small business, certain start-ups)	Poland (R&D tax allowance), United Kingdom (SMEs)	Belgium (young innovative firms), France (JEI/JEU), Netherlands (start-ups), Spain (innovative SMEs)
Collaboration			
France	Italy, Iceland, Japan	Hungary	Belgium
Limitation of benefits			
Threshold-dependent credit rates			
Canada (CCPCs), France			Netherlands, Russian Federation
Ceilings on amount of eligible R&D expenditure or value of R&D tax relief			
R&D expenditure: Australia, Austria (subcontracted R&D), Chile, Denmark, France, (subcontracted R&D), Iceland, Norway Ireland (subcontracted R&D), R&D tax relief: Hungary, New Zealand (deficit only)	R&D expenditure: Portugal (incremental) R&D tax relief: Italy, Japan, Korea (large firms), Spain, United States	Subcontracted R&D expenditure: China, Turkey R&D tax relief: Hungary (R&D collaboration), United Kingdom (SMEs); R&D expenditure and tax relief: Slovak Republic (volume-based tax allowance)	Belgium, France, Netherlands, Hungary, Russian Federation, Spain, Sweden, Turkey
Accelerated depreciation provisions for R&D capital			
Belgium, Brazil, Chile, China, Denmark, France, Ireland, Israel (non R&D specific), Lithuania, Poland, Romania, Russian Federation, Spain, United Kingdom			
No expenditure-based R&D tax incentives			
Bulgaria, Cyprus, Estonia, Finland, Germany, Luxembourg, Mexico, Switzerland			

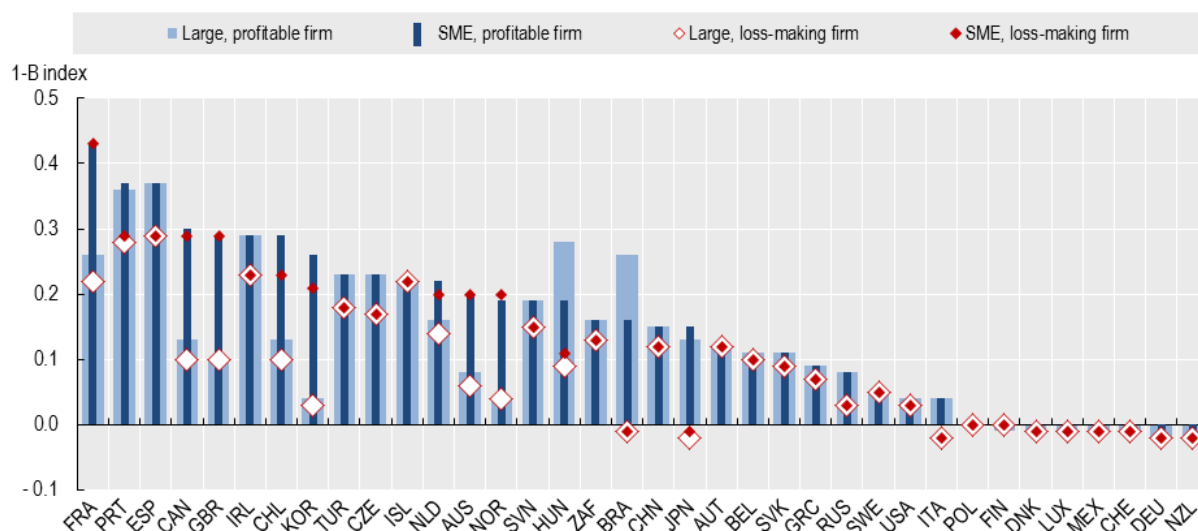
Source: OECD, based on R&D Tax Incentives Database, <http://oe.cd/rdta>, December 2016 and country responses to the EC/OECD International Survey on STI Policies (STIP) 2016.

The impact of tax relief on the cost of R&D

The design of R&D tax incentives such as the level of the tax credit/allowance rate and availability of refund and carry-over provisions significantly determines the “expected” tax relief per unit of R&D investment. The B-index, a measure of the pre-tax income needed for a company to break even on a marginal, monetary unit of R&D outlay (OECD, 2015c), takes into account tax relief provisions described in the previous section to derive implied tax subsidy rates (1 minus the B-index). This measure has been calculated across OECD countries and key partner economies offering tax relief for different firm size and profit scenarios. To provide a more accurate representation of different, relevant, scenarios, B-indices have been calculated for “representative” firms according to whether they can claim tax benefits against their tax liability in the reporting period. When credits or allowances are fully refundable, the B-index of a firm in such a position is identical to the one derived in the profitable scenario. Carry-forwards are modelled as discounted options to claim incentives in the future. Figure 1 presents the notional levels of tax support (before tax) per additional monetary unit of R&D outlay to which firms with defined characteristics are in principle entitled.

