



**Paul Smith**  
Senior Tax Manager, Global Investment &  
Innovation Incentives (Gi<sup>3</sup>), Deloitte

## R&D Tax Credit Revenue Audit Readiness: How Strong Is Your Endgame?



### Introduction

“In chess, ‘endgame’ refers to the final moves of the game when only a few pieces are left on the board. It’s a critical point in the game; one wrong move can end it all.” Anticipating when an endgame is beginning and being in position to take advantage is

what chess grandmasters do. The same is true in business.<sup>1</sup>

In the context of this article, it is true also as regards readiness for your R&D tax credit audit. In a self-assessment system, it is understandable that Revenue audits are carried out, as evidenced by the table below.

1 See <http://www.hni.com/blog/bid/63377/what-s-your-endgame>.

**Table 1: Revenue's R&D tax credit interventions, 2012–16.**<sup>2,3</sup>

Year	No. of claims	No. of interventions
2012	1,543	49
2013	1,576	105
2014	1,570	162
2015	1,535	178
2016	1,506	276

Although the number of tax credit claims has been consistent over the past five years, the number of interventions is increasing. The most recent reported figures (for 2016) show that almost one in every five claims was subject to an intervention.

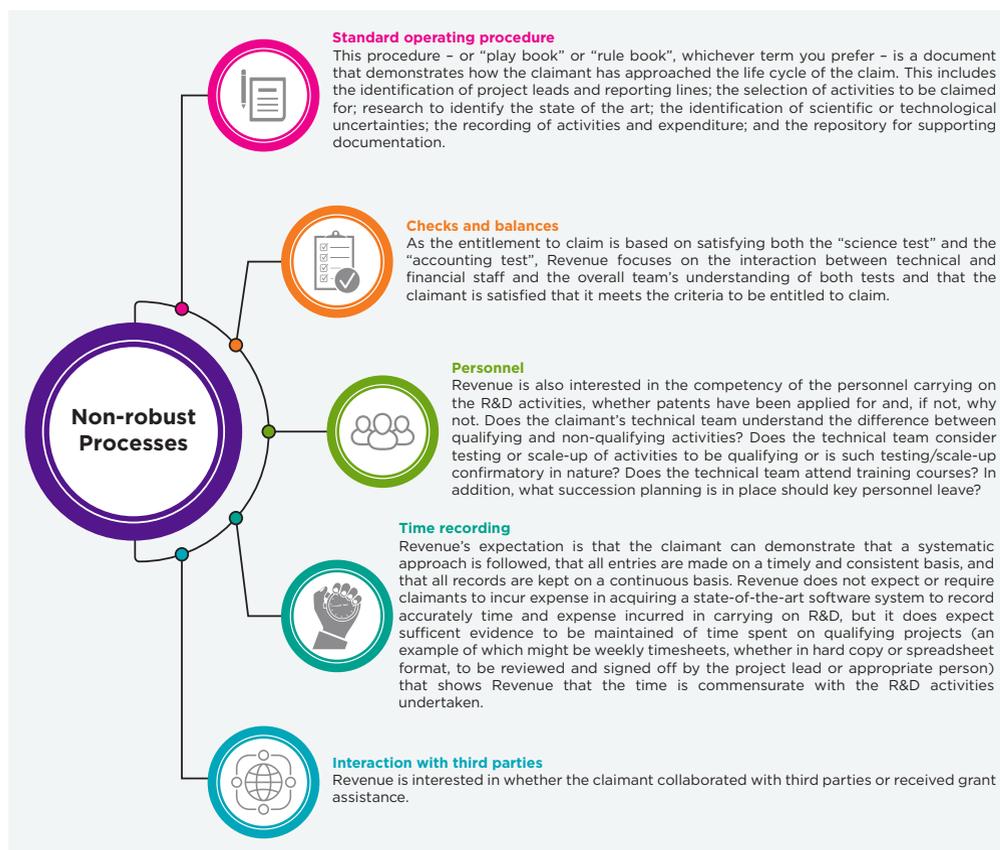
The article is based on the writer's experience at R&D tax credit audits and identifies

the main reasons why claims are reduced and, importantly for the reader, makes recommendations to mitigate the risk of reductions. The article cannot cover all of the variables at play during an audit: the type of audit (single year, multi-year, R&D specific, e-audits, all taxes audits with particular focus on R&D). Nor is it industry specific; rather, it is a general commentary on some of the most common pitfalls experienced at audits.

## Main Reasons Why Claims are Reduced

### Non-robust processes

Revenue takes a keen interest in the processes that the claimant uses to support the carrying on of the R&D activities. A non-exhaustive list includes the following.



2 <https://www.oireachtas.ie/en/debates/question/2018-02-13/137/>.

