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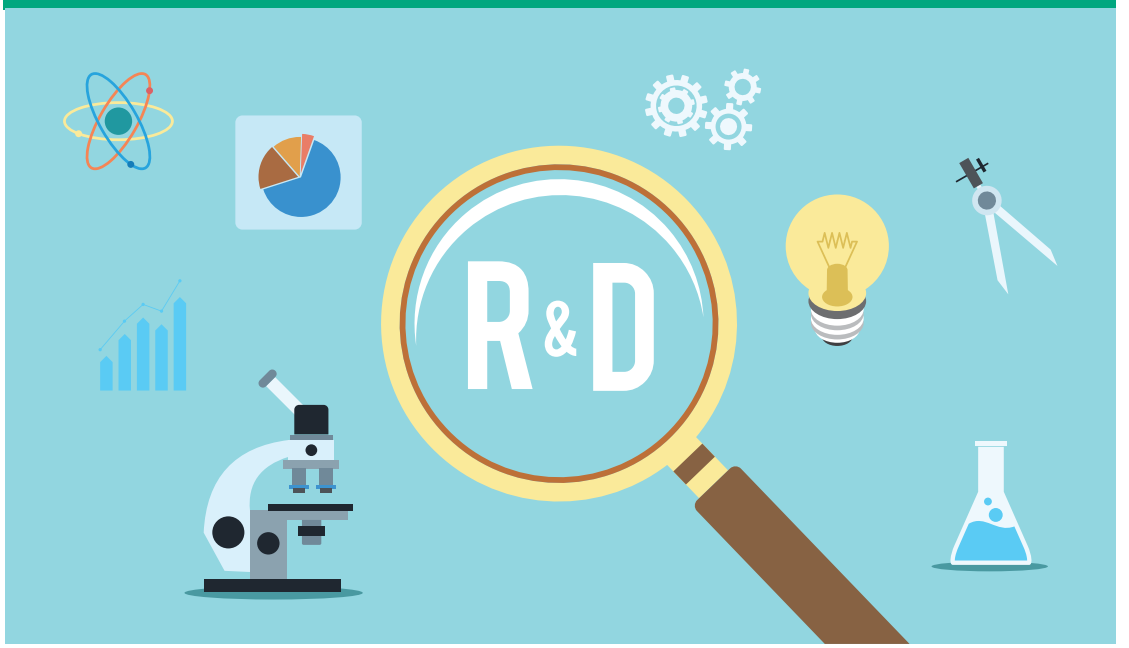
Finance Act 2019: Key Changes to the R&D Tax Credit Regime



Introduction

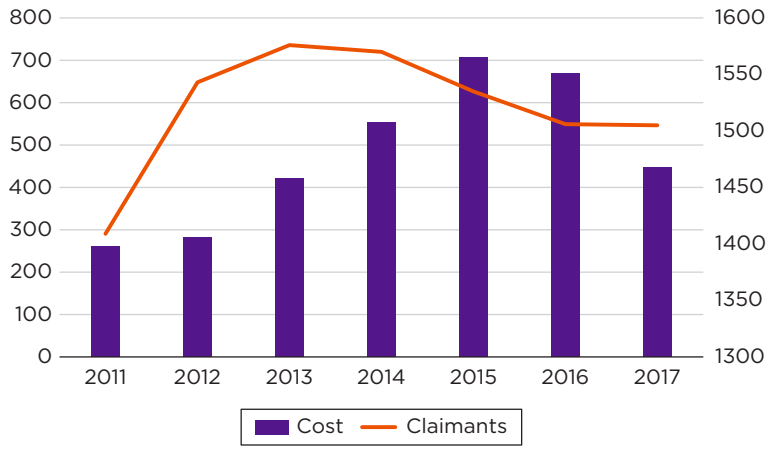
Innovation in business has long been a key driver of productivity and is an integral component of maintaining competitiveness within industry – crucial, given the external challenges faced by Irish businesses. The research and development (R&D) tax credit was introduced in 2004 to incentivise innovation in business and to encourage firms to invest in R&D in Ireland. Since its introduction, the credit has been a highly successful policy tool in fostering innovative activity and attracting jobs and investment to Ireland.

