Innovation Monitor

Insights into innovation and R&D in Ireland

2017/2018

Contents

Methodology:

This survey was conducted by Red C Research on behalf of KPMG. The survey was confined to businesses with at least 10 employees and quotas were placed on company size to ensure a nationally representative sample. Interviews were conducted with the Finance Director, Tax Director, or a similar individual in the company.

Executive summary

Ireland's open economy is highly exposed to the impact of geopolitical developments. This, combined with changes to customer behaviour, technologies, regulation, and demographics, has made innovation a strategic imperative for Irish businesses.

Research conducted by RedC Research on behalf of KPMG shows that innovation levels continue to increase. 88 percent of companies currently innovate in Ireland and/or abroad, up eight percentage points on 2016. Yet despite their innovative work, most have never claimed an R&D tax credit and many could potentially lose out on financial benefits through lack of awareness of the knowledge development box ("KDB").

In October 2016, the Department of Finance published an economic evaluation of the R&D tax credit regime, which concluded that the R&D tax credit is "reasonably successful in its aim of increasing business R&D"[i]. The evaluation concluded that 60 percent of research and development work was directly attributable to the R&D tax credit, while 40 percent would have taken place whether the credit was in place or not. To reduce the so-called 40 percent "deadweight" a number of suggestions have been proposed, which we put to our survey participants.

Seven in 10 said that a limit on the amount of cash refunds they could claim, or a reduction in the rate of the R&D incentive for non-taxpaying firms that avail of the refundable mechanism over a number of years, would reduce the attractiveness of the R&D tax credit.

It is important therefore that the impact of any proposed changes are fully considered before any action is taken. Equally important, particularly in the context of multinationals' investment decisions, is that there is no "uncertainty" in relation to the operation of the R&D tax credit, which is one of the key pillars of Ireland's corporation tax policy. Helpfully, the Government report published on 12th September entitled Review of Ireland's Corporation Tax Code, (otherwise known as the Coffey Report), recommended that no changes be made to Ireland's R&D tax credit regime or the KDB.

Damien Flanagan
Director, Tax

We also asked how the attractiveness of the R&D tax credit as an incentive for R&D would be impacted if it was only available on incremental R&D spend in excess of the prior year R&D spend: 73 percent of companies believe this would have a negative impact.

While most companies (62 percent) consider Ireland "innovation friendly", this is down eight percentage points on last year. Businesses must innovate to maintain competitive advantage as they prepare for Brexit and it appears that access to funding and skills are the main barriers to increasing levels of R&D and innovation. These will be challenges for policy-makers in the coming months and years; incentivising and rewarding innovators has never been more important.

We hope you find this year's *Innovation Monitor* interesting and thought-provoking. If you would like to discuss how to build more innovation into your business, please do get in touch — our contact details can be found at the back of this report.

Key findings

88 percent of companies engage in innovative activity in Ireland and/or abroad (up eight percentage points on last year).

