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**TAXATION AND TECHNOLOGY
TRANSFER: KEY ISSUES**

EXECUTIVE SUMMARY



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Executive summary

Tax policies in both technology-importing and technology-exporting countries have implications for the form and mode in which transfer of technology takes place. In general, taxation affects technology transfer in two ways: by increasing the cost of the actual transfer, and by reducing the subsequent return to the transferor.

Taxation in importing and exporting countries falls under a number of headings. These include business profits, fees for services, rents and royalties, dividends and capital gains, and employees' salaries.

In the importing country, the tax most likely to affect transfer of technology is the tax on business profits (i.e. the corporate income tax – CIT). Import duties can also affect the importation of technology, especially where the technology takes the form of tangible goods or equipment. Other taxes, such as capital duties, stamp duties and transfer taxes, are also important in some countries. If these tax rates are high, they may impede transfer of technology.

The most important exporting-country tax likely to affect technology transfer is, again, the CIT. In general, exporting countries do not tax the actual transfer of technology. However, tax liability arises on receipt of the returns that accrue from the technology transfer. The fee for the services, the price (or rent) of the equipment and the royalty for use of the patent constitute part of the exporting firm's (ECo's) income for tax purposes in the exporting country. However, there are cases where the transfer itself creates a tax liability. When the transfer involves the disposal of a capital asset (tangible or intangible), it may give rise to a taxable capital gain: if the asset is a depreciable asset, there may be a recapture of some of the depreciation previously claimed.

Most countries (both exporting and importing) have anti-avoidance provisions in their tax legislation. From the importing country's perspective, among the most important provisions related to technology transfer are the transfer pricing rules. The expression "transfer pricing" refers to transactions in goods and services between related enterprises. Transfer pricing legislation seeks to give a country's tax authorities the power to examine the price charged in a transaction between related persons and to replace it with an amount representing the price that would have been charged in a transaction between unrelated persons.

From the exporting country's perspective, income earned by a foreign subsidiary is normally taxed in the home country only when it is remitted to the parent company, or when the parent company becomes entitled to receive it. Home-country tax can consequently be avoided (a) in the case of dividends, simply by not declaring them; and (b) in the case of royalties, rents, fees and the like, as well as dividends, by diverting them to another affiliated company in a country that imposes little or no tax on them. The home country may attempt to counter this by controlled-foreign-company (CFC) legislation, according to which a country taxes its own resident individuals or companies on their proportionate shares of income of non-resident companies and other entities (such as trusts), as that income accrues and regardless of whether it is distributed to them or not.

The formulation of a tax policy with respect to the importation of technology involves the balancing of conflicting objectives. On the one hand, countries wish to facilitate the acquisition of technology: on the other, they wish to derive, in the form of tax revenue, a fair share of the profits that accrue to the foreign owner of that technology by virtue of the transfer. To what extent is the importing country able to tax the various transactions involved in technology transfer without deterring such transfers altogether?

Provision of tax incentives is considered inefficient in theory because they cause distortions: investment decisions are made that would not have been made without the inducement of special tax concessions. In practice, the incentives are considered both ineffective and inefficient. They are ineffective in that tax considerations are only rarely a major determinant in foreign direct investment (FDI) decisions; they are inefficient because their cost, in terms of tax revenue forgone, often far exceeds any benefits they may produce. They are also inequitable (since they benefit some investors but not others), are difficult to administer and are open to abuse. To the extent that tax considerations do play a part in investment decisions, it is commonly claimed that the general features of the host country's tax system are more important to potential investors than are special incentives. However, there is also substantial evidence that tax incentives are an important factor in some types of investment decisions.

Careful targeting of investment incentives can increase their effectiveness and reduce their inefficiency. If tax incentives are to be used, an initial issue that confronts policy makers is to decide *which* enterprises or activities should qualify. For instance, many countries offer generous tax incentives to high-technology investors because these industries are seen as especially desirable for providing employment, boosting exports and modernizing the economy. An alternative approach is to confer tax privileges on investments that meet one or more of a number of listed criteria. Several countries have developed the concept of "pioneer" industries, with qualifying industries receiving preferential tax treatment.

Attempting to promote technology transfer by favouring hi-tech industries has its limitations, since many conventional industries use advanced technologies, the introduction of which could be equally (or perhaps more) beneficial to the host country. An alternative approach is to require actual transfer of technologically advanced equipment, rather than simply favouring hi-tech industries. Nevertheless, this approach, too, can pose problems. In the case of foreign investment, the equipment remains the property of the investor and is often retained under the control of foreign technicians, so that there is no real transfer of *technology*.

From the perspective of technology-exporting countries, tax policy also requires the balancing of objectives. They wish to encourage their enterprises to exploit their technologies abroad and thereby increase their ability to earn income. At the same time, they wish to derive tax revenue from what they consider to be a fair proportion of the profits resulting from the export. These two objectives can conflict, and tax rules designed to protect the domestic tax base can create disincentives to transfer technology abroad.

As is the case in technology-importing countries, a number of the exporting countries' tax provisions may have implications for technology transfer. Particularly important are immediate tax liability occasioned by the transfer, transfer pricing rules, disallowance of expenditures incurred in creating the technology and failure to allow tax-sparing credits.

In recent years, the international community has focused on whether developed countries' tax systems might do more to facilitate and encourage investment in developing countries and thus promote transfer of technology. Various measures have been considered, including the adoption of tax-sparing credits and tax exemptions for business income earned in developing countries, particularly in sub-Saharan Africa.

Perhaps the most effective approach for technology-exporting countries would be to tailor tax policy to facilitation of FDI in developing countries generally, in the expectation that increased technology transfer will be among the benefits flowing from such investment.