

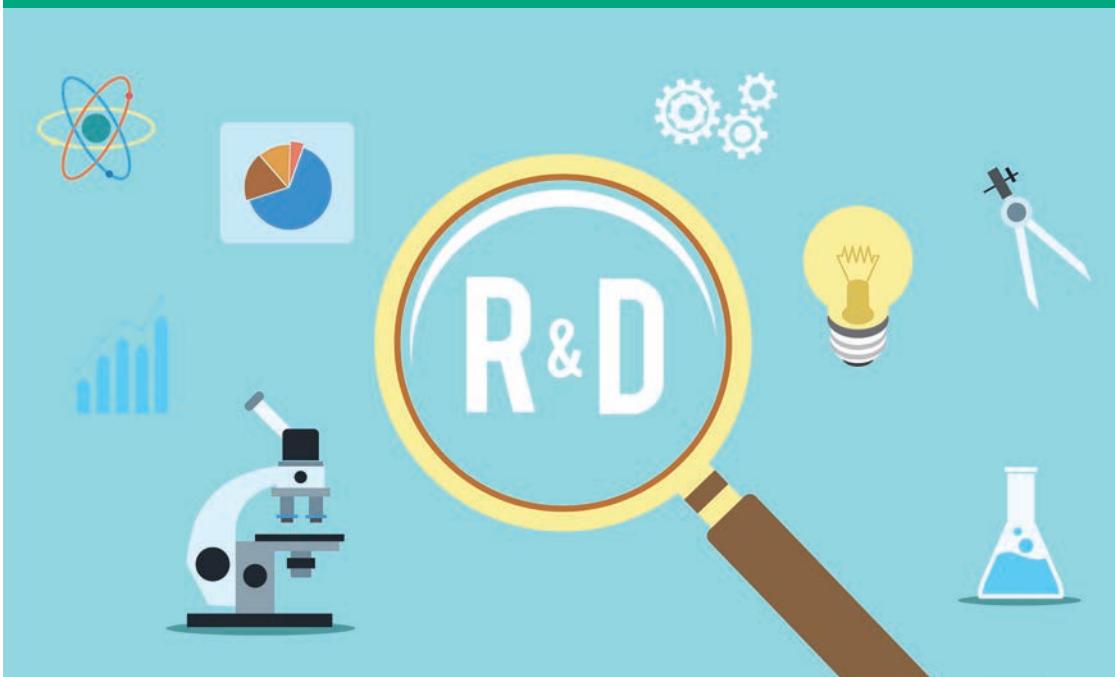
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Research and Development Tax Credit: Updated Revenue Guidelines, July 2020



Introduction

Revenue updated its “Research and Development (R&D) Tax Credit” guidelines in July 2020,¹ replacing the version published in June 2019.² Finance Act 2019 introduced changes to the R&D tax credit regime that predominantly focuses on

small and micro companies. These were measures for which various bodies and interested parties had been calling for over the last few years, and their introduction sent out a positive message to companies that meet these definitions. Given the measures introduced by Finance Act 2019,

1 Revenue, Tax and Duty Manual Part 29-02-03, “Research and Development (R&D) Tax Credit” (July 2020).

2 Revenue, Tax and Duty Manual Part 29-02-03, “Research and Development (R&D) Tax Credit” (June 2019).

it comes as no surprise that the R&D tax credit guidelines have been updated. However, the measures introduced on 22 December 2019 for small and micro companies are still subject to Ministerial Order and have not yet been enacted. **As a result, some of the updates in the new R&D tax credit guidelines are merely placeholders, and we can expect updated R&D tax credit guidelines to issue once these measures are enacted.**

Recap of R&D Measures Introduced by Finance Act 2019³

As the latest iteration of the R&D tax credit guidelines is driven by the Finance Act 2019 amendments, we briefly recap the key measures introduced:

- The legislation contained specific measures aimed at small and micro companies. Small and micro companies are those with fewer than 50 employees and whose annual turnover and/or balance sheet total does not exceed €10m.
- Broader measures were introduced in relation to:
 - sub-contractor limits and notification requirements,
 - the treatment of grants and
 - the restriction to offsets.

The updated R&D tax credit guidelines published in July take account of these changes in the Finance Act 2019. Some of the examples in the guidelines have been updated for minor changes such as dates. In addition to these amendments, there was an unexpected change to qualifying expenditure, and in this regard Revenue now deems rental expenditure to be a disallowable cost for the purpose of qualifying R&D expenditure. This is likely to be a contentious area and is certainly a deviation from standard practice heretofore. We set out in this article the various updates to Revenue's R&D tax credit guidelines and what they may mean for taxpayers making R&D tax credit claims.

