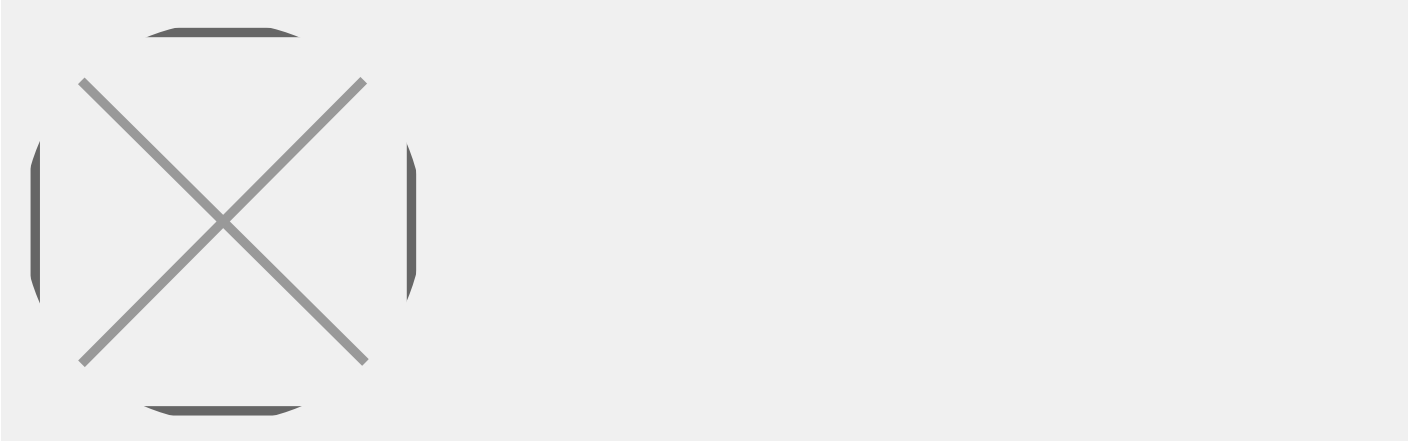
Interview: Wim Eynatten, International Tax Partner, Deloitte Belgium



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An in-depth viewpoint on the current taxation situation for pharmaceutical companies operating in Belgium today, looking at incentive programs and relative positioning in Europe.

Mr Eynatten, can you please provide our readers with an overview of the value added services that Deloitte offers to the life sciences industry in terms of its tax related services?

We offer a wide range of tax related services to large pharmaceutical companies as well as to biotech companies and spin-off and start-up life sciences companies; our tax related services cover corporation tax related matters, indirect taxes, employee related matters and, last but not least, R&D and IP tax incentives. Although I have many tax projects with large pharmaceutical and medical devices companies my personal focus is more geared towards biotech companies and young innovative companies (start-ups and spin-offs) in the life sciences industry. Broadly speaking, it is of paramount importance for biotech and other young innovative companies to take into account their long term tax strategies from the onset. More specifically, if a young innovative company realizes that it is in fact not located in the most tax efficient location as it begins to build up its intellectual property (IP) patents or knowhow, then it would be far more difficult to get these IP's relocated to more tax efficient jurisdictions. Therefore, our role is to get in touch with young biotech companies, for example, at a very early stage and brainstorm together with them on the ideal long term tax strategies, where Belgium most certainly has much to offer.

Multinational enterprises (“MNEs”) in all industry sectors are increasingly considering R&D and IP ownership on a global basis. Central management and/or ownership of IP may indeed provide many commercial benefits such as better identification of existence and ownership of IP; better management of ongoing development spend; better ability to monitor the return on development spend; better control over technical resources; and, the promotion of a culture of excellence in relation to the management of IP. From a tax perspective, such centralization of R&D and IP may give rise to additional tax structuring opportunities and may help MNEs optimizing transfer pricing positions and the use of R&D tax incentives.

