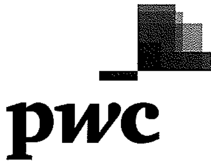


Review of the R&D tax credit
Fiscal Division
Department of Finance
Upper Merrion Street
Dublin 2

12 April 2013

Ref: FOR/SME/ANR

Review of the R&D Tax Credit

Dear Sir/Madam,

PwC welcomes the initiative by the Department of Finance to undertake an R&D tax credit consultation process.

We have actively engaged with our clients who conduct or are interested in conducting R&D activities in Ireland and have set out below a summary of some of the key discussion points raised.

Overview

- A significant number of our clients have benefited greatly from the R&D tax credit in recent years and its existence has helped to increase the number of R&D projects located in Ireland.

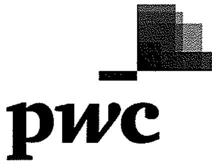
- The availability of the credit was and continues to be a key factor in Ireland being chosen as the location for a number of global centres of excellence in many science and technology fields. The benefit has been both in terms of reducing the net construction costs and also the on-going R&D costs of these centres. The commitment of the Irish Government to the regime has helped unlock corporate capital at head office level.

- The R&D credit has also been integral to a number of our clients preserving the scale of their Irish operations and employment levels. The continuation of the scheme is vital for the future of many Irish sites as it sustains the cost competitiveness of the unit cost of R&D and helps to keep Ireland at the forefront of innovation within many multinational groups.

- The review of the R&D tax credit must take place in open acknowledgement of the very considerable and competitive environment for R&D investment. This is not just an issue for Foreign Direct Investment but also directly impacts Irish companies who are competing on the international market who analyse the after tax cost of where to locate their R&D investments.

- We believe that the scheme can be further enhanced to improve Ireland's standing as a prime location for R&D. In particular, we would like to see improvements to ensure that there is greater flexibility for companies to access the skilled resources necessary to undertake R&D projects without impacting upon the ability to claim this expenditure as qualifying R&D.

- We also believe there is an opportunity for Ireland Inc to rebrand and establish a cohesive 'Innovation Tax' policy that will incorporate existing front end incentives such as grant and tax credits with strong back end incentives such as an improved and more attractive Intellectual



Property (IP) regime coupled with the 12.5% (active trading) corporate tax rate. This packaging of incentives is essential if Ireland is to continue to preserve and increase employment through R&D activities as well as achieving the highly sought spill over benefits such as manufacturing and services for export.

International Competition

The important role innovative companies' play in their national economies has led to the enactment of R&D tax incentives and grant programmes internationally to encourage research investments by businesses. There are R&D incentive regimes in circa thirty countries worldwide and most are improving their regimes in an attempt to become a jurisdiction of choice for R&D activity. The types of incentives available include grants, super deductions, IP amortisation and reduced tax for income associated with IP.

Countries are constantly revamping their 'Innovation Tax' policy evidenced by the fact that seven European Union (EU) countries have adopted "patent box" regimes that sharply reduce the corporate tax rate on qualifying IP income to very low effective tax rates. These countries include the likes of Belgium, Netherlands, Luxembourg and UK. These countries all provide strong competition for Ireland when companies are deciding where to locate R&D centres and/or associated activities.

Recent UK corporate tax reform has led to improvements in their volume based R&D tax credit regime as well as introducing a Patent box. From an Irish perspective these developments are challenging as it is relatively easy for MNC's, and indeed Irish companies, to prioritise locating R&D activity in the UK.

We have included a link to a recent Global PwC document which discusses the global innovation landscape. It is evident from this document that there is intense global competition and Ireland's offering is unfortunately declining in profile.

http://www.pwc.com/en_GX/gx/tax/assets/pwc-global-research-development-incentives-group-november-2012-pdf.pdf

We are very aware from our clients that the R&D tax credit is an important strategic tool and at the very minimum must be retained in its current format. We would however strongly urge for recognition that the R&D tax credit is only one policy instrument. We feel that the entire suite of 'Innovation Tax' policies should be considered together to ensure a 'best in class' offering and afford Ireland a real opportunity to compete at an international scale for R&D investment.

