



THE KNOWLEDGE DEVELOPMENT BOX

Finance Act 2015 introduced Ireland's newest tax incentive for innovative companies; the Knowledge Development Box ("the KDB"). The KDB offers an effective tax rate of 6.25% on qualifying profits generated in periods commencing on or after 1 January 2016.

As the first OECD compliant box-type regime, the relief available is linked to the percentage of qualifying R&D expenditure incurred in Ireland.

Given the links between the KDB and the R&D tax credit legislation, companies that already claim the credit should examine the potential benefits of also accessing the KDB regime.

What Intellectual Property Qualifies for the KDB?

In order to qualify for the regime the first thing that should be considered is whether or not the company has or is capable of creating qualifying assets and in turn exploiting those qualifying assets as part of a profitable trade.

A Qualifying Asset is IP, other than marketing related IP, which is the result of R&D activities. The definition of IP includes computer programs within the meaning of the Copyright and Related Rights Act 2000, inventions protected by qualifying patents, supplementary protection certificates for medicinal or plant protection products and plant breeders' rights.

With a view to increasing access to the relief for certain SME's which might otherwise consider patenting to be restrictive, there is an expansion of the definition of IP to include inventions that are certified by the Controller of Patents, Designs and Trademarks as being novel, non-obvious and useful. For KDB purposes an SME is defined as a company with annual income from IP of up to €7.5m, group turnover of up to €50m, less than 250 employees across the group and a group balance sheet of under €43m.

There is also scope to link assets and create a "family of assets" where it can be demonstrated that there is significant commonality of scientific, technological or engineering challenges underlying the associated R&D.

Where a company has qualifying assets for KDB purposes, the qualifying income from those assets will include royalties and licence fees. Also, where the price of a product or service includes an amount which is attributable to a qualifying asset, a portion of the income from those sales can qualify (i.e. embedded IP scenarios).

How is the Quantum of Relief Calculated?

The qualifying profits are halved by way of a 50% tax deduction in order to give effect to the 6.25% rate on those profits.

The qualifying profits are determined by way of the following formula:

$$\frac{QE + UE}{OE} \times QA$$

Where: QE is qualifying expenditure on qualifying assets

UE is uplift expenditure

OE is overall expenditure on qualifying assets, and

QA is the profit from the qualifying assets

What is Qualifying Expenditure?

It is expenditure on a qualifying asset which has been wholly and exclusively incurred by the company in the carrying on by it of R&D activities in a Member State, where such activities lead to the development, creation or improvement of a qualifying asset.

Outsourcing to third parties is included in qualifying expenditure however spend on outsourcing to related parties is excluded.

Acquisition costs relating to qualifying assets are also excluded. A portion of these excluded costs may be brought back in under the calculation of uplift expenditure.

Qualifying expenditure also excludes interest expenses, expenditure to group companies in order to take on R&D activities under a cost sharing agreement or otherwise and any expenses which are relieved for tax purposes in a territory other than Ireland.

What is Overall Expenditure?

It is all of the qualifying expenditure on the asset as above together with the acquisition costs and related party outsourcing costs.

Given the nature of this aspect of the formula it is likely that the maximum benefit from the regime is to be derived where the company which is generating income from the qualifying IP is the same company that developed and incurred the cost of associated R&D activities which were carried on in Ireland.

What is Uplift Expenditure?

Uplift expenditure is calculated as the lower of:

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



What is the Profit from Qualifying Assets?

This is the profit from the KDB trade (provided for as a “specified trade” under the legislation) which is related to the qualifying asset(s) before the 50% KDB tax deduction is taken into account.

Expenses incurred in generating income from the qualifying assets are to be attributed to the KDB trade on a just and reasonable basis. Companies which are within the remit of Irish transfer pricing legislation must apply those rules in determining the profit of the KDB trade.

What about Documentation?