Figure 1. Implied tax subsidy rates on R&D expenditures, 2015

1-B-Index, by firm size and profit scenario



Source: OECD (2015c). OECD STI Scoreboard 2015, based on OECD, R&D Tax Incentive Indicators, www.oecd.org/sti/rd-tax-stats.htm and Main Science and Technology Indicators, www.oecd.org/sti/msti.htm, June 2015.

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This level is highest, at over 40%, for SMEs in France, and it is also relatively high, at around 30-35%, for SMEs and large firms in Portugal, Spain and Ireland and for SMEs in Canada and the United Kingdom. It is, on the contrary, below 10% for firms in Greece, Russia, Sweden and the United States. The marginal tax subsidy rates for SMEs in Australia, Canada, France, Korea, the Netherlands, Norway and the United Kingdom, are markedly higher than those observed for large enterprises. Conversely, Spain, Austria, China, Czech Republic, Turkey and South Africa do not differentiate between firms of different sizes in form of enhanced tax credit/allowance rates for SMEs relative to large firms. Refunds and carry-forward provisions are sometimes used to promote R&D also in firms that would not otherwise be able to use their credits or allowances. Such provisions tend to be more generous for SMEs and young firms in France, Canada and Australia where SMEs may benefit from a refund of excess credits in the case of insufficient tax liability. In most countries, implied tax subsidy rates are lower for loss-making firms.



The administration of R&D tax relief

Administrative requirements for obtaining R&D tax assistance vary widely across countries, as does the assistance provided (OECD, 2014). Practices differ in terms of the documentation required of claimants, the maximum delays for firms to submit claims, and the administrative formalities, e.g. pre-registration (Australia, Japan), prior approval or accreditation (China, the Netherlands, South Africa, Turkey), prior audit (Austria, Hungary, Poland), or extra certification, e.g. environmental certificate (Belgium) or tax clearance certificate (Brazil). Complex and costly administrative formalities that may discourage claimants and prolong unduly the time required to process claims and refund firms. However, some countries consider those necessary to ensure that claims are not fraudulent and that support provided represents value for money.

Many countries offer services to assist firms in tax claiming procedures (e.g. online information and simplified claim form) and to improve the speed and predictability of claims processing. Canada proposes a first-time claimant programme and offers assistance in the form of pre-claim reviews to help firms identify eligible R&D activities, plan investments, and reduce the time and cost of preparation. Australia and Canada provide eligibility self-assessment tools. Austria, France, Hungary and Spain provide for certification procedures that have binding effects on national tax authorities.

There are also differences in terms of the allocation of policy and operational responsibilities for the administration of R&D tax incentives within governments (OECD, 2014). For example, the R&D Tax Credit in France is administered by the Ministry of Higher Education and Research (MESR). The Netherlands Enterprise Agency, a division of the Dutch Ministry of Economic Affairs which is responsible for various programmes in the field of sustainable economic growth, reviews applications and manages the tax credit for R&D wages (WBSO). The Australian R&D Tax Incentive is jointly administered by the Australian Taxation Office and AUSIndustry on behalf of Innovation and Science Australia, an independent body responsible for researching, planning, and advising the Government on all science, research and innovation matters. In Canada and the United Kingdom, the national tax authorities are in charge of the SR&ED tax credit and the UK R&D tax relief schemes, respectively.


Recent policy trends

The information periodically collected since 2007 through the OECD data and information collection on R&D tax incentives points that the general trend over the past decade has been towards an increase the availability and generosity of R&D tax incentives in the OECD area and beyond (OECD, 2015c, Appelt et al., 2016). As also confirmed by the responses to the general STI Outlook policy questionnaire, several countries have redesigned their tax relief schemes to increase the availability, simplicity of use and generosity of R&D tax incentives. As a result, public support for business R&D through tax incentives has increased in relative importance and R&D tax incentives have become a major instrument of STI policy in many countries (see Chapter 4 on Recent trends in STI and policies and the policy profile on Government financing of business R&D and innovation).

