Research and Development Tax Credit Clinic
Kilkenny, 7th October 2015
Key Points Covered

R&D Tax Credit History

- Numbers of claimants and cost has increased year on year – now €400m+ being claimed by over 1,500 companies
- Review of R&D Tax Credit carried out by Department of Finance in 2013 concluded

> *"The Irish R&D Tax Credit regime has been a significant driver for increasing R&D spend in Ireland over the last decade, the scheme itself continues to be 'best in class' internationally, and it remains a significant aspect of Ireland's successful formula for attracting foreign direct investment, which is jobs rich."*

- Report in Irish Times on 3rd September 2015 stating that audits commenced in 2013 had yielded >€21m and 2014 audits have yielded >€14m to date
- R&D companies highlight concerns regarding Certainty, Clarity and Consistency.
- New R&D Tax Credit Guidelines published in January 2015 and updated in April 2015

R&D Tax Credit – Building the claim

<u>Science/Technology Test</u>

Do activities meet the definition of R&D Activities set out in S766 TCA 1997 and can they be supported?

+

<u>Accounting/Tax Test</u>

Has only expenditure relating to these activities been included and treated correctly? Can it be supported ?

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R&D Tax Credit

1. Scientific/Technological Advancement

- **R&D Tax Credit Guidelines**

  “The test relates to knowledge or capability reasonably available to the company or a competent professional working in the field”

  “an advance in science or technology means an advance in the overall knowledge or capability in the field of science or technology (not an advance in the company’s own state of knowledge or capability alone).”

  “where knowledge of an advance in science or technology is not reasonably available……companies may not be disqualified from claiming the tax credit where they undertake activities seeking to independently achieve the same scientific or technological advancement”

- **Clearly demonstrate competence to be seeking scientific/technological advancement**

- **Technological Advancement = New Knowledge (including new knowledge embodied in product, process, system etc.)**

1. Scientific/Technological Advancement (C'td)

2 key components to demonstrating and supporting scientific/technological advancement

1) Benchmark existing knowledge/capabilities at outset

"Evidence that the scientific or technological advance(s) sought had not already been achieved and that the scientific and/ or technological uncertainties …were not already resolved or that such resolution would not be available to a competent professional working in the field, for example, evidence that a comprehensive literature review to determine the current status of scientific or technological knowledge in the area had been conducted prior to commencing the project."

(Section 8.1, R&D Tax Credit Guidelines)

2) Clearly state objectives at the outset (Quantify where possible)

"indicators or measures identified at the commencement of the project to determine if the scientific or technological objectives of the R&D activities are met".

(Section 8.1, R&D Tax Credit Guidelines)

2. Scientific/Technological Uncertainty

- A company should be able to support:

1) The presence of scientific/technological uncertainties at the outset of the project;

<u>and</u>

2) That the scientific/technological uncertainties could not be resolved through routine engineering

- Identify and document the technological uncertainties at the outset

- Two types of uncertainty:

a. Uncertainty as to whether a particular goal can be achieved, or

b. Uncertainty (from a scientific or technological perspective) in relation to alternative methods that will meet desired specifications such as cost, reliability or reproducibility."

(Section 3.5, R&D Tax Credit Guidelines)

Type a. = scientific uncertainty.

Type b. = system uncertainties

- When describing system uncertainties, look at unpredictable upstream and downstream effects on other parts of the system

Systematic Investigative or Experimental Activities

- Section 3.1 of the R&D Tax Credit Guidelines indicates that in order to satisfy the "systematic" requirement, activities should be documented, e.g.

  "It is important that claimants realise the importance of contemporaneous and relevant documentation to support the claim. Failure to keep such documentation may result in the claim for the R&D tax credit being disallowed."

- Section 8.1 of the R&D Tax Credit Guidelines describes the documentation required to satisfy the science test and includes:

"Details of the systematic investigation, including

- *the hypothesis advanced.*
- *the series of experiments or investigations undertaken to test the hypothesis.*
- *documentary evidence of the necessity for each major element and how it fits into the project as a whole.*
- *dated documents of the original scientific or technological goals, the progress of the work, how it was carried out and the conclusions.*
- *indicators or measures identified at the commencement of the project to determine if the scientific or technological objectives of the R&D activities are met."*

Systematic Investigative or Experimental Activities

SciMet R&D

- Identify the method appropriate to your R&D, e.g.

