The R&D tax credit regime

18 February 2014
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Agenda

- The R&D incentive in the current environment
- Overview of the R&D regime
- The science test
- The accounting test
- Overview of documentation requirements
- Putting a framework in place
- How to prepare for a Revenue audit
The R&D incentive in the current environment
The R&D incentive in the current environment

Key improvements in recent years:
► Cash refunds for excess R&D credits from Irish Revenue
► 1st €100K/€200K/€300K on a volume basis
► Use credit to reward key R&D employees

Very successful regime:
► Encouraging growth in R&D spend in Ireland
  ► 2003 R&D spend was 0.78% of GDP increasing to 1.17% of GDP (2011)
  ► The EU 2020 target for Ireland is 2.5% of GDP
► Greater flexibility around refunds

Department of Finance Review published October 2013
► Government’s commitment to maintain the R&D tax credit
► Among ‘best in class’ internationally

The R&D tax credit regime is a fundamental cornerstone to building Ireland as a cost competitive knowledge economy
The R&D incentive in the current environment

Company is profitable and paying Irish tax

- 25% Credit available on qualifying incremental R&D expenditure
- Allowable against Irish corporation tax
- Where excess credit is available the excess will be refunded per below

Company in losses and declares Nil Irish tax

- 25% Credit available on qualifying incremental R&D expenditure
- Available as Cash Refund
- Refunded over three years
The R&D incentive in the current environment
Example of tax credit/ cash refunds

<table>
<thead>
<tr>
<th>Corporation Tax liability y/e 31.12.13</th>
<th>€100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>R&amp;D tax credit</td>
<td>€500,000</td>
</tr>
<tr>
<td><strong>Excess R&amp;D tax credit</strong> – available for repayment</td>
<td>€400,000</td>
</tr>
</tbody>
</table>

Repayment of the excess R&D tax credit of €400,000 is as follows:

<table>
<thead>
<tr>
<th>Excess R&amp;D tax credit payable no earlier than</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Instalment (33%)</td>
</tr>
<tr>
<td>2nd Instalment (50% of balance)</td>
</tr>
<tr>
<td>3rd Instalment (remainder)</td>
</tr>
</tbody>
</table>
The R&D incentive in the current environment
Example of tax credit/ cash refunds (cont’d)

<table>
<thead>
<tr>
<th>Excess R&amp;D tax credit – for repayment</th>
<th>31 Dec 2013</th>
<th>31 Dec 2014</th>
<th>31 Dec 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>€400,000</td>
<td>€400,000</td>
<td>€400,000</td>
<td></td>
</tr>
</tbody>
</table>

R&D tax credit not repayable before

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FY13</td>
<td>€400,000</td>
<td>€132,000</td>
<td>€134,000</td>
<td>€134,000</td>
<td>€134,000</td>
<td>€134,000</td>
</tr>
<tr>
<td>FY14</td>
<td>€400,000</td>
<td>€132,000</td>
<td>€134,000</td>
<td>€134,000</td>
<td>€134,000</td>
<td>€134,000</td>
</tr>
<tr>
<td>FY15</td>
<td>€400,000</td>
<td>€132,000</td>
<td>€134,000</td>
<td>€134,000</td>
<td>€134,000</td>
<td>€134,000</td>
</tr>
<tr>
<td>Total</td>
<td>€1,200,000</td>
<td>€132,000</td>
<td>€266,000</td>
<td>€400,000</td>
<td>€268,000</td>
<td>€134,000</td>
</tr>
</tbody>
</table>
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Overview of R&D regime
Overview of R&D regime
Key highlights

► Qualifying R&D project with 20% grant aid:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>R&amp;D spend of</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Grant aid</td>
<td></td>
<td>(20)</td>
</tr>
<tr>
<td><strong>Net of grant aid</strong></td>
<td><strong>80</strong></td>
<td></td>
</tr>
<tr>
<td>CT deduction @ 12.5%</td>
<td>(10)</td>
<td></td>
</tr>
<tr>
<td>R&amp;D credit @ 25%</td>
<td>(20)</td>
<td>(30)</td>
</tr>
<tr>
<td><strong>Net cost</strong></td>
<td></td>
<td><strong>50</strong></td>
</tr>
</tbody>
</table>

