Tax Incentives Rise As Companies Invest In Research

PwC

NEW YORK – The average three-year effective tax rate (ETR) through December 31, 2011 of industrial product [1] (IP) companies was 26.3 percent, a 0.7 percent increase over the 25.6 percent ETR in the prior year, according to a new PwC [2] US study. Many ETRs were lower than statutory rates, driven by the impact of foreign operations and tax [3] incentives related to research and innovation. Companies based in the U.S. had higher ETRs than many of their global counterparts, while companies based in Canada and Germany, for example, reported lower ETRs. Clearly, the higher ETR results for U.S.-based companies are a strong example of why so many of these companies are focused on corporate tax reform. The prevalence of these factors, among others, is detailed in PwC [2]'s 2012 *Assessing tax* [4], a tax rate benchmarking study for IP and services companies across six sectors: aerospace & defense [5], chemicals [6], engineering & construction [7] , industrial manufacturing [8], metals [9] and transportation & logistics [10].

According to the report, the economic recovery for IP companies resulted in a decrease in the volatility of ETRs across the sectors as corporate earnings increased, although individual sector performance remained uneven. For example, during 2011, not one of the 46 chemical companies included in the study reported a loss in their audited financial statements.

“Volatility in the ETR among global IP companies moderated in 2011, as the recovery continued to take hold. This resulted in a rise in the ETR across multiple sectors,” said Michael W. Burak [11], U.S. and global industrial products tax leader for PwC. “We are beginning to see increased levels of investment spending as companies refocus on strengthening their products and competitive positions, earning tax incentives that provide a favorable impact to the ETR compared to the statutory rate. Furthermore, as emerging markets develop and companies increasingly expand into these territories, we expect more companies to benefit from the lower tax rates within developing countries.”

This year's edition of the report includes a special section focused on transfer pricing [12], a critical area of focus for IP companies, in part because of their expansion into emerging markets and the fact that, despite economic recovery, there is a continuing strong need for tax revenues by the relevant government authorities. The special report examines the impact of globalization, supply chain management, and merger and acquisition activity on transfer pricing considerations.

“Since IP companies are expanding into emerging markets, they must develop robust and defensible transfer pricing structures and policies. They must also deal with the growing number of jurisdictions that have adopted rigorous transfer pricing policies that, at times, rely upon inconsistent intercompany transfer pricing laws and standards," continued PwC's Burak. "Multinationals must also respond to more aggressive enforcement by tax authorities, a consequence of the attempt by many countries to prevent perceived abuses by taxpayers and a desire for increased revenues to reduce deficits. We are seeing these developments take place both in developed and emerging countries."

A breakdown of PwC's tax benchmarking analysis for the 324 IP companies in the study follows:

Aerospace & Defense [13] – A&D companies, which were the least impacted by the economic downturn, generated an average three-year ETR of 27.4 percent. The most favorable drivers of ETR were tax losses and changes in valuation allowance, a result of improving economic conditions as losses incurred in previous years were used against current profits. Tax incentives were reported by the largest number of the companies in the sector, with 39 companies gaining an average benefit of 4.6 percent.

Chemicals [14] – In 2011, many chemical companies continued their recovery from the economic downturn, achieving higher sales and earnings growth as a result of investment in high-growth emerging markets, joint venture acquisitions and deals, and global expansion to meet higher demand. The average three-year ETR of the chemicals sector was 26.3 percent, driven by foreign operations and the impact of joint ventures. For companies in the study, profits increased on average by 28.7 percent, and all companies were profitable in 2011, a picture not seen since before 2009.

Engineering & Construction [15] – For the engineering and construction industry, 2011 remained a challenging year as the anticipated economic recovery stalled. However, while markets, especially in Europe and America, remained relatively weak, there were signs of stabilization. Rapid growth in Asia Pacific and Latin America demonstrated the shift in demand to emerging markets and contributed to the improved performance of many companies. The average three-year ETR of the sector was 24.3 percent, with tax incentives and the impact of foreign operations the most favorable drivers of the ETR.

Industrial Manufacturing [16] – The industrial manufacturing industry experienced a recovery in 2011 during a volatile business climate with the average three-year ETR of the sector being 27.6 percent. For companies in the study, profits increased on average by 24 percent. The most common reconciling item, reported by 41 companies, was the impact of foreign operations, which reduced the ETR by 5.7 percent. This reflects the increasing significance of emerging markets for the sector. Tax incentives were the next most favorable driver, reflecting investment in innovation in the sector.

Metals [17] – Many metals companies experienced substantial increases in the price of almost all commodities, mineral resources and energy in 2011. The average three-year ETR of the metals sector was 25.5 percent, and profits increased on average by 31.5 percent between 2010 and 2011. The most common tax reconciling item, reported by 26 companies, was the impact of foreign operations, which reduced the ETR by 2.6 percent, a reflection of increasing globalization in the sector, as demand for resources in emerging markets increased.

Transportation & Logistics [18] – In 2011, the transportation & logistics sector faced slow global economic growth and high fuel costs. The average three-year ETR of the sector was 24.3 percent and remained relatively constant between 2009 and 2011. The most favorable driver of the ETR in 2011 was the use of losses as profits increased on average by 16.3 percent.

For a copy of Assessing Tax, PwC's tax rate benchmarking study for industrial products and services companies, please visit: www.pwc.com/us/industrialproducts [4].

About PwC's Industrial Products practice

PwC's Industrial Products [1] (IP) practice provides financial, operational, and strategic services to global organizations across the aerospace & defense [5] (A&D), business services [19], chemicals [6], engineering & construction [7] (E&C), forest, paper, & packaging [20] (FPP), industrial manufacturing [8], metals [9], and transportation & logistics [10] (T&L) industries. For more information please visit: www.pwc.com/us/en/industrial-products [21]

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