Issue 21

International Business

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Making of a family business

At first, it's hard to put your finger on what makes Hannay Reels such a successful company.

This family-run manufacturer of hose reels is nestled in the Helderberg Mountains in Upstate New York – a location that doesn't afford a particularly strong strategic advantage. In fact, you could argue that being in a US state that abounds in regulations, taxes and labour costs might logically undermine its market position among competitors.

But Hannay Reels has something special: a legacy of 'homespun culture' that Roger Hannay and his family continue to practise with their customers and 150 employees, all of whom they call 'part of the family'. It's been the backbone of their healthy USD 45 million-a-year business since 1933.

"I suppose we could hire professionals to run the business and be silent owners, but I don't know of any other way to do business," Hannay says.

Visitors to Hannay Reels, in the community of Westerlo, about 20 miles south of Albany – a client of UHY's firm in the US, UHY Advisors – may not realise that the quaint office where people bring you coffee and take your coat is the company's nerve centre that competes on the frontlines of a global marketplace. You get the sense you've gone back to a day when personal contact was paramount to maintaining strong customer relationships and promises made for delivery dates and high-quality products were kept.

Hannay Reels each year makes nearly 80,000 high-quality hose and cable reels using tonnes of steel, stainless steel and aluminium. The reels are used in industries from fire-fighting to fuel delivery and deep-sea exploration.

The company's so-called 'secret sauce' – while competitors from China and other emerging markets offer lower-cost alternatives – is what matters most. "We have a motto here: 'Built to last, delivered fast,' " says Hannay. "Because of this commitment, we've somewhat insulated ourselves from low-cost competitors."

Core strengths

So what can family businesses worldwide learn from the likes of Hannay Reels?

Retaining a stable workforce has long been a core strength of the company – employees are with the company on average for 20 years, and many employees' families have enjoyed several generations of parents, children, spouses, siblings and cousins at the plant.

But, exceptional employee loyalty apart, Hannay offers other tips for a successful family business:

- ***Make it in your own country –*** Companies should do everything they can to make their goods in their own country. They shouldn't outsource simply to make a greater profit, but rather find other ways to be competitive, such as identifying markets that appreciate quality products, speedy delivery and good old-fashioned customer service.
- ***Commit to your community –*** It's hard to think of what Westerlo, and surrounding rural towns, would be without Hannay Reels, which employs about 150 workers and contributes significantly to the tax base and local economy. The company and its employees also give generously to causes in the region and beyond.
- ***Customers are king –*** This axiom will never go out of style, says Hannay. Everything you do needs to be focused on the customer's experience, from ordering the product to using it.
- ***Make leaders accessible –*** Don't hide in your office. Regularly get out and walk the production floor to observe and talk with employees. "I answer my own phone when anyone calls and our customers prefer that," says Hannay.
- ***A stable, quality-driven workforce makes it all possible –*** Get to know your employees by name and be there for them. Trust in them and they will generally respond with quality work. "Some of our reels made more than 50 years ago are still being used today," says Hannay.
- ***Keep it in the family –*** Too many family businesses allow outsiders to have ownership, such as through private equity investors. "It can dilute the common philosophy and approach to major areas of the business," says Hannay. "Only family members who are active in the company should hold stock."
- ***Say little, do much –*** It's worked for every generation since Clifford Hannay made his first reel in the 1930s — and now Hannay Reels is a leader in its industry sector.

Family businesses like Hannay Reels are all around us — from neighbourhood stores and the millions of small and mid-size companies that underpin many economies, to household names such as BMW, Samsung and Wal-Mart. One-third of all companies in the S&P 500 index, and 40% of the 250 largest companies in France and Germany, are defined as family businesses, meaning that a family owns a significant share and can influence important decisions, particularly the election of the Chairman and CEO.

Key activities for success

So what else can we learn from family businesses? Research by global business consultants McKinsey pinpoints five key activities that must work well and in synchrony for family businesses to be successful.

They are:

- Harmonious relations within the family and an understanding of how it should be involved with the business
- An ownership structure that provides sufficient capital for growth while allowing the family to control key parts of the business
- Strong governance of the company and a dynamic business portfolio
- Professional management of the family's wealth
- Charitable giving to promote family values across generations.

