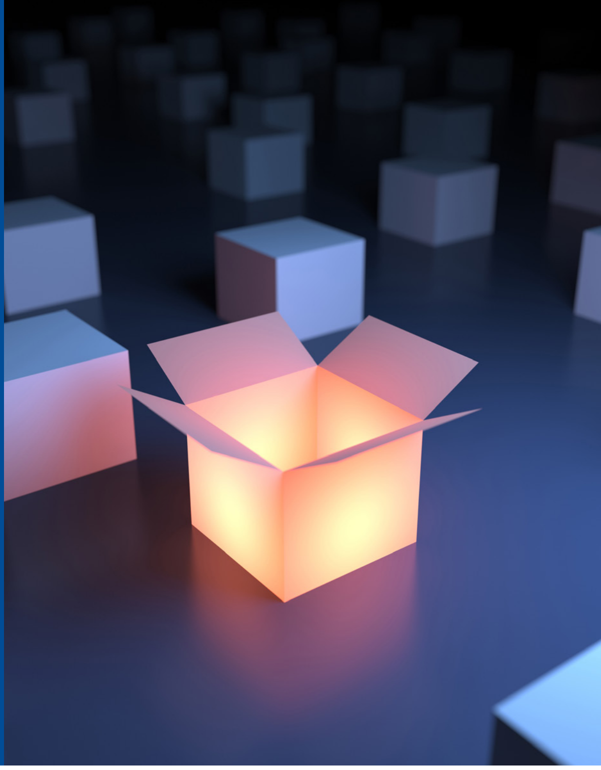
KPMG

Knowledge Development Box



Overview

The Knowledge Development Box (KDB), introduced in Budget 2016, is aimed at incentivising companies to undertake innovative activities in Ireland by providing a 6.25% corporate tax rate for income generated from commercialising certain intellectual property ("IP").

The KDB applies to accounting periods commencing on or after 1 January 2016 and the relief must be claimed within a two year period from the end of the accounting period to which the claim relates. In order to qualify for the KDB rate, the income generated from the IP must flow into the same entity that undertakes the R&D activities leading to the IP creation.

The KDB is designed to complement the other innovation tax incentives in Ireland, targeting different stages of a company's IP development:

- the R&D tax credit supports firms at the time they are undertaking the actual R&D which generates the IP;
- the intangible assets relief reduces the after tax cost to companies who are investing in and exploiting certain intangible assets and using them in respect of their Irish trade; and
- the KDB targets the future income that is generated from the results of the R&D activity.

Key facts about the KDB:

- The corporation tax rate for income qualifying for relief is 6.25%.
- The KDB applies for accounting periods commencing on/after 1 January 2016 and a claim must be made within two years from the end of the accounting period.
- Relief under the KDB is linked to the proportion of qualifying R&D expenditure being incurred by the Irish company as a percentage of overall group R&D expenditure on the same IP asset.
- The IP must be the result of R&D activities as defined by the R&D tax credit legislation.
- Smaller companies will not be required to patent their IP – "patentable" is sufficient.
- The income generated from the IP must flow into the same entity that undertakes the R&D.
- The nexus formula must be used to determine how much of the IP income qualifies for the KDB.
- Taxpayers will be obliged to 'track and trace' and provide documentary evidence of expenditure incurred, income generated from the IP assets, and activity undertaken to generate the IP assets.

What intellectual property qualifies for the KDB?

The IP that qualifies is restricted to:

- Certain patented inventions and copyrighted software.
- Plant breeders' rights, supplementary protection certificates for medicinal products and plant protection certificates.

Marketing related IP such as trademarks, brands and image rights do not qualify for the KDB.

Small companies:

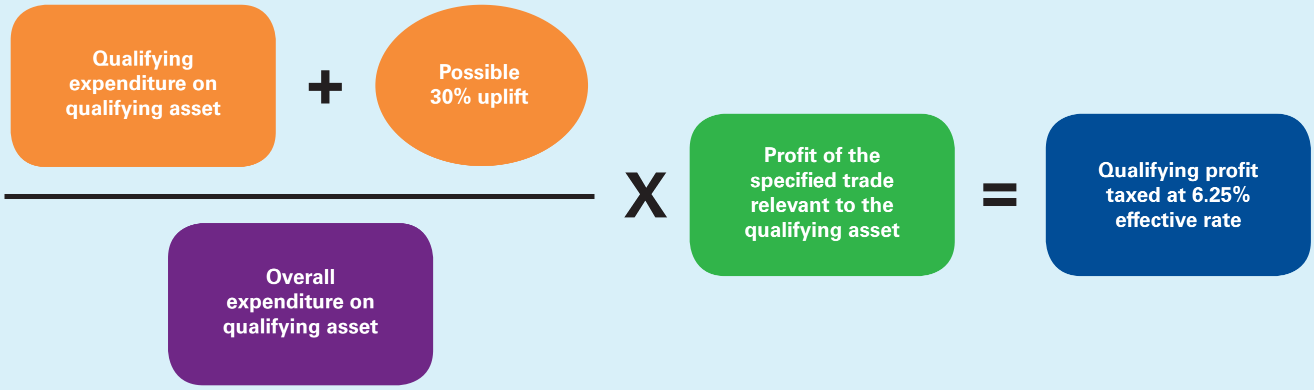
Smaller and medium sized companies (defined for this purpose as companies with annual income from IP not in excess of €7.5m, which employ less than 250 people and which have a turnover of less than €50m or a balance sheet of less than €43m) may be permitted to expand the definition of intellectual property to include inventions that are certified as being novel, non-obvious, and useful. In other words, the IP must be "patentable", but not patented.

