Knowledge Development Box: Revenue Guidance Issued

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Introduction

Ireland's Knowledge Development Box (KDB) – with the claim to fame of being the first OECD-compliant intellectual property regime in the world (let's get back to this later!) – was introduced by Finance Act 2015 and can be availed of by companies in respect of accounting periods starting on or after 1 January 2016. The KDB is intended to encourage innovative research, and it further enhances Ireland's suite of tax offerings (which includes the 12.5%

tax rate, the 25% refundable R&D tax credit and tax amortisation on qualifying intellectual property). The KDB offers companies an effective corporation tax rate of 6.25% on profits arising from patents (including patents pending), copyrighted software and certain other assets where some or all of the related R&D is undertaken by the Irish company. Revenue's guidance on the KDB was issued in August 2016 (see Revenue eBrief No. 73/2016), and this article discusses some key observations on these guidance notes.

Setting the Scene

The guidance was eagerly awaited by companies and practitioners alike to get a sense of Revenue's interpretation of certain complex areas of the new legislation, as well as certainty on some specific concerns raised after the introduction of the KDB. Revenue took an open and collaborative approach to the process of developing the guidelines by seeking input from a wide range of interested bodies, tax practitioners included. The guidance, to its merit, is detailed, containing 88 pages, which include 65 examples. The examples in general reflect real-life scenarios that companies may encounter, and there are a number of sector-specific examples across the technology and life science sectors, as well as the more traditional sectors such as manufacturing. Revenue has stated that the guidance is very much a living document, so as companies start to implement the KDB and identify practical difficulties, companies and practitioners are encouraged to bring these to Revenue's attention so that they can be considered and included in subsequent guidance as appropriate.

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KDB Guidance: Key Highlights

So what are some of the key highlights that companies can take from the guidance? Set out below are some of the more noteworthy aspects. As we go through these, it is useful to remind ourselves of the KDB formula (all good tax reliefs must include a complicated formula!) and the basics of how companies can obtain KDB benefits.

Families of Assets

Section 769H TCA 1997 provides that where a company has a number of qualifying assets that are interlinked in their use by the company such that any effort to apportion either the cost of developing those assets or the income associated with those assets would involve nothing more than an arbitrary allocation, the company must treat those assets as a single unit, i.e. a "family of assets". The guidance

Figure. 1: KDB formula

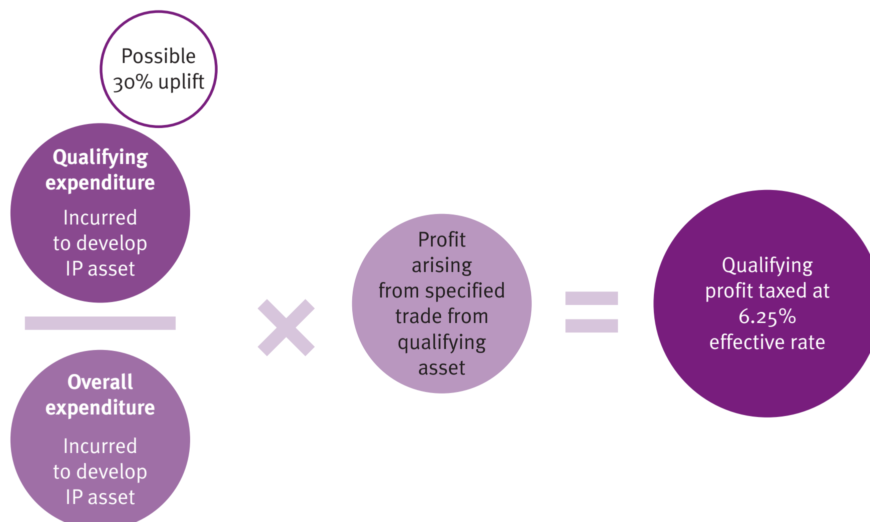
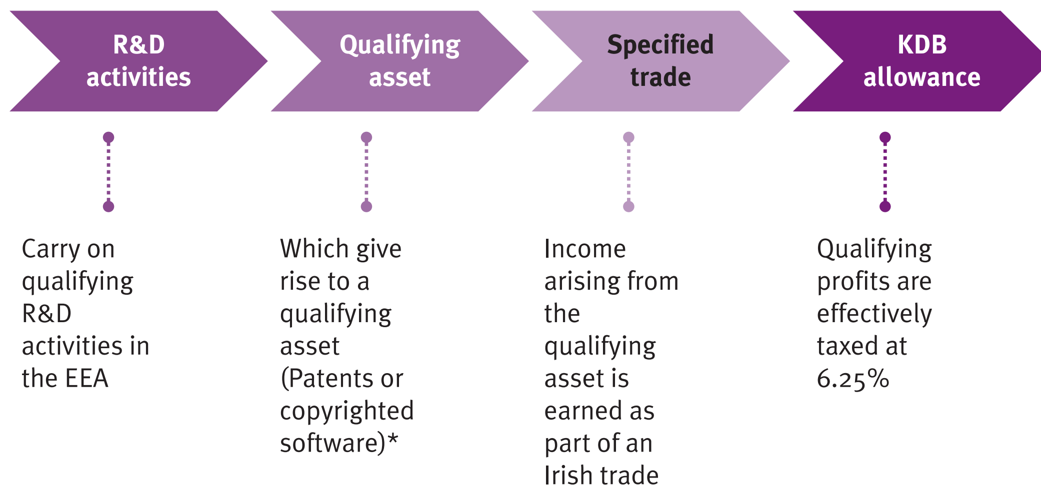