The research also shows that family businesses tend to have lower levels of financial leverage,

and a lower cost of debt, than their corporate peers; and that publicly traded, family-influenced companies often have higher shareholder returns than do companies in leading indices such as MCSI Europe, MSCI World and S&P 500.

Generational issues

As family businesses expand from their entrepreneurial beginnings, they often face performance and governance challenges. For example, generations that follow the founder may insist on running the company, even though they are not suited for the job. And, as the number of family shareholders increases exponentially generation by generation, with fewer family members actually working in the business, the commitment to carry on as a family business cannot be taken for granted.

Indeed, less than 30% of family businesses survive into the third generation of family ownership. However, those that do so tend to perform well over time compared with their corporate peers.

"To be successful as both the company and the family grow, a family business must meet two intertwined challenges: achieving strong business performance and keeping the family committed to, and capable of, carrying on as the owner," say the McKinsey researchers.

Family businesses can go under for many reasons, including family conflicts over money, nepotism leading to poor management, and in-fighting over the succession of power from one generation to the next. Regulating the family's roles as shareholders, board members and managers is essential because it can help avoid these pitfalls.

Large family businesses that survive for many generations ensure they permeate their ethos of ownership with a strong sense of purpose. Over decades, they develop oral and written agreements that address issues, such as the composition and election of the company's board, the key board decisions that require a consensus or a qualified majority, the appointment of the CEO, the conditions in which family members can (and can't) work in the business, and boundaries for corporate and financial strategy.

The continual development and interpretation of these agreements, and the governance decisions guided by them, may involve several kinds of family forums. A family council representing different branches and generations of the family, for instance, may be responsible to a larger family assembly used to build consensus on major issues, says McKinsey.

Long-term survivors usually share a meritocratic approach to management. There's no single rule for all, however — policies depend partly on the size of the family, its values, the education of its members, and the industries in which the business competes.

For example, the Australia-based investment business ROI Group, which now spans four generations of the Owens family, encourages family members to work outside the business first and gain relevant experience before seeking senior-management positions at ROI. Any appointment offered to them must be approved both by the owners' board, which represents the family, and the advisory council, a group of independent business advisors who provide strategic guidance to the board.

As families grow and ownership fragments, family institutions play an important role in making continued ownership meaningful by nurturing family values and giving new generations a sense of pride in the company's contribution to society.

Ownership issues

How to maintain family control or influence while raising fresh capital for the business and satisfying the family's cash needs is a juggling act that must be addressed, as it's a major source of potential conflict, particularly in the transition of power from one generation to the next. Enduring family businesses regulate ownership issues — for example, how shares can (and cannot) be traded inside and outside the family — through carefully designed shareholders' agreements that often last for 15 to 20 years.

Many family businesses are privately held holding companies with reasonably independent subsidiaries that might be publicly owned. Though in general the family holding company fully controls the more important ones. By keeping the holding private, the family avoids conflicts of interest with more diversified institutional investors looking for higher, short-term returns. Financial policies often aim to keep the family in control. Many family businesses pay relatively low dividends because re-investing profits is a good way to expand without diluting ownership by issuing new stock or taking on big debts. "In fact, some families decide to shut out external investors of the entire business and fuel growth by re-investing most of the profits, which requires good profitability and relatively low dividends," says McKinsey. "Others decide to bring in private equity as a way to inject capital and introduce a more effective corporate governance culture."

Others take the Initial Public Offering (IPO) route and float a portion of the shares. An IPO can also be a way to provide liquidity at a fair market price for family members wanting to exit as shareholders.

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To keep control, many family businesses restrict the trading of shares. Family shareholders who want to sell must offer their siblings, and then their cousins, the right of first refusal. In addition, the holding company generally buys back shares from exiting family members. Payout policies are usually long-term to avoid decapitalising the business.

Because exit is restricted and dividends are comparatively low, some family businesses have resorted to 'generational liquidity events' to satisfy the family's cash needs. These may take the form of sales of publicly traded businesses in the holding, or of sales of family shares to employees, or to the company itself, with proceeds going to the family.

With clear rules and guidelines as an anchor, family enterprises can get on with their business strategies.