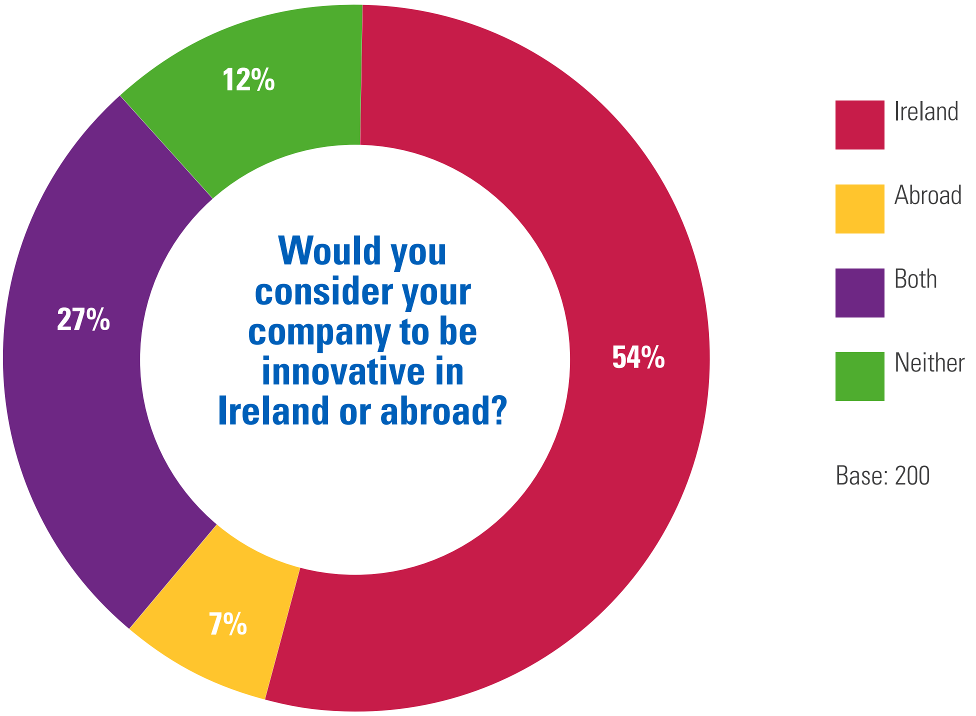
The availability of qualified in-house personnel (68 percent) and R&D funding (63 percent) are the factors most frequently cited by businesses when asked what influences their ability to innovate.

73 percent of companies say that the attractiveness of the R&D tax credit as an incentive for R&D would be negatively impacted if the Government was to reintroduce some form of mechanism that meant the credit was only available on incremental R&D spend in excess of the prior year R&D spend.

Limiting the amount of cash refunds a company can claim, or reducing the rate of the incentive for non-taxpaying firms that avail of the refundable mechanism over a number of years, would negatively impact the attractiveness of the R&D tax credit for seven in 10 companies.

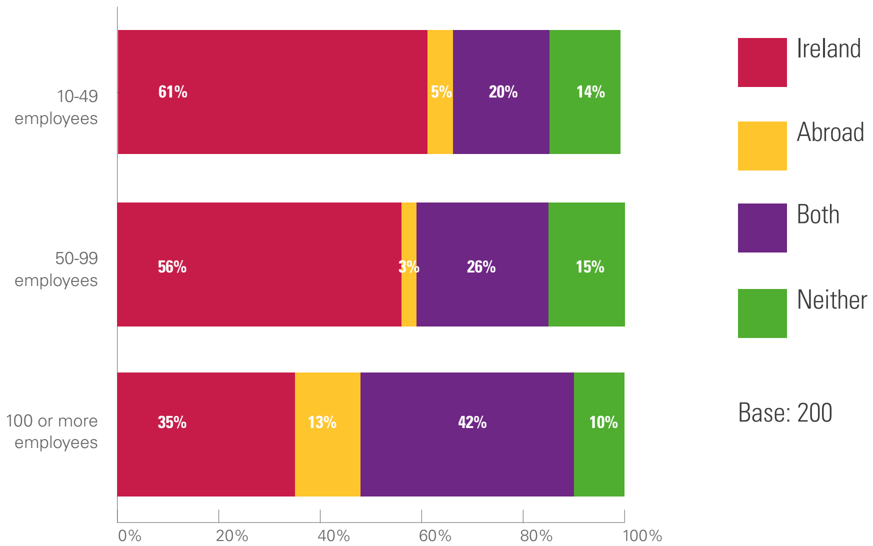
52 percent of companies were unaware of the KDB prior to this survey.

The innovators



Across Ireland, businesses of all sizes consider themselves to be innovators. 88 percent report that they are engaged in innovation, an increase of eight percentage points on last year. Of these, 81 percent innovate in Ireland, an increase of six percentage points.

Would you consider your company to be innovative in Ireland or abroad?