Scientific Method	Engineering Method
State your question	Define the problem
Do background research	Do background research
Formulate hypothesis, identify variables	Propose alternative solutions; choose the best candidate and build a prototype
Design experiment, establish procedure	Design experiment, establish procedure
Test your hypothesis by doing an experiment	Test your prototype by doing an experiment
Analyse results and draw conclusions	Test and redesign as necessary
Communicate results	Communicate results

Systematic Investigative or Experimental Activities

- Documentation must show the R&D journey, not just the destination!

"It is important that the claimant is able to provide records and details of the activities carried on, not just the outcomes.

"Where a particular path has not been successful and a different path required, then documentation to support these decisions should be available if needed"
(Section 3.1, R&D Tax Credit Guidelines)

Some examples of supporting documentation

- Project planning documents;
- Records of resources allocated and timesheets;
- Status and/or progress reports;
- CAD drawings, FEA reports
- Design of experiments, feasibility plans with details of the methodology adopted;
- Sprint/scrum reports;
- Minutes of project meetings;
- Whiteboard drawings proposed solutions;
- Photographs & Videos of unsuccessful prototypes;
- Test protocols, data, analysis, results, conclusions;
- Proof of concepts, samples, prototypes with notes on technical challenges to overcome;
- Emails or data extracted from a dedicated project management software system;

Software

New R&D Tax Credit Guidelines

“Software developments using known methodologies in standard development environments using the standard features and functions of existing tools would **not** typically advance technology and would not address or resolve technological uncertainty.”

“Undertaking routine analysis, copying, upgrading or adaptation of an existing product, process, service or material would not be considered to be R&D activities.”

“Advances are typically made through innovation in software architectures, algorithms, techniques or constructs.”

Systematic Investigative or Experimental Activities

New R&D Tax Credit Guidelines

“Within a typical software development cycle there will be also be features that do not constitute qualifying R&D activity such as:

- User acceptance testing designed to satisfy users as to the accuracy and completeness of the product rather than to test feasibility or capacity;

- Development work aimed at packaging a product for market where no scientific or technological uncertainty exists; or

- *Inclusion of features or functionality where no scientific or technological uncertainty exists.”*

“It is important for claimant companies to identify not only those developments that result from qualifying activity but also the phases of the software development life-cycle that are qualifying activity.”

Revenue Audit – Software

Arguments that can be made by Revenue in an audit that a company has to be prepared to defend include:

“The solution, or the method of arriving at the solution, would have been readily apparent to appropriately skilled and experienced software developers after they had analysed the problem using generally known software development techniques”

“These are the correct techniques that a trained IT professional would perform under the same circumstances”

“These new functions and features have been developed to provide commercial advancement and do not seek to achieve technological advancement or resolve technological uncertainties”

“These are feature extensions developed within the architecture of the original package using tools proven during the development of that package”

“Activities were after resolution of technological uncertainties e.g. QA, UAT”

The Accounting Test & Eligible Expenditure

- **25%** of "qualifying group expenditure on research and development"
- Claim must be made within **12 months**
- Base Year removed from 1 January 2015. For 2014, only relevant if it exceeds €300,000
- Expenditure met by grant assistance must be excluded. Excess over grant amount can be included.
- R&D Tax Credit and S291A Capital Allowances (Intangible Assets) must not be claimed on same expenditure

R&D Tax Credit – Eligible Expenditure

SciMet R&D

Section 4 of the R&D Tax Credit Guidelines

"The tax credit is available in respect of expenditure incurred wholly and exclusively—

1. in the carrying on

2. by it (the company)

of qualifying R&D activities."

