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The Knowledge Development Box: An Overview

Kevin Delaney

Bernard Doherty

James Mc Mahon

William Coffey

Ger Nangle

Knowledge Development Box (KDB)

Finance Act 2015 introduced the Knowledge Development Box (KDB). The broad objective of the KDB is to promote innovation and provide an incentive whereby profits arising from patented inventions, copyrighted software and certain other specific asset classes can effectively be taxed at a reduced rate of 6.25%.

Any royalty or other sum in respect of the use of a qualifying asset or income reasonably attributable to a qualifying asset, can benefit from the reduced rate. Broadly, the relief is linked to the qualifying Research and Development (R&D) expenditure incurred by the Irish company as a proportion of its overall global R&D expenditure, thereby making the KDB very attractive to companies that carry on a significant element of their R&D activities in Ireland.

The KDB is also attractive to large groups that are capable of isolating individual qualifying assets, the R&D for which is carried on in Ireland.

<u>What is a qualifying asset?</u>

For the purposes of the KDB, a qualifying asset is copyrighted software, certain patented inventions, plant breeders' rights, protection certificates for medicinal products and plant protection certificates. A qualifying patent must have been granted following substantive examination for novelty and inventive steps and have undergone a search by the patent office in relation to the invention, with a search report duly prepared. Transition arrangements apply for unexamined patents which were certified before 1 January 2017.

Small and Medium Enterprises (SMEs) benefit from an expansion of the definition of Intellectual Property (IP) to include inventions that are certified by the Controller of Patents, Designs and Trademarks as being novel, non-obvious and useful. For the purposes of the KDB relief, SMEs are companies with annual income from IP not exceeding €7.5 million and **group** turnover not exceeding €50 million.

<u>What income qualifies for the relief?</u>

The following income generated from the qualifying assets qualifies for the relief:

- royalty income;
- licence fee income; and
- where a sales price includes an amount which is attributable to a qualifying asset, a portion of the income from those sales calculated on a just and reasonable basis.

How does the relief work?

The mechanics of the KDB relief are to allow a tax deduction of 50% of the qualifying profits from the R&D activities, thereby resulting in an effective tax rate of 6.25%.

In arriving at the qualifying profits figure, there is a calculation required which broadly looks at the percentage of the R&D activities carried on by the Irish company, including third party outsourced costs (‘qualifying expenditure’), as a proportion of the overall expenditure incurred on the qualifying asset (including acquisition costs and outsourcing costs, both group and third party). Finance Act 2015 introduced the Knowledge Development Box (KDB). The broad objective of the KDB is to promote innovation and provide an incentive whereby profits arising from patented inventions, copyrighted software and certain other specific asset classes can effectively be taxed at a reduced rate of 6.25%.

The formula can be summarised as follows:

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

QE = Qualifying Expenditure on qualifying asset
UE = Uplift Expenditure (see below)
OE = Overall Expenditure on qualifying asset
QA = profit from relevant Qualifying Asset

How is qualifying expenditure and overall expenditure defined?

Qualifying expenditure is expenditure incurred by the company, wholly and exclusively in the carrying on of R&D activities in an EU member state, the consequences of which lead to the development, improvement or creation of the qualifying asset.

Outsourcing costs incurred in relation to a person which 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. However, any group outsourcing costs are specifically excluded as qualifying expenditure.

Overall expenditure refers to the company’s overall expenditure on R&D in respect of the qualifying asset, including all outsourced costs (including to group companies) together with any acquisition costs incurred by the company in relation to the qualifying asset (either from a group company or a third party).

It should be noted that in establishing the amount of tax relief each year under the KDB, the expenditure figures, both qualifying and overall, will include amounts of historic expenditure. The rules in relation to this key aspect are set out at the end of this page.

The exclusion of group outsourcing costs and acquisition costs will dilute the benefit of the KDB for many multinational corporations. To partially mitigate this, there is a provision for an uplift in the amount of qualifying expenditure.