When asked whether they are innovative in Ireland and/or abroad, 61 percent of small companies innovate only in Ireland, compared to 56 percent of medium-sized companies and 35 percent of large companies.

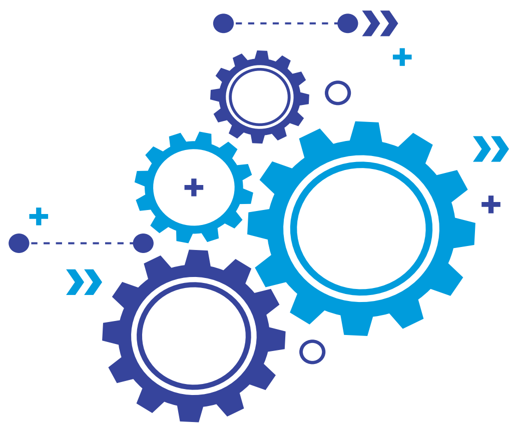
Yet, despite the high levels of activity, companies miss out on potential financial benefits through lack of awareness of the KDB and low uptake of the R&D tax credit.

Fewer than half of the companies surveyed were aware of the KDB (48 percent) and only 41 percent have claimed an R&D tax credit since the regime was introduced in 2004.

Large companies are almost twice as likely to claim the R&D tax credit as small companies (58 percent vs. 30 percent), suggesting that the more resources a company has, the more likely it is to claim the credit.

In line with last year, two-thirds (67 percent) of innovative businesses say their innovation work has not led to patented inventions or computer programmes protected by copyright. Most of this group (76 percent) do not believe their innovation work is patentable.

More positively, 70 percent of businesses with patented or patentable work expect to generate an income in Ireland from commercially exploiting their inventions or computer programmes; this is an increase of nine percentage points on last year.



Innovation culture

Government is a critical partner in Ireland's innovation culture, lowering the risk of capital through incentives and tax measures, and creating an ecosystem in which innovators can collaborate with one another to share ideas and expertise and create value.

Overall, 62 percent of businesses rated Ireland's innovation culture as either "friendly" or "very friendly", down eight percentage points on last year. This weaker sentiment may reflect the increased challenges businesses are facing as a consequence of Brexit and other external factors.

"The external forces like Brexit, mean people are worried. They are not overextending on expenditure at the moment unless they know where their chips are going to be coming from."

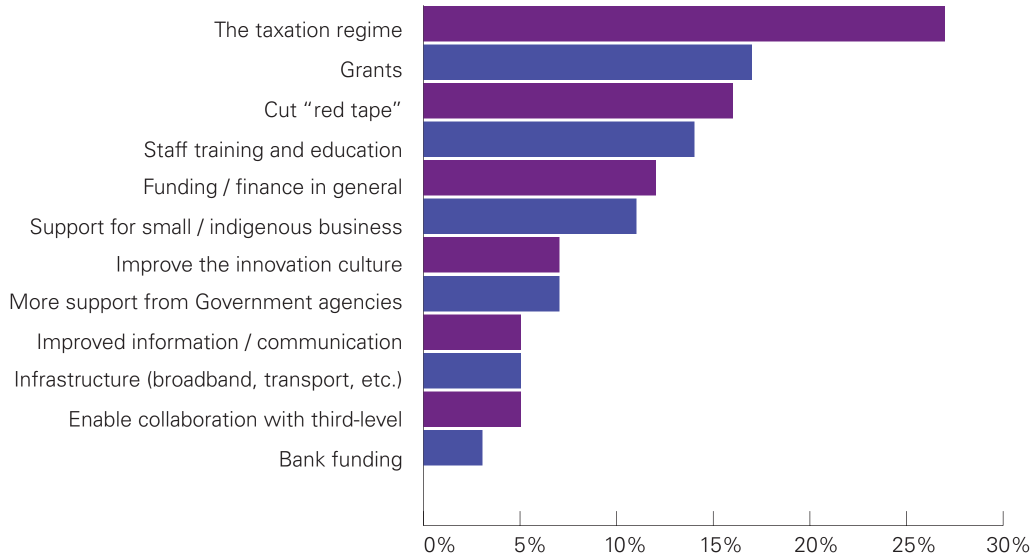
The largest companies are the most positive with 69 percent rating Ireland "friendly" or "very friendly" for innovation projects, compared to 59 percent of SMEs.

