KPMG

Guidance note: Accounting for R&D tax credits

Overview of research and development tax credits

The R&D tax credit was first introduced in 2004 and since then has been amended and enhanced frequently. The credit is available to companies and groups subject to Irish taxation that undertake qualifying R&D activities in the European Economic Area ("EEA"). In the case of an Irish resident company, the tax credit is only available if the R&D expenditure is not otherwise available for foreign tax benefit.

In the first instance, the credit can be used to reduce current year corporation tax liabilities. Where you do not have sufficient corporation tax liabilities in the current period, the credit is available to carry back to the preceding tax period or for carry forward to future tax periods.

Instead of carrying forward the tax credit, companies can also in certain cases opt to have any remaining credit refunded to the company over three years.

To see if you may be available to claim the R&D tax credit use KPMG's assessor at www.kpmg.ie/RDassessor or consult one of our R&D tax credit specialists (see contact details below).

Key reminders on R&D tax credits

- You could be entitled to a cash refund over a three year period from Revenue worth up to 25% of your qualifying R&D expenditure;
- The credit is available in addition to the trading deduction for R&D spend which can result in a net subsidy of 37.5% (i.e. 25% R&D tax credit plus the standard 12.5% trading deduction);
- Eligible expenditure can include direct expenses (e.g. salaries, certain overheads, materials) that are deductible for the purposes of corporation tax;
- Certain expenditure on plant and machinery used for R&D activities can qualify for R&D tax credits;
- Certain outsourced R&D spend can also qualify;
- Key R&D employees can also benefit from an employee reward mechanism allowing them to receive part of their remuneration tax free;
- Claims must be made within 12 months of the end of the relevant accounting period.
- All of the above are subject to certain conditions, which you should consider thoroughly with your tax advisor prior to submitting an R&D tax credit claim.

Accounting for the Irish R&D tax credit

This guidance note outlines the accounting standards and policies that should be used in accounting for R&D tax credits under IFRS and now also under new GAAP (FRS 101 and FRS 102). Please note that if a company receives other forms of tax credits, then they will need to be analysed separately from this guidance, the guidance below is solely in respect of Irish R&D tax credits.

Clients transitioning from Irish GAAP to FRS 101, FRS 102 or IFRS in the current year that may have previously presented the Irish R&D tax credit as part of the tax line will need to consider whether this approach continues to be appropriate under the new accounting framework. It would appear that the Irish R&D tax credit will be accounted for "*above the line*" from now on. Therefore clients will need to assess the impact that accounting for the R&D tax credit "*above the line*" would have on the presentation of the financial statements under a new accounting framework.

The guidance note also outlines the requirements of the standards and key issues that clients may need to consider on transition. It also provides guidance on the timing and recognition of the Irish R&D tax credit, including the period over which it should be recognised.

Presentation of the Irish R&D tax credit

IFRS and FRS 101

The R&D tax credit falls within the scope of investment tax credits ("ITCs") as it relates to specific expenditure on R&D activities. Accounting for ITCs is not addressed directly under IFRS because ITCs are specifically scoped out of IAS 12 *Income Taxes* (IAS 12.4) and IAS 20 *Government Grants* (IAS 20.2 (b)). The substance of the Irish R&D tax credit needs to be considered in determining the appropriate accounting treatment. In practice because ITCs are typically government incentive schemes delivered through the tax systems, entities generally account for ITCs using either IAS 12 or IAS 20.

In our view, the economic substance of the Irish R&D tax credit is that it is more akin to a government grant because the Irish R&D tax credit is independent of the amount of taxable profit or tax liability generated by an entity. Its purpose is to incentivise companies to invest in research and development activities. Therefore in our view, it is more appropriate to account for the Irish R&D tax credit by applying IAS 20. This is similar to the view taken in the past by the Accounting Committee of Chartered Accountants Ireland (CAI), when they reviewed the R&D tax credit previously, which considered that "*under IFRS, the R&D credit is, in substance, a government grant towards R&D expenditure*".

