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booklet

HOW TO QUANTIFY THE TAX EFFECTS OF INNOVATIONS

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CRITERIA OF USING TAX RELATED ALLOWANCES

Criteria of using tax related allowances for innovations:

- An innovation project qualified as R&D is required
- A R&D project conducted as part of own activities is required
- It is necessary to enter into registry all the costs relating to the R&D project

Warning! All these conditions must be met at the same time! It is reasonable to use a R&D* qualification.

Note: From now on the abbreviation R&D will be used for the term research and development.

WHAT KIND OF TAX RELATED ALLOWANCES ARE POSSIBLE I.

Tax related allowances can be summarized as follows:

1. **For pre-tax profit:** The amount of pre-tax profit can be reduced with depreciation in the capitalized R&D project or the R&D project costs in the year they incurred
2. **For corporate taxes:** The corporate tax base can be reduced with adjusted costs of the R&D project
3. **For local business taxes:** The local business tax base can be reduced with adjusted costs of the R&D project
4. **For innovation contributions:** : The sum of innovation contributions will decrease because the local business tax base is reduced

WHAT KIND OF TAX RELATED ALLOWANCES ARE POSSIBLE II.

Warning! Tax related allowances can be claimed twofold for R&D projects:

1. **We account for the R&D project's time proportional depreciation or the full R&D project costs in the year they incurred:** profits are directly reduced this way. Thus the tax base and pre-tax profit will be smaller!
2. **We reduce the amount of pre-tax profit with the R&D project's total adjusted costs:** thus the tax base will be further reduced and become even smaller!

THE KINDS OF COSTS A R&D PROJECT HAVE I.

To define allowances, we have to know the R&D projects' cost structure:

- Time proportional payroll expenses and taxes for employees involved in the project
- Costs of services used for the project
- Costs of materials used for the project
- Historical costs of goods and intangible assets purchased for the project
- Usage proportional depreciation of assets used for the project

The total costs of R&D projects equal to the total of the above costs incurred during project implementation.

THE KINDS OF COSTS A R&D PROJECT HAVE II.

Let's see an example for a R&D project's cost structure:

Description	Size	Ratio '000, %
1. Payroll expenses and taxes for own employees	3 500	35,0
2. Purchase prize of the services used	3 450	34,5
2.1. Out of which: R&D services provided by universities	2 450	24,4
2.2. Out of which: services provided by businesses	1 000	10,0
3. Purchase price of the materials used	1 550	15,5
4. Historical costs of purchased assets	1 500	15,0
5. (1+2+3+4) Total historical costs of the R&D project	10 000	100,0

Warning! The project will be regarded as R&D carried out as part of own activities only if the payroll expenses and taxes for own employees exceed 5% of the total historical costs of the R&D project.

HOW TO DEFINE THE SUM OF ALLOWANCES I.

Criteria for defining allowances:

- The business's choice of an accounting method
(in one sum in the year of occurrence, or depreciation proportionally if capitalized)
- In case of a depreciation proportional write-off the capitalized R&D project can be depreciated in 5 years without any residual value, thus the depreciation write-off rate to be used for a R&D project is 20% a year.
- When adjusting the tax base, project costs need to be reduced with the services provided by businesses.
- When adjusting the tax base, project costs need to be reduced with the grant used for R&D project implementation.
- The R&D project can be capitalized at total historical costs (which will be the capital gain), or accounted for as costs in the year they incurred (this will be its profit reducing effect); tax allowances, however, are defined with the help of the R&D project's adjusted costs.
- Tax allowances can be used for 5 years therefore it is reasonable to examine the R&D project's effect on tax allowances for 5 years.

HOW TO CALCULATE THE SUM OF ALLOWANCES II.

Calculation of a R&D project's adjusted costs:

+ Total historical costs of the R&D project

- Services provided by businesses
 - Grants used for R&D project implementation
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= R&D project's adjusted costs

QUANTIFICATION OF ALLOWANCES I.

When quantifying allowances, the project in the example will be used!

1. Effect exerted on pre-tax profit: Through depreciation

Description	Size
1. Total historical costs of the R&D project (HUF '000)	10 000
2. R&D project's capitalized value (HUF '000)	10 000
3. Depreciation amount (5 years, 20% annual depreciation rate, no residual value, HUF '000/year)	2 000
4. Corporate tax sum reduction (for a 9% tax bracket, HUF '000/year)	180

QUANTIFICATION OF ALLOWANCES II.

When quantifying allowances, the project in the example will be used!

2. Effect exerted on pre-tax profit: In case of depreciation in the year of occurrence

Description	Size
1. Total historical costs of the R&D project (HUF '000)	10 000
2. R&D project costs write-off against profit (HUF '000)	10 000
3. Corporate tax sum reduction (for a 9% tax bracket, HUF '000/year)	900

QUANTIFICATION OF ALLOWANCES III.

3. Effect exerted on corporate and local business taxes: Through a tax base reduction

Description	Size
1. Total historical costs of the R&D project (HUF '000)	10 000
2. Amount of business provided services in the R&D project (HUF '000)	1 000
3. Sum in the R&D project that reduces the tax base (HUF '000)	9 000
4. Sum in the R&D project that reduces the local business tax base (HUF '000)	9 000
5. /A Corporate tax base reduction (HUF '000/year, 9% tax rate, spread over 5 years, in case of depreciation proportional accounting)	162
5. /B Corporate tax sum reduction (HUF '000/year, 9% tax rate, in one sum, in the year of occurrence)	810
6. Local business tax sum reduction (HUF '000/year, in one sum, in the year of occurrence)	180
7. Innovation contribution reduction (HUF '000/year, in one sum, in the year of occurrence)	27

QUANTIFICATION OF ALLOWANCES IV.

4. Summary of tax savings for a R&D project value of HUF 10 000k

Description	Annually	In 5 years
1. Corporate tax savings due to depreciation (HUF '000)	200	1 000
2. Corporate tax savings due to tax base reduction (HUF '000)	162	810
3. Local business tax savings due to tax base reduction (HUF '000)		180
4. Innovation contribution savings due to HIPA (Hungarian Investment Promotion Agency) tax base reduction (HUF '000)		27
5. Total Tax Savings (1+2+3+4) (HUF '000)	362	2 017

Note: Without grant, in case of a 10% corporate service ratio, 9% corporate tax, 2% local business tax, and 0.3% innovation contribution!

WHAT IS THE CORRELATION BETWEEN THE R&D PROJECT VALUE AND TAX SAVINGS

5. Summary of tax savings for R&D projects of different sizes

Description	Project Value				
Capital gain (HUF '000)	10 000	20 000	40 000	80 000	100 000
Tax savings in 5 years (HUF '000)	2 017	4 034	8 068	16 136	20 170

Note: Without grant, in case of a 10% corporate service ratio, 9% corporate tax, 2% local business tax, and 0.3% innovation contribution!

SUMMARY

Now, what should be considered:

- There is a good chance that the businesses that carried out product and/or service development also carried out R&D activities.
- There is a good chance that they accounted for the costs and expenses thereof as current costs, and didn't use, didn't claim possible tax savings!

If innovation and R&D projects are conducted in a professional way, the following legal advantages will be available:

- By capitalizing innovation and R&D projects (by displaying own knowledge), the relevant business's market value will grow. Increase in the market value will exceed that in the book value.
- R&D projects' costs and expenses can be claimed back twice when calculating taxes to be paid.
- R&D projects may achieve legal tax savings as much as of 20% in 5 years.



Should you have any questions or requests, please feel free to contact us.

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