What would improve the conditions for innovation?

When companies were asked what would improve the conditions for innovation in Ireland, the following key themes emerged:

- The taxation regime (27 percent)
- Grants (17 percent)
- Cut "red tape" (16 percent)
- Staff training and education (14 percent)

What would you like to change to improve the conditions for innovation in Ireland?



Base: 200. Participants were invited to give more than one response

Consistent with previous *Innovation Monitor* reports, a significant majority of respondents focused on various types of innovation funding, from tax incentives and bank lending to the more general availability of finance. Typical responses included:

- "More tax incentives, especially for start-ups";
- "More information as to what is out there in terms of funding";
- "Offer more grant aid";
- "Improve the availability of credit".

The taxation regime and grants

Over one in four (27%) companies suggested tax changes to improve conditions for innovation.

Regarding the R&D tax credit, respondents cited difficulties in the administrative work required for a claim, and difficulties in applying legislation and Revenue guidelines in practice. There were calls for greater consistency between Revenue and grant bodies in respect of the criteria for the R&D tax credit and grants, and for better access to information about incentives generally.

Many respondents also proposed that more availability and awareness of tax incentives and grant schemes aimed specifically at start-ups would help to encourage innovation.

Reduce "red tape"

One in six companies called for a reduction in "red tape" and a more straightforward application process when applying for funding and incentives.

"I feel that there are a lot of good programmes out there to encourage innovation and support companies to do it, but they make you jump through hoops. There is too much paperwork and documentation; there is too much bureaucracy. It would almost turn you off proceeding with it."

Staffing, education, and training

Education and training issues were also flagged for improvement, with calls for greater emphasis on innovation and entrepreneurship at second and third-level.

"If we hire engineers there are very few who are educated in innovation in products or processes. They should be exposed to it at an earlier stage. They don't seem to be innovation aware in their daily thought; it is not a process they understand."

Additional areas of the innovation ecosystem requiring improvement include support for SMEs, access to information, ease of collaboration with educational institutions and/or other companies, infrastructure such as broadband and transport links, and attitudes to failure.

Funding & incentives

Grants and incentives are very important to Irish innovators, with 63 percent saying that the availability of grant funding would influence their decision to invest in innovation.

Survey participants were fairly evenly divided in their opinion on the most effective incentives for R&D. 35 percent favour competitive grant funding such as IDA or Enterprise Ireland grants, 30 percent favour R&D tax credits and 35 percent say both are equally effective.

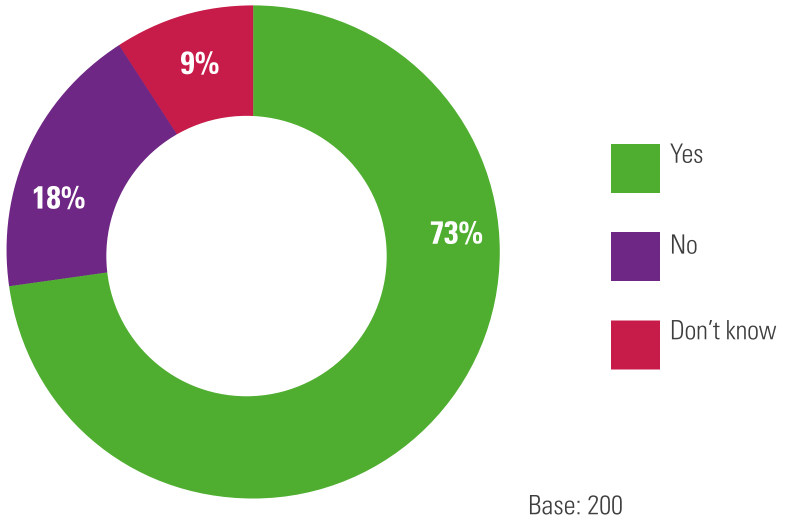
R&D tax credit

Introduced in 2004, the R&D tax credit was designed to stimulate innovation and attract investment and jobs. It is a 25 percent tax credit that can be offset against a firm's corporation tax liability or encashed if a company has insufficient corporation tax.

