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R&D Tax Incentives – The Hidden Strength of the Domestic Economy

The field of Research and Development (R&D) is no longer reserved only for large technology companies; today, it represents an important driver of growth and competitiveness in modern business. Although they are often unaware of it, many companies already carry out activities in their daily operations that may qualify as R&D, yet they fail to recognize them and fully leverage their potential.

Many countries around the world have recognized the importance of R&D and actively encourage companies to invest in innovation through various tax and financial mechanisms. In the Republic of Serbia, tax incentives in this area have been in force since 2022. However, in practice, R&D still remains an abstract and complex concept for many, often perceived as something accessible only to a narrow group. As a result, a significant number of companies do not utilize the available incentives, even though in many cases they already meet the required conditions.

In such an environment, understanding the legal and tax framework governing investments in research and development is not merely a matter of regulatory compliance, it becomes a key strategic issue, both for cost optimization and for long-term market positioning.

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What is R&D and why is it important?

When discussing research and development in a business context, it often appears as something highly abstract. In practice, however, R&D is much more tangible and present in the everyday operations of modern companies, especially those involved in technology, software development, or innovative manufacturing. R&D activities are essentially projects that a company deliberately initiates to create something new or significantly improved, thereby advancing existing knowledge, products, or processes. In other words, these are not simple modifications or cosmetic changes, but systematic efforts aimed at innovation that can generate measurable value. Therefore, it is important to understand what specific elements an activity must contain to be considered an innovation.

R&D activities usually begin with an idea that is challenging enough to require planning and experimentation. For example, developing a new software solution does not simply mean adding another feature to an existing program. A true R&D project implies that the team is tackling a problem that existing tools cannot solve, exploring different approaches, testing new algorithms, and creating a prototype that can be evaluated. Each step in this process is documented – from the initial idea, through experimentation, to the final model ready for application.

The same applies to physical products or technological processes, where developing a new material, device, or production process involves planning experiments, building prototypes, evaluating results, and refining solutions until a genuinely new or significantly improved outcome is achieved. Such activities require creativity but also systematic work, meaning that every step must be tracked and recorded to document progress and justify the investment.

One of the key characteristics of R&D activities is uncertainty: success cannot be guaranteed in advance. This uncertainty and experimental nature are precisely what make R&D valuable from both an innovation and tax incentive perspective. Only activities that truly push the boundaries of existing technology or knowledge can qualify as R&D.

Practical examples include developing new programming languages, creating algorithms, testing functional prototypes, or conducting pilot projects in production processes. While the IT sector offers the most visible examples, R&D is not limited to it; it is equally applicable in manufacturing, pharmaceuticals, energy, automotive industries, and many other sectors. Regardless of the industry, every successful R&D initiative enables faster adaptation to change and creates opportunities for cost optimization and financial savings through more efficient processes. In other words, R&D does not only create technological and market advantages, it also delivers tangible financial benefits, allowing companies to reinvest in new projects and achieve sustainable growth.

Instruments of tax support for innovation

As previously noted, in comparative practice, countries use various instruments to encourage investment in research and development. Therefore, tax incentives represent only one possible model, while in certain jurisdictions incentives are also provided through direct grants for R&D projects, favorable loans for innovation activities, or special financial support programs aimed at developing new technologies.

Despite this diversity of instruments, a significant number of countries have chosen to base their primary mechanism for encouraging innovation on tax incentives, given their relative simplicity of application and the ability to link them directly to companies' investment decisions. Serbian tax legislation has followed this trend and developed a relatively broad framework of tax incentives for companies investing in research and development.

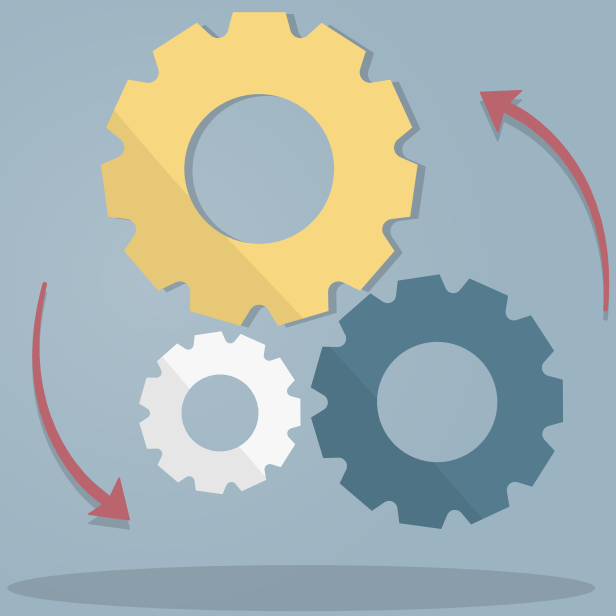
The most significant among them include the R&D tax incentive, which allows costs incurred in connection with R&D projects to be recognized at double value in the tax balance.