Optimising the benefits of Ireland's R&D regime

As outlined above, many Irish companies have benefited greatly from the provisions of the Irish R&D tax credit regime since its introduction in 2004. However, we and our clients believe that the mechanics of the scheme may be improved in a number of ways to enhance Ireland's standing when compared to other international regimes.

1. *Rewarding key employees*

We welcomed the mechanism introduced in Finance Act 2012, which allows companies in receipt of R&D tax credits to reward 'key employees' who are involved in the R&D process. The definition of a key employee provides that the employee must perform 50% (reduced from 75% in Finance Act 2013)

or more of their activities in the *"conception and creation of new knowledge, products, processes, methods and systems"*.

While we appreciate the merits of this provision, particularly in the context of retaining and attracting key talent, the associated legislative conditions mean that it has had, and will continue to have, limited application in incentivising R&D within organisations;

- The 50% qualification threshold means that only a limited number of employees will be eligible for this scheme.

  Most R&D activities are split across various technology pillars. As such, it is rare that an employee will devote the required level of time to R&D and instead they perform a multi-faceted role which also includes routine enhancements, business development and customer interaction. Nonetheless, these individuals do play a vital role in R&D projects.

  In addition, the threshold is proving prohibitive from a Human Resource perspective as it is difficult to justify applying different rewards to employees on the basis of a marginal variance in the level of their R&D activity (e.g. an employee spending 50% of their time on R&D may qualify for the scheme, but a colleague who spends 48% of their time on R&D will not).

  The requirement that an individual has to have worked at least 50% of the time on R&D and that the R&D has to qualify for the tax credit in order for the individual to qualify will result in a small number of people who are not necessarily a company's key employees qualifying. Also, an employee qualifying in one year may not necessarily qualify the next year. Some companies may view their key employees as the heads of departments and team leaders. These heads of departments include the Sales, Finance, Operations, Engineering, Regulatory functions. Companies rely on team work to win R&D projects and the exclusion of Directors etc by the legislation is unhelpful in this regard – particularly as Ireland Inc is relying on these individuals to be motivated to source R&D projects for Ireland.

  In order to widen access to the scheme to include those employees who are actively involved in R&D, we would suggest that the threshold is reduced to 30%.

- The definition of the activities which a key employee must perform differs from those R&D activities which qualify for the credit, thus potentially restricting the incentive to those individuals performing only 'high-end' R&D.

  Much of the R&D undertaken in Ireland is within the category of experimental development which is defined as *"work undertaken which draws on scientific or technical knowledge or practical experience for the purpose of achieving technological advancement and which is directed at producing new, or <u>improving</u> existing, materials, products, devices, processes, systems or services including incremental improvements thereto"*

  However, time spent by individuals on this type of work does not appear to count towards the 50% threshold.

  As such, we would suggest that the definition of activities which a key employee can perform is aligned to the definition of R&D activities as set out in Section 766 Taxes Consolidation Act 1997 ('TCA').

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- The incentive is designed to reward those employees involved in R&D activity, however, under the current system there is a significant lag between the time the R&D work is undertaken and the delivery of the tax benefit to the key employee. For example, if an individual is rewarded for their involvement in a key R&D project undertaken in 2013, they will not receive a refund of payroll taxes paid until 2015.

  In order to encourage and better reward key employees, we believe that it would be beneficial if employees could receive a 'live' benefit of any credit which has been awarded to them. For example, an alternative might be to offset the credit against payroll taxes suffered in the preceding or current period thus accelerating the benefit

- Legislation also provides that an employee cannot use the credit to reduce their effective tax rate to below 23%. This would limit access to the scheme to those employees earning in excess of circa €55,000 (i.e. management level positions).Organisations try to encourage R&D at all levels of the organisation as this ultimately helps to foster a culture of innovation as junior employees move to more senior positions.

  As such, we would recommend that the 23% floor is removed or certainly reduced to allow the credit to be shared with employees of all grades.

  This would also help Irish companies and subsidiaries of MNC's to attract key global R&D employees to relocate to Ireland as the 23% rate is proving to be unattractive when compared to some other international tax regimes. The presence of such high-calibre individuals is critical to the success of global centres of excellence delivering mobile R&D projects for Ireland, especially where skills shortages may exist in Ireland.