Figure. 2: How companies can obtain KDB benefits



Note there are special rules for SMEs, i.e. companies with income form IP of < €7.5m

contains a number of examples of where a family-of-assets claim is appropriate across the manufacturing, pharmaceutical and IT sectors. It also provides an example of where such a claim would not be appropriate, i.e. where a company decides to make a family-of-assets claim on the basis that the allocation of income and costs in relation to each qualifying asset is simply too burdensome from an administrative or other perspective. The important point to take from this is that a family-of-assets claim is not a choice – as one may be led to believe from the wording of the legislation, which refers to "opting" to apply a family-of-assets treatment – but rather a necessity. Where it is not possible to allocate either the income **or** the expenditure to each qualifying asset individually, the assets must be treated together as a family of assets; in this situation the family is the smallest grouping of assets beyond which arbitrary decisions would be required.

Embedded Royalties

The overall income from a qualifying asset that feeds into the specified-profit calculation for the purposes of the KDB formula includes the portion of the sales price of a product or service that is attributable to the value of the qualifying asset on a just and reasonable basis. The guidance provides some practical examples where a company sells a product that has embedded royalties (including actual embedded royalties and amounts attributable to the sale of copyrighted materials). These practical examples include:

- in the software sector, where a company sells embedded royalties and both open-source software and software as a service and the practical considerations to take into account when assessing entitlement to the KDB;
- where a company can charge a premium for its product because of the IP it has developed; the KDB is available in respect of that premium;
- in the case of a particularly price-sensitive product, where a company may not be able to charge a higher price but it may be able to demonstrate that it increased its market share vis-à-vis a competitor's less innovative product; in this scenario the KDB is available;
- if, however, the company's IP simply reduces the cost of manufacturing the product, the KDB treatment is not available.

Companies must determine the most appropriate method for their specific fact pattern of identifying the portion of income that relates specifically to the qualifying asset, taking care to exclude any element attributable to brand or marketing. A transfer pricing-type analysis may be relevant in particular circumstances.

Certain smaller companies may not be in a position or may not consider it worthwhile based on the level of expected KDB benefits to have their patents valued professionally by a valuations expert and a royalty rate calculated. In recognition of this, Revenue has confirmed in the guidance that, unless there is evidence to the contrary, it will accept a notional royalty rate of

up to 10% for key IP used by micro and small companies. Evidence to the contrary may include the existence of substantially similar products where brand is the main differentiator, or the link between the IP and the product not being adequately evidenced. A company is a micro or small company, for the purposes of the guidance, if it has fewer than 50 employees, and its annual turnover and/or annual balance sheet total does not exceed €10m. Where a company is a member of a group, this notional royalty rate applies only where the threshold amounts are met by the group as a whole.

