KPMG

Innovation Monitor 2019

Insights into innovation and R&D in Ireland

“The findings of our survey indicate that firms which avail of the RDTC value it and that it is a driver of R&D and innovation in the economy”

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Foreword

Irish exporters are achieving international sales at record levels. And they are doing so by driving innovation and creating a competitive edge globally.

Research, development and innovation (RD&I) is globally recognised as the key economic differentiator. Put simply, RD&I enables Irish companies to make products and services that are better, cheaper or more innovative than those sold by competitors in global markets. Innovation is a game-changer in relation to a company's ability to compete.

RD&I-active companies which have availed of Enterprise Ireland in-company supports such as the RD&I Fund and the Agile Innovation Fund perform better on average in terms of exports, turnover and employment than their RD&I-active peers who have not availed of this support.

However, as this KPMG Innovation report points out, there is a need to drive greater familiarity with the available supports and schemes to encourage increased uptake as well as additional R&D activity. This will facilitate increased spend on innovation and R&D.

The results of the survey outlined in the report state that participants should all potentially be claiming or intending to claim the R&D Tax Credit (RDTC) for their investment in R&D. This is not currently the case however. Only 55% of the companies surveyed had claimed an RDTC since it was introduced in 2004.

For Irish businesses to remain sustainable and competitive, they need to ensure that their products and processes are cutting edge and that they are investing in R&D and are supported in availing of R&D supports from across the innovation eco-system.

In line with Enterprise Ireland's corporate strategy to grow spend in innovation by 50% to €1.25bn per annum by the end of 2020, we will continue to strengthen collaboration with our stakeholders to assist and advise our client companies on how to reap the benefits that are available to them through the range of R&D supports on offer.

Julie Sinnamon
CEO
Enterprise Ireland

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CEO
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Introduction

KPMG has conducted annual research of Irish business attitudes to innovation and research and development ("R&D") since 2009. We see this research and associated commentary as essential in encouraging an informed debate about how we further develop Ireland's strengths in this area. The 2019 research, conducted on our behalf by Red C Research, gauges opinion amongst a sample of 100 Irish business leaders in receipt of research, development and innovation ("RD&I") grant funding from Enterprise Ireland.

Innovation is now generally considered to be a key driver of competitiveness, both for individual firms and national economies. The Irish Government has recognised this and has set ambitious targets for investment in RD&I, to bring Ireland in line with the most innovative EU countries.

Growth in pure financial terms has been very strong with gross expenditure on R&D (which includes business, higher education, and Government sectors) reaching a record €3.4 billion in 2017 (this is the latest data available). However, Ireland's exceptionally strong economic growth in recent years has meant that RD&I expenditure when expressed as a percentage of GDP has remained stubbornly around the 1% level – approximately half the European average which is our ultimate goal.

Previous KPMG *Innovation Monitor* reports uncovered a mismatch between the level of innovation actually taking place in the economy and the rate of uptake of the R&D tax credit ("RDTC"). This suggested that there may be scope to further stimulate RD&I activity in Ireland if the RDTC uptake could be increased.

The results of our latest survey suggest that there is an opportunity to further increase the amplifier effect of the RDTC. The RDTC is an essential part of the R&D support system and a natural companion to Enterprise Ireland grant aid for many SMEs. If these two reliefs worked seamlessly together it could make R&D activity more affordable and attractive for smaller firms in particular.

This situation could be brought about through increased awareness and an improved understanding of the RDTC. We would like to see the Government and other stakeholders continue their efforts in that regard. The RDTC could also be made more attractive to earlier stage companies by accelerating the cash payment to companies not yet paying tax from the current three year period to one year – this move would entail very little net cost to the exchequer other than the short-term cost of funds.

The RDTC is a relief that is directly targeted at companies employing highly skilled people in Ireland to conduct R&D activity. There is real economic substance and physical presence behind the companies that claim this relief, and it should continue to be nurtured.

If you would like to discuss any of the findings of this year's *Innovation Monitor* or find out how your business could become more innovative, please do get in touch — our contact details can be found at the back of this report.