In October 2016, the Department of Finance published an economic evaluation of the R&D tax credit regime, which concluded that the R&D tax credit is "reasonably successful in its aim of increasing business R&D"[ii]. The evaluation concluded that 60 percent of research and development work was directly attributable to the R&D tax credit, while 40 percent would have taken place whether the credit was in place or not. To reduce the so-called 40 percent "deadweight" a number of suggestions have been proposed, which we put to our survey participants.

Possible changes suggested by the report to reduce the "deadweight" include either a limit to the number of times a company could receive the repayable credit, or a reduction in the rate of the incentive for firms availing of the refundable mechanism over a number of years. Large companies – who we found are more likely to be claiming the credit – took a more negative view of these proposals than smaller companies, with 75 percent having concerns that this would negatively impact the attractiveness of the credit as an incentive for R&D, compared to 65 percent of small companies.

If the Government was to reintroduce some form of mechanism that meant the R&D tax credit was only available on incremental R&D spend in excess of the prior year R&D spend, would you have concerns that this would negatively impact the attractiveness of the credit as an incentive for R&D?



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We also asked how the attractiveness of the credit as an incentive for R&D would be impacted if the Government was to reintroduce some form of mechanism that meant it was only available on incremental R&D spend in excess of the prior year R&D spend. Overall, almost three-quarters (73 percent) of the companies surveyed said it would negatively impact the attractiveness of the credit as an incentive. Once again large companies were the most strongly opposed (85 percent), compared to 65 percent of small companies.

In its research the Department of Finance also found that the credit is more effective in encouraging R&D in older firms than in younger firms; the majority of our respondents agreed that a separate R&D tax regime for newer firms is necessary to encourage R&D.

Revenue audit

51 percent of claimant companies have had an R&D tax credit claim subjected to a Revenue audit. This is an increase of eight percentage points over a two-year period, and reflects recently published statistics showing a stark increase in the number of Revenue interventions from 178 in 2015 to 276 in 2016 (a 55 percent increase)[iii].

Issues relating to the perceived complexity of the application process for the R&D tax credit and difficulties accessing information were raised by a number of respondents. One noted:

"They need to give businesses more information on the pros and cons of using these types of schemes, as they are a long term commitment. They need to show people all the different resources that they can avail of [and] have a marketing campaign to give more awareness of the benefits and issues."

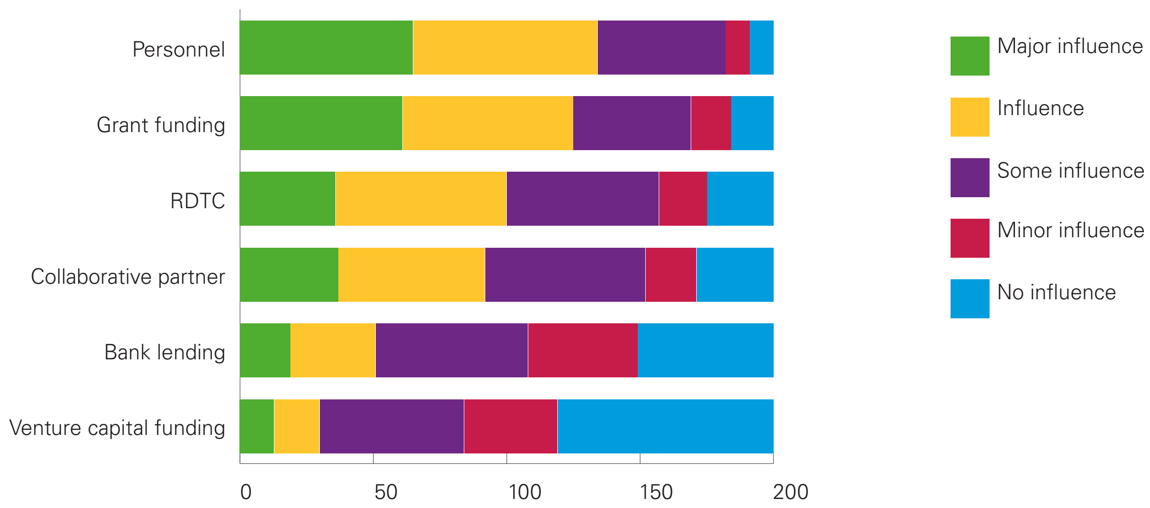
Knowledge development box (KDB)