As a result, in most of the cases we come to the conclusion that, in order to take optimal advantage of the myriad of highly attractive tax incentives, it could be considered to establish the IP (patent) bearing organization in Belgium, from where the company can then penetrate the international markets. Nonetheless, I believe the most important aspect of the entire process involves engaging in an open dialogue with such companies in order to devise an appropriate long term operational and tax strategy where we can deliver value. The tax strategy should be consistent with the way the business model is set up and run.

Furthermore, in addition to the patent income deduction incentive, Belgium also offers a number of R&D based incentives which allow companies to increase their R&D budgets. Similarly, these incentives also present innovators with the opportunity to obtain grants and subsidies, for instance. This also represents one area in which Deloitte can add value by assisting companies to maximize their R&D budgets and increase their research spending in Belgium or Europe.

How would you describe the main characteristics of Belgium’s incentive programs for the various categories such as taxation on R&D or production activities, for instance?

With respect to tax incentives, Belgium offers an excellent combination of so-called input incentives (i.e., incentives relating to R&D activities) with so-called output incentives (i.e., incentives relating to the exploitation of IP rights). In terms of input incentives, Belgium offers on the one hand, refundable R&D tax credits which allow companies to gain cash tax savings derived from qualifying R&D related investments (5% to 7.5% cash tax credit). On the other hand, there also exists a ‘wage withholding tax exemption’ which allows companies that employ qualified researchers to retain 75% of the wage withholding tax for the company which results in a salary cost decrease of approximately 15% – 20%. Within the context of the Economic Stimulus Plan the Belgian Government announced to increase the exemption percentage of this R&D wage withholding tax exemption to 80% effective as from 1 January 2013. It therefore becomes clear that Belgium offers a number of interesting tax incentives which allow companies to reduce their costs associated with labor and R&D activities as well as to increase their R&D budgets.

As companies continue to evolve and develop their products, these input incentives are then further supported by Belgium's output incentives. In other words, once the IP phase has been completed and built up, there is an appealing incentive to go-to-market with the IP product and enjoy reduced tax rates. More specifically, Belgium introduced in 2007 a patent income deduction regime which broadly specifies that 80% of patent related income can be exempted from corporate income tax. The most appealing feature of this 80% tax exemption is that it is applied on a gross basis of generated turnover or royalties. This means that the 6.8% effective tax rate is the maximum effective tax rate that can be applied on qualifying patent (improvement) income. Moreover, since the R&D expenditure remains fully tax deductible as are all other related R&D costs such as financing charges and since the patent income deduction regime can be combined with the R&D tax credits and notional interest deduction, in practice we see that the actual effective tax rates are reduced to negligible amounts close to 0% instead of 6.8%. It therefore goes without saying that the combination of input and output incentives with the notional interest deduction regime creates a very powerful tax framework for pharmaceutical and biotech companies.

Does Belgium have an absolute advantage in terms of tax incentives compared to its European counterparts? And to what extend do these incentives enhance Belgium's appeal as an investment destination for the life sciences industry?

In terms of input incentives, Belgium does not have the most competitive tax incentives despite being quite attractive. The most competitive input incentives in Europe are in fact currently found in France where companies can obtain a 30% tax credit for R&D expenses. On the other hand, France's output incentives are not quite as competitive as Belgium's patent income deduction regime. As regards competitiveness of input incentives it should furthermore be noted that the Netherlands is catching up with the introduction of its 140% super deduction for R&D expenses effective as of 1 January 2012. When taking into account the combination of the Belgian input and output incentives with the notional interest deduction regime Belgium offers an appealing tax framework for investments in life sciences.

However, I would not consider Belgium's tax incentives in isolation in order to rate the country's investment climate and appeal. Although tax related factors are important to consider, in order to maximize the return on investment, they are not the only relevant factor. Other critical factors that must be taken into account for life sciences organizations include the governments support activities as well as infrastructural considerations. These consist of, among others, solid education systems, qualified talent pools and a rich network of research institutes as well as academic and commercial organizations that can serve as potential partners.

