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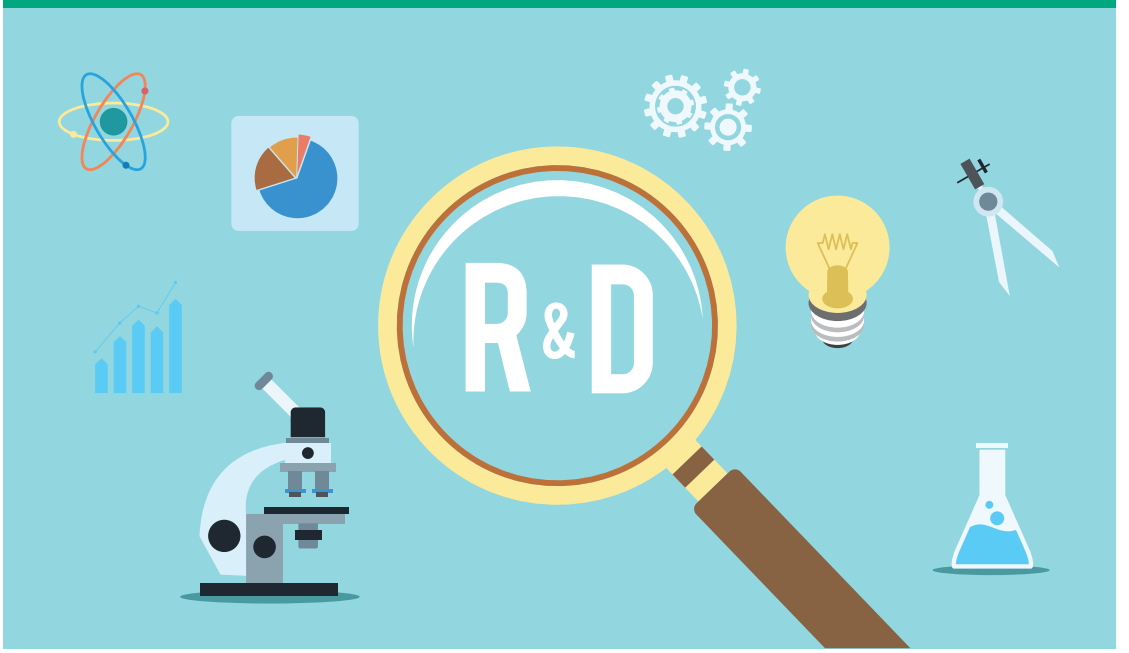
Revenue's R&D Guidelines: What's New?



Introduction

Revenue published new research and development (R&D) tax credit guidelines[1] in March 2019. Their publication had been widely anticipated as this is the first update to the guidelines since April 2015, previous updates having been published in 2012, 2011, 2008 and 2007. The current update is the result of collaboration between Revenue's internal R&D network and an external working group from industry, professional services and other bodies. The new guidelines are to be considered a work in progress, and Revenue advises that further updates will be made more regularly as issues are resolved and industry-specific guidance is released.

What does this mean for companies claiming R&D tax credits in Ireland? First, it is important to note that the guidelines are largely unchanged from the previous version, but we outline below the fundamental changes and the potential impact on companies claiming the credit.

1 Revenue, Tax and Duty Manual Part 29-02-03, "Research and Development (R&D) Tax Credit".

Importance of the Credit

The R&D tax credit is a key incentive for companies performing R&D in Ireland, and there has been an increase in innovation expenditure (comprising in-house R&D; purchase of external R&D; acquisition of machinery, equipment and software; acquisition of other external knowledge; and all other innovation activities) from c. €1.84bn in 2004 to c. €4.6bn in 2016, according to the Central Statistics Office.[2] This increase, together with the Government's *Innovation 2020* strategy of seeking to double R&D spend and make Ireland a "global innovation leader", underlines the importance of investment in R&D:

> "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".[3]

Regardless of whether companies are profitable and paying Irish corporation tax, they can claim a 25% credit/cash refund on qualifying R&D expenditure. This is an extremely attractive incentive for companies in various fields of science and technology to invest in R&D in Ireland.

Although the new guidelines do not represent a change to the legislation, i.e. ss766, 766A and 766B of the Taxes Consolidation Act 1997, they give the taxpayer guidance on how Revenue interprets that legislation. This will be very relevant, of course, in the event of a Revenue R&D audit, and so the guidelines should be used to help companies prepare for R&D audits. What remains true is that relief is provided on qualifying expenditure, on qualifying activity, by a qualified company. To claim the R&D tax credit, companies still need to demonstrate the satisfaction of two essential tests:

- the science test, i.e. the activity is qualifying R&D activity; and
- the accounting test, i.e. the costs relate to qualifying R&D activity.