Not Expenditure incurred in connection with R&D

Not Expenditure incurred for the purposes of R&D

Not Expenditure incurred to enable R&D to be carried out

Not indirect overheads such as recruitment fees, insurance, travel, equipment repairs or maintenance, shipping, business entertainment, telephone, bank charges and interest

Not HR costs, payroll team costs, canteen costs or similar

R&D Tax Credit – Eligible Expenditure

1. R&D Staff Costs

- Calculated based on their deployment to and actual engagement in qualifying R&D activities
- Fully loaded staff costs (salary, bonus, pension, health insurance or other items included in the reward package)

2. Plant and Machinery

- Must qualify for capital allowances
- If not used exclusively for R&D, apportionment is required
- Apportionment used must be monitored and adjusted if necessary
- Costs can be treated as incurred either a) the date the P&M is brought into use or b) the date the expenditure becomes payable

R&D Tax Credit – Eligible Expenditure

3. Subcontracting

- Subcontracting to unconnected third parties – from 2014 the limit is the greater of a) **15%** of in-house spend or b) €100,000

  "It is important to note that the outsourced activity must constitute qualifying R&D activity in its own right." **(Section 6.1 of R&D Tax Credit Guidelines)**

- Subcontracting is not restricted to EEA

  "Ireland is not alone in having a limit on the amount of outsourced expenditure that is allowable for the tax credit. Most countries seek to limit the location of the outsourcing to within their own countries borders,or theEU/EEA as applicable. It is notable that Ireland allows the outsourcing to take place anywhere in the world."

  (Section 8.66, Review of Ireland's R&D Tax Credit 2013, Department of Finance)

- Notification Requirement

- Subcontracting to universities – limit is the greater of a) 5% of in-house spend or b) €100,000

- Subcontractor restriction may not apply to individual consultants where conditions are met **(Section 4.3.1, R&D Tax credit Guidelines)**

R&D Tax Credit – Eligible Expenditure

4. Direct Costs – Two very important new sections in guidelines:

Materials used in R&D Activities which may be subsequently sold **(Section 4.6)**

R&D carried on as part of an Existing Trade **(Section 4.7)**

5. R&D Overheads

*"Costs which are **not** wholly and exclusively incurred **in the carrying on** of the R&D activity, including indirect overheads such as recruitment fees, insurance, travel, equipment repairs or maintenance, shipping, business entertainment, telephone, bank charges and interest, **do not qualify** as relevant expenditure.*

However, overheads which are wholly and exclusively incurred directly in the carrying on of the qualifying R&D activity, for example power consumed in the R&D process, qualify for the credit."

(Section 4.1, R&D Tax Credit Guidelines)

R&D Tax Credit – Eligible Expenditure

5. R&D Overheads (C’td)

- Note significant changes from previous guidelines (Pre-2012):

“The tax credit will be available in respect of expenditure incurred in the carrying on of research and development activities under the usual tax rules relating to such expenditure. Under these rules expenses such as staff and overhead costs can be apportioned and the credit will be available for the portion expended in the carrying on of the research and development activity.

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Allowable expenditure would include the cost of the following activities:

(a) engineering, design, operational research, mathematical analysis, computer programming, data collection, testing, or psychological research;

(b) indirect supporting activities such as maintenance, security, administration and clerical activities, finance and personnel activities;

(c) ancillary activities essential to the undertaking of research and development activities such as taking on and paying staff, leasing laboratories and maintaining research and development equipment including computers used for research and development activities;

(d) the cost of plant and machinery used wholly and exclusively for R&D activity. Please also refer to 8 above.

R&D Tax Credit – Using the R&D Tax Credit

1. Offset against corporation tax of current period;
2. Excess carried forward indefinitely for offset against future corporation tax;

or

- Claim made to carry excess back for offset against prior year corporation tax, and
- Remaining excess to be received in three instalments

Instalment 1: 33%, paid no earlier than filing deadline of CT1;

Instalment 2: 50% of excess to be paid no earlier than 12 month anniversary of above date;

Instalment 3: Balance to be paid no earlier than 24 month anniversary of date specified for instalment 1

Order of Offset: Pre-2009 carry forward can be used in priority to any year other than current year tax credit **(See Example 11 in new guidelines)**

R&D Tax Credits – Payable Tax Credits

Aggregate amount of payable credits is restricted to the greater of:

A. "the aggregate amount of Corporation Tax paid by the company for accounting periods ending in the ten years prior to the year preceding the accounting period concerned, reduced by any amounts of Payable R&D Credit claimed in respect of prior periods",

OR

B. the aggregate of payroll liabilities for the period concerned and the preceding accounting period (Payroll liabilities include amounts due to Revenue in respect of PAYE, PRSI and USC) reduced by the lesser of

a. any excess of aggregate payable R&D credit over aggregate payroll liabilities for all periods in respect of which a payable credit was claimed prior to the period in question; OR

b. the payroll liabilities for the preceding period.