Therefore, it would appear that under IFRS and now also FRS 101 (which applies IFRS for recognition and measurement purposes), Irish R&D tax credits are more appropriately accounted for as pre-tax income "*above the line*" in the financial statements in accordance with IAS 20 *Government Grants* ("the government grant method").

Companies that are transitioning from Irish GAAP to IFRS or FRS 101 in the current year will need to consider the impact that the requirement to record the R&D credit "*above the line*" may have on their company. Please see transition guidance section below.

FRS 102

The presentation of the R&D tax credit under FRS 102 may represent a change from the previous presentation adopted under Irish GAAP. Under Irish GAAP when analysing the R&D tax credit legislation, the Accounting Committee of CAI permitted that the directors of a company had a choice of accounting policy between presenting the Irish R&D tax credit as a pre-tax government grant in accordance with SSAP 4 Government Grants or, alternatively as a reduction in corporation tax payable.

However under FRS 102, this accounting policy choice would no longer appear to be available. Under FRS 102 the Irish R&D tax credits would be subject to the same consideration as for IFRS and therefore in our view it is more appropriate to account for Irish R&D tax credits in accordance with Section 24 *Government Grants* of FRS 102. This will result in the recognition of the R&D tax credit above the line in the financial statements, which is the same as the treatment outlined above for IFRS and FRS 101.

Accounting treatment for Irish R&D tax credits

In applying IAS 20 *Government Grants* or FRS 102's Section 24 *Government Grants*, it is noted that in both circumstances in principle, government grants are recognised when "*there is reasonable assurance that the entity will comply with the relevant conditions and that the grant will be received*" (IAS 20.7 and FRS 102 Section 24.3A).

In our view, grants in such forms as the Irish R&D tax credits should be recognised on a systematic basis as the entity recognises an expense for the costs that the grants are intended to incentivise (IAS 20.12 and FRS 102 section 24.5D) i.e. in the period in which the related expenditure is reflected in profit or loss. To the extent the related expenditure is capitalised the government grant would be deferred on the balance sheet.

However, it is important to note that the individual facts and circumstances relating to each company and claim need to be considered in order to determine whether receipt and compliance is "*reasonably assured*". For example, a company with a history of successful claims for similar qualifying R&D would be more likely to reach the recognition threshold than one submitting its first untested claim.

Impact of transition from Irish GAAP to IFRS, FRS101 or FRS102

While the tax payable does not change as a result of the transition from Irish GAAP to IFRS, FRS 101 or FRS 102, the profit or loss classification of the Irish R&D tax credits will be different if they were previously presented as a reduction in corporation tax payable. The required presentation under the government grant method in the profit or loss is outlined below using a simple scenario for illustration purposes:

Operating profit	€4,000
Qualifying R&D spend	€2,000
Corporation tax rate	12.5%
Irish R&D tax credit rate	25%

Government Grant Method

Presentation of P&L	€
Government grant income	500[1 2]
Other operating profits	4,000
Profit before tax	4,500
Tax charge	(500)
Profit after tax	**4,000**
Accounting tax calculation for the government grant method	
Profit before tax	4,500
Adjustments:	
Non-taxable government grant income	(500)
Taxable profit	4,000
Tax charge at 12.5%	500

[1] Qualifying expenditure is calculated as €2,000 at 25% R&D tax credit rate

[2] Please note the government grant income shown above will not be highlighted specifically on the profit or loss. It will form part of other income and be shown separately in the note disclosure. It is shown separately above for illustration purposes.

Any change in accounting for the Irish R&D tax credit on transition to IFRS, FRS 101 or FRS 102 will result in presentation changes which will need to be captured on the company's transition note and then accounted for and presented consistently using the government grant approach going forward. Clients will need to be careful to ensure that they appropriately account for the transition and adopt appropriate presentation going forward.

Over what period is the credit recognised?

Under IFRS, FRS 101 and FRS 102, government grants should be recognised as income over the periods necessary to match them with the related costs they are intended to incentivise.