In addition, the so-called IP Box regime has been introduced, under which income generated from the commercialization of intellectual property resulting from R&D is taxed at a lower rate.

Another important incentive is the tax exemption for a portion of taxes and social security contributions on the salaries of employees directly engaged in R&D projects. An additional mechanism for fostering the innovation ecosystem is reflected in tax incentives for investments in startup companies.[1]

Each of these incentives targets different aspects of a company's operations. Some primarily affect business expenses, particularly development and labor costs, while others aim to provide more favorable taxation of income generated as a result of successfully conducted R&D activities.

For this reason, these mechanisms are not designed as isolated measures, but rather as instruments that can support the entire lifecycle of innovation, from the development phase, through the engagement of skilled personnel, to the commercialization of research results. Depending on the specific business situation, a company may use only one of these incentives, while in other cases it is possible to combine them, provided that the prescribed conditions are met.



[1] For further details on the application of these incentives, please refer to: https://vp.rs/2023/05/04/poreski-podsticaji-u-oblasti-istrazivanja-i-razvoja/.

Strategy of combining incentives

In practice, particularly significant effects are achieved when tax incentives are properly combined. Since each of them impacts a different element of the tax burden, their simultaneous application can result in substantial savings for a company. For example, the double deduction of R&D costs reduces the corporate income tax base, while exemptions related to employee salaries decrease overall labor costs during the project's duration. Once the development is successfully completed and results in protected intellectual property, the income generated from its commercialization may be taxed under the IP Box regime at a significantly lower rate.

Within such a structure, incentives operate simultaneously across multiple levels of business activity—reducing development costs, lowering employee-related expenses, and optimizing the taxation of income derived from innovation. As a result, the company achieves significantly higher net income and more stable cash flow, creating room for further investments in the development of new products, technologies, and business models.

A practical example of this approach can be seen in technology companies that develop their own software. During the development phase, the costs of programmers and other experts may be covered by R&D salary tax exemptions, while all project-related costs are simultaneously recognized at double value in the tax balance. Once the software is completed and begins generating revenue through licensing or sales, the profit derived from that intellectual property may be taxed under the IP Box regime at an effective rate of 3% (a practical example of the combined effects of the R&D double deduction incentive and the IP Box regime is provided below).

In this way, combining incentives allows tax benefits to be utilized both during the development phase and in the commercialization phase of the innovation.

Of course, in practice, the proper application and combination of these mechanisms requires careful planning and analysis of each individual case. Therefore, companies are advised to, in cooperation with tax and legal advisors, assess available options in advance and develop an appropriate strategy for their use.

Common mistakes in using R&D tax incentives

Practical experience to date shows that applying for R&D incentives often raises a number of practical issues. These challenges typically become most apparent when companies attempt to respond to requests from tax authorities during the process of determining whether the conditions for granting such incentives have been met. Interestingly, certain issues recur regardless of the industry or the size of the company. Below, we outline the most common shortcomings that may slow down or complicate this process.

1) Activities are not clearly documented as R&D projects

The first step in utilizing tax incentives is the proper identification of activities that may qualify as research and development. Although such activities may in substance fall within R&D, in many cases projects related to product development, software, or technological solutions are not formally defined as such.

In addition, there are often no clear descriptions of project objectives, planned phases, or documentation indicating which activities were carried out and what results were expected. When such structure is lacking, it becomes significantly more difficult to subsequently demonstrate that a specific project has the characteristics of research and development. Without systematic documentation, it is challenging to determine whether the project truly includes elements of novelty, creativity, and technological uncertainty that are characteristic of R&D activities.

2) Incomplete records of employee engagement in R&D projects

Another challenge relates to tracking the work of employees involved in R&D projects. Certain tax incentives are based on the amount of time employees spend working on such projects, making it necessary to maintain precise records of their engagement. In practice, employment contracts and internal documentation often do not reflect actual activities, or there may be inconsistencies between job descriptions and the tasks employees actually perform. As a result, even when employees are involved in developing new solutions, without clear records of working hours and project-specific engagement, determining the scope of R&D activities becomes problematic.

3) Insufficiently identified R&D costs

A similar issue arises in identifying costs directly related to research and development. To apply the double deduction incentive, it is necessary to clearly determine which expenses were incurred specifically in connection with R&D activities. If development costs are not tracked through separate records or are not linked to a specific project, it may be difficult to determine the exact amount. In such circumstances, it is often not possible to apply the incentive in full due to a lack of documentation confirming the precise amount of relevant expenses.

4) Development for own purposes vs. on a contractual basis

Another important issue concerns the question of for whose benefit the R&D is conducted. In order to use certain R&D tax incentives, a company must perform activities for its own purposes and retain the results of that development. In practice, however, companies often develop software or technological solutions for clients. In such cases, the development project represents a service provided to another party, while the rights to the final product belong to the client. When development is carried out on behalf of another party, such activity generally cannot be treated as R&D for the purposes of tax incentives intended for a company's own development projects.

