



R&D Tax Credit Revenue Audits: Be Prepared

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Introduction

The R&D tax credit is one of Ireland's key offerings to attract foreign direct investment (FDI) and encourage entrepreneurs to grow their businesses in Ireland. There is no doubt that it is an important and valuable tool in Ireland's innovation toolbox.

That said, the cost to the State is significant (€553m in 2014, with 1,570 companies filing claims) and has increased by a factor of 2.5 over the past five years.¹ Perhaps this increased cost is a consequence of the success that we have had in attracting FDI

into Ireland and fostering the growth of entrepreneurship and innovation among our indigenous firms.

Given the high cost to the State and the fact that the R&D tax credit falls under the self-assessment corporation tax system, Revenue audits of R&D claims are an accepted fact of life.

In 2013, during the Department of Finance's review of the R&D tax credit, *The Irish Times* ran a front-page article with the headline "Revenue to Move on Tax Research Loophole as Millions Lost".²

¹ See www.revenue.ie/en/about/publications/corporation-tax-receipts-2014-2015.pdf.

² See <http://www.irishtimes.com/business/revenue-to-move-on-tax-research-loophole-as-millions-lost-1.1491122>.

The article referred to the fact that statistics provided in response to a request under the Freedom of Information Act showed that in 80% of R&D tax credit cases examined settlements were made. The article expressed concern that this indicated that the R&D tax credit system was being abused.

It is important to note that there is no pre-authorisation of claims, there is no immediate verification and acceptance process. It is only really once an audit has been conducted and concluded that one can have certainty on the quantum of credit available for the period(s) under audit. Your claim may be subjected to Revenue audit up to five years after the year in which the R&D activities have taken place.

If we consider the significant level of subjectivity involved in the R&D tax credit legislation, the 11 iterations of Revenue guidance since 2004, the potential time lag between the R&D, and the audit and the high costs associated with proceeding to tax appeal, it is disappointing but perhaps unsurprising that a significant proportion of audits will result in settlement.

Claiming the valuable credit is important. Maintaining a high level of confidence over the credit you have claimed and its ability to withstand a Revenue audit while minimising any settlement is crucial.

An Aspect Query Letter or Revenue Audit Notification Lands on Your Desk – What Next?

An aspect query is a form of non-audit intervention by Revenue. From an R&D tax credit perspective, it usually begins with Revenue issuing a letter with 23 to 25 questions that seek specific, detailed information about the activities and expenditure included in your claim. Many Revenue Districts will issue the letter before a refund is processed.

The best approach is to address the queries quickly and comprehensively. Revenue will often not respond once you send the requested information. It is important to bear in mind that this silence or the subsequent payment of the credit is not an acceptance of the claim and you could still be subjected to an audit.

The same list of queries is typically used by Revenue at the start of a formal audit.

It is important to keep in mind that failure to defend a claim in the event of an audit can lead to denial of all or some of the credit claimed, resulting in repayment of any overclaimed credit along

with interest. Revenue may seek to impose penalties, and in extreme cases there is a risk of publication.

Typical Information Requested by Revenue

It is worth considering whether you could answer all of the questions below for each project included in an R&D tax credit claim – and, importantly, whether you could provide evidence to prove it.

- (1) State the number of R&D projects undertaken.
- (2) Provide a summary of the R&D activities in relation to each project.
- (3) Confirm the date on which each project commenced.
- (4) Confirm the date on which each project ceased (if applicable).
- (5) Confirm whether the claim made is in respect of s766 or s766A of TCA 1997.
- (6) State the amount of the 2003 expenditure threshold amount.
- (7) Confirm that all group expenditure has been included in the threshold amount.
- (8) Outline the specific scientific or technological advancement that the company sought to achieve at the start of each project.
- (9) Outline the specific scientific or technological uncertainty that the company sought to resolve at the start of each project.
- (10) Once the uncertainty was resolved, confirm that no further expenditure has been attributed to the R&D claim.
- (11) Was the solution already known and available to a competent professional in the field?
- (12) What were the qualifications of each project leader?
- (13) State the field of science or technology involved.
- (14) Confirm which of the following categories the activities fall under:
 - › basic research
 - › applied research

- › experimental development.