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Executive summary

Background

The Government has set a target for total investment in R&D in Ireland to reach 2% of GDP (2.5% of GNP) by 2020. Progress towards that goal is being supported with substantial investment from the state. In 2018, direct incentives to stimulate R&D is estimated at €751 million, including €96 million from Enterprise Ireland in the form of supports for Research, Development & Innovation ("RD&I"). In 2016, indirect supports in the form of the R&D tax credit ("RDTC") were €670 million.

The survey

There has been anecdotal evidence to suggest that the level of investment in R&D could have been even higher if more small and medium sized firms availed of the RDTC.

The 2019 survey carried out by Red C Research on behalf of KPMG included 100 participants, all of whom were in receipt of R&D grant funding from Enterprise Ireland.

On the face of it, it might have been expected that the great majority of those receiving Enterprise Ireland RD&I grants would also have claimed the RDTC at some stage, but only 55% had done so.

Survey responses indicated a level of confusion in relation to the qualification criteria, the application processes, the value, and the rules governing the two support instruments. The two schemes should be regarded as part of a continuum of support for R&D, but this is not the case in many instances.

Gap in understanding

Those firms which had not claimed the RDTC appeared to have a poor understanding of the scope of eligible activity and expenditure covered.

Responses included: "I have no knowledge of the R&D tax credit, we have only availed of Enterprise Ireland grant aid", and "I feel like it would have less impact on the business in the long run".

The nature of Enterprise Ireland as a business support body was also significant with many respondents referring in positive terms to the assistance received from the organisation when it came to the grant aid application process.

Interestingly, where criticisms of the RDTC were made they tended to be based on misconceptions and misunderstandings rather than fact.

KDB awareness

Only half of the respondents to the survey had heard of the Knowledge Development Box ("KDB") and only one third (34%) of those who had heard of the scheme intended to claim the incentive in future. At the very least, this suggests a requirement for efforts to boost awareness of the scheme.

Value of the RDTC

The 2016 Department of Finance review of the RDTC found that it represented quite a high return on investment for the state with an additional €2.40 spent on R&D for every €1 in tax foregone.

The findings of our survey indicate that greater familiarity with the scheme and its benefits may encourage increased uptake as well as additional R&D activity.

"On the face of it, it might have been expected that the great majority of those receiving Enterprise Ireland RD&I grants would also have claimed the RDTC at some stage, but only 55% had done so."

Conclusions

The survey findings indicate that firms which do avail of the RDTC value it and that it is a driver of R&D and innovation in the economy, with some firms stating that it is more beneficial to driving R&D activity than grant aid. Naturally, this also suggests that if more R&D performing firms could be encouraged to claim the RDTC this would in turn stimulate additional R&D activity due to the extra funding available.

A number of barriers (perceived and actual) which may act as a dampener on uptake were indicated. These include a poor understanding of the true financial value of the RDTC and the fact that many companies do not realise it is payable in cash to companies which do not pay tax. The restrictions on outsourcing and limitations on the range of costs which can be claimed were also identified as barriers.

Recommendations

- A campaign should be mounted by Government and stakeholders to promote greater awareness of the RDTC and the KDB.
- The value of the RDTC to smaller companies that are not taxpaying should be enhanced by paying it over one year, instead of three.
- A wider selection of costs, possibly aligned with Enterprise Ireland criteria, should be eligible for the tax credit.
- Limitations on outsourced activity should be increased for SMEs.

"The value of the RDTC to smaller companies that are not taxpaying should be enhanced by paying it over one year, instead of three."

Investment in R&D

The vision of the Irish Government's Innovation 2020 Strategy is for this country to become a global innovation leader. Among the key measures of progress towards meeting this goal is a target of total investment in R&D in Ireland of 2% of GDP (2.5% of GNP) to be reached by 2020. This is almost double the 1.19% of GDP level which had been reached in 2015, the year the strategy was published.

While the increase was to be led by the private sector, the Government did commit to investing in innovation. "The primary rationale for Government investment in innovation is to develop a competitive knowledge-based economy and society and to drive innovation in enterprise, develop talent, and maximise the return on our investment for economic and social progress", the Strategy stated.