► Significantly reduces net cost of doing R&D in Ireland
► Accelerate investment – provide a budget to pay for targeted hires
► Increase ROI on R&D spend
► Increase margins on qualifying projects
► **Can account for the R&D tax credit above the profit line**
Overview of R&D regime
Key highlights (cont’d)

► Credit in addition to corporation tax deduction
  ► 37.5% tax relief on net of grant expenditure

► How is relief obtained:
  ► Credit to be offset against current year corporation tax liability
    ► Excess R&D tax credits can be carried back and offset against corporation tax paid in the previous year
  ► Claimed on corporation tax return
  ► Cash refunds for excess credits
  ► Claims must be made within 12 months of the period end

The introduction of a cash refund scheme can offer significant cashflow and financial statement benefits
Overview of R&D regime
Key highlights (cont’d)

► Limits on subcontracting costs capped at the greater of:
  ► Up to 5% (University or Institute of higher education) and 10%/15% of qualifying in-house R&D spend where subcontracted to an unconnected third party respectively, or
  ► €100,000

► Managing and controlling R&D performed by 3rd parties
► For 2012 onwards, onus on principal to claim the R&D benefit and notify subcontractor in writing
  ► Insert clause in contract terms
  ► Letter of notification etc.
  ► Form CT1 panel to be completed

Always bear in mind the 25% incentive when negotiating with R&D subcontractors
Overview of R&D regime
Key Finance Act (No.2) 2013 changes

- Increase volume base credit from €200K to €300K
- Outsourcing limits for unconnected third parties increased from 10% → 15%
- Key employee – claw back provisions onus now on the company

<table>
<thead>
<tr>
<th></th>
<th>Pre Finance Act (No.2) 2013 €</th>
<th>Post Finance Act (No.2) 2013 €</th>
<th>Difference €</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-house R&amp;D expenditure</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>Nil</td>
</tr>
<tr>
<td>Subcontracted R&amp;D expenditure*</td>
<td>150,000</td>
<td>225,000</td>
<td>75,000</td>
</tr>
<tr>
<td>(10%)/(15%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base Year R&amp;D expenditure 2003*</td>
<td>100,000</td>
<td>0</td>
<td>100,000</td>
</tr>
<tr>
<td>(€200K/ €300K volume basis)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Qualifying R&amp;D spend</td>
<td>1,550,000</td>
<td>1,725,000</td>
<td>175,000</td>
</tr>
<tr>
<td>R&amp;D tax credit</td>
<td>387,500</td>
<td>431,250</td>
<td>43,750</td>
</tr>
</tbody>
</table>

*Subcontracted expenditure €300,000  Base Year expenditure €300,000
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Overview of R&D regime
Key employee

- Must be 50% involved in R&D
- Poor uptake
- Claw-back provisions
- Capped at corporation tax liability
- Effective income tax rate cannot be <23%
- Cannot be director or connected to director
- Cannot have >5% shareholding

Key Employee

Claw-back provisions

Effective income tax rate cannot be <23%

Cannot be director or connected to director

Cannot have >5% shareholding

Key Employee

Poor uptake

Capped at corporation tax liability

Overview of R&D regime
Key employee

Page 12  18 February 2014  The R&D Tax Credit Regime
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R&D activities means:

1. Systematic, investigative or experimental activities
2. In a field of science or technology
3. Being one or more of the following categories of R&D:

- **Basic Research** (experimental/theoretical work without a specific objective)
- **Applied Research** (work undertaken for a specific objective) or
- **Experimental Development** (producing new/improving existing, materials, products, devices, processes, systems or services including incremental improvements thereto)

It’s not just people in white coats in labs that qualify!
4. Scientific or technological advancement

Activities which **seek** to achieve an advance in science or technology

5. Scientific or technological uncertainty

The solution, or method of arriving at the solution is not readily apparent to an appropriate skilled competent professional

AND
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Accounting test
“expenditure incurred by the company wholly and exclusively in the carrying on by it of R&D activities..”

