Knowledge Development Box

The Knowledge Development Box ("KDB") came into effect on 1st January 2016 and is as a further dimension to Ireland's 'best-in-class' corporation tax regime.

The aim of this new patent box regime is to incentivise innovation and encourage companies to develop Intellectual Property (IP) in Ireland that have a high 'value add' for the Irish economy.

The KDB, the only one in the world to meet the OECD's "modified nexus" standard, provides for a reduced tax rate of 6.25% on profits arising from certain Intellectual Property Assets that are the result of qualifying R&D activity carried out in Ireland.

What does the "modified nexus" standard mean?

Essentially, there must be a direct 'nexus' or link between the income generated from the IP and the R&D activities that contribute to that income. This means that benefits (in the form of the reduced tax rate of 6.25%) can only apply to income arising from IP where the actual R&D activity is undertaken by the business itself.

What is a qualifying asset?

Qualifying IP assets include patented or similarly protected inventions and copyrighted software. In the case of Small and Medium Enterprises (SMEs), the definition of IP may be expanded to registered inventions that are certified as being novel, non-obvious and useful. SMEs, for the purposes of the KDB, are companies with income arising from IP/qualifying assets of less than €7.5 million, who employ less than 250 people and whose turnover is less than €50m or have a balance sheet of less than €45m.

What income qualifies for the relief?

- Licence fee income
- Royalty Income
- The portion of income from sale of a product or service which relates to the IPU

How does it work?

The amount of profits that can avail of the relief will be determined by the percentage of R&D activities carried out by the Irish company (including third party outsourced costs) as a proportion of the total R&D costs incurred to develop the qualifying asset (including acquisition costs and outsourcing costs, both group and third party). For example if the Irish company performs 50% of the R&D that developed the asset in Ireland, then 50% of the income arising to that asset will qualify.

The formula used to determine the qualifying profits taxed at 6.5% is:

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

QE = Qualifying expenditure on the qualifying asset.

This is the expenditure wholly and exclusively incurred by the company in the carrying on of R&D activities in EU. The R&D activities must lead to the development, improvement or creation of the qualifying asset i.e. the IP.

Outsourcing costs incurred in relation to a person who is not a member of the group/company which is engaged to carry on R&D activities on behalf of that company will be treated as if it were expenditure incurred by the company.

Exclusions from qualifying expenditure include acquisition costs, interest, group outsourcing costs and any costs that may be tax deductible outside the State.

UE = Uplift Expenditure.

This is based on lower of: 30% of qualifying expenditure **or** total of acquisition costs and group outsourcing costs.

OE = Overall Expenditure on qualifying asset

Qualifying expenditure as above, plus acquisition costs in relation to the assets and expenditure incurred by group companies.

QA = Profit of the specified trade relevant to the qualifying asset (before KDB relief).

When can I claim?

The KDB relief is available to companies for accounting periods beginning on or after the 1st January 2016 and ending 31st December 2020. Any claim for the deduction must be made within 24 months of the relevant accounting period.

What documentation do I need?

Companies who wish to claim the relief are required to maintain detailed records. The company will have to provide documentary evidence of expenditure incurred, income generated from the IP assets, and activity undertaken to generate the IP assets.

As the R&D tax credit and KDB are interlinked, the majority of this information will already have been obtained for the R&D tax credit claim. We would expect Revenue to carry out R&D and KDB audits simultaneously.

How Crowleys DFK can help?

- Establish whether your R&D activity results in qualifying assets.
- Prepare a report documenting overall income from the qualifying asset; qualifying expenditure on qualifying assets; overall expenditure on the qualifying assets and how such expenditures and income are linked to the qualifying asset.
- Train your staff on how to record and evidence their R&D activity.
- Implement a tailor-made system allowing you to record and document your R&D activity to assist in identifying what profit results from each qualifying assets held.
- Claim the KDB tax credit through your company's corporation tax return.
- Liaise with Revenue in the event of an audit.

Working example

Techpro Limited is a company involved in providing technology services and the following information is provided in respect of the year ended 31 December 2016:

- Expenditure on acquisition of a qualifying patent €50,000
- Outsourcing costs relating to R&D carried out in the US (by group) €75,000
- Qualifying expenditure on patents and computer software €90,000
- Overall expenditure on qualifying assets €200,000
- Profit of specified trade relating to the patents and computer software €450,000
- Profit of non-specified trade €100,000
- Uplift expenditure €30,000

Note: UE is calculated as the lower of 30% of €90,000 and €125,000 (being the acquisition and outsourcing costs) the lower of which is €30,000

Note: Qualifying profits is calculated using the formula:

(QE + UE)/OE x QA:

(€90,000 + €30,000)/€200,000 x €450,000 = €270,000

The qualifying profits of €270,000 will be liable to tax at an effective lower rate of 6.25%.

The manner in which the deduction operates to yield the lower effective rate is as follows:

- Taxable profits from non-qualifying assets €100,000
- Qualifying profits €270,000
- Non-qualifying profits of the specified trade €180,000
- Total taxable profits 550,000
- Less KDB deduction (€270,000 x 50%) (€135,000)
- Taxable profits €415,000
- Tax at 12.5% €51,875
- Equivalent to (€280,000 x 12. 5%) + (€270,000 x 6.25%)

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