(15) Where did the R&D activities take place?

(16) State the number of staff employed in R&D activities.

(17) Confirm the amount of expenditure incurred (if any) in respect of third-party contractors or service providers (excluding utilities).

(18) Confirm the amount of expenditure incurred (if any) in respect of payments made to a university or institute.

(19) In respect of (17) and (18) above, briefly outline the work carried out by the other parties.

(20) Where expenditure has been allocated to R&D by apportionment, state in respect of each item the method and basis used.

(21) If the claim includes expenditure on plant and machinery, state the percentage used of such equipment on R&D over the useful economic life of the asset.

(22) Provide details of any grants received in respect of R&D.

(23) Provide your computation of the tax credit claimed, showing an itemised analysis of each expenditure item.

(24) Provide details of any R&D work carried out on behalf of other parties and details of payments received.

(25) Provide a computation of the R&D claimed, showing the figures as input in the corporation tax return, taking into account the limits as applied, if applicable, as per the Revenue Guidelines.

What Does an R&D Tax Credit Audit Involve?

An audit involves Revenue examining whether:

- › the company is entitled from a legislative perspective to claim the credit,
- › the activities included in the claim meet the necessary criteria to be considered “R&D activities” for the purposes of the R&D tax credit (what Revenue calls the “science test”),
- › the expenditure included in the claim has been properly treated and is expenditure incurred wholly and exclusively by the company in the carrying on by it of R&D activities (what Revenue calls the “accounting test”) and

- › there is on balance sufficient, relevant and contemporaneous evidence that the accounting and science tests have been met.

Science test

The science test is typically conducted by Revenue’s appointed technical expert and involves a review on site at a company’s facility. For each project included in the claim, the relevant project technical lead(s) must present the case for why the company believes that the activities meet the necessary R&D tax credit criteria and that there is sufficient evidence available to demonstrate that this is the case. This can often take a number of days, depending on the number of projects involved. Revenue’s expert may robustly challenge the position put forward by the company to determine whether it stacks up. It is crucial that the project leads are available, prepared and tuned into the evidence that is available to support their project. If steps are not taken, issues can arise where key staff leave the business or if evidence/documentation is not appropriately maintained over time.

Accounting test

The accounting test involves a detailed examination of all expenditure items included in a claim. The legislation (s766(7) (a) TCA 1997) provides that the technical expert appointed by Revenue is to assist Revenue in ascertaining whether the expenditure incurred by the company was incurred in the carrying on of R&D activities. Increasingly, technical experts appear to be involved in determining the reasonableness of the costs included in the claim.

The accounting test may include a review of the methodology and controls in place to capture relevant R&D expenditure and a detailed review of the calculations and underlying primary records (e.g. invoices, contracts) for expenditure such as staffing costs, overheads and materials consumed in the R&D process, equipment used in the R&D and outsourced R&D payments.

Why Might Disagreements Arise?

Given the subjectivity involved, during an audit it is possible that the company and Revenue will not agree on every aspect of a claim. Examples of the various reasons for this are given below.

Effect of time lag between claim and audit

Disagreements can arise where later versions of Revenue’s Guidelines are used by Revenue for audits of earlier-year claims.

This can lead to a mismatch between Revenue expectations and the company's understanding of the requirements at the time that the claim was prepared.

Although the legislation has remained constant, there are clear and notable differences between the 2011, 2012 (published in February 2013) and 2015 Revenue Guidelines on a number of important matters. We have also experienced an evolution in the practice applied during audits over the past number of years. Notable examples of where guidance and practice appear to differ in more recent years include:

- › The eligibility of supporting activities that are crucial to the carrying on of the R&D. These activities were specifically permissible before the 2012 Guidelines but are no longer widely accepted.
- › The eligibility of overhead costs incurred to facilitate the R&D. Although previously accepted in practice, many overhead-type costs are no longer accepted.
- › The 2015 Guidelines introduced for the first time the concept of deducting the lower of cost and net realisable value from the cost of any materials that are sold after being used in the R&D process.
- › The approach adopted by technical experts has also evolved over time as a result of the changes in Revenue guidance relating to R&D activities and documentation requirements.