Last year, KPMG found that companies were missing out on potential financial benefits of the KDB – which provides an effective tax rate of 6.25 percent on the profit earned by an Irish company on "qualifying assets" – through lack of awareness.

53 percent of respondents agreed that the 6.25 percent effective corporation tax rate under the KDB would be attractive to their company and just over a third (35 percent) agreed that they would be more likely to invest in innovation as a result of the KDB. However, while 22 percent expect to avail of the KDB in the near future, 41 percent believe the KDB won't apply to their business.

37 percent of companies say that better communication, of both incentive availability and eligibility criteria, is the single improvement they would like to see to both the R&D tax credit and KDB regimes.

What influences innovation?



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Deciding to innovate

The availability of talent

68 percent of companies rated the availability of qualified in-house personnel as an "influence" or "major influence" on their company's decision to invest in innovation projects, while access to talent is the area of Ireland's innovation culture they would most like to see improved.

"When companies are looking for talent for development in tech areas, you have to compete against the big multinational companies. It is easier for the larger companies to attract talent".

"If you are a small firm you want to be able to get someone to help you. Innovation takes a lot of time and you want someone to be able to do your job".

Grant funding and the R&D tax credit

63 percent of companies said that the availability of grant funding would influence their decision to invest in innovation, while half (50 percent) said that the availability of the R&D tax credit would influence them.

Collaboration

Collaboration is another important aspect of the innovation ecosystem. 47 percent of companies said that the availability of a collaborative partner such as a university would influence their decision to innovate.

"Make it easier for companies to collaborate with universities and research centres".

"More interaction between universities and the manufacturing sub-contractors".

Bank lending and venture capital funding

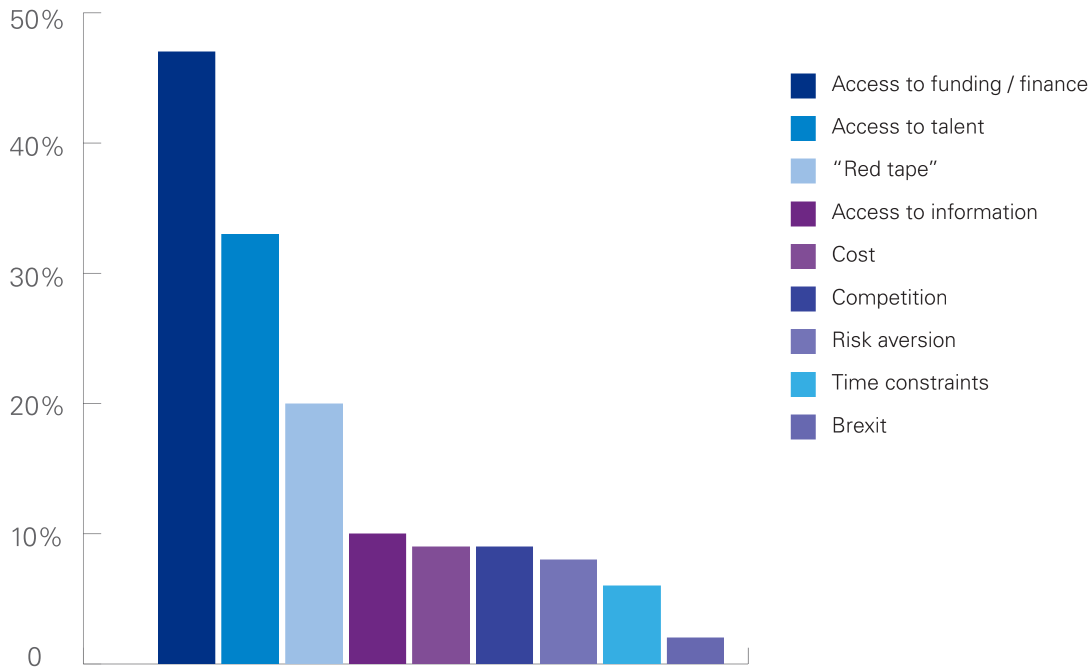
When asked about the extent to which bank lending and venture capital funding influenced their investment decision-making, just over a quarter (26 percent) said bank lending was an influence or major influence; only 16 percent said that access to venture capital funding would influence their decision.