Strong governance

Large and durable family businesses also tend to have strong governance. Members of these families avoid the principal–agent issue by participating actively in the work of company boards, where they monitor performance diligently and draw on deep industry knowledge gained through a long history. On average, 39% of family business board members are directors from within the business (including 20% who belong to the family), compared with 23% in non-family companies, according to the S&P 500.

Of course, it's important to complement the family's knowledge with fresh strategic perspectives of qualified outsiders. Even when a family holds all of the equity in a company, its board will most likely include a significant proportion of outside directors. One family business has a rule that half of the seats on its board must be occupied by outside CEOs who run businesses at least three times larger than the family one.

Procedures for all nominations to the board — insiders as well as outsiders — differ from company to company. Some boards select new members and then seek consent from an inner family committee and formal approval by a shareholder assembly. Mechanisms differ: what counts most is for the family to understand the importance of a strong board, which should be deeply involved in top-executive matters and manage the business portfolio actively. Many have meetings that stretch over several days to discuss corporate strategy in detail.

Family businesses, like their non-family peers, face the challenge of attracting and retaining world-class talent to the board and to key executive positions. In this respect, they have a handicap because non-family executives might fear that family members make important decisions informally and that a glass ceiling limits outsiders' career opportunities. Yet, family businesses often emphasise caring and loyalty, which some talented people see as values above and beyond what non-family corporations offer.

Long-term growth strategies

Successful family companies usually seek steady long-term growth and performance to avoid risking the family's wealth and control of the business. This approach shields them from being tempted to pursue maximum short-term performance at the expense of long-term company health. Longer-term planning, and more moderate risk-taking, serve the interests of debt holders too, so family businesses tend to have not only lower levels of financial leverage but also a lower cost of debt than that of their corporate peers.

The longer perspective may make family businesses less successful during booms but increases their chances of staying alive in periods of crisis and of achieving healthy returns over time. In fact, despite challenges facing family-influenced businesses, from 1997 to 2009 a broad index of publicly traded ones in the US and Western Europe achieved total returns to shareholders two to three percentage points higher than those of the MSCI World, the S&P 500, and the MSCI Europe indexes.

This long-term focus, says McKinsey, implies relatively conservative portfolio strategies based on competencies built over time, coupled with moderate diversification around the core business and, in many cases, a natural preference for organic growth.

Family-influenced businesses also tend to be prudent in mergers & acquisitions, making smaller but more value-creating deals than their corporate counterparts do, according to McKinsey's analysis of M&A deals worth more than USD 500 million in the US and Western Europe from 2005 to late 2009. The average deal of family businesses was 15% smaller, but the total value added through it — measured by market capitalisation after the announcement — was 10.5 percentage points, compared with 6.3 points for their non-family counterparts.

Wealth management

Nonetheless, too much prudence can be dangerous, says McKinsey. Family owners, who usually have a significant part of their wealth associated with the business, face the challenge of preventing an excessive aversion to risk from influencing company decisions. Excessive risk aversion might, for example, unduly limit investments to maintain and build competitive advantage and to diversify the family's wealth. Diversification is important, not only for overall long-term performance but also for control, says McKinsey, because it helps make it unnecessary for family members to take money out of the business and diversify their assets themselves. That's why most large, successful family-influenced survivors are multi-business companies that renew their portfolios over time.

Five key factors increase the chances of wealth management success:

- A high level of professionalism through institutionalised processes and procedures
- Rigorous investment and divestment criteria
- Strict performance management
- Strong risk-management culture, with aggregated risk measurement and monitoring
- Thoughtful talent management.

McKinsey adds: "Almost all companies start out as family businesses, but only those that master the challenges intrinsic to this form of ownership endure and prosper over the generations. The work involved is complex, extensive, and never-ending, but the evidence suggests that it is worth the effort for the family, the business and society at large."

UHY has offices in most major business centres around the world. For details of UHY's family business support in your region, please contact the UHY executive office.

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Signs of a rebound spur M&A

While family businesses globally may be enhancing their strategies to survive and prosper, some are coming to the end of their family line and choosing to sell when the prospect of an attractive offer is presented.

In many regions, the global economic downturn has put paid to a worthwhile sale in the immediate term: family owners are sitting tight till values improve. But in Latin America it's a different story.