2. *R&D Business Models – Flexibility*

Connected parties

Where a company engaged in R&D pays a sum to another company to carry out R&D on its behalf, it is entitled to claim the R&D credit on that sum (to the extent that it does not exceed 10% of the expenditure incurred by the company itself on qualifying R&D). However, where such a payment is made to a connected company, the credit cannot be claimed.

It appears inequitable to distinguish between payments made to connected and unconnected parties. By facilitating Irish companies engaging with an affiliate as opposed to a third party would provide more transparency as regards the R&D undertaken and would increase the level of technical knowledge being transferred to Ireland (which is of course one of the objectives of the R&D regime). Given the existence of transfer pricing legislation, all payments made to connected companies would need to be arm's length.

This flexibility is required as typically certain deep expertise will be located in various specialised satellite centres globally. While the majority of the R&D project work clearly needs to be performed in Ireland (and the relevant legislative cap will ensure this), it would be helpful in promoting Ireland as a location for R&D/IP if such connected party costs could potentially qualify for the R&D tax credit.

We therefore believe that the rules as regards claiming the credit on outsourced R&D costs should be extended to include payments made to connected parties.

Expats / Secondees to Irish Companies

In a multinational context, we often see secondees or expats from group affiliates coming to Ireland to work on qualifying R&D projects. The involvement of expats generally occurs as a result of a skills shortage locally in a particular area of expertise. The role of the expat in these situations is twofold:

1. To up skill local employees here in Ireland and
2. To aim to deliver the R&D project in a more timely way than might otherwise have been possible.

Normally individuals who are expats /secondees will continue to be paid by their home location and remain on an overseas payroll. The Irish company often bears the financial costs of the individual while they are in Ireland, through reimbursement of the affiliate.

From a policy perspective, the Irish R&D legislation is designed to lead to an up skilling of Irish employees and retention of this knowledge within Irish companies. The involvement of expats in Irish R&D projects does not run contrary to this policy.

An R&D claim by a company for expat costs such as those outlined above is not specifically provided for in the legislation at present. While a claim may be accommodated by transferring the expat to the Irish payroll this is not always practical and can have a significant impact on the expats home country tax and social security position.

If the concept of "beneficial employer" were introduced into the R&D legislation to allow salary costs borne by an Irish company on behalf of an affiliate to qualify for the R&D credit, we feel this would be very welcome. It would make it easier and more cost effective for organisations to locate R&D projects in Ireland where the required skill level might not exist in the Irish entity at the commencement of the project.

Additionally, when the expat returns to his /her home country, the skills they have imparted during their time in Ireland remain here to be built upon. The issue is especially relevant to companies locating in Ireland for the first time or companies bringing new products/technologies to Ireland for the first time.

Improvements to the Irish SARP (Special Assignee Relief Programme) regime should also be considered to improve flexibility for Irish companies. We have included an enclosure to this document which provides more detail on this.

Unconnected parties

The business model of most R&D centric organisations requires certain core skills and competencies to enable R&D projects won by senior management to be undertaken in Ireland. At particular times, companies do not possess all of the necessary resources with the relevant skill sets and competencies to facilitate an activity.

Therefore, in order to successfully compete for R&D projects companies must maintain and manage a flexible workforce, particularly given the current global economic environment where some parent companies have imposed employment embargos.

Notwithstanding any potential embargo it is increasingly difficult for companies to be able to source individuals to employ in the ICT sector. The recently published Action Plan for Jobs 2013 outlines the various disruptive reforms being prioritised including that of making Ireland the most attractive location in the world for ICT skills availability, ensuring the continued success of the ICT sector. The recognition that there is a skills shortage in this particular sector is common place. As a consequence of this, ICT companies must engage with a number of third parties to provide a mix of externally sourced workers and R&D technical services.

In addition to the above, companies that operate in regulated industries (e.g. Pharmaceuticals and Medical Devices sector) are often required to obtain independent third party evidence to support/verify their products in order to obtain regulatory approval for them. In this regard, they are required to collaborate with and engage third party consultants in the course of their research and development activities.

We understand that Revenue's view is that payments made to third parties for the provision of externally provided workers are capable of coming within the ambit of subparagraph (viii) of subsection (1) (b) of S. 766 TCA on the basis that such payments are a component of a larger R&D project. We further understand that if the activities undertaken by the externally provided workers contribute to the resolution of the scientific or technological uncertainty being sought by the Irish company then the amount paid will be viewed as being expenditure on research and development, but subject to the 10% cap contained in the legislation.