Barriers to innovation

Finally, when companies were asked about the barriers to innovation, funding and talent again topped the list of concerns.

"I'd like to see improvements in the availability of skills and knowledgeable personnel who are actually available to participate in research projects, and availability of funds both commercially and publicly."

Overall, 47 percent cited funding and resource-related barriers, while just under a third (32 percent) cited difficulties accessing talent.



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Conclusion

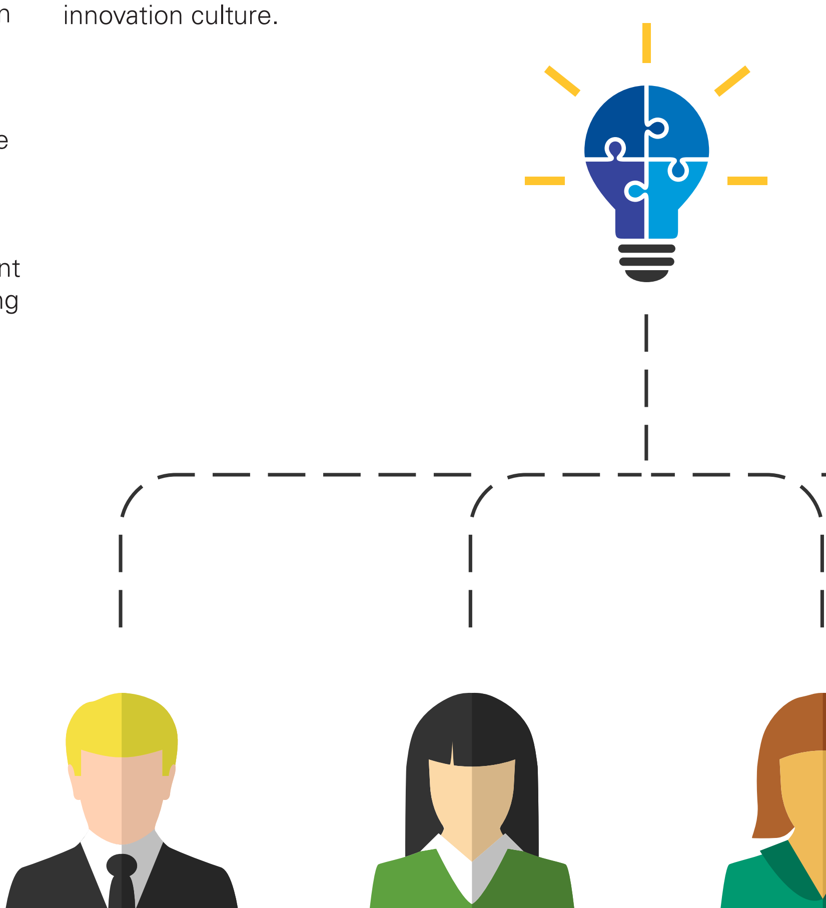
Successful innovation requires a strong ecosystem, one that is supported by Government initiatives designed to lower the risk of capital through a range of tax measures, incentives, and grants. The organisations who participated in KPMG's research have provided valuable insights into Ireland's current innovation ecosystem, indicating what is working and flagging key areas where improvement could result in greater investment in innovation.