"Modified nexus"

The KDB follows the "modified nexus" approach endorsed by the OECD. This approach links the KDB relief to the proportion of qualifying R&D expenditure being incurred by the company in Ireland as a percentage of overall group expenditure.

In simple terms, the higher the proportion of R&D that takes place in the Irish entity, the greater the proportion of income that may qualify for the KDB rate.

The "qualifying profit" to which the KDB rate applies is determined by reference to the following 'nexus formula':



a) What is qualifying expenditure?

Qualifying expenditure means expenditure incurred by the company itself on R&D activities, where such activities lead to the development, improvement or creation of the qualifying asset (i.e. the IP). This includes outsourcing costs to unconnected parties.

Recognising that companies may acquire IP and outsource R&D activity to a group company while still being responsible for much of the value creation that contributed to IP income, the KDB regime allows an up-lift in the amount of qualifying expenditure, to include the lower of:

- 30% of the amount of the qualifying expenditure, or
- the aggregate of acquisition costs and group outsourcing costs.

b) What is overall expenditure?

Overall expenditure includes:

1. Qualifying expenditure as above

   +

2. Any acquisition costs in relation to the qualifying asset

   +

3. Expenditure incurred by group companies for the carrying on of R&D, including related-party cost-sharing arrangements.

The KDB relief available will be reduced where the intellectual property has been acquired by the company (from a third party or a group company) or where the company outsources R&D activities to another group company. Conversely, where an Irish company does all of the R&D work in-house, the KDB could be of significant benefit.

c) What is "profit of the specified trade relevant to the qualifying asset"?

This includes:

1. Royalties,
2. License fees, and
3. Insurance, damages or compensation,
4. The portion of income from sale of a product or service which relates to the IP (embedded IP).

A company must also deduct appropriate expenses incurred in earning the income. Therefore it is the net profit attributed to the qualifying asset that qualifies for the KDB 6.25% tax rate.

Transfer pricing

Unlike large companies, SMEs will not be required to apply arm's length transfer pricing practices when it comes to determining the market value of the intellectual property, apportioning income to the qualifying asset, apportioning R&D activities and expenditure, and so on. Instead, SMEs will be required to apportion income on a "just and reasonable" basis, which should reduce the administration cost of claiming the KDB for SMEs.

Documentary evidence

Taxpayers will be obliged to 'track and trace' and provide documentary evidence of expenditure incurred, income generated from the IP assets, and activity undertaken to generate the IP assets. Companies claiming the R&D tax credit may be able to leverage the information already maintained for the purposes of claiming the credit when claiming the KDB.

KDB and the R&D tax credit

The KDB will be granted only where the qualifying assets are the result of qualifying R&D activities that have been carried out by the entity claiming the tax benefit. The definition of "R&D" mirrors the definition for the purposes of the R&D tax credit. Likewise, the definition of qualifying expenditure is similar for the KDB and the R&D tax credit.

Claiming the KDB should therefore be a natural extension for those companies already availing of the R&D tax credit on an annual basis.

Revenue audits

Similar to the R&D tax credit, Revenue will be able to consult with technical experts in relation to many aspects of the KDB regime. Given the similarities, we would expect that Revenue will conduct R&D tax credit and KDB audits simultaneously.

