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An instinct for growth™

The impact of innovation tax for fast-growing tech firms

When thinking about future growth locations, today's scaling digital technology companies are more likely to think about attracting the best talent and gaining funding than considering tax. But for an ambitious technology firm you must pay attention to a country's innovation tax regime. It will have important future effects for both innovation and talent as the business grows.

The value of many of today's fast-growing software-oriented technology firms is rooted firmly in their intellectual property. For these businesses, the ability to innovate and to stay ahead of the competition can secure their path to global expansion without the need to build a strong physical presence in every overseas territory where they do business.

For instance, during its rapid global expansion in 2014, Uber was launching its services in a new city every day,¹ and while Airbnb now has an office presence in 16 different countries, it has active listings in more than 190.

Seizing the power of digital to transcend geographic boundaries makes successful technology firms thrive. And the same principle applies to their approach to innovation.

Tapping into a global talent pool of programmers and developers allows technology firms to maintain competitive advantage, playing to their strengths to access specialist skills they need to carry out their research and development (R&D) — skills that cannot always be found where the firm's central research function is located.

contributors with specialist skills, or employing methods such as crowdsourcing to help with R&D.

Despite this becoming commonplace, the tax legislation determining reliefs available for R&D expenditure has, in many countries, failed to keep pace with the changes in how technology companies are using R&D.

The head of finance at a digital technology provider we spoke to in Canada, says the firm encounters this challenge frequently as it seeks to develop innovative payments technology. For instance, when they were exploring new payment channels they had to look outside of Canada to find resources with the necessary expertise.

But under Canada's innovation tax regime, only the development carried out in the country qualifies for tax relief. "Business is much more global now, especially in relation to technology, such that a country may not have all the internal expertise residing there to be able to help them with their innovation. So it's a drawback if part of the efforts to find the solution is excluded from the R&D relief," says the head of finance.

Innovation across borders

As the security of digital channels improves and the process of finding IT talent from a global pool is simplified, you'll find technology companies outsourcing software development to overseas

¹ Uber's Global Expansion In Five Seconds, Forbes – 11 December 2014.



Innovation tax and the growth journey

During the earlier stages of growth, ambitious technology companies typically seek to re-invest their revenues in further innovation as they attempt to achieve market dominance and international expansion. This can come at the expense of profit.

Amazon is a good example. Since it started in 1994, it's seen huge revenue growth – surpassing the \$100 billion mark in 2015 – yet its profits have remained largely flat.²

This trait has implications for what constitutes a favourable innovation tax regime for technology companies in the earlier stages of growth. Reliefs in the form of cash back – rather than tax credits that can be offset against income – have a more practical benefit.

Another trait of fast-growing technology companies is that in the earlier stages of growth, resourcing tends to focus on establishing sizeable teams of programmers and technology experts that can support the rapid growth of the business. Meanwhile, they're likely to put less effort into building the back office skillset, such as tax professionals, who they may only consider further down the line.

And so the complexity of many innovation tax regimes is a concern for fast-growing technology companies, as they often lack devoted tax specialists in-house. “The UK needs to work harder to simplify its tax code from the current 17,000-odd pages, into something that is fit for purpose, particularly when it comes to the knowledge economy and developing IP (intellectual property),” says Dominic Preston, a Grant Thornton partner helping UK businesses manage tax issues related to growth and innovation.

Given the cost and complexity involved in preparing various applications for R&D reliefs, the head of finance we spoke to says they've had to create internal thresholds to determine when to devote resource to the process. “It's costly to commit staff to completing applications,” she explains. “We've now put criteria in place to assess which ones are really worth our time to gather the information – if it doesn't meet the threshold then it doesn't make financial sense to spend the time.”

² Why Amazon Has No Profits (And Why It Works), Nasdaq – 5 September 2014.

Getting strategic

In the start-up phase, strategic decisions about location and investment will be driven almost entirely by the business model. Yet as technology firms move out of the Small and medium-sized enterprises (SME) phase and get bigger, they should factor tax into such decisions.

“When you reach substantial scale as a tech business, you can make strategic decisions about tax because you are dealing with multi-million pound R&D budgets, and therefore tax is a cost line in the same way that employment is,” explains Dominic.

With international expansion, a key consideration is to ensure a favourable IP tax regime that will lower the tax levied on the overseas earnings borne out of a technology firm’s IP. Firms need to weigh up the various merits and drawbacks of the regimes of different countries as they set their strategy in this area — it’s not always a straightforward decision.

Across Europe – much of which has historically focused on tax credits and direct grant investment – there is now a broad transition to an output taxation approach. In the UK, the government introduced a patent box legislation in April 2013 that reduced the corporation tax on profits generated from patented IP assets to 10%. This type of legislation may sway companies as they make strategic choices about where to locate their R&D function.

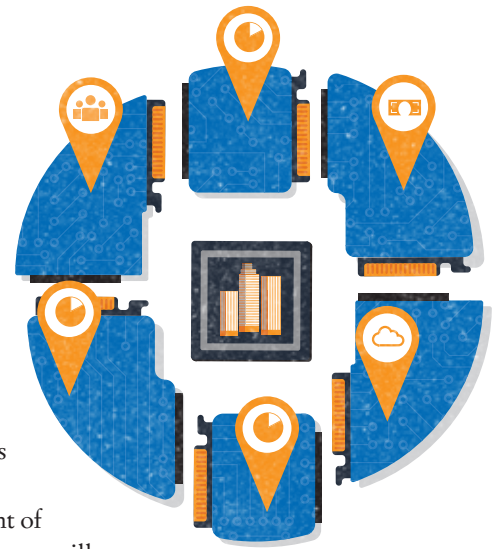
For those firms whose business models rely on developing innovative software, however, they may be reluctant to file a patent application because it will disclose commercially sensitive information to

competitors. And given the rapid pace at which software evolves, its effective commercial lifespan is often just a few years.

While the treatment of IP-driven profits overseas will likely be at the heart of strategic tax conversations as technology firms scale up, the reliefs in place for company founders could be a significant factor too. This is especially true where the business is run by entrepreneurs whose ultimate aim is to exit and realise wealth from the business.

Martha Oner, national leader of R&D and government incentives for Grant Thornton in Canada, says innovation tax regimes should not only be a consideration when readying a business for sale or exit. “Working with clients through a lifecycle planning approach for their product development activities is now commonplace,” says Martha. “The key is to maximise the value of the technology from initial concept stage using government-based incentives and credits to fund further development and growth strategies across the globe.”

Leveraging government investment and R&D tax credits also helps start-up technology companies to retain a greater share of equity during the pre-revenue stage, making exit even more attractive to the founders.



Maximising the tax advantage

Technology firms will give themselves the greatest chance of fast growth and international success by establishing themselves where specialist talent and investors are based. But as they seek to minimise costs, the competitiveness of a country’s regime will need careful consideration. As they scale and invest in the business they will be seeking benefits that are aligned with their innovation models, their investment and growth models, and that are straightforward to access.

The treatment of IP by a particular regime may become a more important factor in their strategic decision-making too. Those jurisdictions with innovation tax regimes that deliver in all of these key areas will be increasingly attractive growth areas for the technology sector when building out their R&D functions.



If you would like to discuss any of the areas raised in this article, please speak to your usual Grant Thornton contact or one of those listed below.

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