<u>What is “uplift expenditure”?</u>

An additional “uplift expenditure” is allowed to increase the qualifying expenditure on the qualifying asset. The uplift expenditure is the lower of:

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

<u>How does this calculation appear in my corporation tax return?</u>

The 6.25% rate will not appear on the face of the corporation tax return. The KDB qualifying activities are treated as a separate specified trade. The profits of this specified trade should be calculated separately from the other activities of the company. The relief is obtained in the form of an additional trading expense against the profits of the specified trade, which will equal 50% of the qualifying profits (12.5% x 50% = 6.25%).

<u>What happens if I have a number of qualifying assets but it is not possible for me to identify the overall income and expenditure on each qualifying asset?</u>

Owing to the interlinked nature of many qualifying assets, it is not always possible to identify the breakdown of income and expenditure on each asset. This scenario is overcome using the “family of assets” approach. A family of assets permits the smallest grouping of identifiable qualifying assets for which income and expenditure is reasonably identifiable to utilise the KDB as if the “family of assets” was one qualifying asset.

<u>What happens if I have not started trading, but have incurred expenses relating to qualified assets?</u>

Any pre-trading expenditure which is qualifying expenditure shall be deemed to have been incurred in the first accounting period of the company, therefore allowing the expenditure.

<u>When is it effective?</u>

The relief is available to companies for accounting periods beginning on or after 1 January 2016 and before 31 December 2020.

<u>How many years of expenditure are included in the formula?</u>

For accounting periods beginning on or after 1 January 2016 but on or before 31 December 2019:

- acquisition costs shall include both current costs and historic costs incurred prior to 1 January 2016;
- group outsourcing costs include costs incurred prior to 1 January 2016 and where such costs relate to more than one qualifying asset, those costs shall be apportioned on a just and reasonable basis; and
- qualifying expenditure (as referenced above) incurred during the three years prior to the year in which the first claim is made, together with the current year (restricted). However periods prior to that may be included where there is sufficient supporting documentation.

For accounting periods beginning on or after 1 January 2020:

- acquisition costs shall include costs incurred prior to 1 January 2016;
- group outsourcing costs include costs incurred prior to 1 January 2016 and where such costs relate to more than one qualifying asset, those costs shall be apportioned on a just and reasonable basis; and
- qualifying expenditure may include any amount incurred prior to 1 January 2016 where there is sufficient documentation.

What documentation must I have?

A company must have records available which track:

- overall income from the qualifying asset;
- qualifying expenditure on qualifying assets; and
- overall expenditure on the qualifying asset.

The company must also show how such expenditures and income are linked to the qualifying asset.

Other provisions:

- the KDB provisions should have no impact on claiming capital allowances on IP under S.291A;
- the KDB may impact on cash refund claims made under the R&D tax credit regime. Broadly, the R&D tax credit is calculated as if the KDB regime was not in place. This should only present a cash flow timing issue;
- should there be a trading loss in respect of a qualifying asset in an accounting period, 50% of the loss will be available for offset in the normal manner; and
- if a company is subject to transfer pricing rules, the apportionment and application of all qualifying income and qualifying expenditure must be in line with transfer pricing rules. For smaller companies, income and expenses should be apportioned on a just and reasonable basis.

This article is the second of a three-part series of articles focusing on tax and engineering. It is derived from material delivered by Grant Thornton to students taking the Innovation and Knowledge Management module in the School of Mechanical and Design Engineering TU Dublin. This article focuses on Knowledge Development Box (KDB). The **previous article looked at the research and development (R&D) tax credits** *and the final article will look at capital allowances and accelerated capital allowances (ACA). This series of articles was written by Bernard Doherty BE MIEI and James Mc Mahon BAgrSc of Grant Thornton and Gerard Nagle BE MIEI and Dr. Kevin Delaney CEng FIEI of TU Dublin.*