A significant share of the Latin American market comprises family-run companies — often in need of capital, or better standards of corporate governance, or both.

Some family businesses, founded in the 1950s, are reaching the third or fourth generation facing falling birth rates and a weaker tradition of handing management down to children. Owners are thinking about cashing in.

And now, the time is ripe — family-run, small to medium-sized businesses in the region are set to become a significant target for takeovers.

M&A activity in global context

At present, Latin America is a relatively small global player in mergers & acquisitions (M&A), accounting for just 5% of total global activity in January-September 2009. In fact, M&A all but dried up in the region during the global economic downturn after what had been a significant increase in the number and value of deals during 2003-2008.

The Latin America region was not alone: while recession typically results in a slowing of deal activity, as companies push back deals in the hope that valuations will fall, the economic downturn had a particularly suffocating effect on M&A globally. The sharp reduction in available credit made it extremely difficult for companies to raise finance for new deals.

During the worst period of the downturn, in the first half of 2009, the value of announced worldwide M&A activity dropped by 40% year-on-year, to USD 941bn. The number of deals also fell, albeit less dramatically, from 20,342 in the first half of 2008 to 17,389 in 2009.

And Latin America in particular was badly affected: deals in Mexico and Central America came to a virtual standstill. Announced M&A in Brazil fell from USD 50bn in the first half of 2008 to USD 29bn a year later.

In addition to these challenging financing conditions, because the US dollar is the global currency for M&A deals, exchange rate volatility in Latin America complicated valuations — many target enterprises held US dollar-denominated debt.

Yet, as the global economy has begun to recover, deal activity in Latin America is on the increase. Compared with mega deals in the region driven by a wave of privatisations during the 1990s, and mainly led by European and American investors, the focus is now on smaller transactions. The trend has shifted increasingly to mid-market deals (USD 39.5m – 395m) among intra-regional players.

According to a Brazilian M&A advisor, the number of deals is returning to pre-crisis levels. Sentiment already appears to have shifted in the market, with most advisors in the region expecting an increase in activity — in terms of both volume and value — during 2010. A spate of deals appears to substantiate this assessment, including the announcement, in September 2009, from a French telecommunications company, Vivendi, that it was purchasing GVT, a Brazilian mobile phone firm, for USD 2.9bn. Indicators suggest that was the turning point in the region's M&A market.

Reasons for M&A revival

The main reason for this shift is that credit markets have reopened and facilitated access to finance. Improvements in market conditions and risk appetite have been reflected in substantial amounts of primary bond issuance, and a narrowing of spreads on secondary markets, since global risk appetite returned from March 2009. The number of initial public offerings (IPOs) nose-dived in late 2008 and early- to mid-2009, but has recovered in recent months. Banco Santander Brasil's USD 8bn deal, in October 2009, was the largest-ever IPO in Brazil.

Although these trends incorporate a recovery globally, several factors point to a pick-up in deals in Latin America in particular. Credit access is improving, but costs remain elevated, suggesting that a greater share of deals will be financed by cash or equity. This suggests a shift in the size of M&A deals, with small and medium-sized companies likely to become the main targets. They're ripe for takeovers.

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This M&A spur among family businesses may be heightened further by larger parent companies seeking to divest poorly performing assets to raise capital. Acquiring companies could view these factors as an opportunity to enter new markets — and focus their attention on the mid-market sector. Also, less mature industries in Latin America could become targets of more developed industries in neighbouring countries — witness how Chile's successful retail industry has expanded across the region in recent years.

There is also a sense that stock market falls in late 2009 have provided significant opportunities, particularly for the acquisition of financially distressed firms that are structurally sound but face cashflow problems from difficulties in rolling over debt repayments. Although the strength of the Brazilian stock market means this is likely to be less of a factor driving M&A in Brazil, it may encourage M&A in countries where stock exchanges have taken a harder hit.

A survey on corporate response to the downturn by the international Boston Consulting Group identified strategic M&A as the second most important priority for firms generating excess cash. One respondent stated that "eight times out of 10, companies wait too long and end up paying three times more than they would have, had they taken advantage of the situation when times were bad".