3 <https://www.oireachtas.ie/en/debates/question/2017-02-28/252/>.

Although none of the above processes is, in isolation, the root cause of reductions in claimed tax credits, their combination with poor report writing and record keeping (see below) often is.

### Report writing

Although there are many variables determining how claims are selected for audit, we can but assume that one of the main reasons is responses to Revenue aspect queries and inadequate technical reports issued in support of same.

It is not uncommon for inspectors to challenge the entitlement to claim in cases where the answers to questions about the “uncertainty” and “advancement” requirements<sup>3</sup> are indecisive as “The claimant was uncertain this could be achieved...” or “The claimant has never used this process before, hence was uncertain that...” The issue with these examples is that it is not enough that the claimant did not know; it is required that the wider scientific/technological community did not know, and so the resolution of the uncertainty and its related advancement are adding to the knowledge of the scientific/technological community.

Also, the absence of any information about failures in technical reports is at odds with the requirement to carry on “investigative or experimental activities”. Documenting failures, ironically, supports the carrying on of R&D.

### Record keeping

Given that the legislative entitlement to claim the tax credit is grounded in the claimant’s carrying on of R&D activities (the “science test”) and maintaining a record of expenditure incurred by the claimant thereon (the “accounting test”), it is unsurprising that the principal focus of the audit is on the supporting documentation.

One of the main difficulties encountered by claimants in evidencing their carrying on of

R&D activities is a perceived lack of sufficient and relevant documentation. Therein lies the rub. Although the legislation is silent on the nature of the documentation required, Revenue conducts audits using its own guidelines,<sup>4</sup> which set out prescribed records that should be maintained to satisfy the science and accounting tests.

To illustrate this point, consider that Revenue places great importance on the claimant’s being able to demonstrate, through documentation, the existing state of knowledge before commencing the claimed activities. This “state-of-the-art” or “pre-research” research is evidence that the scientific or technological advancements have not already been achieved nor their underlying uncertainties resolved, or that they could not be resolved by a competent professional working in the relevant field of science or technology. An example of this is evidence that a comprehensive literature review has been conducted before starting the project.

So what does a claimant do if it cannot demonstrate that it conducted a comprehensive literature review at the outset of the project? Does the absence of a literature review undermine the claim, thus leaving the validity open to challenge? I will illustrate this with an example.

Consider the position of a manufacturer that is conducting R&D to seek technological advancements by making incremental improvements to its products or processes and that is operating under a unique set of constraints (ingredient, sensory, formulation, processing). If the manufacturer is using a competitor’s product as a benchmark, it will not have relevant information in the public domain, other than patents, which are protected intellectual property (IP) and therefore may not be copied/replicated. However, if that manufacturer can demonstrate the scientific/technological complexity of the multiple constraints at play, a documented stage-gate process, and provide other relevant documentation and correspondence (such

3 The legislation (s766 TCA 1997) requires that qualifying activity, *inter alia*, “seek to achieve scientific or technological advancement, and... involve the resolution of scientific or technological uncertainty”.

4 See <https://www.revenue.ie/en/companies-and-charities/documents/research-and-development-tax-credit-guidelines.pdf>.

as correspondence with internal experts, subcontractors, and material and machine providers), this should constitute evidence of the state of knowledge, given the level of IP protection in the manufacturer's particular industry. The question then arises of whether this is acceptable to Revenue.

It is important for claimants to be mindful that although the technical experts who assist Revenue in audits are predominantly academics, the majority of claimant companies are undertaking R&D activities in the category of experimental development and thus are not operating in an academic setting and arguably should not be assessed to an academic standard. Furthermore, there is no reference to either literature review or state of the art in the legislation, which is the legal basis on which a claim is made.

Another area of difficulty in record keeping is the inconsistency in the standards of acceptable documentation between Revenue and its fellow State agencies Enterprise Ireland, Údarás na Gaeltachta and IDA Ireland in respect of applying for RD&I funding. Revenue issued eBrief No. 17/2017 acknowledging that there are differences in the definitions of R&D for RD&I grants and the R&D tax credit but stating that it is considered that the two definitions are relatively close. Therefore, with a view to minimising the burden of engaging experts to verify the science test in R&D tax credit claims, Revenue decided that it would not, as a rule, seek to challenge the science test in relation to projects that have received Enterprise Ireland or IDA Ireland R&D grants. However, the mitigation has limited application with conditions attaching such as the requirement for the claimant to be a micro or small enterprise whose total R&D tax credit claimed for an accounting period (of not less than 12 months) is €50,000 or less. An extension of this concession for claims over €50,000 would be welcomed.

### Non-qualifying activities

Appendix 2 of Revenue's R&D guidelines sets out the "Categories of Activity that are not research and development activities", which replicates the content of Statutory Instrument 434 of 2004.