This is the definition referred to in the guidance and is based on the European Commission's recommendation on the definition of small companies from 2003. Interestingly, this differs from the definition in Irish company law, which defines a small company as one which can meet two of the following three criteria:

(a) turnover not in excess of €8.8m

(b) balance sheet total not in excess of €4.4m

(c) average number of employees not in excess of 50.

Profits of the Specified Trade

Companies must treat their KDB-qualifying activities as a separate "specified trade". This involves determining the net profit attributable to each qualifying asset and/or family of assets. This is calculated as the "overall income" from the asset less the expenses (both R&D and non-R&D) that an independent company would incur in earning that income and less any capital allowances claimed in relation to the assets used for the purposes of the specified trade.

There are a number of allocations and apportionments to be made in arriving at the appropriate level of specified-trade profit and then determining how or if it may be allocated to individual qualifying assets. In recognition that some of these are subjective and to try to ease the burden on companies, Revenue outlined in its guidance that a just and reasonable approach to certain elements can be taken. For example:

› The guidance includes a number of practical examples that demonstrate Revenue's view of what may constitute a just and reasonable approach in apportioning expenses.

› In recognition that the appropriate allocation factors will vary between sectors and companies and that each company must determine ones that provide a reasonable nexus with the costs incurred and the income earned specific to its own fact pattern, Revenue has confirmed that where the management accountant, the financial controller or an appropriate director with appropriate knowledge of the company documents the reason for choosing the allocation factor and that choice is bona fide, is based on facts and is not unreasonable, Revenue will accept that allocation factor for the purposes of the KDB.

› The guidance also outlines that companies may choose between applying the KDB formula to the profits of the specified trade as calculated individually for each asset or to the profits of the specified trade (being from all assets together) calculated as a whole and then apportioned between the qualifying assets on a just and reasonable basis. Companies may therefore choose which method to apply. This is in recognition that where a company has many qualifying assets, it might not be possible to calculate the profit for each asset other than by arbitrary allocations of expenses. However, whichever method the company chooses to apply, that choice must be applied consistently year on year (unless there is a significant change in the company's business).

Mergers and Acquisitions

Before the guidance was issued, questions were raised about how qualifying expenditure (the numerator of the KDB fraction) and overall expenditure (the denominator of the KDB fraction) might be calculated when mergers or acquisitions between certain companies took place. One of the scenarios envisaged was where, before the merger or acquisition, a company incurred expenses in outsourcing qualifying R&D to an unrelated third party. This expenditure would be qualifying expenditure, thereby forming part of the numerator of the company's KDB fraction. After a merger or acquisition of that unrelated third party (which would not be that uncommon), the relationship would change and the unrelated third party would become part of a group for the purposes of group outsourcing costs as defined in s769G TCA 1997. This begged the question of whether what was once qualifying expenditure in the numerator of the KDB fraction would then become group outsourcing and move to the denominator of the KDB fraction, thus potentially significantly altering the level of the company's specified-trade profit qualifying for KDB relief.

Revenue has included an example in its guidance clarifying the position in such a scenario and has confirmed that third-party and group relationships are determined at the time that the expense in question is incurred. Thus, if the ownership later changes, the nature of the expense (e.g. unrelated third-party outsourcing) does not change. It is also confirmed that in a merger or acquisition, the IP of one company must be treated as being acquired by the other. Therefore it would increase the denominator of the KDB fraction on the basis that the IP in question is reflected in the value of the qualifying asset in respect of which KDB benefits are being claimed.

Ireland must continue to monitor international competitors to ensure that the KDB regime can live up to its billing as "best in class".

Expenditure on Clinical Trials

Qualifying expenditure in relation to the qualifying asset is defined in s769G(2)(a) as "expenditure incurred by a relevant company, in any accounting period, wholly and exclusively in the carrying on by it of research and development activities in a Member State where such activities lead to the development, improvement or creation of the qualifying asset...". In most cases the R&D will lead to the "creation" of a new qualifying asset. However, Revenue has confirmed in the guidance that expenditure on clinical trials (which typically happens after patent) that constitutes R&D is an example of where expenditure on the "improvement" of a qualifying asset would be considered qualifying expenditure on the development of the qualifying asset. This is an important clarification for companies in the pharmaceutical sector, where significant expenditure is incurred after patent on clinical trials and where, without incurring these costs, the qualifying asset (i.e. the drug protected by patent) would never get to market and thus generate income.