Continuing balance sheet problems in developed economies are also likely to prompt large parent companies to divest assets in some emerging markets. Some of the large Latin American companies (multi-latinas) will be well placed to take advantage of this trend, contributing to the increasing trend of intra-regional M&A.

Barriers to investment

However, there are still significant barriers to intra-regional investment, which continue to hinder the attainment of M&A levels seen in other regions of the world: cultural factors remain a structural constraint.

Although family ownership is a potential spur to M&A activity, particularly in the case of small companies struggling with cashflow or succession issues, in the case of larger firms it can hinder M&A. This is particularly evident in Mexico, where a small number of families control several of the largest business groups, resulting in a high concentration of the stock exchange — more than half of the total share volume is controlled by five companies.

Weaker standards of due diligence may also continue to present a barrier to successful M&A. A 2008 survey conducted by the private sector firm mergermarket, which reports on potential deals, found that respondents identified a lack of reliable information on the target company as the most serious obstacle to M&A in Latin America. Respondents also highlighted difficulties associated with a business culture that is protective of its operations. Weaker standards of financial reporting also remain a problem, particularly when assets are overvalued. This is a particular problem in countries with complex tax regimes.

Although most of the region's banks have emerged relatively unscathed from the global recession — boding well for growth prospects in 2010 — this has to some degree reflected the fact that financial systems are less developed than their Western counterparts, with little exposure to the toxic assets that inflicted so much damage in developed markets. However, given that deals are likely to be characterised by less-leveraged transactions, this is unlikely to be sufficiently important to prevent the growth of M&A in the region, although it will constrain the pace of expansion.

Spread of M&A prospects

The expected increase in M&A activity will not be spread evenly across the region. Deals are set to be concentrated in certain countries. Brazil, already accounting for the lion's share of deal activity, will consolidate its position as a regional leader, with increasing investment from regional players, as well as further afield from the Middle East and Asia. This reflects both its scale and Brazil's macro-economic progress made in recent years, which has allowed it to rebound quickly and strongly from the downturn, as well as the increasing depth and relative sophistication of its financial markets. Significant amounts of positive media coverage in recent times emphasise Brazil's attributes as a high-quality investment destination.

Orthodox policy frameworks will also encourage an increase in M&A activity in Colombia, Chile and Peru. By contrast, deterioration in the business environment in Venezuela, Argentina and Bolivia makes it less likely that these countries will be targets for firms seeking significant acquisitions in new markets.

In terms of sectors, nearly 60% of current M&A activity in Latin America takes place in just three sectors: mining, financial services and retail. While these sectors are expected to remain important, expected significant consolidation in the fragmented education and health sectors will also create opportunities.

The healthcare sector, in particular, looks buoyant: global pharmaceutical firms have bucked the trend of a sharp M&A deceleration and witnessed some of the largest deals in recent years. Healthcare companies are likely to be looking for strategic acquisitions that serve as a stepping-stone into new markets.

Construction is also expected to be a dynamic growth area for M&A, given the emphasis of several governments in the region on improving infrastructure. This trend is being fostered by Spanish companies offloading their holdings by selling assets in Latin America.

All of which adds up to bright prospects for the mid-market in Latin America — and the prospect of more family businesses deciding that the time is right to move on.

UHY has extensive coverage of the Latin America region with firms in key business centres in Argentina, Brazil, Chile, Colombia, Ecuador, Guatemala, Mexico, Peru, Puerto Rico, Uruguay and Venezuela. UHY's specialist knowledge of M&A is co-ordinated through a global Special Interest Group (SIG) made up of representatives from our business centres in different countries and regions who share technical knowledge and exchange information on opportunities for investment and details of interested potential buyers.

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R&D: incentives for growth

While economies around the world struggle out of the economic downturn, many businesses are continuing to invest significantly in research and development (R&D).

These businesses realise that cutting R&D budgets can limit future growth. But to stretch budgets further, companies are evaluating not just how much R&D to conduct but also where to do it.

Tradition dictates that R&D should be near at hand, but looking outside your home country can often lead to both highly qualified and less expensive labour, as well as attractive jurisdictional incentives, such as R&D tax credits, tax deductions and grants.