We would recommend that the cap is reviewed to determine a more appropriate limit comparable with the treatment offered by the UK regime where up to 65% of the expenditure paid for the provision of externally provided workers is potentially eligible to be treated as qualifying expenditure.

Collaboration

The R&D tax credit legislation is drafted in a manner that focuses on activities undertaken by the company itself and is therefore restrictive in terms of facilitating R&D collaboration. It would be a very positive development if the legislation could be amended to cater for R&D joint ventures in a manner that the relevant parties can include the component parts as part of their respective group's R&D tax credit claim.

The in – house focus is also a limiting factor on companies engaging with academia and the Irish research ecosystem. It would be supportive to Ireland's reputation as a proactive R&D location if the R&D tax credit was broadened to encourage the FDI community to deepen their interaction with key research institutes. This is an area identified in the Action Plan for Jobs which includes an objective whereby through Science Foundation (SFI) Ireland and industry contribution, five new research centres of global scale are to be created.

It would be beneficial if payments to Universities and SFI etc can be included in the R&D tax credit expenditure or the relevant outsourcing caps are increased to facilitate this.

3. *Claims process in respect of construction of R&D building*

Section 766A TCA provides for the availability of a separate R&D tax credit in respect of the construction or refurbishment of an R&D building. The section provides that where a company incurs expenditure on a qualifying building, it is entitled to an R&D tax credit of 25%.

A "qualifying building" is defined as a building or structure, which, for the specified relevant period, not less than 35% of its use is attributable to R&D activities carried on by the company. As the legislation is presently drafted all claims for credit on an R&D building must be made within 12 months from the year-end in which the expenditure was incurred.

In effect, a claim for R&D buildings must be made for the period in which the expenditure is incurred. The treatment of capital expenditure on plant and machinery in Section 766 TCA provides for a claim to be made either:

(1) When the expenditure is incurred **or**
(2) When the plant and machinery is put into use.

The fact that taxpayers may only make a claim for R&D buildings when the expenditure is incurred (rather than when it is put into use) gives rise to a number of practical difficulties.

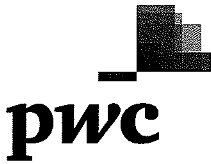
As stated above, a building is regarded as a "qualifying building" where for the "specified relevant period" the proportion of R&D use is not less than 35%. In the case of the construction of a building the specified relevant period is a period of 4 years beginning at the time the building is first brought into use. In the case of a refurbishment, the relevant period is a period of 4 years beginning no earlier than when the refurbishment commences and beginning no later than when the refurbishment ends.

Practically, where a company begins a large construction project – which often can last 2-3 years, the company is obliged to file a claim for the R&D buildings credit at the end of year two (in respect of year one). In Ireland, it is unusual for a building to be fully dedicated to R&D, and the company must assess whether the R&D use in the specified relevant period will meet the 35% threshold or not. In the example above this would mean looking out as far as 6-7 years to assess whether the building qualifies or not.

This is extremely difficult to forecast and companies are forced to employ a degree of estimation meaning that it is unlikely that any claim is entirely accurate. If the expenditure is not claimed in the year when it is incurred it, currently, cannot be claimed in subsequent years. As a result, we find that companies are claiming the credit on the expenditure incurred and subsequently withdrawing the claim, if it later transpires it does not qualify.

If the proportion attributable to R&D is overstated, the R&D credit will have been over-claimed and this will trigger interest and penalties. If the proportion attributable to R&D is understated, the R&D credit will have been under-claimed and, given the 12 month deadline, a company would not be in a position to increase their claim.

We believe that if a company was allowed to adjust its claim upwards (after the 12 month period) or downwards (without triggering interest and penalties) this would provide a greater degree of transparency for both Revenue and the claimant.



Alternatively, if the buildings claim could be made, either in the year the expenditure is incurred or when the building is first put into use, the level of estimation involved would be significantly lower. It would also mean that all capital expenditure associated with R&D projects would be treated in a similar way providing more certainty and reducing the complexity of the regime.