In 2018, direct state incentives aimed at stimulating R&D totalled €751 million, including €96 million from Enterprise Ireland in the form of various supports for RD&I. In 2016 (the most recent figure available), indirect supports in the form of the RDTC were €670 million.

This represents a very substantial investment by the State in stimulating R&D activity. However, the investment in R&D by all sectors (i.e. business, higher education and government) as a percentage of GDP actually declined to 1.05% - just over half the EU average of 2.07%.

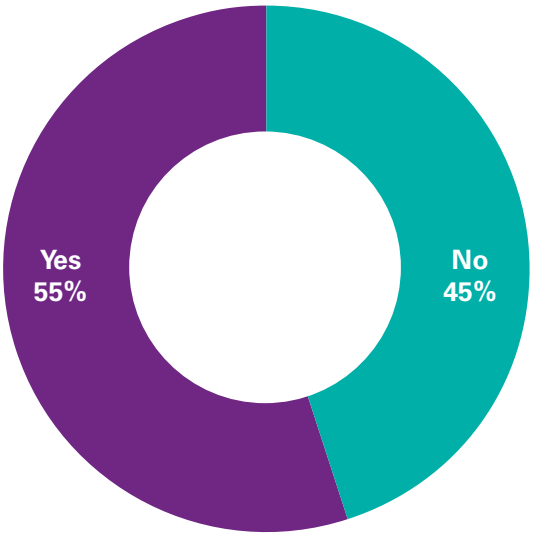
That decline must be seen against the background of the dramatic growth in Ireland's recovering economy over the period in question, during which time GDP growth outpaced the increase in investment in R&D. In that same context, the cost of the RDTC as a proportion of GDP also fell and this offers Government an opportunity to rebalance it's investment.

Notwithstanding the healthy growth our economy has experienced, the lack of progress towards the 2% target is a cause for concern in light of the importance placed by the Government on reaching it. Given the significant level of State investment in the area, the level of R&D intensity deserves closer scrutiny.

The survey carried out by Red C Research on behalf of KPMG included 100 participants, all of whom were in receipt of R&D funding from Enterprise Ireland. It follows that the participants should all potentially be claiming or intending to claim the RDTC for their investment in R&D.

Surprisingly, this is not the case, however. Only 55% of the companies surveyed had claimed an RDTC since it was introduced in 2004. Furthermore, 58% of those that had claimed the RDTC said they had not claimed it on all of the projects for which they were receiving Enterprise Ireland grant support.

Has your company claimed an R&D tax credit in Ireland since this was introduced in 2004?



While not all of the companies surveyed would necessarily have qualified for the RDTC due to the differing eligibility criteria between the RDTC and grants, it is likely that there are many who could qualify but have not claimed the RDTC, perhaps due to misinformation or a lack of awareness of the incentive. The responses from that cohort of companies suggested a level of confusion in relation the nature of the two support instruments.

For example, there was a perception of the Enterprise Ireland grant as a straightforward option. One survey participant pointed to the Enterprise Ireland application form as being 10 pages in length with the RDTC form comprising 300 pages. This is also an example of the misconceptions which abound in relation to the RDTC – there is no "application form" for the credit.

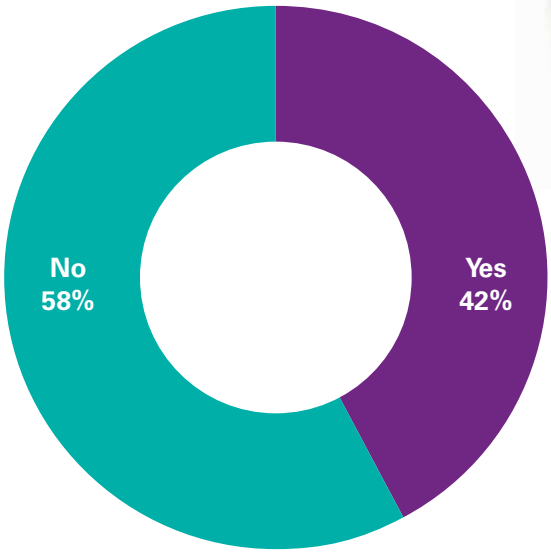
Perceived value is also an issue. A number of the companies surveyed were unaware of the fact that the RDTC is worth 25% of the qualifying spend in addition to the 12.5% corporation tax deduction that is available. There also appears to be a lack of clarity around how the RDTC is paid out, and the fact that it is payable in cash to companies that aren't paying tax did not appear to be widely understood.