Revenue Experience

Given the large number of companies claiming the credit (c. 1,500 in 2017) and the amount of R&D tax credits being claimed (c. €450m in 2017)[4], it should come as no surprise that this area is highly scrutinised by Revenue. Although the average yield per intervention fell by 31% between 2012 and 2015, the revenue yield from interventions increased from c. €5.5m in 2012 to c. €13.5m in 2015.[5]

Key Change to the Guidelines

Suggested file layout

The most fundamental change to the guidelines is contained in Appendix 3, which provides a "suggested file layout" that sees the information requested from Revenue effectively going from 23 questions (as seen in previous aspect query letters) to 37. This suggested file layout is based on Revenue's experience of reviewing R&D tax credit claims and, certainly in the authors' view, is consistent with what is typically asked by Revenue inspectors and their technical experts on R&D audits. It constitutes a basic guide to the contemporaneous documentation that Revenue would expect to receive after, for example, issuing an aspect query letter to a company. It is important to note that there is no requirement to keep documentation in this format; it is illustrative and is provided as a suggested guide, although in the authors' view practitioners should not be surprised if this file format becomes the adopted approach on audit! Bear in mind, too, that not all questions will be applicable to all industries, all companies or all projects.

The key additional "asks" are as outlined below.

2 https://www.cso.ie/en/statistics/multisectoral/innovationinirishenterprises/.

3 Interdepartmental Committee on Science, Technology and Innovation, *Innovation 2020* (December 2015), p. 15.

4 https://www.revenue.ie/en/corporate/documents/statistics/tax-expenditures/r-and-d-tax-credit-statistics.pdf.

5 https://www.audit.gov.ie/en/Find-Report/Publications/2016/2015%20Annual%20Report,%20Chapter%2014%20Research%20and%20Development%20Tax%20Credit.pdf

Technology Readiness Level (TRL) scale

Identify at which step on the Technology Readiness Level (TRL) scale the R&D process is operating (see Fig. 1). The TRL scale is a metric used to describe the maturity of a technology and is a way for Revenue to understand how companies have considered the nature of the activities that they are performing in each year.

State of the art

We have already observed Revenue and its technical experts increasingly asking for evidence of the due diligence performed by companies to determine that the solution they were seeking was not already available **at the time the R&D commenced**. Revenue has included examples in the new guidelines of what is expected in order to prove that this due diligence has been performed, such as details of journal searches and literature reviews and evidence of research into competitor solutions. We would expect technical experts engaged on audit to continue and even increase their focus on asking for this type of information.

Internal use

Where activities were aimed at developing a product for internal use (not as part of a product for sale to customers), Revenue asks what the alternative plan would have been if the activities had been unsuccessful. Even if a product was being developed for internal use, it will be important for companies to have evidence of the R&D activities that were carried out and any challenges and failures that were encountered in the work.

Academic research

The new guidelines ask for details of any academic research involved, e.g. an MSc project, and of any report into the activities carried out by an independent expert (although it is not mandatory to provide this report). These pieces of evidence would be useful supports for any projects included in an R&D tax credit claim.

Fig. 1: Guidance on Technology Readiness Levels.

TRL 9	System ready for full-scale deployment
TRL 8	System incorporated in commercial design
TRL 7	Integrated pilot system demonstrated
TRL 6	Prototype system verified
TRL 5	Laboratory testing of integrated system
TRL 4	Laboratory testing of prototype component or process
TRL 3	Critical function: proof of concept established
TRL 2	Technology concept and/or application formulated
TRL 1	Basic principles observed and reported

Source: *http://www.blue-growth.org/Blue_Growth_Technology_Innovation/TRL_Technology_Readiness_Levels/2_Technology_Readiness_Levels_Two.htm.*

Allocating staff

Finally, in relation to the allocation of staff to projects, although timesheets are **not** a Revenue requirement, the new guidelines seek evidence of the documentation process and control procedures that companies have in place to record work on qualifying and non-qualifying activities, including when staff record their work, the determination of eligible activities and the review procedure. This, again, reflects the style of questioning that typically arises on R&D audits.