Other relevant factors

- › The definition of qualifying R&D is subjective. Revenue's experts are independent and thus bring with them a variety of academic and industry experience and differing expectations of what R&D is. It is often the case that technical experts are provided with the latest Guidelines by Revenue. It appears that the framework set out in the Guidelines, rather than the legislative definition of R&D activities, often influences the expert's ultimate decision.
- › Revenue's expectations for documentation may not match the reality of what has been maintained by the company to enable the R&D to be carried out.
- › Professional advice may not have been taken, which can often result in a lack of awareness of the requirements of legislation, guidance, Revenue practice etc.

How Does an Audit Conclude?

After applying the science and accounting tests and if there are no areas of disagreement, Revenue will issue a letter informing the company that the audit has concluded.

If there are areas of disagreement, the company has a number of options, including:

- › work to arrive at a mutually agreeable position with Revenue, which may result in a settlement, or
- › take the matter to be heard by the Tax Appeals Commission.

The quantum of credit at stake is generally a key deciding factor in the route that a company may wish to take.

What Steps Should I Take to Be Prepared for an Audit?

Prepare for success and take action at the earliest opportunity. Ideally, steps would be taken before you start the R&D, but action taken at any stage can improve the outcome of your audit.

Before the R&D begins

- › Ensure that you are clear on what the criteria are for qualifying R&D activities, expenditure and documentation. The R&D tax credit's criteria are often not perfectly aligned with what a company might consider its R&D and associated R&D spend to be.
- › Ideally, at this point you should plan to structure efficient R&D tax credit documentation processes into your day-to-day activities. For example, although time sheets are not currently required, if you do not have them, you need to ensure that alternative evidence is available to support the time claimed.

During the R&D

- › Assign a "champion" internally to manage and police documentation and expenditure identification on a regular basis.
- › Develop a process to ensure that you are future-proofed against loss of corporate memory/evidence when key staff leave or internal systems are changed.

Before a claim is filed (or earlier if possible)

- › Take professional advice; this is a specialist and constantly evolving area. Although it is a tax legislative matter, it is truly a hybrid of science/technology and tax/accounting and requires an approach that considers all aspects.

- Only file a claim once you are confident that it would reasonably be expected to withstand a rigorous Revenue audit.

When an audit is announced

- Refresh. Often, much time will have passed since the R&D happened. In some cases Revenue will want to review in detail R&D activities that happened more than five years ago.
- Check that documentation is available and well organised.
- Be aware of the latest guidance and the guidance in place when the R&D was done/the claim was filed. Significant changes have occurred in the treatment of various items of expenditure between iterations of the Revenue guidance, particularly in the 2015 Guidelines.

Conclusion

The R&D tax credit is an important, valuable incentive for Irish-based businesses. The credit appears to be a crucial tool to attract companies to locate in Ireland and to stay and grow here, but it brings with it a significant cost to the Exchequer. In a

self-assessment system, it is understandable that Revenue audits of claims are necessary and to be expected.

That said, given the high proportion of audits that appear to result in settlement, it would probably be preferable for all stakeholders that steps be taken to reduce the degree of uncertainty presented by the current system. This uncertainty appears to stem from things such as the effects of the time lag between the R&D being done and the audit; a mismatch between Revenue expectations and taxpayer understanding, resulting from an evolution in Revenue practice; the subjective nature of the legislation and Guidelines; and the use of later guidance on earlier-year claims.

Taxpayers can take steps to mitigate this uncertainty and its associated risks (i.e. repayment, interest, penalties etc.) by ensuring that they are well prepared at the earliest opportunity in their R&D tax credit claim journey.

Read more on **taxfind** *The Research and Development Tax Credit - The Professionals' Guide, 2013*



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