As in previous years, a key theme arising from our research was the perceived "red-tape" and administrative burden of preparing an R&D tax credit claim. Revenue has recently taken steps to address this by establishing a steering committee, of which KPMG is a member, to review the administration of the R&D tax credit regime. The committee will act as a forum in which issues relating to the regime can be aired and discussed, with a view to addressing them wherever possible.

Respondents to our survey also indicated concern with the certainty of R&D incentives, specifically the R&D tax credit and issues relating to the application of the regime's technical criteria in a Revenue audit situation. In recent months Revenue published an eBrief providing clarity on the role of the independent technical expert (how they are appointed, the briefing they receive, and the expectations in terms of the expert's report)[iv], which we hope will alleviate some concerns and provide reassurance to taxpayers.

Certainty relating to the regime itself is also of concern following the publication of the Department of Finance's *Economic Evaluation of the R&D Tax Credit* report in October 2016. The report sought to evaluate the effectiveness of the R&D tax credit and to determine if it remains "fit for purpose"[v], and proposed potential regime changes to address perceived "deadweight". KPMG understands from discussions with the Department of Finance that no changes to the regime are imminent. This would appear to be supported by the recent Coffey Report which recommended that no changes be made to Ireland's R&D tax credit regime or the KDB. However, it is still worth noting that amendments mooted in the report could have a significant impact on the decision to invest in R&D and innovation in Ireland and we would stress the need to carefully consider such changes to the regime, particularly as they pertain to multinationals.

As Ireland prepares for Brexit and other potential external challenges, innovation has never been more important. Government, state agencies, businesses, and higher education institutions will all need to continue to work together to maintain Ireland's robust innovation culture.



How KPMG can help

At KPMG, we understand how difficult it can be to undertake and fund an innovation project. We have a proven record of working with ambitious businesses, from indigenous start-ups to leading multinationals, and can help with a wide range of business and finance issues to ensure that companies stay focused on what matters. In particular, we have a dedicated R&D Incentives Practice who can advise companies on relevant tax incentives like the R&D tax credit and the knowledge development box.

Our team of tax, finance and engineering / science professionals can guide companies through all the issues that need to be considered during the innovation process. We are approachable, efficient, and jargon-free. Get in touch with us today to find out more about how we can help your business succeed.

Endnotes

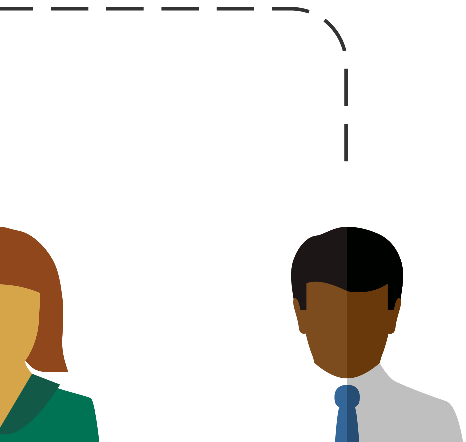
i) Department of Finance, *Economic Evaluation of the R&D Tax Credit*, October 2016, p. 55.

ii) Ibid.

iii) Houses of the Oireachtas, Dáil Éireann Debate, Vol. 940 No. 3, 28 February 2017, Written Answer 252.

iv) Revenue eBrief No. 19/17, 17 February 2017.

v) Department of Finance, *Economic Evaluation of the R&D Tax Credit*, October 2016, p. 6.



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