R&D tax incentives have been a fertile area for experimentation. In some cases, this might have generated some degree of tax uncertainty, the consequences of which can be detrimental for R&D and innovation (Guellec et al., 2003, Westmore, 2013). In light of this, many countries have sought to enhance the stability and predictability of the R&D tax incentive regimes. The United States made the US Research and Experimentation Tax Credit permanent in December 2015 and reformed several of its features, allowing eligible small business can now claim the tax credit against their alternative minimum tax liability, while qualifying start-ups can claim the credit against their payroll tax liability up to a set amount. Finland allowed its temporary R&D tax allowance scheme to expire at the end of the 2014 as it had been anticipated.

Among some of recent changes concerning the extent and nature of tax support for R&D, it is possible to note the following examples:

- Ireland replaced in 2015 its hybrid volume and incremental-based schemes with a simpler and more generous volume-based scheme.
- In Thailand, the allowance rate for R&D and innovation expenditures rose from 200% to 300%.
- In Poland, an R&D tax allowance was introduced for 2016, replacing the “New technology” tax relief scheme, which was limited in its scope to acquisitions of intangible assets.

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- New Zealand introduced in 2015 a tax credit for deficit related expenditures, i.e. those R&D expenses that firms cannot fully deduct because of an insufficient liability. However, the tax credit has to be repaid once the company becomes profitable again. In order to support business R&D, New Zealand places more emphasis on the use of direct support with a reduced degree of discretionality.
 - In Mexico, budget proposals for 2017 foresee the re-introduction of R&D tax support. Mexico had abolished its tax support scheme in 2009.
 - In October 2016, the European Commission submitted proposals for a new Common Consolidated Corporate Tax Base that would not only confirm the deductibility of all R&D expenses - as it is common in most countries - but goes on to propose a harmonised enhanced allowance of 50% extra for R&D.

These examples show that this policy area remains the object of continued focus for reform in many countries, as indicated in Figure 2, especially regarding the provision of corporate income tax relief for R&D and revenues arising from IP assets. The implementation of the BEPS action plan has resulted in countries revising their existing IP or patent boxes, while other countries have introduced new schemes that are compatible with the BEPS rules. For example, Ireland introduced a Knowledge Development Box (KDB) in January 2016, requiring that beneficiaries demonstrate the link between domestic R&D and innovation and the income derived from the resulting intellectual property. In Italy, the application of the patent box regime has been restricted in order to align with the standards set out in BEPS. Grandfathering rights apply for provisions introduced prior to BEPS (Appelt et al. 2016), restricting the scope to taxpayers not previously benefiting from the regime and new IP assets owned by taxpayers already benefiting from the regime.