In this context, the RDTC could be made more attractive by making the credit payable in one year rather than over three. This would have a very minor net cost to the exchequer (other than the short-term cost of funds) and could stimulate additional R&D activity by encouraging a greater uptake of the RDTC by early stage companies.

Finally, many of the companies surveyed expressed the view that claiming the RDTC could expose them to a scientific audit by Revenue. In some cases at least, they may not have been aware of the guidance issued by Revenue which has indicated that claims valued at less than €50,000 would not be subject to scientific audit once the firm was already in receipt of Enterprise Ireland RD&I grant support.

These findings suggest something of a mismatch between these two valuable forms of RD&I support. The two schemes should be seen as complementary to one another, but this is not the case in many instances.

"It is likely that there are many who could qualify but have not claimed the RDTC, perhaps due to misinformation or lack of awareness"



Does your company claim the R&D tax credit on all of the projects for which it is receiving Enterprise Ireland grant aid?

The meaning of R&D

The research reveals a lack of clarity in relation to eligibility criteria for the RDTC. While it is true that not every RD&I activity supported by Enterprise Ireland will qualify for the RDTC, and that the word "innovation" is not mentioned anywhere in the relevant tax legislation, the divergence between the two regimes is not actually that great.

Indeed, activity eligible for the RDTC can range from new product development, to production process improvements, testing new materials, to cost reduction programmes. Importantly, the work doesn't have to take place in a lab or other dedicated R&D facility.

There is quite a wide scope of eligible activity and expenditure within the RDTC regime, but this appears to be poorly understood by many companies. Indeed, when asked to compare Enterprise Ireland RD&I support with the RDTC, responses included that "the criteria for R&D are a lot more strict for tax credits" and "the criteria are a little less stringent for the grant aid."

These sentiments were expressed time and again with respondents stating that the Enterprise Ireland requirements are less strict and narrow than those for the RDTC. In some instances, respondents believed the RDTC was not available to them for projects involving "process improvements" when this may not have been the case.

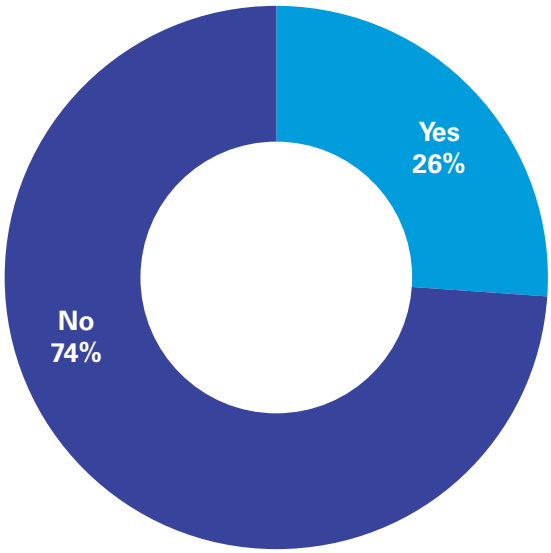
Another comment made was that "Enterprise Ireland understands business better, they get how they operate and are helpful." This was echoed by others who spoke in very positive terms about the nature and level of support received from Enterprise Ireland development advisers.

"You have a development advisor with the grant aid and they are like an account manager to help", noted one respondent. Another said: "We have formed a good relationship with them over the years. It's the comfort factor that we know what to expect and who we're dealing with." Of course, Enterprise Ireland's role is to help Irish businesses grow and innovate and this involves supporting companies to claim grant incentives.