Contract R&D

The guidance outlines Revenue's view that companies that undertake contract R&D, for either group or unrelated third parties, from which a qualifying asset results are not entitled to KDB benefits in respect of the income they earn. Although the expenditure they incur in carrying on qualifying R&D activities may qualify for R&D tax credits, it is Revenue's view that the income they earn is attributable to the companies' ability to provide an R&D service and is not attributable to a qualifying asset. The fact that a qualifying asset results from the R&D carried on by such a company is not relevant.

There are many companies in Ireland that carry on contract R&D services. Many of these companies have invested heavily in R&D jobs in Ireland, and their R&D activities are directly leading to the development of IP, the income attributable to which is earned in Ireland. This is exactly the type of activity that the KDB is seeking to encourage in Ireland (there being a direct nexus between the income receiving benefits and the expenditures contributing to that income), and it is therefore disappointing that companies carrying on these activities cannot qualify for KDB benefits. As the international tax landscape continues to change at a fast pace, and other OECD-compliant patent boxes are introduced by other jurisdictions, it is important that Ireland is not unnecessarily restrictive in how its KDB can be availed of by businesses in these types of scenario. Ireland must continue to monitor international competitors to ensure that the KDB regime can live up to its billing as "best in class".

Documentation Requirements

The documentation required to support a KDB claim is listed in s769L TCA 1997. It is extensive and specific and could merit a full article in its own right. However, the point to highlight here is that s769L(7) states that a failure to have available any documentation that is required under s769L will result in a company not being eligible to claim KDB relief for the accounting period to which the failure relates. This means that a lack of documentation in relation to any particular part of the claim will result in the whole claim being denied for the accounting period in question. The guidance offers a little relief in this regard by confirming that where the failure to maintain documents of a sufficient standard relates to only a single project, and there are no concerns in relation to the documentation of all other projects, Revenue will deny claims for relief under the KDB only in respect of that particular project. So there is a small measure of relaxation of the rules where the failure is in relation to an isolated incident on one project. This reinforces how important it is for companies to understand what is required of them in terms of documentation and to put in place appropriate tracking tools and good documentation practices and procedures where required.

Conclusion

Revenue's guidance on the KDB has been well received by companies and practitioners alike. Although it is long and detailed, it provides insight into the approach that Revenue is expected to take when auditing KDB claims and gives many practical, sector-specific examples. Revenue's collaborative approach in the development of the guidelines to date and going forward is welcomed.

There are significant compliance and documentation burdens in making a KDB claim. However, opportunities exist for all companies, and it represents an attractive, long-term, sustainable option for companies looking to invest in R&D activities in Ireland. This article began by saying that Ireland had the claim to fame of being the first OECD-compliant intellectual property regime in the world when the KDB was introduced by Finance Act 2015. Since then, Hungary and Italy have also introduced OECD-compliant regimes, and other countries are hot on their heels. Both of those regimes allow relief for capital gains arising on the disposal of qualifying assets, whereas Ireland's KDB regime does not. Although the Italian regime is uncompetitive from a rate perspective – 18.84%, decreasing to 13.95% from 2017 – compared to Ireland's effective rate of 6.25%, rates of between 5% and 9.5% can be achieved under the Hungarian regime. With this in mind, it is important that Ireland's KDB regime remains competitive and, as mentioned above, that it is not unnecessarily restrictive in terms of how the benefits may be accessed. We would hope that the KDB is incrementally improved in future Finance Acts and that it is continually monitored to maintain its competitiveness.

Read more on taxfind eBrief No.73/2016: Knowledge Development Box; *FINAK - Finance Act 2015 Explained*; Knowledge Development Box: Best in Class, *Irish Tax Review*, Issue 1, 2016

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