Department of Finance Review

Although the R&D tax credit delivers a high return on investment, it remains a relatively significant cost to the Exchequer as a tax expenditure (despite consecutive decreases in the annual cost since the €708m high in 2015), as can be seen in Fig. 1.

In line with review procedures for tax credits, a review of the R&D tax credit is undertaken every three years by the Department of Finance.(DoF), who review its effectiveness as a policy tool for incentivising R&D in

Fig. 1: Cost (€m) to Exchequer and number of claimants of R&D tax credit, 2011–2017 (data from Revenue, "Research & Development ('R&D') Tax Credit Statistics: May 2019".



Ireland. The first, carried out in 2013, was a comprehensive review of a range of aspects of the R&D tax credit. It involved an economic literature review, data analysis and, importantly, a public consultation involving a survey of firms active in R&D. This report found that Ireland's R&D tax credit regime performed "very strongly" when compared to R&D incentives adopted in comparable international jurisdictions, and it was judged to be "best in class" internationally. Even with the positive findings, the report recommended improvements to the scheme, such as the phasing out and removal of the "base year" and enhancements to the outsourcing limits, both of which were implemented shortly after.[1]

The second DoF review, in 2016, was a solely economic evaluation of the R&D tax credit and did not involve a public consultation. From an economic viewpoint, the report considered the R&D tax credit to be "a reasonably successful policy tool" and found that for every €1 of tax revenue forgone, an additional €2.40 is spent on R&D by companies that claim the credit. The report expressed cautious optimism about the credit, as although additional R&D expenditure was deemed to arise as a result of the R&D tax credit, there was also "deadweight" with respect to R&D that would have happened regardless of the credit, which was not to be ignored.[2]

The latest, soon-to-be-published DoF review of the R&D tax credit was conducted during the summer of 2019. This, the third major review of the credit since 2013, is expected to outline similar positive results.

Finance Act 2019 Updates

Over the years there have been several important enhancements to the R&D tax credit to ensure that the scheme maintains its competitiveness with respect to other jurisdictions' R&D incentives.

Finance (No. 2) Act 2008 increased the R&D tax credit rate from 20% to 25%. It also introduced a cash refund mechanism, allowing companies to claim, subject to the satisfaction of certain conditions, a refundable R&D tax credit over approximately a three-year period in the absence of a sufficient amount of corporation tax.

1 Department of Finance, "Review of Ireland's Research and Development Tax Credit 2013".
2 Department of Finance, "Economic Evaluation of the R&D Tax Credit 2016".

Finance Act 2012 introduced enhancements to the outsourcing limits, and Finance Act 2014 finally brought about the end of the "base year", which previously required companies to calculate their R&D tax credit on an incremental basis against the 2003 threshold period.

Finance Act 2019 provides updates to the R&D tax credit scheme, the first major legislative changes since the removal of the base year. The updates would be generally regarded as positive, with the most significant enhancements being those for small and micro companies.

Small and micro companies

A significant focal point of the DoF's "Research & Development Tax Credit Review 2019: Public Consultation", was how to improve the regime for small and medium enterprise (SMEs).[3] Although the 2019 DoF review has not yet been published, the following enhancements introduced by Finance Act 2019 specifically for small and micro companies are most likely based on its findings. The Irish Tax Institute's response to this consultation and recommendations were summarised previously in the *Irish Tax Review*[4].

1. R&D tax credit rate

The R&D tax credit rate for small and micro companies has been increased from the standard rate of 25% to 30%. This is a very positive update and sees the first increase to the rate since the overall increase from 20% to 25% more than ten years ago. One of the questions in the DoF's consultation focused on ways to improve the current tax credit system to make it more attractive to smaller companies. We expect that the rate increase will certainly increase the attractiveness of the tax credit to smaller firms.

