Knowledge Development Box: Best in Class?

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Introduction

Finance Minister Michael Noonan announced in Budget 2015 that Ireland would introduce a "best-in-class knowledge development box" (KDB). Have we achieved this? In Budget 2016 we learnt that the tax rate applicable to income qualifying under the KDB would be 6.25%. A predictable start, perhaps, given that the UK has a patent box regime with a tax rate that is exactly half of its main corporate tax rate. Although a bolder rate in the region of 5% to allow Ireland to match other intellectual property (IP) regimes in the EU would have been welcome, in reality this was probably never going to happen. In the context of BEPS and the fact that Ireland's KDB was "the first OECD-compliant KDB in the world", it was unlikely that we could "push the envelope".

The question remains, however: is our KDB "best in class"?

Background

The objective of the KDB is to provide a highly attractive tax rate for income generated from commercialising R&D/IP. Although new to Ireland, patent box measures have existed for many years in other countries.

According to Minister Noonan, Ireland's KDB is "the first OECD-compliant KDB in the world", which means that it will be in line with new international guidelines, e.g. the "modified nexus approach". In summary, the "modified nexus approach" seeks to link the relief under the KDB to the proportion of qualifying R&D expenditure (in relation to a specific IP asset) being carried on by the company in Ireland, as a percentage of the overall group expenditure, including acquisition costs, on the same asset.

Therefore, for Irish indigenous businesses and SMEs that undertake most of their R&D in Ireland, the KDB could be very attractive. Perhaps it will be less so for multinational companies, where the generation of the qualifying assets is the result of R&D activity conducted in countries outside Ireland and the EU.

KDB: Key Aspects

Set out below are the key components of the KDB, with the provisions contained in a new Chapter 5 (ss769G–R) of Part 29 TCA 1997.

What IP qualifies for the KDB?

Certain patented inventions and copyrighted software will be considered IP for the purposes of the "qualifying asset" definition. The definition also includes plant breeders' rights, supplementary protection certificates for medicinal products and plant protection certificates. The IP must be the result of R&D activities, as defined by s766 TCA 1997.

The KDB will reward companies that invest the time and effort into legally protecting their IP. This is not always straightforward, as many Irish businesses may not protect their IP for a range of good commercial reasons (e.g. risk of exploitation, high costs associated with registering patents, lack of effective enforcement, preference to keep knowledge as a "trade secret" etc.).

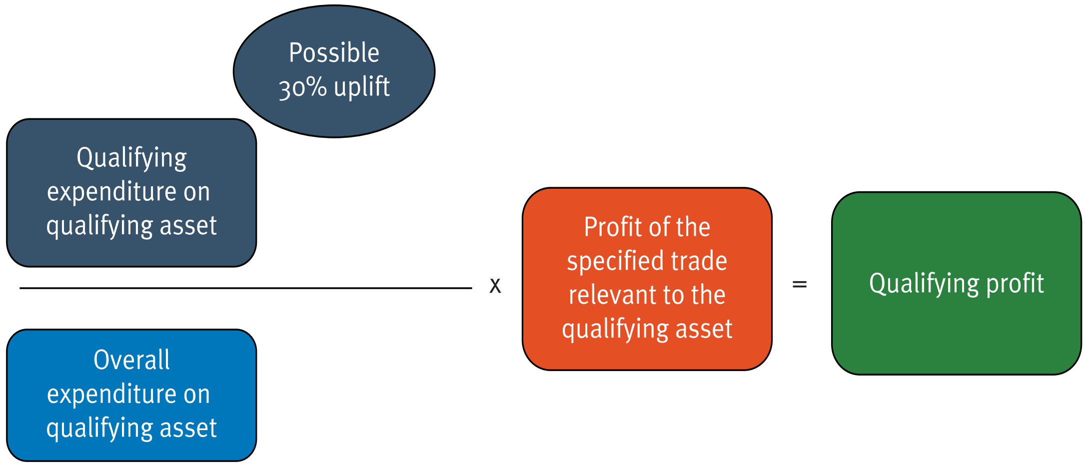
In this context, of particular interest to smaller companies (defined for this purpose as those with annual income from IP of less than €7.5m, fewer than 250 employees and a turnover of less than €50m/or a balance sheet of less than €43m) may be the expansion of the definition of IP. For those companies, IP also includes inventions that are certified by the Controller of Patents, Designs and Trade Marks as being novel, non-obvious and useful, i.e. the IP may be patentable but not actually patented. In theory, this should open up the availability of the KDB regime to SMEs, as the costs associated with formally protecting their IP will be reduced.

Nexus formula

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. Only income derived from the qualifying asset will qualify for the reduced tax rate.