To what degree are tax incentives in Belgium tailored to the specific needs of the life sciences industry? Have you identified a potential for improvement to enhance the industry's capacity to innovate for instance?

The Belgian input and output incentives equally apply across all industry sectors and we see actual application of both input and output incentives in basically all industry sectors.

With respect to the patent income deduction regime, it is interesting to note that it was introduced in 2007 as a result of lobbying activities of the pharmaceutical industry. Taking a closer look at the conditions to be eligible for this tax regime, we see that it very well matches the needs of pharmaceutical companies. In particular, one of the conditions of the regime is that it is only applicable as of the moment the patent has been granted. As pharmaceutical companies can invest up to 15 years, or more, in developing and successfully bringing products to market such companies do not yet need the benefits of the patent income deduction as from the patent filing date. Furthermore, once a patent has been granted, it basically retains its full economic value up until the expiration of the patent after 20 years.

By contrast, in other industries which tend to have much shorter economic life cycles of the patents, they are often able to market their products while its patent is still pending. However, in the period between the filing of the patent and the grant of the patent, companies cannot yet benefit from the 80% exemption. Hence, the patent income deduction regime works very well for the pharmaceutical industry. We also see application of the patent income deduction regime in other industry sectors.If there is one area with a potential for improvement, then it would be for the biotech and young innovative companies. More specifically, it could be considered to introduce a system of carry-forward of unused patent income deductions for young innovative and biotech companies. Under the current system, one can apply this 80% exemption only given that there is sufficient taxable income for a fiscal year. However, what we typically see in biotech and young innovative companies is that they first have their ‘cash burn’ phase where they are accumulating tax losses. During this phase, they may very well conclude license deals with large pharmaceutical companies on which they receive upfront or milestone payments which could benefit from the 80% exemption. Unfortunately however, as long as they are still in a (tax) loss position, they cannot effectively use the patent income deduction. Obviously, the tax/investment climate for biotech and young innovative companies could be improved by allowing them to carry forward unused patent income deductions.

Turning our attention to Deloitte, how would you describe the firm’s competitive advantage and unique approach in terms of tax consultancy services?

I believe that what makes Deloitte in Belgium, as well as globally, unique is our dedicated R&D tax teams which combine our tax expertise with our technological engineering expertise. What we typically see is that there is indeed fierce competition within Europe to have increasing amounts of R&D tax incentives, with countries seeking to either enhance their incentives or introduce new ones altogether. At the same time, this trend runs in parallel to the implementation of improved monitoring and auditing methods of the incentives by employing engineers alongside tax

inspectors. This is important because it is essential to ascertain that these incentives are indeed being applied to R&D activities. Translating this into the life sciences environment, the investments relating to the drug discovery, testing and development should as a general rule qualify as eligible R&D activities but our combined teams of technical engineers working together with our tax experts can deliver added value to life sciences companies when the line between R&D and other activities becomes blurred. For instance, if a pharmaceutical company intends to establish a manufacturing facility in Belgium and maximize its investment and R&D tax savings, then our R&D team can effortlessly distinguish and document the qualifying R&D activities that are going into the building of the plant and production line(s) and ensure the best possible result for our clients.

In sum, I would say that the diverse and highly qualified talent pool in Deloitte is undoubtedly a strong competitive advantage for us and our clients, both in Belgium and within our global network.

In conclusion, what contributions would you like to make to Deloitte's tax consultancy department over the next 3 years?

When looking at my contribution to our life sciences practice, we are working with both pharmaceutical and biotech companies where we help them to create added value in their businesses in terms of tax related matters. In addition to this, we are also active in various strategic initiatives. Belgium is already a major player in the European BioPharma market and could become the leading country in Europe in this sector provided some vital conditions are met: the government attention currently paid to the sector, combined with private commitments will need to be maintained and further improved. In this regard, my goal is to continue to contribute to these strategic initiatives and connect with all relevant stakeholders in view of maintaining and improving Belgium's competitive position for the life sciences industry and the biotech sector in particular. Personally I see much potential for Belgium in the biotech sector.

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