► Staff costs **and overheads** directly attributable to R&D activities, including:

► Salaries of R&D personnel

► Directly attributable costs

► Plant and machinery

► Third party royalties
Accounting test
Examples of some eligible costs

N.B., Any tax allowable expense incurred in the carrying on of qualifying R&D activities of the claimant.
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Overview of documentation requirements
Overview of documentation requirements

► Self assessment
► Write up on a project by project basis
► Key documentation requirements of Irish Revenue
  ► Satisfy both accounting and science tests
Overview of documentation requirements

- No standard template used by Revenue
- Project reports do not have to be submitted to Revenue unless requested
- 23 Point Revenue Query letter (next slide)
- Ensure written by a scientist/technologist and **not** an accountant
- Bear in mind external expert used by Revenue
Overview of documentation requirements
Revenue’s query letter

*R&D department:*
1. The number of projects undertaken?
2. Summary of the R&D activities for each project?
3. Date the project started?
4. Date the project ended (if applicable)?
5. Specific scientific/technological advancement sought at the start of the project?
6. Specific scientific/technological uncertainty the company sought to resolve at the start of the project?
7. Was the solution already known to a competent professional in the field?
8. The field of science/technology involved?
9. The type of R&D, being one/more of the following:
   - Basic research,
   - Applied research, or
   - Experimental development
10. Where did the R&D activities take place?
11. If claiming for subcontracting activity, outline the work carried out by those other parties?
Overview of documentation requirements
Revenue’s query letter

Finance/HR department:

1. Is the claim in respect of s766 or S766A TCA 1997?
2. The amount of the FY2003 base year amount?
3. Has all group spend been included in the FY2003 base year?
4. Once the uncertainty has been resolved, confirm no further spend attributed to R&D?
5. Qualifications of each project leader?
6. The number of staff employed in R&D activities?
7. Quantify expenditure paid to a third party contractor/service provider?
8. Quantify expenditure paid to a university/institute?
9. Where spend allocated to R&D by apportionment, detail the basis and method used?
10. If claim includes P&M, state the % used in R&D over the useful economic life of the asset?
11. Details of any grants received in respect of R&D?
12. Computation of tax credit claimed for the accounting period, showing itemised analysis of each expenditure item?
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Putting a framework in place
Putting a framework in place
Annual process

### Identify
- Identify your target projects within your business
- Identify and categorise the project staff
- Articulate the scientific/technological advancement and uncertainty present in the project
- Consider concise front-end assessment

### Quantify
- Determine which activities have contributed to the scientific/technological advancement and uncertainty
- Understand how the project staff have contributed to the qualifying activities by individual or role
- Allocate qualifying percentages to staff/roles

### Substantiate
- Finalise project write ups
- Leverage existing internal company documentation including grant claims/patent applications etc.,
Putting a framework in place
Documenting projects

<table>
<thead>
<tr>
<th>Technical</th>
<th>Purpose of the Project</th>
<th>Technical Objectives</th>
<th>R&amp;D Methods and Activities</th>
<th>Personnel Involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>Treatment of Grants</td>
<td>Computation of Credit</td>
<td>Expenses per Project</td>
<td>Apportionment Methodology</td>
</tr>
</tbody>
</table>

▶ Interaction between R&D dept. & finance dept.
How to prepare for a Revenue audit
How to prepare for a Revenue audit

Economic situation

- Increase in the number of claims for cash from Revenue
- Significant increase in the level of queries from Revenue
- R&D tax credit highly visible
- High risk area
- Many Revenue audits yield settlements
- Failing on the science test
- Failing on the accounting test
How to prepare for a Revenue audit
Types of R&D audits

Financial and tax audit
► Revenue will not appoint an expert to review the science test (at this point!)
► Will focus on the accounting test
► Qualifying expenditure

Scientific audit
► Revenue will appoint a technical expert
► Due diligence by the company first
► Non-disclosure agreement signed between Revenue and the expert
► Usually focus on the science test and the accounting test
How to prepare for a Revenue audit
Factors influencing audit selection?

