R&D tax credits – developing the opportunity

Michael Sheehan and **Adrian Walker** highlight some welcome developments in Finance Bill 2012

Ireland's research and development (R&D) tax credit system is considered one of the more attractive schemes available to reward science and technology development. In a world where multinationals are becoming more mobile with R&D projects, how Ireland compares with other jurisdictions in supports provided has become increasingly important.

The Department of Finance has a track record of continuously developing legislation around the area to keep Ireland in the game and Finance Bill 2012 is no exception, and all the more impressive given the fiscal constraints that exist today. Although international mobility is an important consideration in the legislation, its changes have been predominantly targeted at SMEs.

The benefit to Ireland

The R&D tax credit scheme has been an aspect of corporation tax that has consistently been modified and improved with almost every Budget in recent years. The scheme is recognised as being a vital tool for helping Ireland create and retain a highly-skilled workforce not only for the engineers, software developers and scientists undertaking the development, but for those manufacturing the products and providing the services of the future. The scheme appeals to multinationals choosing the next location for a project or research centre, to indigenous start-ups with innovative technology ideas and to well-established companies maintaining their competitive edge.

Tax definition of R&D

The scheme has financial requirements, often referred to as 'the accountancy test' and technical criteria, 'the science test', for companies to meet. The science test is often broader than many people's initial expectations as to what constitutes R&D and is not restricted to ground-breaking research. The development process must be systematic, investigative or experimental in nature and R&D credits can be claimed for projects in various stages of technology development, from basic research at a theoretical level with no particular application or product in mind, through to applied research where there is an intended purpose or practical application, to experimental developments that build on and improve existing products, devices, processes, materials or systems. Ultimately, the company must be attempting to make an improvement or 'advancement' that would be recognised as such within their industry and has to be overcoming technological or scientific challenges or 'uncertainties' in order to do so. Companies are required to have contemporaneous documentation in support of the claim.

Case study 1

A company making precision cutting tools achieved a significant reduction in cutting noise and vibration of an existing product. Typically vibration, and hence noise, would be reduced or controlled by adding mass in the moving parts giving greater stiffness. However, in this case, the challenge was to substantially increase the overall stiffness of the cutting blade while actually using a thinner blade due to the package constraints. The costs of design, prototyping and in-house testing were successfully included in the claim. This example demonstrates that what many companies might consider as commonplace development projects can often have very challenging aspects that cannot be solved with existing knowledge and understanding. These can qualify for R&D tax credits.

The benefit to the company

Once a project is assessed as meeting the 'science test', qualifying expenditure attracts a 25% credit on top of the usual deduction and capital allowances. Unfortunately, only expenditure which is incremental to the R&D expenditure incurred in 2003 can be claimed and any grant income for the projects must also be deducted. It is worth noting that, currently, a wide range of expenditure associated with an R&D project can be claimed, including salaries, materials and consumables used in the R&D process, sub-contracted R&D (subject to some limits) to unconnected third parties and some company overheads, such as rent, where appropriate.

Case study 2

Another company claimed credits in respect of a number of IT projects developing new software interfaces, database management routines and file-control software. In 2003, the company spent €245,000 on qualifying R&D.

The R&D tax credit claim is outlined in the table below:

*CASE STUDY 2 TABLE

Another company claimed credits in respect of a number of IT projects developing new software interfaces, database management routines and file-control software. In 2003 the company spent €245,000 on qualifying R&D.

The R&D tax credit claim consisted of:

Salary-related expenditure (including company pension contributions, company PRSI and bonuses)	€600,000
Apportionment of general overheads (including rent, rates, electricity and telephone)	€75,000
Total internal expenditure	**€675,000**
Outsourced R&D (subject to an upper limit of 10% of €675,000)	€50,000
Total expenditure	**€725,000**
Less base year expenditure	€245,000
Total qualifying expenditure	**€480,000**
Tax credit @ 25%	**€120,000**

How R&D tax credits are utilised

Credits can be used in a number of ways. Primarily, they are used to reduce a company's current year corporation tax and, soon, there will be an ability to transfer credits to key R&D employees, who can reduce their personal tax liabilities, within certain boundaries. If excess credits remain, they can be used in the order of:

- Reclaiming prior-year tax paid;
- The credit can be carried forward; or,
- Revenue will repay the credits in three instalments over three years.