The relief is given by way of a deduction equal to 50% of the qualifying profit from the qualifying asset to give an effective tax rate of 6.25%. The qualifying profit is determined by reference to the formula below.

Figure 1: Formula for calculating qualifying profit for KDB



What is qualifying expenditure?

For the purposes of the above formula, “qualifying expenditure” on the qualifying asset means “expenditure incurred by a relevant company...wholly and exclusively in the carrying on by it of research and development activities in a Member State, where such activities lead to the development, improvement or creation of the qualifying asset” (i.e. the IP, as defined above). The definition of R&D activity mirrors the definition for the purposes of the R&D tax credit.

Specifically excluded from the definition of qualifying expenditure (but included in the definition of overall expenditure for the purposes of the formula) are any acquisition costs in relation to the qualifying asset. Payments to a related group member for the carrying on of R&D, including related-party cost-sharing arrangements (“group outsourcing costs”) are also excluded from qualifying expenditure, although outsourcing R&D payments to non-related parties are considered to be qualifying expenditure for the purposes of the relief.

In arriving at the various apportionments in computing the relief, large companies must apply transfer pricing rules, whereas smaller companies should apportion income and costs, where required, on a just and reasonable basis.

It is possible to receive an uplift 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.

As a consequence of the restrictions on acquisition costs and group outsourcing costs, the potential relief available will be diluted where the IP has been acquired by the company (from a third party or a group company) or where the company outsources R&D activities on the IP 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.

Profit of specified trade

The qualifying company is required to treat its KDB-qualifying activities as a separate “specified trade”. The income to be included in the computation of the profits of a specified trade will include any royalty or other sum in respect of the use of that qualifying asset (e.g. licence fee or compensation). In addition, where the sales price of a product or service includes an amount attributable to a qualifying asset, the income that will qualify is the portion of the income that is attributable to the value of the qualifying asset on a just and reasonable basis. An appropriate portion of expenses laid out in earning the income will be deducted in computing the profits of the specified trade.

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R&D activity and income flows

One key element of the KDB is that the income from the sale or exploitation of the IP must flow into the same entity that undertakes the R&D activity. In reality, in the case of many groups in Ireland, R&D activities are carried out in a group subsidiary company that is dedicated to R&D – or the R&D activity is simply conducted in a separate entity from the group company that is engaged in the sale to customers, licensing etc. of the related IP. This may exclude such companies from the KDB altogether.

When will this relief be available?

Relief under the KDB will be available to companies for accounting periods starting on or after 1 January 2016.

Interaction Between KDB and 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. Therefore, claiming the KDB should be a natural extension for those companies already claiming the R&D tax credit on an annual basis. The R&D tax credit already provides a 25% tax credit on qualifying R&D expenditure.

The definitions of “R&D” from a KDB perspective are the same as those under the R&D tax credit regime. Likewise, the definition of qualifying expenditure for the KDB is very similar to that for the R&D tax credit. It therefore makes sense for companies to start thinking of these two incentives under the same workflow: the R&D tax credit will directly feed into any KDB claim.

It is also worth noting that, similar to the R&D tax credit, Revenue will be able to consult technical experts in relation to many aspects of the KDB regime. We would expect that one area that Revenue will focus on is whether the qualifying asset arose as a result of R&D activities, thereby effectively conducting R&D tax credit and KDB audits simultaneously.

What Should Companies be Doing Now?

To ensure that your company is best placed to claim the KDB at the first opportunity (which would be the 2016 corporation tax return, filed at the latest in September 2017), there are a number of important actions that should be considered.

The first thing to do is to identify the assets and income streams that could qualify for the KDB and to then quantify the expenditure incurred by the Irish company on developing those assets, including outsourcing costs.

FA 2015 provides that taxpayers will be obliged to "track and trace" and to provide documentary evidence of expenditure incurred on, income generated from and activity undertaken to generate the IP assets. As "track and trace" is key to a successful claim, companies should ensure that they have good systems and tools in place to enable this. Keeping and maintaining good records will ensure that substantiating the KDB claim will be an easier task.

Obviously, larger and more sophisticated organisations are better resourced to track and trace than some SMEs. However, we would expect that SMEs should be able to use the information already maintained for the purposes of claiming the R&D tax credit.

Suggested Improvements to KDB

Although devising an OECD-compliant KDB was a key requirement, there are a number of areas that should be considered to improve Ireland's KDB offering.

Expenditure incurred by a company in the conduct of a trade carried on by a non-Irish branch of the company should be included in the scope of "qualifying expenditure".