Evaluation and review

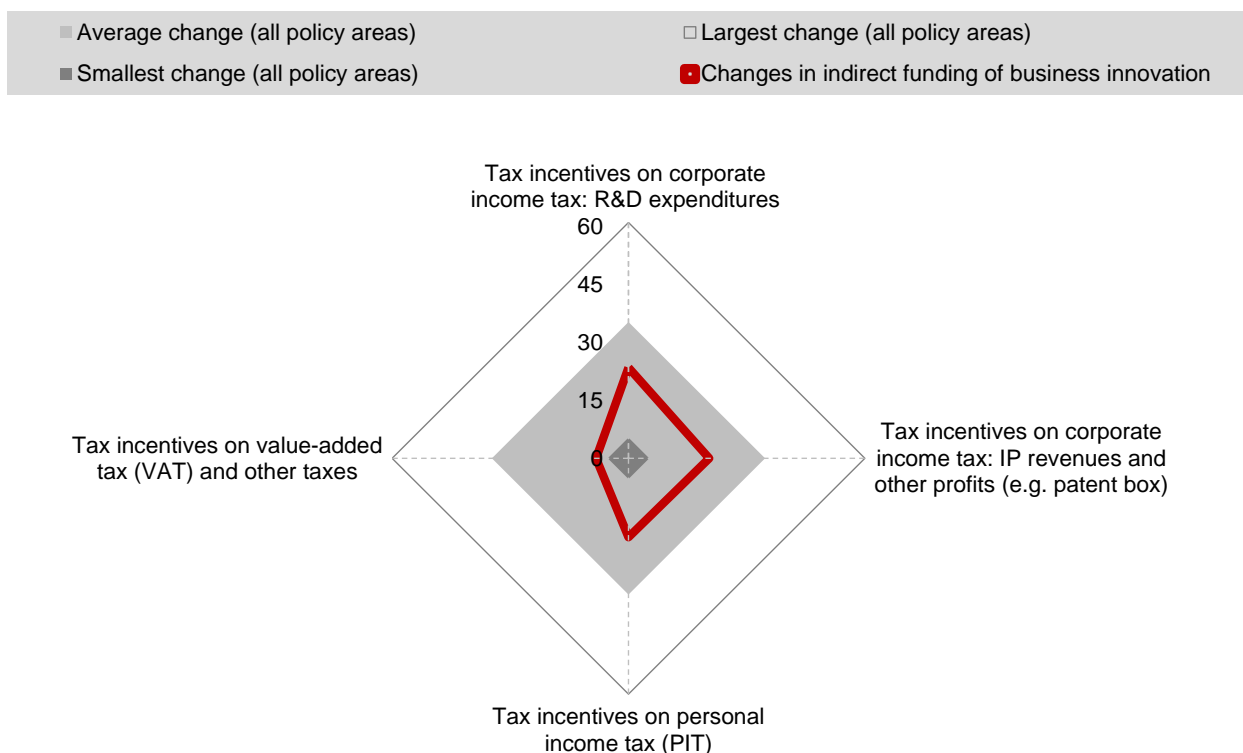
The use of formal evaluation and the application of quantitative, counterfactual-based approaches have become more widespread in recent years. A significant number of national governments have commissioned quantitative evaluations, and in some cases their results are also publicly available (e.g. Ireland in 2013, the United Kingdom in 2015, Finland in 2016). The academic literature in this area has experienced significant growth, facilitated by increased research access to firm-level microdata.

A number of countries have undertaken in depth reviews of and consultations that included within their scope the operational procedures used in the process of awarding tax relief for R&D. For example, the Australian government conducted in 2016 a review of the R&D Tax Incentive resulting in a series of recommendations aimed at improving the performance of the programme, especially its additionally, and enabling its long-term continuation. The Government will release its final response to the review as part of a broader National Innovation and Science Agenda in early 2017.

The OECD is currently undertaking a distributed micro-data analysis project (microBERD) which, in partnership with participating national agencies, aims to identify how different R&D support design features across countries contribute to explain the distribution of innovation and economic performance of firms within and across countries.

Figure 2. Tax incentives for R&D and innovation among other areas of STI policy change, 2014-16

Percentage of policy initiatives that have been newly introduced, revised or repealed over the period



Note: The EC/OECD STI Policy survey 2016 aims to review major changes in national policy portfolio and governance arrangements for STI. The survey builds on the conceptual work carried on under the aegis of the OECD Committee for Scientific and Technological Policy (CSTP) for mapping the policy mix for innovation and therefore covers a broad range of policy areas (Kergroach et al., forthcoming-a). 52 economies participated in 2016, including OECD countries, key emerging economies (e.g. Argentina, Brazil, the People’s Republic of China, Colombia, Costa Rica, Egypt, India, Indonesia, Malaysia, Peru, the Russian Federation, South Africa and Thailand), non-OECD EU Member States, and the European Commission. Taken together, the countries covered in the STIP survey 2016 account for an estimated 98% of global R&D. The responses are provided by CSTP Delegates and European Research and Innovation Committee (ERAC) Delegates for EU non-OECD countries.

This is an experimental indicator that accounts for the number of major policy initiatives implemented, repealed or substantially revised during 2014-16 as a share of total policy initiatives active at the beginning of the period. Although simple counts do not account for the magnitude and impact of policy changes, this ratio reflects STI policy focus and activity in specific policy areas and over specific periods of time. The chart above shows the intensity of changes in the policy area(s) under review as compared to the whole policy mix for innovation. Changes in the whole mapping are represented by the smallest, the largest and the average changes observed in all policy areas taken together.

Source: Based on EC/OECD (forthcoming), International Database on STI Policies (STIP); and Kergroach et al. (forthcoming b).

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Notes

Note by Turkey: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

Note by all European Member States of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

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