This view of Enterprise Ireland is very important in light of the fact that a quarter of respondents said that Enterprise Ireland required them to implement changes to how they documented time or activity for the purpose of claiming grant aid. The implication being that the additional burden is at least partly offset by the assistance received from Enterprise Ireland development advisers. It may be helpful if Revenue and Enterprise Ireland could streamline their requirements to make it more straightforward for SMEs to leverage the information gathered to support both claims.

It is interesting to note that the issues raised were perceptual rather than factual in almost every case. In other words, the criticisms levelled at the RDTC were frequently the result of misunderstandings or confusion in relation to the scheme on the part of the companies concerned.

Did Enterprise Ireland require you to implement any changes to how you document time or activity for the purpose of claiming Enterprise Ireland grant aid?



The Knowledge Development Box

Introduced in the Finance Act 2015, the KDB is designed to offer similar incentives to other patent box measures that exist in countries that compete with Ireland for Foreign Direct Investment ("FDI"). It provides for an effective tax rate of 6.25% for income generated from intellectual property which has been developed here in Ireland. Like the RDTC, the aim is to encourage companies to locate the high-value jobs associated with intellectual property creation in Ireland.

Interestingly, while the early publicity surrounding the KDB highlighted its potential attractions for FDI companies, it is the indigenous companies who may be better suited to claiming the KDB as they undertake most of the R&D in-house which leads to patents and copyrighted software, which qualify for the KDB. By contrast, multinationals may undertake the R&D activity on a particular IP asset in a number of jurisdictions outside of Ireland.

The KDB is potentially very valuable to R&D performing Irish companies that are taxpaying but uptake has been slow with just, we understand, 11 claims made under the scheme as of 31 December 2018.

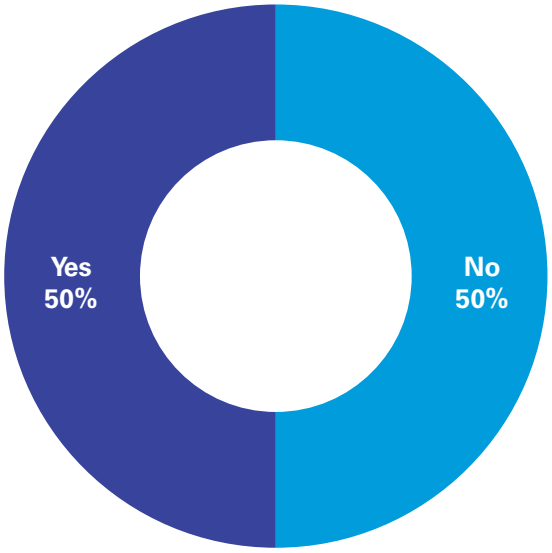
The scheme is still in its infancy, however, and companies still have time to make claims for 2017 should they wish. That said, the complexity of the scheme may be acting as a deterrent to the indigenous companies which stand to benefit most from it.

Another reason could be a simple lack of awareness. Half of the participating firms in our survey had not heard of KDB. Since all of the participant companies were in receipt of Enterprise Ireland grant aid for innovative activities, it may have been expected that more would have heard of the KDB.

Furthermore, only one third (34%) of those respondents who had heard of the scheme intended to claim the incentive in future.

These findings suggest that there is an opportunity to increase awareness of the scheme and consideration could also be given to making it more attractive.

Prior to this survey, were you aware of the knowledge development box tax incentive?



An important driver of R&D activity

The RDTC has been highly successful since its launch in 2004, helping companies to attract and retain high-value jobs with a spill-over effect into local businesses who support companies engaged in R&D and innovation.

While Ireland's R&D spend as a proportion of GDP may have fallen in recent years this belies the very strong increase in the actual spend. Gross expenditure on R&D, which includes business, government and higher education expenditure, has been increasing steadily since 2012 and is estimated to have reached the highest figure on record at €3.4 billion in 2017.

The business share of this figure (Business Expenditure on Research and Development – "BERD") rose to almost €2.4 billion in 2017 from €1.7 billion in 2011, an increase of over 35%.

The RDTC has been an important driver of this increase in spend. Among the key reasons for this are:

1. At 25% it offers a significant contribution towards reducing the cost of conducting R&D activity;
2. As a tax credit it is available as a cash payment to companies which are not yet paying tax;
3. It is claimed on a self-assessment basis; and
4. It is available to any firm doing R&D, where specific entitlement criteria are met.

