Submission by IEA

With Reference to the

Review of the R&D Tax Credit
By
The Department of Finance

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The Irish Exporters Association (IEA)

The IEA's primary mission is to articulate and represent the needs of its members all of whom are involved in exporting from the island of Ireland. The IEA is the only organisation exclusively representing the export sector , and has been doing so since 1951. The members of the IEA cover the full spectrum of foreign and indigenous multinationals as well as small and medium sized businesses The IEA members account for over 70% of all exported goods and services from Ireland, but they also account for over 50% of all import volumes into Ireland.

The IEA's approach to the Consultation Process

The IEA has consulted widely with its membership on matters raised in the Department of Finance Review document.

Acknowledgement
The IEA wish to acknowledge the support of the following members of the sub-committee of IEA National Council who reviewed and co-ordinated this Submission ;
Mr James O Riordan , chief technical officer , Silicon Software Systems Ltd .
Mr Gerry Vahey , partner, Mazars.
Mr John Whelan , chief executive ,IEA

Introduction

Ireland is no longer a low cost country , and hence it's export sector has to compete more and more internationally on the basis of new product developments with high technical content .In a Morgan Stanley Asset management report Ireland is ranked 5th in the OECD in terms of high tech exports at 51 % of the total exports .Whereas this is an achievement we can be proud of , it also means that without continuous high levels of R& D our export sector could rapidly decline .
Indecon in it's 2011 ' Analysis of Irelands Comparative Advantage for Foreign Investors ' found that foreign owned firms were strongly attracted to invest in Ireland because of the quality of R& D carried out here in business and institutions.
The Eurostat figures for 2012 show that Ireland had a 1.7% spend on R& D as a percentage of GDP .This is below the EU average of 2% and obviously below the Euro 20/20 target of 3% of GDP.
Hence , for export growth to continue and for Ireland to remain a competitive high tech export nation, it is essential that quality R& D continues to be carried out across the business community with the support of third level institutions.
The Department of Finance must ensure that supportive tax structures are in place to incentivise a greater level of investment by industry in research and development across a wide range of sectors. This Submission offers some best practice routes to achieve this objective.

The IEA in this Submission addresses the following issues;

1. **Incentivising R&D in multinational corporations (MNCs) located in Ireland, and attracting new R& D investment activity into Ireland.**
2. **Incentivising small and medium manufacturing and services businesses to undertake more R& D activity.**

3. **Other cross cutting Taxation measures;**
   - **EII Scheme**
   - **Innovation Voucher Scheme.**

The IEA's key recommendations are as follows;

1. *To continue to attract international mobile investment in the sector the IEA recommend to the Dept. of Finance to introduce an IP Innovation box offering such that all profits from ownership, development, and distribution are taxed at a composite rate of 5%.*

2. *To incentivise greater R& D investment by Small and medium sized enterprises , the IEA recommend ;*

a) *That the R&D Tax credit scheme be changed to focus on benefiting the company and to allow the company to use that tax benefit from that credit to reward any / all their employees, including those in sales who bring in the money, including managers who assign the work and the priorities, and create new R&D jobs, and including other support staff who play key roles in helping to make companies doing R&D successful.*

b) *If it is necessary, in order to reduce the risk, Revenue/Dept. of Finance may wish to limit the amounts that can be paid to any one employee p.a.*

c) *Allow the Tax credit refund to be paid out within 12 months, with no recall clause.*

d) *Eliminate the 2003 base year as the base for relief on added research and development investment.*

e) *The outsourcing 5% cap on outsourcing to third level institutions and the 10% cap on outsourcing to other parties is limiting the* *growth of R& D specialist centres and impacting on the amount of third party research being done in Ireland. Hence the IEA recommend the removing of these 2 caps.*

f) Extend the ability of companies to allocate the tax credit to key employees to those companies who are not in a corporation tax paying position.

3. The EII scheme could act as a key source of R & D funding for the indigenous businesses if the E11 scheme were *modified so that:*

a) its provides the tax relief at the higher income tax rate

b) Angel investor group syndicates are allowed to participate in the scheme

4. Finally, the IEA advise that greater SME involvement in R&D can be achieved by streamlining more and better focused efforts to promote cooperation between industry and researchers are needed.

    a) *The IEA recommend that the existing €5000 innovation brochures should be extended to €20,000 to ensure more meaningful development is carried by third level institutions on behalf of SME's*

1. Incentivising MNCs to locate R&D activity

Today's multinational companies benefit from an increasing number of IP friendly jurisdictions from a corporation tax perspective. These incentives can be applied to the sale of innovative products, advancements in production processes, licensing income, and the provision of services. European governments in particular have become increasing competitive and innovative in their offerings.