5) Overlooking territorial requirements for R&D activities

When applying certain incentives, it is also important to consider the territorial aspect of R&D activities. Specifically, the double deduction of costs can only be applied to activities that are predominantly carried out within the territory of the Republic of Serbia (subject to certain exceptions). Companies that organize part of their research activities abroad sometimes overlook this requirement or lack documentation clearly demonstrating where specific activities were performed.

6) Intellectual property rights are not protected

Issues also frequently arise in relation to the protection of development results. For the application of the IP Box regime, it is necessary for the company to be the holder of a registered copyright, patent, or other intellectual property right resulting from R&D activities (or to have filed the appropriate application with the Intellectual Property Office no later than the end of the tax period in which the incentive is first applied).

In practice, companies sometimes develop software or other technological solutions but fail to register them with the competent authority, or do not file an application for protection with the Intellectual Property Office of the Republic of Serbia. In such cases, even though the development has effectively been carried out, the company does not meet the formal requirement for applying the IP Box incentive, as the intellectual property has not been registered or applied for within the prescribed deadline.

Innovations That (Don't) Pay Off: What Is the Real Cost of Ignoring R&D Incentives?

In a world where competitiveness is measured by the speed of innovation and the ability to bring something new to market, any savings generated through tax incentives can be decisive. On the other hand, the consequences of failing to use them are often not immediately visible, yet they are very real: higher corporate income tax, higher labor costs, and less capital available for reinvestment in new technologies and products. In other words, unused incentives are not just a missed opportunity—they represent a tangible financial loss.

To illustrate this more clearly, consider a software company developing an innovative platform for managing industrial production processes. The company employs ten developers with an average gross monthly salary of RSD 300,000, working on a project that involves developing a new algorithm for production optimization and testing functional prototypes of a software solution.

Assuming the company generates annual revenue of approximately RSD 200 million, with total expenses of around RSD 150 million, its taxable profit would amount to roughly RSD 50 million, resulting in corporate income tax of RSD 7.5 million.

However, if these activities are properly recognized as R&D and systematically documented, the impact of tax incentives becomes significant: the double deduction of project costs reduces the tax base by approximately RSD 36 million annually, lowering the taxable profit to around RSD 14 million and the corporate income tax to about RSD 2.1 million. When combined with the IP Box regime, which can reduce the effective tax rate on software-related income to as low as 3%, the company achieves substantial savings. In some cases, through proper combination of incentives, the total tax burden can be reduced to zero.

This example clearly illustrates the magnitude of the difference between a scenario in which incentives are not used and one in which they are properly identified and applied. Although in real, more complex business systems the calculations are significantly more intricate and depend on a number of factors, the underlying logic remains the same. There is almost always room for optimization, but its utilization depends directly on the timely identification of R&D activities and their proper legal and tax treatment. Therefore, this example should not be viewed as an exception, but rather as a reminder of how significantly decisions regarding R&D incentives can impact financial outcomes.

When Innovation Becomes a Financial Strategy

What becomes evident in practice is that R&D incentives are not merely a technical tax matter, but a reflection of how a company understands its own business. The difference between companies that use them and those that miss out on them often does not lie in whether innovation exists, but in whether it is recognized, structured, and properly documented. In this sense, R&D is not only about developing new products or technologies, but also about a company's ability to translate its internal processes into a framework that allows for measurability, proper documentation, and ultimately, strategic tax planning and optimization.

At the same time, the importance of these incentives goes beyond individual savings and extends to long-term project planning. When properly structured, R&D mechanisms become a tool that connects development, finance, and strategy, enabling companies to view innovation not as a cost, but as a controlled and optimized investment.

In this process, the need for coordinated action across different functions within a company becomes particularly evident, given that the proper application of incentives requires maintaining various records throughout all phases of a project. It is precisely at this point that the key distinction arises between ad hoc development and a systematic approach that fundamentally transforms how a company manages its operations in the long term.

Nevertheless, the line between legitimate optimization and improper application is often subtle and largely depends on the specific facts of each project. For this reason, the application of R&D incentives cannot be reduced to a universal model, but requires an individual assessment of each case in order to fully unlock the potential of these mechanisms.

VP Law Firm provides legal advisory services to domestic and international companies in the field of tax incentives for research and development (R&D), with a particular focus on the identification of R&D activities, their appropriate tax treatment, and the application of available tax reliefs in accordance with the applicable legislation of the Republic of Serbia.

Our team advises clients through all phases of the utilisation of R&D incentives, which primarily include the identification of eligible projects, structuring of relevant documentation, as well as providing legal support in proceedings before the tax authorities.

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