2. R&D tax credit calculation

The methodology used to calculate the refundable R&D tax credit amount for small and micro companies has also been enhanced. The limit applying to the cash refundable R&D tax credit that can be received has been increased to the aggregate of twice the payroll tax liabilities for the relevant accounting period. We expect that this will allow small and micro companies that are not paying corporation-tax- to receive a greater portion of their R&D tax credit as a refund. This is a hugely important aspect for smaller companies, as for many "cash is king".

3. R&D tax credit for pre-trading expenditure

A new section of legislation (s766C TCA 1997) has been introduced enabling small and micro companies that are conducting pre-trading R&D to claim the R&D tax credit before trading commences. Previously, a company would have been able to claim an R&D credit for pre-trading expenditure only in the accounting period in which the company actually commenced trading. Under the new rules, small and micro companies can offset any excess of their pre-trading R&D tax credit claim after offsetting against their corporation tax liability, against the aggregate of payroll tax (i.e. PAYE and USC but not PRSI) and VAT liabilities for the period to which the pre-trading claim relates. The enhanced rate of 30% applies when calculating the pre-trading R&D tax credit. Companies must still make a pre-trading R&D tax credit claim within 12 months of the end of the accounting period in which the expenditure was incurred and will not be a repayable credit. The pre-trading R&D tax credit cannot be transferred to key employees. It is also important to note that the pre-trading R&D tax credit cannot be offset against payroll or VAT liabilities if emoluments on which the payroll

3 Department of Finance, "Research & Development Tax Credit Review 2019: Public Consultation" (April 2019), https://assets.gov.ie/8279/f41bc90b2f1246f0a6e21ee5c0c7e7d3.pdf.

4 Institute Responds to Six Consultations on Key Tax Incentives for Business, *Irish Tax Review 2019* Issue 3.

liability occurred remain unpaid 3 months after the end of the accounting period. The enhancements outlined in 1 to 3 above will apply following a Ministerial Order and relate to small and micro companies only, i.e. companies with:

- fewer than 50 employees and
- an annual turnover and/or annual balance sheet total not exceeding €10m.

The enhancements for small and micro companies are positive, and an extension to include medium sized enterprises in the future would be welcomed. It is worth noting with Brexit in mind that the UK has a competitive R&D regime for SMEs that includes medium sized companies.(medium companies have fewer than 500 employees, an annual turnover of €100m and balance sheet total of under €86m) With a headline rate similar to Ireland's 25% rate and the credit is payable as a cash refund in the absence of a corporation tax liability[5].

Outsourcing

Third-level institutes of education

The limit on outsourcing to third-level institutes of education will be increased to a maximum of 15% (previously 5%) or €100,000 (whichever is higher) of a company's "in-house" R&D expenditure . This change applies in respect of all claimants and relates to accounting periods starting on or after the passing of Finance Act 2019 (22 December 2019).

This update appears to be an attempt to encourage further R&D collaboration between companies and universities/higher-education institutes. While the update is clearly positive, it may affect only a small number of claimant companies. In the authors' experience, the current outsourcing limits with regard to universities are rarely reached by claimants.

Notification to third parties

Until Finance Act 2019 an R&D claimant company that outsourced R&D activities to third-party sub-contractors was required to notify the relevant sub-contractors that the payment(s) made would form part of the claimant company's R&D tax credit claim (and that the sub-contractor may not make an R&D tax credit claim for the same activities). This notification requirement was in place to prevent both companies claiming the tax credit for the same activities. Previously, there was no time limit set out in the legislation for when this notification should be made.

To ensure more effective administration of the outsourcing provisions, a company that outsources R&D activity to third parties must now issue notifications to the third parties before, or on the day of, payment. This applies for accounting periods starting on or after the date of passing of the Act (i.e. 22 December 2019). For many companies, therefore, these rules are now in effect and will apply for the 2020 period.

We understand that the purpose of this amendment is to ensure that sub-contractors do not receive notifications after their R&D claims have been filed. However, there may be some unintended consequences. For example, it is the authors view that this amendment will encourage companies to make "protective notifications" to all third-party sub-contractors, but ultimately the claimant companies may not file an R&D tax credit claim for this expenditure because their outsourcing limits have been reached with other payments. This could result in R&D expenditure not being claimed by either the sub-contracting entity or the sub-contractor, which would be an unfavourable outcome for all involved.