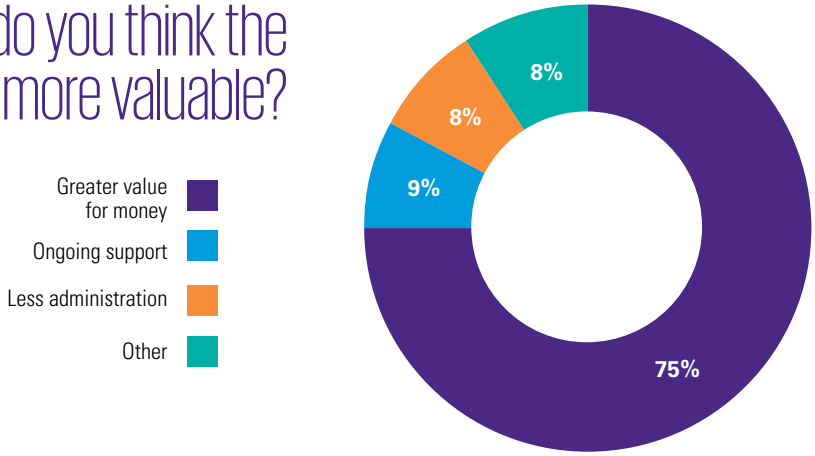
Indeed, comments from some respondents indicated that they believe the RDTC to be more valuable than Enterprise Ireland grant aid. Comments from those companies included: "we get a larger amount for the R&D tax credits", and "the financial benefit is greater with the R&D tax credits."

Just a quarter of firms claiming both the RTDC and Enterprise Ireland grant aid said the tax credit involved a lower administrative burden, while 31% of them said the process involved was quicker and more straightforward than for Enterprise Ireland support. This suggests there is still room for the improvement in how the RDTC is administered.

A total of 1,506 firms availed of the RDTC in 2016, down from a high of 1,576 in 2013; this is believed to have decreased again in 2017. The 1,506 companies which claimed the €670 million in RDTC in 2016 paid €2.45 billion in net corporation tax receipts. Interestingly and perhaps significantly, this is approximately one-third of the total corporation tax take.

The Department of Finance carries out reviews of the RDTC regime every three years (with the 2019 review in progress at the time of publication). The 2013 review found it to be among the "best in class" internationally. In terms of the competitiveness of the regime, the 2013 review found that the credit at least matches the international benchmarks, and is among the most attractive in respect of certain elements.

Why do you think the RDTC is more valuable?



The 2016 review found that for every €1 of tax revenue forgone an additional €2.40 is spent on R&D by companies claiming the RDTC. This represents quite a high "bang for the buck" for the Irish exchequer and compares favourably with outcomes for similar schemes internationally.

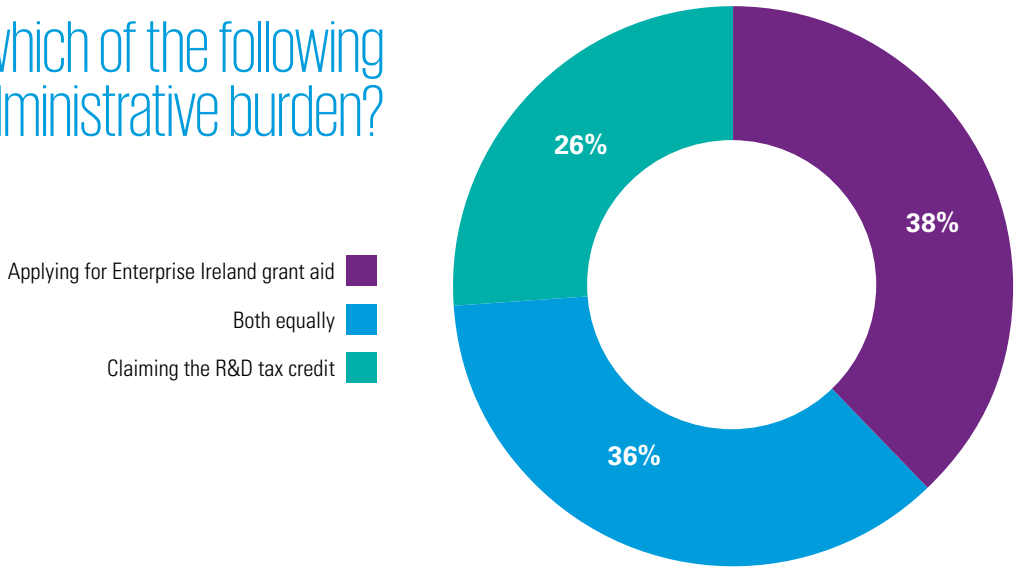
The 2016 review concluded that "the RDTC in its current form can be considered a reasonably successful policy tool." It found that the credit stimulates additional R&D activity at a rate of 60%, but the remaining 40% activity may have taken place in any case.