By following the new layout, companies are likely to have the information requested by Revenue, but as each R&D claim is unique, there may be requests for further information. Accordingly, following the new file layout rigidly is by no means a guarantee that additional information will not be requested.

Other changes

A number of other changes are minor updates or clarifications made in response to queries and experiences on audit. For example, in section 6.1 of the guidelines, Revenue states that the requirement to notify a sub-contractor that it cannot make an R&D tax credit claim does not apply where the sub-contractor is a person who could not make a claim, such as an individual or a non-resident third party that does not have a branch in Ireland. In addition, in section 3.1, Revenue confirms that issues in relation to documentation for one project will not impact on other projects where sufficient supporting documentation exists, which should give comfort to companies submitting R&D tax credit claims involving multiple projects.

IDA Ireland, Enterprise Ireland and Horizon 2020 grants

A positive update to the guidelines has been made for micro and small enterprises that are supported by R&D grants. This update was the subject of a Revenue eBrief on 17 February 2017, but having this small-company treatment incorporated in the guidelines should give SMEs more comfort in claiming the R&D tax credit. Section 2.7.1 refers to interaction with IDA Ireland, Enterprise Ireland and Horizon 2020 R&D grants:

> "While there are differences to the definition of R&D for the grants and the R&D tax credit, it is considered that the two definitions are very close. Therefore, with a view to minimising the burden of engaging experts to verify the science test in R&D tax credit claims, it has been decided that Revenue would not, as a rule, seek to challenge the science test in relation to a project where an…R&D grant has been approved in respect of the project and the total R&D tax credit claimed by the company for an accounting period is €50,000, or less".

Employee secondments

In section 4.4 Revenue confirms that:

> *"Where an individual is seconded to a company undertaking R&D activities and the costs of that person's employment are borne by the company undertaking the R&D activities, they will be treated as direct employee costs, provided the following conditions are met:*
>
> - *The individual undertakes their duties in Ireland,*
> - *The individual must contribute specialist knowledge, to a specific R&D project being undertaken by this in-house team."*

This is seen as a positive practical update and will be especially important for larger multinational companies where, for example, employees are seconded from group companies outside Ireland.

Materials used in R&D activities that may be subsequently sold

In section 4.7 new examples are provided by Revenue in relation to process R&D, biopharma and generic pharma. Revenue clarifies that where materials used in qualifying R&D activities may have further commercial value after the research has concluded, it must be determined whether those materials were used wholly and exclusively in the carrying on by the company of qualifying R&D activities.

> "Where it is reasonable to consider that there will be a saleable product, then the lower of cost, or net realised value of any materials or other saleable product which remain after the R&D activity should be deducted from the expenditure claimed".

It will be interesting to see how the interpretation of this will play out in practice.

Sub-contracting R&D activity

In section 6.1 the guidelines have been updated to state:

> "It is important to note that the outsourced activity must constitute qualifying R&D activity of the company which appointed the sub-contractor, and not necessarily R&D of the sub-contractor".

The previous version of the guidelines stated that outsourced activity must constitute qualifying activity **in its own right**. This change in wording could be seen as positive in terms of allowing the company claiming the credit to classify costs more easily and to make the determination of qualifying R&D activity based on its own experience and not that of a third party. The guidelines are also updated to clarify that the outsourcing limits in respect of unconnected third parties and universities are applied separately. Again, this is seen as a positive clarification.

Cost apportionment

In section 8.2 Revenue provides additional detail on apportioning expenditure to R&D under the accounting test. This detail aligns with the Knowledge Development Box guidelines,[6] but it remains to be seen how this will be applied in practice.

> "The appropriate allocation factor for costs will vary between sectors, and may indeed vary between companies within sectors. The appropriate allocation factor must be determined by each claimant company as one which provides a reasonable nexus with the costs incurred. Revenue will accept the company's allocation where it is clear that the management accountant, financial director or an appropriate director with knowledge of the company documents chooses the percentage of the overall costs to be allocated, if that choice is bona fide, reasonable, and based on the facts of the individual claim."

It is the authors' view that this area will require additional focus by taxpayers, as it is often challenged by Revenue. It will be important for companies to document the system used to record work on qualifying vs non-qualifying projects, identifying when staff record their work and documenting any review process and the governance/controls in place to support the methodology.

Penalty application

Section 8.7 of the guidelines states that where an R&D intervention results in a settlement, penalties will apply in line with legislation and Revenue's Code of Practice and publication may also apply.