Also, it should be noted that the current iteration of Revenue's Tax and Duty Manual

5 See https://www.gov.uk/guidance/corporation-tax-research-and-development-tax-relief-for-small-and-medium-sized-enterprises.

(TDM) Part 29-02-03, "Research and Development (R&D) Tax Credit" (June 2019), accepts that notifications to third parties are not required where the third party is unable to make an R&D tax credit claim (for example, where it is an individual, or by a non-resident third party which does not have a branch in the State).

This amendment is one that all R&D tax claimant companies should be aware of, as immediate action may be required. We expect that the R&D TDM will be updated to reflect how these provisions will operate on a practical level for both sub-contracting entities and sub-contractors.

Grants

Previously, only grants received directly or indirectly from the Irish State, from European Economic Area states or from any statutory board, public/local authority or any other agency of the Irish or European Economic Area states were required to be deducted from R&D expenditure for the purpose of an R&D tax credit claim. Finance Act 2019 now requires that any grant funded by **any** state or by the European Union be deducted from such expenditure. This includes funding from any body, board, authority, institution, office or agency of these entities. This update applies with respect to expenditure incurred on or after 1 January 2020.

It is worth noting that grants received from the European Commission (such as Horizon 2020 grants) may not have had to be deducted from R&D tax credit claims before this amendment.

Scientific research allowances

In addition to the R&D tax credit legislation, an amendment has been made through Finance Act 2019 to a less-used section of the legislation (s765 TCA 1997), providing for scientific research allowances (SRAs). This section provides for accelerated capital allowances for capital expenditure incurred on scientific research. The updated legislation now sets out that buildings and structures will not qualify for tax relief under the section unless the construction or development of the building or structure is itself regarded as being "scientific research". Additionally, if a company is claiming SRAs under s765, it prohibited from also claiming the R&D tax credit.

Conclusion

Finance Act 2019 introduces some important amendments to the R&D tax credit scheme. Many of these updates, particularly the changes to the regime for small and micro companies, are positive and should lead to further investment in R&D by companies operating in Ireland.

The OECD recently published a report on "SME and Entrepreneurship Policy in Ireland", which found that overall expenditure on R&D in Ireland as a percentage of GDP was below both the OECD and the EU28 average. Interestingly, despite this finding, in 2015 almost 40% of business expenditure on R&D (BERD) was attributable to SMEs, which was above the OECD average of 35%. Although, based on this statistic, SMEs in Ireland appear to be dedicating resources to carrying on R&D activities, the report also found that Irish SMEs perform worse in terms of securing government funds to carry out R&D, with only 40% of government-funded BERD going to Irish SMEs compared to an OECD average of 56%.[6] In light of the report's findings, the DoF's focus on seeking to make the R&D tax credit scheme more attractive to SMEs makes sense.

The report makes other recommendations for the R&D tax credit, which could limit the uncertainty around the potential clawback of an R&D tax credit claim. For example, a "pre-approval" process for prospective R&D claimants could be introduced, or the window in which Revenue may audit an R&D tax credit claim – which is currently four years from the

6 OECD, "SME and Entrepreneurship Policy in Ireland", OECD Studies on SMEs and Entrepreneurship (Paris: OECD Publishing, 2019), https://doi.org/10.1787/e726f46d-en.

end of the accounting period in which a claim is filed – could be reduced.

The Finance Act 2019 amendment to the timing of notifications to third-party sub-contractors could prove to be problematic for claimant companies that do not issue notifications within the time limit (i.e. before, or at the time that, payment is made). Claimant companies should be aware of this update as it applies to payments made to sub-contractors from 2020 onwards. Failure to act could render all or part of a company's outsourced R&D expenditure ineligible.

Recommendations

We await the release of the Indecon report on the R&D tax credit for future recommendations to enhance the regime. Recommendations put forward by the Institute were included in an article by Clare McGuinness "Institute Responds to Six Consultations on Key Tax Incentives for Business" *Irish Tax Review*, Issue 3, 2019.

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