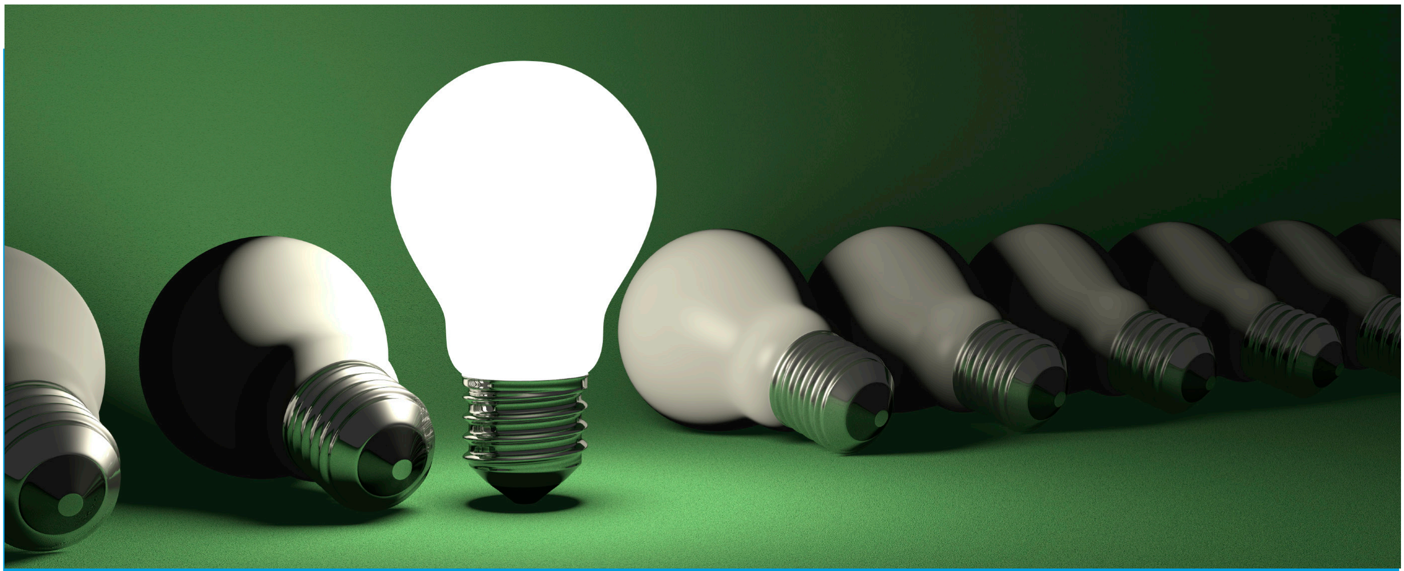
Example 1:

- Company A, an Irish Indigenous SME.
- Incurred €500k on its own R&D activity relating to the development of a qualifying asset.
- No outsourced R&D.
- Net profits of €1m relating to the qualifying asset.
- The amount of qualifying profit available for the KDB tax rate would be:

$$\frac{\text{€500k}}{\text{€500k}} \times \text{€1m} = \text{€1m}$$

- Therefore, the full €1m is available for the reduced KDB rate.
- The corporation tax payable in this instance would be **€62,500**, versus **€125,000** without the KDB.

Example 2:



- Company B, a multinational company based in Dublin.
- Incurred €500k on its own local R&D activity relating to the development of a qualifying asset.
- Sub-contracted €500k to a group company based in the USA for R&D work on the same qualifying asset.
- Net profits of €1m relating to the qualifying asset.
- The 30% uplift is the lower of 30% of the qualifying expenditure (i.e. €500k x 30% = €150k), or the aggregate of acquisition costs and outsourcing costs (i.e. 500k)
- The amount of qualifying profit available for the KDB tax rate would be:

$$\frac{\textbf{€500k (+ 150k uplift)}}{\textbf{€1m}} \;\; \mathbf{x} \;\; \textbf{€1m} \;\; \mathbf{=} \;\; \textbf{€650k}$$

- Therefore, only 65% (€650k) of the profits relating to the qualifying patent are available for the reduced KDB rate.
- The remaining €350k would be taxed as normal at 12.5%.
- The corporation tax payable in this instance would be **€84,375**, versus **€125,000** without the KDB.

Revenue Guidelines

Revenue Guidelines on the KDB are currently being drafted and are expected to be published early in 2016. These should provide clarity on how exactly the Revenue envisages the KDB working in practice.

About us

KPMG's R&D Incentives Practice is a multidisciplinary practice comprising highly trained tax, finance, science and engineering professionals who specialise in assisting companies prepare R&D tax credit claims. We are highly experienced in helping our clients identify qualifying R&D activities and related expenditure, and can work with companies to identify the assets and income that would come within the KDB.

Contacts:

Anna Scally
Tax Partner
t: *+353 1 410 1240*
e: *anna.scally@kpmg.ie*

Damien Flanagan
Director
t: *+353 1 700 4214*
e: *damien.flanagan@kpmg.ie*

kpmg.ie/KDB

Produced by: KPMG's Creative Services. Publication Date: January 2016. (1287)