Ireland itself has been fairly competitive in its offerings to companies both foreign and Irish owned, to carry out R&D activities, to patent these and manage them from Ireland. However, in recent years there has been a loss of some good incentives through the dropping of the patent royalty tax free scheme, and by the flaws in the R&D Tax credit scheme.

In reviewing schemes to incentivise MNCs, it must be taken into account that it is an amalgam of the IP registration and the associated patent royalty tax exemptions, in conjunction with the R&D tax credits on expenditure that drives the final decision as to whether to expand R&D facilities and where to locate the IP. Also, most MNCs have share option schemes and high salary levels to attract and retain the skilled R& D staff, and rely less on the use of the Tax Credit schemes to incentivise their employees.

Internationally, there has been an amalgamation of the offerings into Innovation boxes, or IP boxes with the net effect of reducing Ireland's competitive position. The lowest composite box tax rates are available in Belgium, Luxembourg, Netherlands and the Swiss canton of Nidwalden. The widest range of IP that qualifies for the reduced tax rate appears to be in Luxembourg, Netherlands and Switzerland as these regimes are not restricted to patents. The UK is also competitive because a wide variety of income relating to patents will qualify. The UK, Netherlands and Belgium, now offer the most flexible business models for ownership of patents.

The UK IP box will offer a 10% flat rate, in France an effective rate of 15% , in Spain the rate ranges from 6 to 15%, whereas, the Netherlands IP incentive regime, known as the Innovation Box, offers one of the lower rates at 5%. Belgium offers between 0 and 6.8% and Luxembourg no more than 5.76%. Switzerland is unique in that the country does not have a national IP incentive regime. Instead, rates are offered on a canton-by-canton basis. The canton of Nidwalden offers an IP Box with a rate between 2 and 8.8%. Other Swiss cantons offer a variety of rates, often negotiated with individual companies.

The majority of the regimes recognize both beneficial ownership and legal ownership of the patent or IP. The Belgian regime allows co-ownership of the patent or, in the case of the UK Patent Box regime, cost-sharing arrangements. Partnership business models will also qualify.

The IEA fully acknowledge that in terms of settling on a location in which to hold IP to qualify for an IP incentive regime there will be a number of factors to consider alongside the potential benefit obtainable from the regime. These include Research and Development (R&D) skilled labour to develop the IP, on-going maintenance of the structure, set-up costs, and existing presence in the territory. However, we need to be conscious of the competitive moves by other EU regimes and modify our offerings accordingly.

Hence, the IEA recommend to the Dept. of Finance to introduce an IP Innovation box offering such that all profits from ownership, development, and distribution are taxed at a composite rate of 5%.

Currently the Revenue Commissioners have effectively up to five years to review a claim for Research and Development Tax Credit expenditure. On the flip side a company has one year from the end of the accounting period to make a valid claim. In other jurisdictions, the timeline in which the Fiscal authorities can review a claim is considerably shorter, for example in Canada the time period can in certain instances be 120 days. Many companies account for the credit above the line i.e. they net the tax credit against the research and development expenditure as it is a more accurate reflection of the cost of incurring research and development activities. If a claim is reviewed after the date the Financial Statements are signed off and a portion of th credit is subsequently disallowed then this could result in a hit to the profit and loss account. We would recommend that in order to bring some degree of certainty to the benefit of the tax credit that the time period in which the Revenue Commissioners can review the credit is shortened from this current period of 5 years.

2. Incentivising Small and Medium businesses to innovate through R&D

R&D tax credits introduced in 2004 for businesses as a means of stimulating investment activity has worked well in the MNC sector. However, it has by and large failed to appeal to small business and hence we see a very low take up of R&D in small business.

Also the base year of 2003 for relief on increases over the expenditure in that year was acceptable when introduced in 2004, but is now acting as a disincentive. In addition, the trend towards outsourcing of certain research functions has increased in the time frame and the current outsourcing cap is now seen as excessively restrictive, particularly when compared to similar schemes amongst our trading partner countries.

The old Patent tax exemption scheme had many benefits to SMEs, before it was dropped because of the abuse by a very small number of people. The current R&D Tax credit scheme has a number of benefits to incentivise, but also flaws which if eliminated could push the SME sector into greater R&D and new product development.

The IEA support the R&D Tax credit criteria as attaching tax benefits not to a 'patent', but to the company doing R&D (as per the OECD R&D definition) . It now means that the Government/Revenue has a tool that singles out the R&D companies (Knowledge Workers, Smart Economy etc.) for support. However, if this was combined with the previous 'payment' approach used on the Patent tax exemption it would be a good basis for a much more effective scheme.