Include a group election mechanism

The KDB legislation is drafted in such a manner that it benefits group companies only where the R&D activity is undertaken in the same entity that generates the income. Where two companies are both within the charge to corporation tax in Ireland and are otherwise eligible for inclusion in a corporation tax group for Irish tax purposes, there seems to be no obvious policy reason why Ireland's KDB design should not permit those companies to make a claim for KDB relief on a group basis. A similar election already exists for the R&D tax credit, which allows a group for R&D tax credit purposes to elect that expenditure incurred by one of its members is eligible for a tax credit relief claim by another member.

Applying a similar election mechanism to the KDB might mean that, based on an election, qualifying expenditure of one group member might be treated as "qualifying expenditure" incurred by another group member, where the latter claims relief under the KDB.

This could mean that, for example, a company engaged in selling products that reflect "qualifying assets" emerging from the R&D activities of an Irish group company might jointly elect that the "qualifying expenditure" of the group company be treated as being its expenditure and that such expenditure be taken into account in its calculations to determine the amount of relief available under the KDB.

Qualifying expenditure should include expenditure incurred by a foreign branch

Expenditure incurred by a company in the conduct of a trade carried on by a non-Irish branch of the company should be included in the scope of "qualifying expenditure".

The Forum for Harmful Tax Practices recognises that such expenditure may be taken into account as part of qualifying expenditure provided that the related income of the branch is taxed in the claimant jurisdiction. To the extent that such income potentially includes "qualifying income" for KDB purposes, branch expenditure should be included in "qualifying expenditure". If Ireland seeks to restrict qualifying expenditure to exclude expenditure which is included as 'qualifying expenditure' for the purposes of a 'patent box' in another jurisdiction this can be achieved by other means.

Other forms of income arising from the exploitation of qualifying assets

The KDB would be enhanced if revenues arising from the use or exploitation of assets in the course of the trade included sales proceeds arising on the disposal of the asset itself. Some businesses exploit "qualifying assets" created by them through the outright sale of their interests in such assets, in like manner to the sale by a manufacturing company of its trading stock. The receipts from such sales are simply taken into account in measuring the receipts of the trade, in the same way as other receipts of the trade.

This is in line with guidance given in Action 5 of the final OECD BEPS reports, where it is provided that overall income from a qualifying asset "may include royalties, **capital gains and other income from the sale of an IP asset**". It is clear that a "patent box" regime can and should extend to capital gains arising on the disposal of qualifying assets. This would be a more balanced position.

Interaction with the R&D tax credit "cash back" rules

Companies that are not paying corporate tax can potentially avail of the R&D tax credit by way of 'cash returned' from Revenue. The interaction of a claim for relief under the KDB and a claim for a cash refund of R&D tax credits is another area where the KDB should be enhanced.

Where the corporation tax liability of a company for the period is reduced by a claim to relief under the KDB, the reduction in the corporation tax liability is ignored so that a lesser amount is potentially available by way of a cash refund to the company. The KDB regime would be significantly enhanced if it were not necessary to restrict the amount of relief available under the cash refund mechanism.

Relief under the KDB and the R&D tax credit target fundamentally different stages of activity in the business cycle of an innovation-rich company. The aim of the KDB is to provide taxpayer relief once successful R&D activity has resulted in qualifying income arising to the company from completed R&D activity. In contrast, the R&D tax credit relief is designed to afford cash tax savings to companies engaged in R&D activities.

Conclusion

The Department of Finance has determined that the annual cost to the Exchequer of the KDB could be around €50m, not particularly significant in the context of the Exchequer returns. The "modified nexus approach" will mean that the benefit of the KDB may be limited for multinational groups, which typically undertake R&D activities globally on a joint and collaborative basis. In such cases, the qualifying R&D activity undertaken by the Irish company in relation to an asset may equal only a small percentage of the overall expenditure on that specific IP asset, resulting in a reduced KDB percentage of income from that IP being eligible for the reduced effective tax rate. However, domestic SMEs that do much of their R&D in Ireland could be the big winners.

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Ireland's KDB is "best in class" at the moment; no other country has yet introduced an OECD-compliant IP regime. Some countries are close to doing so, including the UK, which has recently completed a consultation process with a view to introducing new patent box legislation early in 2016 that will be OECD-compliant. Ireland will need to watch with interest how far others push the boundaries or, perhaps more accurately, whether others will maximise their regimes within the existing OECD boundaries. We are likely to see other countries allow some or all of the suggested improvements mentioned above, and if they do, we must be prepared to improve our regime incrementally in order to remain competitive.

The Department of Finance has a history of incrementally improving the R&D tax credit regime each year, and we would hope for similar in respect of the KDB.

Read more on taxfind *TaxFax* – 13 October 2015 – Budget 2016; *TaxFax* – 22 October 2015 – Finance Bill