It is not uncommon for Revenue to challenge the inclusion of expenditure on testing in R&D tax credit claims, the challenge being (as per Appendix 2(b)) that the testing is "routine testing and analysis for purposes of quality or quantity control". Even if the claimant can mount a robust defence that the testing is necessary to resolve scientific or technological uncertainty, it is not uncommon for inspectors to challenge that "competent professionals" would know that the testing is confirmatory in nature, i.e. that the resolution of the uncertainty concluded at the bench trial(s).

Another area of difference arises from the sixth criterion that the independent technical expert is required to consider in determining the claimant's entitlement to tax credits<sup>5</sup>. This states that where activities are outsourced, those activities should be "qualifying R&D" when carried on by the contractor. Or, to put it another way, R&D must be in and of itself qualifying R&D to be eligible, which mirrors the wording in the legislation that (irrespective of whether the money is paid to a person/university/institute of higher education) it is "in order for that person/university/institute to carry on research and development". The difficulty leading from this is the impasse that can develop during an audit in respect of claiming expenditure incurred on outsourced activity. If we draw on the previous example of the manufacturer, let us imagine that it did not have sufficient in-house expertise in a particular area and so engaged a third party to undertake certain activities on its behalf. The situation is further complicated by considering that the activities are routine to the third party as it has perfected or is particularly skilled in that activity to such an extent that the contractor would consider the activities routine. So what does the claimant do – not claim these costs? If the claimant had those skills in-house (and thus, did not need to outsource them), would the expenditure have been necessarily incurred to carry on the R&D activities?

### Non-qualifying expenditure

Although the legislation is silent on the matter, Revenue's guidelines (the current edition, April 2015) set out nine examples of expenditure that Revenue considers are not wholly and

<sup>5</sup> <https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-29/29-02-05.pdf>.

exclusively incurred in carrying on R&D: recruitment fees, insurance, travel, equipment repairs or maintenance, shipping, business entertainment, telephone, bank charges and interest. It is common for Revenue to challenge the inclusion of such costs in claims on the basis that, under its interpretation of the legislation wording “in the carrying on”, they are **incidental to** or incurred **for the purposes of** rather than **in the carrying on of** R&D.

In the author’s experience, claimants often have an immediate reaction at audit and agree to remove all of the above examples without challenge, when perhaps there is an argument for their inclusion, based on the wording of the legislation, “incurs expenditure on research and development”. Furthermore, where the audit covers multiple claim years, it is important to remember that it is the legislation and Revenue guidelines that were in existence at the time of making the claim that are relevant, not subsequent legislation or guidelines, which do not have retrospective application to prior claims.

### Recommendations to Mitigate Reductions in Claims

- Educate yourself by being fully apprised of the legislation, case law, Revenue practice, the Revenue Audit Code of Conduct, Revenue guidelines, eBriefs and the definition of R&D as set out in the OECD’s “Guidelines for Collecting and Reporting Data on Research and Experimental Development”, also known as the “Frascati Manual”.
- Review the robustness of your processes, to identify and fill gaps.
- Ensure that claims have appropriate supporting technical documentation that was collated and summarised at the time of claiming. This will protect your company if key technical knowledge holders leave between a claim being made and an audit taking place.
- Review the answers given to the Revenue aspect query (which might have been the precursor to the claim being escalated to a full audit) and ensure that they are sufficient regarding the background to the

activities and the project’s benchmark, aim, uncertainties and advancements.

- Review and, where appropriate, improve the records you maintain to support the science and accounting tests.
- Document failures and the lessons learned from them.
- Consider whether technology can improve your processes, real-time capturing of activities and record keeping.
- Consider engaging an independent expert to review the technical basis for including the claimed-for activities.
- Consider engaging a legal expert to review the technical basis for including expenditure that could be challenged as non-qualifying by Revenue under its interpretation of the legislative phrase “in the carrying on”.
- Consider engaging an R&D tax adviser with relevant experience and success at audits to assist with the above recommendations and guide you through the complexity of a full technical audit.

### Conclusion

So, even if you have never experienced a full audit or your last such audit was several years ago, it is wise to start preparing for the next one. In reviewing the basis for your claim, consider not only what you have claimed but also, and more importantly, why you have claimed it.

As this article began with a chess reference, so it concludes. With almost one in five claims being the subject of Revenue intervention, consider how well you are prepared. When a Revenue audit letter lands on your desk, the clock has stopped on Revenue’s side. Your time is now ticking. It’s your move.

Read more on **taxfind** from Irish Tax Institute *The Professional’s Guide to R&D Tax Credit, KDB and Related Reliefs, 2017*; Part 29-02-05: Research and Development tax credit (R&D) - engaging with independent experts