Although certain countries, such as the US, have historically been leaders in R&D, many other nations, not least in the Asia-Pacific region, are enhancing their incentives and successfully drawing in major R&D investments that help build the credibility of their countries' economies.

In fact, governments often see R&D as a key factor in spurring economic growth. They hope that improved R&D incentives will attract quality jobs, quality people – and still more R&D investment. But although there is broad agreement that R&D incentives help create jobs and boost the overall health of the local economy, incentives vary greatly between countries, and between states within countries.

Incentive types

Countries use two main types of inducement to encourage R&D:

- Tax credits
- Tax deductions.

Tax credits typically act as a direct reduction of a company's tax liability; however, in a limited number of countries, tax credits may actually become refundable when no tax is due. Tax credits tend to be more valuable than tax deductions because the credits directly offset tax liability.

Additionally, in certain countries, local jurisdictions offer additional tax credits that enhance national incentives. As an example, nearly half of the US states offer a tax credit over and above the federal credit. Canada is another example where provincial credits may also be available.

R&D ***tax deductions*** allow taxpayers to deduct certain qualifying R&D expenses from their gross income, typically in the year incurred. Many of the countries that offer an R&D tax credit also allow current expensing of R&D expenditures, so creating an enhanced benefit.

Sample incentives on offer

Many countries offer tailored additional incentives in numerous forms, some incorporating tax credits or expense deductions. For example:

Turkey offers an R&D allowance to enterprises that increase their R&D spending over the previous year. A 100% tax deduction on R&D is also offered for qualifying companies. Additionally, companies can benefit from 'technopreneurship' capital subsidies on personnel working specifically on R&D.

The Board of Investment of ***Thailand*** grants a promotion to qualified biotechnology projects for basic research, applied science, experimental development and R&D. The country offers a 200% deduction for the cost of hiring qualified researchers working on R&D projects; and an initial depreciation on the date of acquisition for machinery used in R&D projects.

Taiwan offers income tax credits amounting to 15% of the qualified R&D expenditure of companies performing R&D within Taiwan. This credit can deduct up to 30% of the income tax payable in the concurrent year of R&D expenditure. Unused credit becomes ineffective and is not allowed for deductions in following years.

In ***Poland*** the government provides subsidies for any type of applied research or development activities that result in a new product or service being introduced into the market. The country allows companies to deduct 50% of qualifying expenditures related to new technology.

In ***the US*** tax credit and tax deductions are offered for R&D expenditures and vary from state to state. Tax incentives sparked development of the biggest global high-tech construction project currently being undertaken. Tech Valley – a 19-county region of eastern New York state that spans from just south of Montreal to just north of New York City – is being established to attract high-tech companies worldwide, especially from Europe and Asia. Tech Valley already has a reputation for R&D in nanotechnology and biotechnology, in particular. "That's the power of incentives in attracting global investment," says UHY Advisors' technology managing director Mike Lipschultz.

Different US states offer different incentives. In Houston, Ted Clark, national director for state and local tax services, UHY LLC, says: "State R&D tax credits range from 3% to 12% of the net new expenditures and many states follow the federal 'look back' period of up to four prior years, enabling companies to realise significant refunds from prior years. In addition, many states allow companies to carry forward credits for as many as 10 years.

"It's also important to remember that state and local governments offer incentives that supplement R&D tax credits, such as tax and non-tax incentives (cash grants) for capital investment, job creation /retention, infrastructure, employee training, utilities and green energy incentives."

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Argentina offers tax credits to all companies performing R&D; larger credits go to small and mid-sized companies. Large incentives are also offered to the software, biotechnology, biofuel, mining, hydrocarbon exploration, and certain automotive and autoparts industries.

Australia offers tax incentives to companies registered with the Industry Research and Development Board. A 125% deduction of R&D expenses (which can be larger for small companies) along with a credit (only allowed for small companies) is allowed. Unlike most countries offering R&D tax incentives, Australia allows amounts that qualify for the credit to be spent in Australia and abroad (with certain limits). Where the applicant is incurring tax losses, the tax credits are paid to the company in cash.

"This is a wonderful stimulus of trading tax losses for cash and assists the development of R&D," says partner Allen Bolaffi, UHY Haines Norton, Adelaide.