The IEA advise that the current R& D Tax Credit 'reward' approach has too many flaws, particularly for SMEs. For example;

- The payment to an employee is 'at risk' until after a Revenue Audit (i.e. the Revenue can disallow an R&D claim after an audit and hence look for repayment) – is a further disincentive.
- The biggest issue is that only an R&D employee can get the tax benefit. Of course we want to reward and incentivise R&D employees, but R&D employees do not create R&D jobs. It is the managers of R&D employees who actually create R&D jobs. So we have the situation that we want to create more R&D jobs, and the scheme does not allow us to incentivise the people who do that, we are actually incentivising the wrong people (but still we do want to have some ability to incentivise the R&D employee).

New product development is becoming more and more specialised, many companies do not have the in-house capabilities to conduct particular aspects of their research and development programmes and consequently outsource significant parts of R&D to third parties. The current sub-contracting limits of the greater of 10% of the qualifying spend or €100,000 place them at a significant disadvantage to other companies in other jurisdictions who are not subject to the same level of outsourcing limits. In the UK and US they have addressed this issue by allowing between 65% and 100% of the expenditure paid to a staff provider (or agency). We recommend that a similar provision type provision is incorporated in the Irish R&D Tax Credit Regime.

The allocation of the R&D Tax Credit to key employees is restricted to companies who are in a corporation tax paying position. This penalises companies who, because they are in the early stages of their business cycle or who do not have a corporation tax liability due to trading losses in the current year and/or previous years, are not in a position to allocate this credit. We recommend that the ability to allocate the credit to key employees should be extended to these types of companies. This extension would have no net tax effect on the exchequer as thse companies would have been entitled to a refund of the credit in any event.

The IEA recommend;

g) That the R&D Tax credit scheme be changed to focus on benefiting the company and to allow the company to use that tax benefit from that credit to reward any / all their employees, including those in sales who bring in the money, including managers who assign the *work and the priorities, and create new R&D jobs, and including other support staff who play key roles in helping to make companies doing R&D successful.*

h) If it is necessary, in order to reduce the risk, Revenue/Dept. of Finance may wish to limit the amounts that can be paid to any one employee p.a.

i) Allow the Tax credit refund to be paid out within 12 months, with no recall clause.

j) Eliminate the 2003 base year as the base for relief on added research and development investment.

k) The outsourcing 5% cap on outsourcing to third level institutions and the 10% cap on outsourcing to other parties is limiting the growth of R& D specialist centres and impacting on the amount of third party research being done in Ireland. Hence the IEA recommend the removing of these 2 caps.

l) Extend the ability of companies to allocate the tax credit to key employees to those companies who are not in a corporation tax paying position.

3. Other cross over Taxation measures to stimulate R&D ;

3.1 The EIIS –Employment Investment Incentive Scheme has the potential to support many start-up companies as well as expanding companies who need to develop new products or processes to remain competitive in international markets

However, there has been very little taking up on the EIIS since its introduction. The IEA believe that the reasons for the poor take-up are associated with two primary issues:

- The scheme does not take into account the target audience who have the funds to invest
- The scheme is too restrictive

The target audience should be the high earners (€150,000 pa plus) and Angel investor groups. The scheme as currently constructed is available only to the individual and does not allow for angel investor group syndicates. Also the scheme is only offering 20% tax offset, whereas the target group are in the 41% income tax bracket.

The restrictive nature of the scheme which allows only 30/44th of tax relief in the first year of investment, with the remainder depending on an assessment in year 3 of jobs created, is not very attractive. Also the mechanism for the year 3 review and when the tax relief will be provided is not clearly defined .The restriction on the amount a company can raise in any one year is also unhelpful, effectively being set at one fifth of the €10 million life time allowed per company forces a company into multiple fund raising rounds and increases the costs of the scheme.

There are many positives to the scheme, however, the reality is that it is not being utilised in its present form and is not achieving its objectives of funding more R&D in small business, or helping to create more jobs.

The IEA therefore recommend that Budget 2013 allows of modifying the EIIS so that:

c) *its provides the tax relief at the higher income tax rate*

d) *Angel investor group syndicates are allowed to participate in the scheme*

3.2 Innovation Voucher Scheme

Greater SME involvement in R&D can be achieved by streamlining more and better focused efforts to promote cooperation between industry and researchers are needed.

The IEA recommend that the existing €5000 innovation brochures should be extended to €20,000 to ensure more meaningful development is carried by third level institutions on behalf of SME's

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