Updates to Revenue's R&D Tax Credit Guidelines

Treatment of grants

R&D expenditure that is met or to be met by grant funding from the State, any board established by statute or any local authority of the State or of another relevant Member State of the EU or EEA does not qualify for relief. In a footnote to the June 2019 R&D tax credit guidelines, Revenue stated that "European Commission grants may not fall within the definition of section 766(1)(b)(v) TCA 1997, this will be dependent on the terms and conditions as set out in each grant agreement", and these European Commission grants were therefore not required to be deducted from R&D tax credit claims. The recently updated R&D tax credit guidelines clarify that funding from the State, an EU or EEA Member State or any state (i.e. non-EU Member State), or an institution, office, agency or other body of any state, would not qualify for relief. This would include funding from the European Commission and institutions of the European Commission and would capture, for example, Horizon 2020 grant funding. Therefore, any R&D grant funding received should be deducted when calculating the amount of qualifying R&D expenditure incurred by the company. The updated R&D tax credit guidelines include a footnote stating explicitly that this section was amended "to extend this definition to ensure grant funding from the European Commission and institutions of the Commission, and from non-European member states or bodies of such a state, is deducted from the qualifying expenditure on research and development activities". The updated definition of grant funding also applies to grant funding received in relation to R&D buildings.

Qualifying expenditure

Perhaps the most surprising update in the R&D tax credit guidelines is the apparent U-turn on the eligibility of rental expenditure. Rental expenditure has typically been an allowable R&D cost since the introduction of the R&D tax credit regime in 2004. Sixteen years later,

³ See article by Ken Hardy and Ronan Moore "Finance Act 2019: Key Changes to the R&D Tax Credit Regime", *Irish Tax Review*, 33/1 (2020).

despite all of the iterations of the R&D tax credit guidelines that have issued over the years, rental expenditure has never been called out as disallowable until now. Even in the 2015 R&D tax credit guidelines,⁴ which introduced Revenue's change in approach to overhead expenditure, there was no reference to the disallowance of rental costs. It is difficult to envisage how any R&D could be performed without incurring facility costs (power, utilities, etc.). In the 2015 R&D tax credit guidelines Revenue emphasised that costs must be incurred wholly and exclusively in the carrying on by a company of R&D and specifically called out costs that in its view were not incurred in the carrying on of R&D activities (e.g. "recruitment fees, insurance, travel, equipment repairs or maintenance, shipping, business entertainment, telephone, bank charges and interest"). The updated guidelines state that "rent is expenditure on a building or structure and is excluded from being expenditure on research and development by section 766(1)(a) TCA 1997". It is important to note that there have been no legislative changes to the treatment of qualifying expenditure, but this will no doubt cause concern for companies that have traditionally claimed rent as an allowable R&D cost.

This amendment appears somewhat out of kilter with the other measures that Revenue introduced to encourage and incentivise small and micro companies to engage with the R&D tax credit regime. Given the uncharted times we face with the Covid-19 pandemic, as well as significant political uncertainty around the globe (not to mention that Brexit is back on the agenda), it is the authors' view that we cannot be complacent about the attractiveness and competitiveness of our R&D regime and Ireland's ability to attract investment from both indigenous companies and FDI businesses. In the authors' view continuing to squeeze the cost base of the R&D regime creates

uncertainty and confusion, which businesses in such challenging times wish to avoid. This change will also create additional challenges for Revenue audits, such as what happens to R&D tax credit claims that are filed before and after the issuing of the updated R&D tax credit guidelines, from when these measures are to apply, and whether Revenue is going to look to apply them. The guidelines do not state from when these measures apply, and only time will tell how this interpretation is applied.

Capital expenditure on a building or structure used for R&D purposes

From an initial reading of the R&D tax credit guidelines, it would appear that there has been a change to Revenue's concession on the treatment of expenditure on buildings under s766A TCA 1997. The June 2019 guidelines stated that "expenditure on buildings and structures to be used for R&D (s.766A) is not subject to the same 12 month period"; however, the updated guidelines have retracted this statement and state that "expenditure on buildings and structures to be used for R&D (s.766A) must be made within 12 months from the end of the accounting period in which the relevant expenditure was incurred".

Qualifying expenditure on the construction or refurbishment of a qualifying building may be treated as having been incurred by reference either to the date when the expenditure was actually incurred or the date when the building is first brought into use. For expenditure that spans two or more accounting periods, the aggregate expenditure may be treated as incurred either on the date when the expenditure was incurred or the date when the building is first brought into use. The 12-month period applies by reference to the date that the expenditure is treated as incurred, and therefore there have been no changes to the time limits in the latest edition of the R&D tax credit guidelines.

4 Revenue, "Research & Development Tax Credit Guidelines" (April 2015).

The updated guidelines clarify that from 1 January 2020 capital expenditure incurred that qualifies for scientific research allowances in accordance with s765 TCA 1997 does not meet the definition of relevant expenditure. In a footnote, the guidelines state that “capital expenditure on scientific research which qualifies for an allowance under s765 TCA 1997 is no longer relevant expenditure on a building or structure” and will therefore not qualify for the R&D tax credit.