The basis of calculation of that latter figure is unclear however, as it is not known if it takes account of R&D that is kept in Ireland as a result of the RDTC (as opposed to new job creation) or of the impact of the tax credit on retaining capital investment in Ireland. Furthermore, no account was taken on the spill-over effect that R&D investment creates. Anecdotal evidence from FDI companies would suggest that the RDTC plays a significant role in retaining headcount at least at the current levels, if not increasing it.

The 2016 review also found no evidence that "the tax credit scheme is effective in encouraging R&D in younger firms." This reflects the findings of our research with a significant number of R&D performing Irish firms not claiming the RDTC.

These findings suggest that greater familiarity with the scheme and its benefits may encourage increased uptake and in turn stimulate additional R&D activity. Furthermore, an increase in the value of the scheme to smaller, early stage companies by making the credit payable in one year rather than over three years to non-tax paying companies, as called for by several respondents, could enhance the perceived value and attractiveness of the scheme.

In your view, which of the following has the least administrative burden?



Conclusions & recommendations

All of the participants in the survey were in receipt of an Enterprise Ireland support grant for research and development activity. It might therefore be expected that the great majority of them would also be claiming or at least intending to claim the RDTC. This is not the case and almost half of them have not claimed the tax credit while 58% of those who do claim have not done so for all of the R&D projects for which they are receiving Enterprise Ireland grant aid.

This suggests a disconnect in how the two pieces of State support are viewed. Instead of being seen as part of a continuum of support they are seen as separate sources of funding and are approached very differently.

Interestingly, views of the RDTC among those companies which do claim it are generally positive, with many pointing out that the administrative burden involved in claiming isn't all that great as much of the work has been done already for the Enterprise Ireland grant aid application. This indicates that there is scope for more closely aligning the two regimes.

In these circumstances, it would appear that if more R&D performing firms could be encouraged to claim the RDTC this would stimulate additional R&D activity. However, a number of barriers need to be overcome first. These are both perceptual and technical.

Many companies do not realise that the RDTC is worth 25%, and not 12.5%. There is a lack of appreciation for the fact that it is payable in cash over three years to companies which do not yet pay tax. There is also a perception that the claims process for the RDTC is too onerous to make it worthwhile.

Furthermore, there is a belief among some that Enterprise Ireland is easier to deal with and more supportive than Revenue. This is quite reasonable given Enterprise Ireland's role is to assist Irish companies to innovate and grow. In addition, some respondents expressed concern that an RDTC claim could trigger a scientific audit. While this is correct, Revenue has issued guidance to the effect that it will not conduct a scientific audit of claims valued at less than €50,000 where the claimant company is already in receipt of Enterprise Ireland grant aid for the same activity. That guidance may not be as widely known as it could be.

One cause for concern is the lack of awareness of the KDB with half of all participants being unaware of its existence. This does not augur well for the future of the KDB as an instrument to stimulate the creation of intellectual property in this country.

The technical barriers include the terms of payment of the credit to non-tax paying firms, the restrictions on outsourcing, and limitations of the range of costs which can be claimed.