It should be noted that the final option of a cash repayment is subject to an upper limit that relates to payroll liabilities or corporation tax paid in the previous 10 years. These options are probably the most flexible use of credits available in any of the main stream countries offering R&D tax incentives.

Finance Bill 2012

Finance Bill 2012 has brought some welcome enhancements to the scheme. Although all sizes of company could benefit, the focus has been to assist SMEs, whose claims can be significantly assisted by the relaxation of the 2003 base year and enabling a larger level of R&D subcontracted expenditure to be claimed. Once the Finance Bill has been approved, the first €100,000 of expenditure will not be linked to expenditure incurred in 2003.

Sub-contracted R&D is where a company pays a third party to resolve scientific or technological challenges on its behalf. The limits on the amount of sub-contracted R&D that can be claimed are being increased to the greater of €100,000 or 10% of total internal expenditure for third parties and 5% for third level institute research.

Base year

The changes are welcome in themselves but also provide flexibility for the government to further extend the assistance for smaller companies in the future by increasing the €100,000 figures in both measures. In addition, might this be a method to gradually remove the base year as it becomes increasingly difficult for companies making their first claims to identify and evidence expenditure incurred nearly a decade ago? Through this approach, the impact of removing the base year could be gradually assessed without running the risk of a drastic change in Ireland's tax revenue almost overnight. Case study 3 provides an illustration of how the changes could benefit a company.

The added generosity in the limits for subcontracted R&D for smaller claims does come with some potential restrictions. The time spent by employees managing subcontracted R&D will no longer be claimable but may not materially affect many claims.

However, some of the clarity contained in the Bill around third party expenditure may do so. Companies may find that what they consider as being a legitimate R&D expense paid to third parties no longer falls within the legislation. Lastly, the Bill introduces the ability of a company to transfer credits to a key employee so that they can reduce their personal income tax liability. There are a number of conditions to be met by both employee and company but, where the circumstances allow, an Irish employee can reduce their overall income tax liability to a minimum of 23% of household income. The surrendered credit can be carried forward indefinitely if it cannot all be used in the first year. In the spirit of the R&D tax regime, this is an innovative approach to incentives for recognising employee contributions to R&D and to attract talent to Ireland.

*CASE STUDY 3 TABLE

Pre-Finance Bill 2012		
2003 base year expenditure	€150,000	
2011 R&D expenditure	€250,000	
Tax credit	€25,000	i.e. 25% x
In 2012, the company with the same level of current year R&D expenditure		(€250,000 - €150,000)
In 2012, the company with the same level of current year R&D expenditure		
Tax credit	€50,000	i.e. 25% x (€100,000 + (€250,000 - €150,000)
Let's also say that the company in case study 3 had €100,000 of R&D it funds by subcontracting work to suppliers, in addition to the €250,000 of internal expenditure.		
In 2010, its claim would include:		
Sub-contracted R&D to third parties	€25,000	(10% of €250,000)
University R&D	€12,500	(5% of €250,000)
Total	€37,500	
Under the new rules, the company will be able to claim the greater of up to €100,000 or the 10% + 5% of internal expenditure, i.e., €100,000.		

Conclusion

The R&D tax regime is a great opportunity for companies with technical staff developing new ideas, new knowledge, new levels of product, process or equipment performance and who are overcoming existing technical limitations to do so. We can look forward to further improvements that will keep Ireland amongst the global front runners for R&D tax relief. In doing so, the scheme will, hopefully, become even more aligned with Industry needs for increased reliability in the claim process, improved efficiency for preparing claims and clear rules that encapsulate the development costs incurred.

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