Valuable Rebate

The R&D tax credit is the largest state financial support for Irish businesses. For clients of Enterprise Ireland, claiming the valuable cash rebate has become easier, writes John Kinsella

The Revenue Commissioners had good news recently for companies engaged in Research & Development. Until now, to claim the valuable R&D tax credit businesses and their advisers have had to satisfy the tax authorities that the R&D satisfies two criteria, namely the Science Test and the Accounting Test.

Now the Revenue has decided that these tests are no longer needed if the company has received an Enterprise Ireland R&D grant in respect of the project, provided that the tax credit claimed is €50,000 or less and the claimant is an SME. The rationale seems to be that if the project is validated by EI, then the Revenue will accept its bona fides.

Mark O'Sullivan, Head of R&D Technical Services at accountancy firm BDO, believes this concession will provide a greater level of certainty to SMEs in making an R&D tax credit claim, as they may be more familiar with the EI definitions of R&D than the R&D tax credit definitions.

"Revenue has stated that the definitions are quite similar, so the EI definition can provide SMEs with a good initial guide as to the likely eligibility for the R&D tax credit regime," says O'Sullivan. "This approach illustrates that the policymakers expect that the R&D tax credit regime should be utilised by SMEs and not just geared towards multinationals."

The R&D tax credit regime is by far the largest state financial support mechanism for Irish businesses. The regime offers companies a 25% tax credit on expenditure on R&D in addition to the 12.5% corporation tax deduction. This 25% credit can be offset against corporation tax liabilities or, alternatively, can be received as a cash refund, subject to certain criteria.

The cash refund aspect means that where there is no offset against corporation tax, the Revenue issues a cheque to the claimant. So for a company spending €200,000 in a year on qualifying R&D, and reporting no trading profit or a loss, the cash rebate will be €50,000.

Hundreds of SMEs have been availing of the R&D tax credit honeypot for years, but many more have not. According to O'Sullivan: "When meeting with SMEs, we often find that they believe the regime is purely a tool to promote FDI. Furthermore, we have found that SMEs are often uncertain as to whether they can make a claim due to complex scientific or technical qualification criteria associated with the regime."

O'Sullivan adds that in addition to the R&D tax credit regime, it may be possible for SMEs to qualify for the Knowledge Development Box (KDB), a new regime effective from January 2016 that offers an effective tax rate of 6.25% on qualifying profits derived from underlying intellectual property. "The KDB regime is very closely tied to the R&D tax credit regime, so availing of the R&D tax credit regime is an extremely useful stepping stone to availing of the KDB," O'Sullivan explains.

> 'The repayable tax credit has become a larger proportion of the total cost'

The R&D tax credit regime was the subject of a detailed review by the Department of Finance in 2016. The tax credit was introduced in Finance Act 2004 and was initially designed as an incremental system. Between 2012 and 2015, the scheme evolved into a full-volume scheme, meaning that all R&D expenditure is currently eligible for the credit.

While a full-volume scheme is less costly to administer, it supports pre-existing R&D which would have taken place even in the absence of R&D tax credits. The other main change to the tax credit occurred in 2009, when the credit became repayable, meaning firms could request a refund if their R&D claim was greater than their tax liability. This was designed to enhance the scheme's attractiveness to firms in the business startup phase.

Since the introduction of the R&D tax credit, the number of claims has increased rapidly, with more than a tenfold rise

Mark O'Sullivan, BDO

from 2004 to 2014. The Exchequer cost of the tax credit in 2014 was €553m, equivalent to 12% of all corporation tax receipts. The Exchequer cost of the tax credit has two main components: foregone tax revenues from a firm making a claim against their positive tax liability, and firms receiving a repayable credit when their claim is greater than their tax liability.

The repayable credit has increasingly become a larger proportion of the total cost, and as there are no usage restrictions an unprofitable firm can benefit from the scheme indefinitely. According to DoF research, 159 companies received a repayable credit every year between 2009 and 2014. Of this cohort, 97% were Irish and 75% had less than 50 employees. These firms accounted for two-thirds of all repayable credits arising between 2009 and 2014.

The DoF review also noted that because R&D tax credits run indefinitely, outstanding credits at the end of 2014 amounted to €590m. "The fact that one-quarter of the outstanding credits relate to R&D conducted before 2009 highlights the substantial legacy costs associated with this policy tool," the review stated.

For both the total Exchequer cost and the repayable credit, recipients tend to be larger and older than other firms. In 2014, 76% of the repayable credit was paid to firms with more than 250 employees while 77% was paid to firms older than 16 years.

In addition to the R&D tax credit, grants for R&D are also provided to Irish and non-Irish firms through Enterprise Ireland and the IDA. From 2007-2014, direct support for R&D rose from €70m to over €120m in 2010 and back to €100m in 2014. Enterprise Ireland R&D grant support provided to Irish firms is concentrated in the Information and Communication sector. Grant amounts to smaller firms average €100,000.

In their review, DoF economists stated that there was insufficient data to conclude on which policy tool is a better use of public funds. They were able to calculate that the repayable credit amounted to half the taxpayer supports for Business R&D in 2014, which totalled more than €600m between the repayable credit, tax credit and grants.

In Budget 2017, finance minister Michael Noonan left the R&D tax credit regime alone, despite misgivings from his department officials. The DoF's Tax Expenditures Report stated that the R&D tax credit is reasonably successful in its aim of increasing business R&D, with the caveat that there is notable deadweight associated with this unrestricted fiscal incentive.

"Of the R&D conducted over 2009-2014, we estimate that 60% is additional (due to the tax credit) and 40% is deadweight (would have been conducted without the tax credit). In other words, the state is partially crowding out private funding for BERD, giving rise to a degree of inefficiency.

"In addition, we did not find evidence that the tax credit scheme is effective in encouraging R&D in younger firms, which suggests other barriers to conducting R&D for this type of firm should be examined in greater detail, and public policy tailored appropriately. On the other hand, the scheme appears to be effective for older firms, so a possible policy response is simply to adopt a 'wait and see' approach."

DoF economists stressed that the R&D cash refund results in notable deadweight. "A tax credit can only rectify the market failure of under-investment in R&D if the root of the problem is financing. If the greatest barrier is insufficient human capital, the tax credit will not solve the failure, and in addition runs the risk of considerable deadweight."

In order to improve the value for money of the R&D tax credit, DoF officials suggested reducing it in temporal terms or lowering the tax reduction for companies that have used the credit for some time. "Given the size of the future liability to the Exchequer, it is pertinent to consider how to prevent it from increasing even further in future. The deadweight inherent in the scheme should not be ignored," the report stated.

In framing the Budget and Finance Act, Michael Noonan chose to ignore the advice of his civil servants. The next finance minister may form a different view, though BDO's Mark O'Sullivan doesn't anticipate radical regime change. "A commitment has been made in the government's Innovation 2020 Strategy to increase public investment in R&D, and we believe that a large amount of this support will be made accessible through the R&D tax credit regime going forward," he says.

"Although these supports can be highly beneficial to SMEs, as with any high value regimes it is likely that claims will be subjected to Revenue review. It is important for all claimants to ensure that their claims for the R&D tax credit or KDB regimes conform with current legislation from all aspects, financial as well as technical."

COST OF THE R&D TAX CREDIT

Year	Exchequer Cost (€m)	Offset Against Tax Liability (€m)	Repayable Credit (€m)
2014	553	228	326
2013	421	186	236
2012	282	146	137
2011	261	155	106
2010	224	158	65
2009	216	183	33

Source: Revenue Commissioners

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