Therefore grants relating to operating expenditure such as salary and other periodic costs are normally recognised in profit or loss (if the related expenditure has been recognised in profit or loss) whereas grants relating to plant and machinery R&D expenditure or capitalised R&D expenditure is recognised as deferred income and taken to profit over the life of the related asset. An example of how R&D tax credits for capital expenditure are accounted for is provided at the end of this guidance note.

Classification of receivable

Where the R&D tax credit has been recognised in the current year's profit or loss, the related receivable should be classified as a current asset — a government grant receivable.

In cases where the benefit will be recovered in future years, the receivable should be allocated between current and non-current assets depending on when the company expects the benefit to be received.

Impact on tax reconciliation footnote

Ignoring deferred tax, the impact on a current tax reconciliation footnote is demonstrated below based on the previous simple example:

Tax Reconciliation for the Government Grant Method

	€
Profit before tax	4,500
At standard rate of 12.5%	563
Effects of:	
Non taxable grant income	(63)*
Corporation tax charge/(credit)	500

* Government grant of €500 at 12.5%

The reconciliation required under IFRS, FRS 101 or FRS 102, requires a reconciliation of total tax and not current tax which would have been presented previously under Irish GAAP.

Presentation of R&D tax credits for the purchase of plant and machinery

Certain expenditure on P&M used for R&D activities can qualify for the R&D tax credit. The R&D tax credit is available for tax purposes in the year the assets are purchased (or come into use for tax purposes) and will be set off against current corporation tax, prior year corporation tax and if either of the previous two options is unavailable due to an insufficient corporation tax liability for these periods, the company may have the option to

either receive the R&D tax credit over the next three years as a cash refund, where certain conditions are satisfied, or carry forward the R&D tax credit for use in future tax periods.

The accounting requirements for such P&M based R&D tax credits are the same as for general expense based R&D tax credits as discussed above for IFRS, FRS 101 and FRS 102, requiring government grant accounting. Government grant accounting requires the benefit to be amortised over the life of the related asset. This is demonstrated in the example below using the following simple assumptions (first 5 years shown):

Annual profit before depreciation	**€4,000**
Qualifying plant and machinery expenditure in year one	**€3,200**
Useful life of asset and period of capital allowances	**8 years**

Deferred tax will also arise because on a tax basis the credit will be received in year one, while on an accounting basis it is recognised over eight years.

Government Grant Method

	Year 1 €	Year 2 €	Year 3 €	Year 4 €	Year 5 €
Profit and loss account					
Profit before government grants	4,000	4,000	4,000	4,000	4,000
Government grant income[3]	100	100	100	100	100
EBITDA	***4,100***	***4,100***	***4,100***	***4,100***	***4,100***
Depreciation	(400)	(400)	(400)	(400)	(400)
Profit before tax	3,700	3,700	3,700	3,700	3,700
Tax charge	(350)	(350)	(350)	(350)	(350)
Profit after tax	***3,350***	***3,350***	***3,350***	***3,350***	***3,350***
Accounting tax charge calculation					
Profit before tax	3,700	3,700	3,700	3,700	3,700
Adjust for:					
Depreciation	400	400	400	400	400
Capital allowances	(400)	(400)	(400)	(400)	(400)
Grant income not taxable	(100)	(100)	(100)	(100)	(100)
Taxable profit	3,600	3,600	3,600	3,600	3,600
Tax charge at 12.5%	450	450	450	450	450
R&D tax credit	(800)	-	-	-	-
Deferred tax	700	(100)	(100)	(100)	(100)
Total tax	***350***	***350***	***350***	***350***	***350***

[3] Qualifying spend of €3,200 x 25% over 8 years

For more information on the R&D Tax Credit regime or accounting of same visit our website www.kpmg.ie/rd, or please contact:

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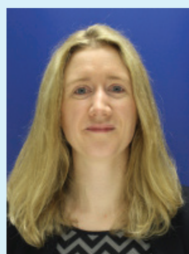

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