- Industry Sector
- Size of the R&D claim
- Cash refunds vs. tax credits
- Compliant tax payer
- Track record with Revenue
- District Project
- Responses to Revenue Query Letter

Random Selection
How to prepare for a Revenue audit

Common pitfalls - science test

Companies are required to maintain and record source documentation to satisfy the science test. Should be maintained contemporaneously.

Technical documentation:

► Eligible Activities overlooked
► Activities don’t meet the technical criteria
► Company cannot identify project parameters
► When did the R&D project activities commence and cease?
► Poor presentation on site visit/lack of quality information
► Agile development methodology applied
► Not maintaining sufficient documentation
► Not being briefed by technical people
► Poorly prepared

Fail to prepare, prepare to fail!
Companies are required to maintain and record source documentation to satisfy the accounting test. Should be maintained contemporaneously.

Financial documentation:

- Base year incorrectly calculated/unsupported due to insufficient documentation
- Over allocation of costs
- Inclusion of non qualifying expenditure
  - Not tax deductible (e.g. depreciation)
  - Relates to R&D activities not carried on in the EEA
- Incorrect apportionments being used for salaries/overheads/plant and machinery
- Not apportioning costs for commencement/cessation of R&D projects
- Allocation methodology unsupportable

Fail to prepare, prepare to fail!
Companies are required to maintain and record source documentation to satisfy the accounting test. Should be maintained contemporaneously.

Financial documentation:

- No amendment of plant & machinery for usage test
- Capital expenditure does not qualify for capital allowances
- Incorrect treatment of subcontracted costs and agency staff
- Incorrect treatment of grants
- 12 month deadline is missed
- Order of offsets not applied correctly
- Refundable credit not appropriately capped

Fail to prepare, prepare to fail!
How to prepare for a Revenue audit

The process

- Main concerns – cost and reputation
- Code of Practice
  - 21 days notice of audit
  - 14 days issue notice of intention to make qualifying disclosure
  - Qualifying disclosure mitigates penalties and avoids publication and the risk of prosecution
- Financial and/or technical review
- Audits can be lengthy and costly process
How to prepare for a Revenue audit
Site visit presentations

Company overview

Science presentation

Accounting presentation

Source records
How to prepare for a Revenue audit
Scientific source documentation – some examples

Development Methodology Standards
Patents/ Patent Applications
Developer’s Journals/ Lab Notebooks
Defect Tracking Records
Test Results
Logs and comments from control systems
Project Plans
Defect Tracking Records
Test Plans
Design Review Minutes
Emails
Status/ Progress Reports
How to prepare for a Revenue Audit
Financial source documentation – some examples

Financial records

- P35 records
- Third party contracts
- P&L
- Base year documentation
- Apportionment methodology used
- Invoices
- Fixed asset register
- Grant documentation
- Corporation tax return and computations

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Page 37   18 February 2014   The R&D Tax Credit Regime
Continue to lobby for improvements

<table>
<thead>
<tr>
<th>Main areas where companies would like to see new features/improvements to the existing R&amp;D tax credit scheme</th>
<th>Have we seen changes?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency/contract workers</td>
<td>X</td>
</tr>
<tr>
<td>Outsourcing to third party companies</td>
<td>✓</td>
</tr>
<tr>
<td>Improved industry specific guidance</td>
<td>X</td>
</tr>
<tr>
<td>Simplification of calculation of the R&amp;D tax credit</td>
<td>X</td>
</tr>
<tr>
<td>Remuneration of key employees through the 'key employee' R&amp;D tax credit scheme</td>
<td>✓</td>
</tr>
<tr>
<td>Reduce current 4 year audit period</td>
<td>X</td>
</tr>
<tr>
<td>Development of IP incentives from the R&amp;D work carried out</td>
<td>X</td>
</tr>
</tbody>
</table>
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How EY can help
How EY can help

- How we can help
- Revenue audit support
- Prepare technical project reports
- Feasibility study
- Mock audits
- Conduct technical interviews
- In house R&D workshops
- R&D grant assistance
- Develop optimal claims methodology
- Calculate R&D expenditure
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