Belgium deducts expenses related to new patents: under certain conditions, 80% of the revenues of patents are free of taxes. Grants for financing tangible and intangible assets can be obtained and profits are free of taxes to a maximum of the grants. There is also an opportunity to convert certain deductions into tax credits.

Brazil also deducts expenses incurred in a technological innovation project, at between 60% and 80% depending on the number of research employees hired. No researcher needs to be hired to enjoy the minimum 60% deduction. A further 20% deduction is allowed when a patent is granted.

Tax reductions of 50% are granted on the purchase of machinery and equipment for R&D. This deduction is made directly on the purchase and so the amount is not paid, generating an effective gain in cash flow.

Canada allows scientific research and experimental development credit equal to 20% of qualifying expenditures. It is creditable against tax liability or, in the case of Canadian-controlled private corporations, 35% is fully refundable.

Hong Kong offers a deduction of R&D expenses in the year in which they are incurred.

Ireland has an R&D tax credit system which effectively provides a write-off for R&D expenditure of 37.5%. The credit may be claimed within 12 months of the end of the accounting period in which the R&D expenditure was incurred.

A tax credit is also available for construction or refurbishment work carried out on a building used for qualifying R&D activities. The credit is equivalent to 25% of the qualifying cost of construction or refurbishment and may be claimed in full in the year in which the expenditure is incurred.

"The expenditure must be tax deductible in Ireland and not in any other country," says Breda Martin, tax consultant at UHY Farrelly Dawe White, Ireland. "The expenditure must be incurred on systematic, investigative or experimental activities in a field of science or technology. Revenue guidelines have stated that an advance in technology means an advance in the overall knowledge or capability in the relevant field and to a company's own knowledge."

Mexico offers an immediately deductible 89% for machinery and equipment used directly for research on new products or developing technology in Mexico.

Meanwhile, ***the Netherlands*** has incentivised R&D investment with a 5% tax cut. Corporate income tax (CIT) law already enabled companies to benefit from a reduced CIT rate of 10% on profit from certain technological intangible assets (referred to as the 'patent box'), instead of the standard rate of up to 25.5%.

The reduced rate already applied to economic benefits from licensing patents, using the intangible assets in regular business operations, and selling the intangible assets.

But from 2010, the CIT rate has been further reduced to 5%; there are more opportunities to apply this lower rate; and the incentive is now known as the 'innovation box' because it applies to many more cases than before – even to assets for which no patent has been granted. Software also now falls within the scope of the 'innovation box', as do some trade/business secrets.

R&D protection

Signs that R&D investment may be protected despite severe economic cutbacks in western nations come from both the US and the UK.

According to data from the Bureau of Economic Analysis and the National Science Foundation in the US, R&D comprised 5% of the nation's GDP growth from 1959 to 2004 and 7% between 1995 and 2004. The recession dried up much of this spending – R&D in ***the US*** has declined by 2.4% since December 2007, according to *R&D Magazine*. (Its commentators point to historical data showing that increases in R&D are consistently followed by increases in GDP.) But, since then, USD18.4 billion of the American Recovery and Reinvestment Act budget has been allocated to R&D spending and President Barack Obama has committed Congress to prioritising R&D investment.

In ***the UK***, an innovation task force published its '*Ingenious Britain*' report on how to make the UK the leading high-tech exporter in Europe. The report stimulated the incoming Conservatives, leading a coalition government, to confirm that R&D tax credits will be protected (whereas they had been under threat beneath a tide of public service cutbacks). The task force report proposes that R&D tax credits should be refocused on high-tech companies, small businesses and new start-ups, and that they should be boosted to 200% when public finances allow.

In tight economic times, companies are inevitably looking at ways to maximise their return on R&D investment. Besides tax considerations, many other business (and political) factors must be evaluated to determine where your company's R&D investment should be located. However, more than ever before, tax departments are being asked to provide input in the R&D investment decision-making process, and tax incentives are playing an increasingly important role in where and how companies spend their R&D investment.

R&D incentives shown are just a selection of those offered by governments around the globe. For the latest details and local knowledge in your own jurisdiction and elsewhere please go to www.uhy.com to find your nearest UHY member firm, or contact the UHY executive office (details below).

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