4. Base year flexibility

The R&D tax credit is calculated on the incremental R&D spend over the corresponding spend in 2003 (i.e. the base year). We understand that this was a reasoned and specific policy decision to only incentivise incremental R&D when the regime was first introduced.

There does however need to be recognition of the fact that there have been considerable deflationary pressures in the Irish economy since 2003 and that the global economy has suffered a very significant downturn. Therefore, there are a number of companies who are not able to incur an R&D spend in excess of the base year number but are clearly competing internationally to secure R&D projects and jobs for Ireland.

In addition, it is important to note that Ireland is one of the very few countries to operate an incremental regime as opposed to a volume based regime. In particular, the UK operates a volume basis and therefore there is an incentive for Irish companies who were undertaking significant levels of R&D in Ireland in 2003 to migrate those activities to the UK.

We very much support the flexibility introduced by recent Finance Acts to facilitate further uptake of the incentive by smaller indigenous Irish companies and would welcome a further review of the base year to determine if it is possible to introduce further flexibility possibly linked to job creation.

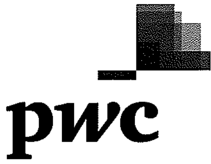
5. Use of R&D credit by other group members

In groups, where one or more companies are claiming R&D credits, it is not uncommon for the R&D credits to be allocated across more than one company.

In accordance with transfer pricing provisions, one would expect that the company benefitting from the use of the R&D credit would compensate the company who actually incurred the R&D expenditure for the benefit received.

The R&D legislation, contained in Section 766 TCA does not, at present, provide for such a payment to be made free of tax. Section 411 (5) TCA provides that payment made for group relief to a surrendering company will not be subject to tax in the hands of the recipient company. It is clear that a payment for the benefit of R&D credits does not fall within Section 411 (5) TCA.

This is an issue which is causing difficulties and confusion for groups (both in the domestic and FDI sectors) and we feel that the uncertainty which exists can be easily addressed by way of an amendment to Section 766 TCA.



6. *Updated Revenue R&D Guidelines (December 2012)*

Certainty is a key factor for companies when evaluating R&D investments. This obviously means that the administration of the R&D tax credit regime needs to be clear and consistent.

Concern has been expressed across all industry sectors in relation to the recently updated Revenue R&D guidelines. These updated guidelines provide a more narrow interpretation of the expenditure that qualifies for the R&D tax credit. A distinction is made in the updated document between expenditure incurred 'for the purposes of or in connection with R&D activities' and expenditure incurred by a company 'in the carrying on by it of R&D activities'. This has created uncertainty as to the qualifying nature of costs that directly contribute to the R&D activity.

This restricted interpretation is not helpful in attracting FDI to Ireland or in encouraging Indigenous Irish companies to upscale their R&D activities/up skill their employees as invariably costs will be incurred to enable R&D activities to be undertaken in Ireland and these may not qualify under the new guidelines.

An advantage which Ireland had was the broad expenditure base on which the R&D tax credit could be claimed. Generally, this was broader than in competing territories. However, the uncertainty that the updated guidelines have introduced casts a shadow on this benefit. This perceived narrowing in the type of expenditure qualifying for the credit is viewed as introducing further uncertainty into the regime for taxpayers.

The PwC experience is that the key factors which influence investment decisions are as follows:

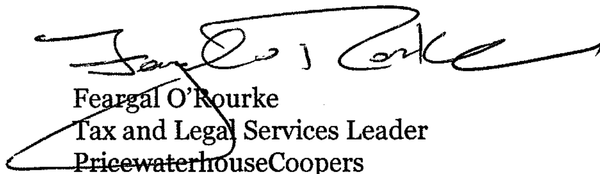
- Access to skilled resources and
- A competitive tax regime.

The R&D tax credit is and has been a strong influence in this regard. However, due to the intense level of global competition, it is essential that Ireland's offering continually evolves.

The comments in this paper represent the views of our clients and the companies that we engage with. While the comments are general in nature, we hope these are helpful. If you require any further information in relation to the above, we would be more than happy to engage with you.

Please do not hesitate to contact Stephen Merriman at 01 792 6505 or Antoinette Ryan at 01 792 6549 if you would like to discuss this further.

Yours faithfully,



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