Department of Finance Reviews

In 2013 the Department of Finance conducted a full policy review of the R&D tax credit, which involved public consultation and a survey of R&D-performing firms. In 2016 it performed a limited-scope evaluation that included a report on tax expenditures and an economic evaluation of the R&D tax credit.[7] The focus was on the R&D performance of firms that claim the credit.

The 2016 review deemed the R&D tax credit in its current form to be a reasonably successful policy tool. In terms of the rationale

6 Revenue, Tax and Duty Manual Part 29-03-01, "Guidance Notes on the Knowledge Development Box" (October 2018).

7 Department of Finance, "Economic Evaluation of the R&D Tax Credit" (October 2016).

for Government support of R&D, the review stated that:

> "R&D can promote productivity and economic growth through its effect on innovation. Typically, firms underinvest in R&D from a social perspective and so there is a strong rationale for Government support. Public support comes in the form of grants (direct support) or tax incentives (indirect support). It is important that public support results in additional R&D activity, rather than private firms simply replacing in-house financing with public funds."

In 2019 the Department of Finance will undertake a further full policy review, which will involve public consultation and a survey of R&D-performing firms. In the scope of this review is everything necessary to assist in the evaluation of the R&D tax credit as required under the Department of Finance Tax Expenditure Guidelines. For large tax expenditures, such as the R&D tax credit, reviews are performed every three years in order to improve the evidence base underpinning tax policy and to determine if tax relief schemes remain fit for purpose. Consideration is given to whether or not the expenditure is still relevant or whether the objectives of the scheme are still valid. However, this does not represent a repeat of the 2013 comprehensive review. The public consultation is very welcome as it will allow for informed input and proposals for change, improve understanding of the interaction between the R&D tax credit and direct supports, and provide for discussion of measures in competitor jurisdictions to assess how Ireland ranks from a competitiveness standpoint.

There are eight specific questions being asked as part of this consultation.

Consultation Questions

1. What are the key considerations to be taken into account when deciding whether to base your R&D activity in Ireland?
2. In the absence of the R&D tax credit, what proportion of your R&D would take place in Ireland?
3. As R&D is project driven the annual cost to the exchequer can fluctuate quite significantly. What steps could be taken to improve advance forecasting of claims for Exchequer purposes?
4. In your experience, has your decision to conduct R&D in Ireland resulted in you recruiting additional staff, interns or apprentices?
5. The R&D credit allows for limited outsourcing of R&D. Are the limits appropriate? What is the impact of these outsourcing provisions on third level institutions and/or smaller firms?
6. What are the factors that are relevant to the relatively low uptake of the current credit by SMEs?
7. Are there ways of improving the current credit system to make it more attractive to SMEs?
8. Having regard to overall Exchequer cost, what measures could be taken to amend the current relief to improve supports for SMEs carrying out R&D?

A positive for SMEs in this review is that the Department of Finance will consider whether greater uptake by them needs to be encouraged. It will also analyse whether there is a cost-efficient method of encouraging more SMEs to invest in R&D and what are the key challenges facing SMEs in using the relief in its current form.

Recommendations for the Future

It is hoped that the forthcoming Department of Finance review will identify how Ireland ranks from a competitiveness perspective and, if there are gaps, that there is an appetite for enhancements. It is welcome that there appears to be scope for an enhanced R&D tax credit regime for SMEs. Currently, Ireland is out of line with its competitors, including the UK, by not having a significantly more attractive regime for SMEs. Areas for improvement could include bundling the cash instalments into one payment for SMEs, to encourage further investment; reducing the audit period to two years; and possibly having a tailored template documentation process to ease the administrative burden on SMEs.

Conclusion

The new guidelines provide clarity in some areas to companies claiming the credit and are aligned with how R&D audits are conducted; however, they also provide greater scope for Revenue to police claims more tightly. One would be foolish simply to dismiss these new guidelines in documenting any future R&D claims, as they offer greater clarity on Revenue's approach on audit. As per the recommendations above, there are areas where the R&D tax credit could be made more attractive, and the results of the Department of Finance review will be important to assess where Ireland currently sits. In light of the uncertainties presented by Brexit and the political landscape in other European countries and the United States, a robust, transparent and competitive regime must be the key objective in order to incentivise companies to continue to invest in Ireland and to retain their highly skilled roles in this country.

Read more on taxfind From Irish Tax Institute *The Professional's Guide to R&D Tax Credit, KDB and Related Reliefs,* 2017