Sub-contractors

Costs incurred in qualifying R&D activities that are sub-contracted to third parties or universities (or institutes of higher education) are restricted to the greater of €100,000 or 15% of the company’s internal qualifying R&D expenditure, subject to the company’s having spent this amount itself on R&D activities.

The guidelines have been updated to reflect the legislative change increasing the sub-contractor limit for universities or institutes of higher education from 5% to 15%. This increase is effective for accounting periods starting on or after 22 December 2019. This will bring the sub-contractor caps for universities and institutes of higher education in line with the sub-contractor limit that has been in place since 2014 for the sub-contracting of R&D activities to third parties and is a welcome amendment to foster greater collaboration between industry and academia. To claim the expenditure on sub-contracted R&D, companies must notify the third party in writing that it may not claim the R&D tax credit in relation to these costs (to prevent “double dipping”). For accounting periods starting on or after 22 December 2019, this notification must be given either before or on the date the payment is made. Companies should be aware of this to ensure that the notification requirements are being met for any sub-contracted expenditure incurred. This

will likely require companies to review their own processes to ensure compliance with this change.

Enhanced regime for small and micro companies

The introduction of specific R&D tax credit measures aimed at small and micro companies is, at the time of writing, subject to Ministerial Order, and therefore has not yet been enacted into the legislation. These changes are a welcome addition to our R&D regime, and it is hoped that they will enhance the competitiveness of the Irish regime when compared to international counterparts. Many readers will know that our closest competitor offers an enhanced R&D regime for SMEs.

To recap, the measures to be enacted for small and micro companies include:

- an increase in the R&D tax credit rate from 25% to 30%,
- an enhanced method for calculating the payable element of the tax credit and
- the introduction of provisions in relation to pre-trading R&D expenditure that may qualify for the tax credit.

The delay in forming a government, coupled with the Covid-19 pandemic, has not helped to expedite the passing of these measures into law. Although the updated R&D tax credit guidelines refer to these measures, they are merely placeholders, and therefore we could expect the guidelines to be updated once the measures come into law. The guidelines state “these measures are subject to a commencement order, the relevant updates to this manual will be made once the sections are commenced”. Now that a government is in place, we would hope that they will be enacted before the forthcoming Budget.

Restrictions to offsets on the clawback of the R&D tax credit

The clawback of the R&D tax credit cannot be offset against any allowances, credits, expenses or losses. This will result in a corporation tax liability to the company, and therefore the application of interest and potentially penalties could arise. Revenue has clarified that the clawback of the R&D tax credit will not result in a close company surcharge arising.

Independent experts

The guidelines, in line with prior iterations, set out the process for the use of independent experts. In June 2020 Revenue updated the manual "Research and Development (R&D) Credit: Appointment of Expert to Assist in Audits".⁵ In one of the main changes, Appendix IV sets out a formal template for the introduction of the independent expert to the company. This document confirms that a confidentiality agreement (which is more comprehensive than earlier versions and indemnifies Revenue in respect of deliberate or careless breaches) has been signed and confirms that the independent expert's role is to evaluate the R&D activities that were undertaken by the company, as opposed to supporting the Revenue Officer's opinion. The manual now also makes reference to the Knowledge Development Box and states that the role of the expert in relation to the KDB regime is to submit "a written report confirming in their expert opinion, whether or not the activities gave rise to a qualifying asset".

Conclusion

Given the measures introduced by Finance Act 2019, we expected updated R&D tax credit guidelines to be issued, and we welcome the legislative changes. However, given that another update will likely be required once the specific

R&D measures for small and micro companies are enacted, in the author's view perhaps it would have been better to release the updated guidelines then, to reduce the number of iterations being produced. The latest set of guidelines are likely to be of some concern, particularly with respect to the interpretation of rental costs, for many claimants.

We find ourselves in unprecedented times. Home working and remote working are the new norm. The landscape for attracting international investment is more competitive than ever before, and companies are making investment decisions with an increased focus on cost competitiveness. The changes to the SME regime are much needed, and it is hoped that they will have the effect of helping to attract more claims in that space. Yet, surely, now is not the time to create additional uncertainty in an increasingly uncertain world. As a small, open economy, it is critical that Ireland avoids complacency and continues to maintain and enhance its cost competitiveness by ensuring that its incentive regimes remain best in class. In a time of unprecedented uncertainty, the authors believe that it is unfortunate that Revenue chose to disallow additional expenditure items in a regime that is otherwise very competitive when compared with other international jurisdictions. Only time will tell how the recent changes to guidance will play out.

Read more on **taxfind** from Irish Tax Institute Revenue Tax and Duty Manual Part 29-02-03; Finance Act 2019: Key Changes to the R&D Tax Credit Regime, *Irish Tax Review*, Issue 1, 2020; *Direct Tax Acts, Finance Act 2019; The Professional's Guide to R&D Tax Credit, KDB and Related Reliefs, Finance Act 2016*.

⁵ Revenue, Tax and Duty Manual Part 29-02-05, "Research and Development (R&D) Credit: Appointment of Expert to Assist in Audits" (June 2020).