In order to make a claim for the KDB rate a company should have records which track qualifying expenditure, overall income and overall expenditure on qualifying assets. The company should also be able to show how such income and expenditure is linked to the qualifying asset.

Are there Transitional Rules to be Aware of?

There are transitional rules in relation to periods between 1 January 2016 and 31 December 2019. During these periods;

- Acquisition costs and related party outsourcing costs incurred prior to 2016 are included in the calculation, and
- Qualifying expenditure on a qualifying asset is calculated by reference to qualifying expenditure on all qualifying assets in the 48 month period ending on the last day of the taxable period. However this can be extended to include any qualifying expenditure from before 2016 if detailed back up and documentation is available to substantiate it.

Can the Company Continue to Claim the R&D Tax Credit and Tax Depreciation on IP?

Both the R&D tax credit and the KDB reduced rate can be claimed by a company in a given taxable period. However, if a company avails of the KDB reduced rate and its R&D tax credit, or a portion of the credit for that period is refundable, the amount to be refunded is not increased by virtue of the 6.25% tax rate. The KDB tax deduction is effectively ignored in calculating the refundable element of the R&D tax credit. The overall quantum of R&D credit is otherwise unaffected.

Also, the KDB provisions do not in themselves impact on the company claiming tax depreciation (i.e. capital allowances) on qualifying IP as provided for under s.291A of the legislation.

When Must A Claim Be Made By?

A claim for the KDB regime must be made within 24 months of the period end to which the claim relates.

Example 1 - Irish Software DevCo Limited

The company has utilised its in house R&D team as well as the services of an Irish university to undertake R&D activities in Ireland. These efforts have resulted in the creation of a computer program which is licensed to third party customers.

The company separately provides R&D services to third party customers. The customers retain all IP related rights and entitlements.

Following a just and reasonable allocation of expenses the following was determined:

Profit of non-KDB R&D activities	€ 30,000
Profit of KDB activity (specified trade)	€ 250,000

As qualify expenditure and overall expenditure on the qualify asset (copyright computer program in this example) are the same because there has been no related party outsourcing or acquisition of IP, the full amount of profits of the KDB trade qualify for relief.

Taxable Profits

Standard Trade	€ 30,000
KDB Trade	€ 250,000
KDB Deduction	- € 125,000
Total Taxable	€ 155,000
Tax at 12.5%	€ 19,375
KDB Tax Saving	€ 15,625

Given the structure of the regime, it is recommended that Irish companies which carry on all or the majority of their R&D activities in Ireland should examine the potential to benefit from the reduced rate as early as possible so as processes and procedures to link, track and document matters can be put in place from the outset.

What can be done whilst the Grant of a Patent is Outstanding?

A company can make a claim in the period in which an application to the Patents Office is submitted. If the patent is ultimately refused then the company will be required to repay the relevant taxes plus interest.



Example 2 - International Innovations Limited

The background facts are as above however instead of outsourcing aspects of the R&D in relation to the qualifying IP to an Irish university, it has been outsourced to a US based group company. On this basis the calculation of profits subject to KDB relief must be examined.

Qualifying expenditure on the IP	€ 400,000
Related party outsourcing	€ 200,000

Uplift expenditure is determined as the lower of:

- 30% of €400,000 (i.e. €120,000), or
- €200,000 (i.e. the aggregate of acquisition and related party outsourcing costs)

Calculating the Qualifying Profits of the KDB trade:

$$\begin{aligned} & ((QE+UE) \div OE) \times QA \\ & ((400,000 + 120,000) \div 600,000) \times 250,000 = 216,667 \end{aligned}$$

Taxable Profits

Standard Trade	€ 30,000
Non Qualifying KDB Trade	€ 33,333
Qualifying KDB Trade	€ 216,667
Less KDB Deduction	-€ 108,333
Total Taxable	€ 171,667
Tax at 12.5%	€ 21,458
KDB Tax Saving	€ 13,543

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