Several comments from respondents highlighted these issues. These included: "you receive the money quicker [from Enterprise Ireland] and it's less of a risk involved"; "you can get cash [from Enterprise Ireland] without already being profitable"; "Enterprise Ireland grant aid is more valuable as in order to claim R&D we would have to make a profit"; "the R&D tax credit is too complicated so I lose interest"; "the R&D tax credit is more restrictive"; and "we do not qualify for certain R&D tax credits because the criteria is too restrictive."

Notwithstanding this, the RDTC has been successful in promoting R&D activity with the Department of Finance's own review indicating that it delivered a return on investment to the taxpayer of €2.4 for every €1 in tax foregone.

"Instead of being seen as part of a continuum of support, the RDTC and Enterprise Ireland grant aid are seen as separate sources of funding and approached very differently"

Recommendations:

The Government and stakeholders should continue to promote awareness of the RDTC with a particular focus on those aspects which seem to be poorly understood, i.e. the rate applicable, the fact that it can be payable in cash, and the Revenue guidance in relation to scientific audits.

A complementary campaign to raise awareness of the KDB should also be undertaken. The two campaigns should be supported by all relevant stakeholders including Revenue, the Department of Business, Enterprise & Innovation, Science Foundation Ireland, Enterprise Ireland, IDA Ireland, Higher Education Authority, trade bodies, business associations etc.

The value of the RDTC to smaller companies should be enhanced by paying it over one year instead of three. For smaller firms, particularly start-ups, three years would seem an unreasonably long timeframe. By contrast, accelerating the payment would entail no significant additional cost to the exchequer, other than the short-term cost of funds. This was cited as a factor by 17% of respondents.

A wider selection of costs – perhaps more closely matching those allowable for Enterprise Ireland grant aid – should be eligible for the tax credit. This would make the RDTC both more financially attractive and more readily understood.

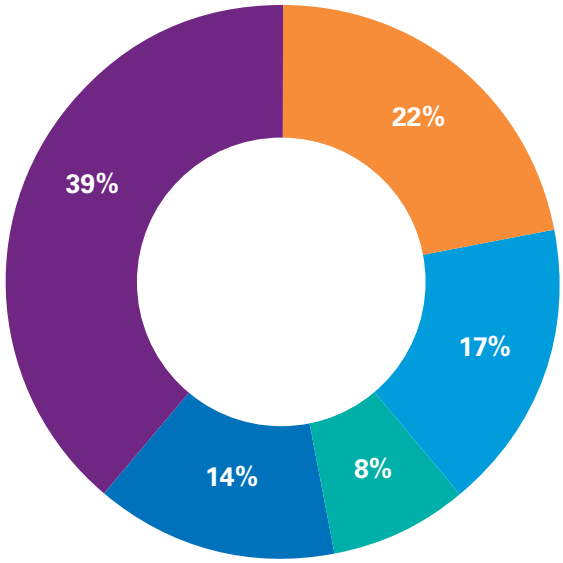
Current thresholds around limitations on outsourced activity should be extended for SMEs, as many smaller companies will not have access to the resources needed to carry out all their R&D work in-house.

An increase in the €50,000 concession limit to €100,000 (whereby Revenue has indicated it will not conduct a scientific audit of claims under €50,000) should be considered to take more companies out of the scope of a scientific audit of their R&D claims.

The findings of our survey indicate that firms which avail of the RDTC value it and that it is a driver of R&D and innovation in the economy. As referred to earlier in this report, companies claiming the RDTC must have a real presence in Ireland, must be employing highly skilled workers and must be conducting R&D. There is nothing "brass plate" about the claimant companies.

It would appear that increasing the awareness of the nature of the scheme while addressing a number of misconceptions in relation to its operation could lead to an increase in claimants among smaller firms. In addition, simple low cost actions could make the RDTC an even more effective catalyst for R&D activity, which will have a positive impact on our economy. This is something that is good for everyone.

Which of the following suggested changes to the R&D tax credit would you most like to see?



- Broader spectrum of costs that could be included in the claim for SMEs
- A higher rate of tax credit
- Quicker access to cash, i.e. full refund in year one or over two instalments
- Higher limit for third party spends
- Don't know

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