R&D Tax Credits – Payable Tax Credits

Example no. 8:

QVR Limited commenced trading in 2010. The company has been continually loss-making.

	2010	2011	2012	2013	2014	2015	2016	2017
CT liability	nil	nil	nil	nil	nil	nil	nil	nil
Payroll liability	€600	€500	€400	€500	€700	€800	€600	€700
R&D credit	€1,000	€2,000	€3,000	€1,000	€2,000	€3,000	€3,000	€3,000
Payable credit	€600	€500	€900	€500	€700	€1,000	€700	€700
Excess payable credit over payroll liabilities	nil	nil	€500	nil	nil	€200	€100	nil
Cumulative excess	**nil**	**nil**	**€500**	**€500**	**€500**	**€700**	**€800**	**€800**

R&D Buildings and Structures

- 25% of specified relevant expenditure on construction/refurbishment
- Specified relevant expenditure = Use for qualifying R&D/Total Use
- Building/Structure must be used at least 35% for qualifying R&D activities
- Expenditure must qualify for Industrial Buildings Allowance or Part 9 allowance
- Clawback if building ceases to be used for qualifying R&D within 10 years
- Claim must be made within 12 months of expenditure being occurred. Qualifying expenditure on may be treated as having been incurred either:-

(i) on the date it was actually incurred, or

(ii) on the date the building was first brought into use for the purposes of a trade, or the refurbishment is completed as appropriate. **(Section 5.1, R&D Tax Credit Guidelines)**

Rewarding of Key R&D Employees

- **Key Employee**

- at least 50% of duties involve “the conception or creation of new knowledge, products, methods and systems” and 50% of staff cost included in tax credit

- Not a director of the company (or connected to such a director).

- Does not hold more than 5% of the shares of the company (or connected to a person who has such a material interest).

- **Limit on amount that can be surrendered**

- the amount the company could otherwise have used to reduce the CT liability i.e. not available to loss-making companies.

Revenue Audit - Desk Audit

23 Questions

1. The number of projects undertaken?
2. A summary of the research and development activities in relation to each project.
3. The date each project commenced?
4. The date each project ceased if applicable?
5. Is the claim in respect of section 766 or section 766A of the Taxes Consolidation Act 1997?
6. The amount of the 2003 expenditure threshold amount?
7. Has ALL group expenditure been included in the threshold amount?
8. Outline the specific scientific or technological advancement, which the company sought to achieve at the start of each project?
9. Outline the specific scientific or technological uncertainty, which the company sought to resolve at the start of each project?
10. Once the uncertainty was resolved confirm that no further expenditure has been attributed to the R&D claim?
11. Was the solution already known and available to a competent professional in the field?
12. What were the qualifications of each project leader?
13. The field of science or technology involved?

Revenue Audit - Desk Audit

23 Questions (Continued)

14. Which of the following categories do the activities fall under? A) Basic Research, B) Applied Research or C) Experimental Development.

15. Where did the R&D activities take place?

16. The number of staff employed in R&D activities?

17. How much (if any) expenditure was paid to third party contractors or service providers (excluding utilities)?

18. How much (if any) expenditure was paid to a university or institute?

19. In respect of (17) and (18) briefly outline the work carried out by the other parties.

20. Where expenditure has been allocated to R&D by apportionment, please state in respect of each expenditure item, the method and basis used.

21. If the claim includes expenditure on plant and machinery state the % use of such equipment on R&D over the useful economic life of the asset.

22. Details of any grants received in respect of R&D

23. Computation of tax credit claimed.

Revenue Audit - Field Audit

- Has an external expert been appointed?
- All taxes or just R&D Tax Credit?
- Prepare presentation for the day of the audit
- Financial and Technical staff present on the day
- Back-up to Science Test and Accounting Test