Introduction
The introduction of a “knowledge development box” in Ireland from 1 January 2016 has further enhanced Ireland’s intellectual property (“IP”) tax regime and bolstered Ireland’s reputation as an attractive location for the development, holding and exploitation of IP. Among the incentives available for IP holding companies located in Ireland are:

- access to the 12.5% corporation tax rate;
- availability of tax depreciation for capital costs incurred on acquiring or developing IP;
- tax credits for research and development expenditure;
- a knowledge development box with an effective tax rate of 6.25% applicable to certain patent and copyright income;
- availability of deductions for interest expenses incurred on borrowings to fund the acquisition of IP; and
- relief for foreign withholding tax suffered on royalty income.

We set out below a brief overview of each of these incentives and the advantages that Ireland has to offer.

Rate of Corporation Tax: Trading or Investment Income
The 12.5% corporation tax rate applicable to active trading income is the cornerstone of Ireland’s corporate tax strategy. Companies operating in Ireland are subject to corporation tax at the 12.5% rate on the trading profits (i.e. active income) earned from their Irish operations. Income attributable to non-trading activities (i.e. passive investment income) is taxed at the higher 25% corporation tax rate.

Whether or not the activities of a company in Ireland amount to “trading” is a question of fact. As a general rule, real substance must be located in Ireland. The following factors are considered by the Irish Revenue as relevant in determining whether an Irish trade is being carried on:

(a) Will the real strategic decision making and planning in relation to the business take place in Ireland?
(b) Are there employees in Ireland with sufficient levels of skill and authority to carry out the activities of the business?
(c) Is any value added by the activities carried out in Ireland or are they merely routine ancillary activities?
(d) Is there a commercial rationale and underlying strategic business purpose for the proposed structure?

A company that holds IP must be engaged in active management, development and exploitation of that IP as distinct from passively holding IP in order to qualify for the 12.5% rate. In addition, capital allowances, research and development tax credits and the knowledge development box (detailed below) are not generally available unless the company qualifies for the 12.5% rate.

Capital Allowances and Intellectual Property
If an IP holding company has sufficient substance in Ireland to be treated as trading it should also be in a position to claim capital allowances (a form of tax depreciation) for capital expenditure incurred on the acquisition or development of “specified intangible assets”, defined as intangible assets which are:

(a) recognised as such under GAAP (IFRS/Irish GAAP); and
(b) included in one wide of the categories of intangible assets listed in the legislation.
The allowances are available for a wide range of intangibles including, subject to certain restrictions, patents, registered designs, design rights, inventions, trademarks, brands, domain names, copyright, computer software, plant breeders’ rights, any application for the grant or registration of any of the above, secret processes or formulae, know-how, customer lists and goodwill (to the extent the goodwill is directly attributable to the specified intangible asset).

Capital allowances are available in respect of capital expenditure incurred on acquiring or developing specified intangible assets, including intangible assets acquired from connected persons. However, the relief does not apply to capital expenditure which exceeds an arm’s length price.

The allowances may be granted:

(a) by reference to the amortisation or impairment charge in the company’s profit and loss account (prepared in accordance with GAAP or IFRS); or

(b) (on election) over 15 years, at the rate of 7% per annum (on a straight line basis) and 2% for the final year (this treatment is usually more appropriate where the asset is not amortised in the accounts, e.g. in the case of brands).

If the IP is disposed of within five years of acquisition for more than its tax written down value, part of the allowances claimed may be clawed back.

The allowances are ring-fenced and are available only against income earned from managing, developing or exploiting specified intangible assets, including from the sale of goods or services that derive the greater part of their value from the IP (the “relevant trade”). The aggregate amount of capital allowances claimed in respect of IP plus interest paid on funding to acquire that IP cannot exceed the amount of the income from the relevant trade. However, unused capital allowances (and related interest deductions) may be carried forward for offset against income from the relevant trade in future accounting periods.

In addition, other revenue expenses incurred wholly and exclusively for the purposes of the IP trade may be deducted in calculating taxable profits, (e.g. salaries, recurrent royalty payments and amounts paid under cost sharing arrangements in respect of research and development). Amounts paid to connected companies must satisfy Irish transfer pricing rules and should reflect the prices that would be agreed between parties acting at arm’s length.

These reliefs can significantly reduce the effective rate of corporation tax on IP related income and are a valuable incentive to companies looking to locate and develop IP in Ireland.

**Research & Development Tax Credits**

Research and development ("R&D") tax credits of 25% are available for qualifying R&D expenditure incurred within the European Economic Area ("EEA"). Payments to third parties are not generally taken into account for the purposes of the relief but R&D activity can be outsourced to an unconnected third party or third level institution subject to certain restrictions.

The credit is allowed against a company’s corporation tax liability for the year in which the R&D expenditure is incurred. Excess credits can be carried forward to future accounting periods and carried back to the immediately preceding accounting period. Where an excess remains, some or possibly all of the excess may be claimed as a refund where it is not possible to utilise the credits in the two years following the accounting period in which they arise. It is also possible to surrender R&D tax credits to key employees who are engaged in R&D activities where certain conditions are met.

R&D activities are defined as meaning systematic investigative or experimental activities in a field of science or technology which either seek to achieve scientific or technological advancement or involve the resolution of scientific or technological uncertainty. R&D tax credits are available across a wide range of areas including pharmaceuticals and medical devices but also in the food and drinks industry and financial services. The credits can be claimed in addition to the usual trading deduction available for R&D expenses. This results in a net benefit of 37.5% (i.e. 12.5% corporation tax deduction plus 25% R&D tax credit).
Eligible expenditure includes revenue expenses, for example, salaries and materials. Capital expenditure incurred on plant and machinery can also be included in the R&D tax credit. The expenditure must be eligible for wear and tear capital allowances but cannot be expenditure in relation to which capital allowances for specified intangible assets are claimed.

In addition, a tax credit may also be claimed for capital expenditure on buildings or structures used for R&D activity. The tax credit amounts to 25% of the cost of construction, reconstruction, repair or renewal and is available on a proportionate basis provided at least 35% of the building is used for R&D activities. The full credit may be claimed in the year in which the expenditure is incurred. A claw back of the relief applies where the building or structure is sold within 10 years, or ceases within 10 years to be used by the company for R&D activities or for the same trade that was carried on by the company in the four years since the building was first brought into use or the refurbishment was completed.

Knowledge Development Box (“KDB”)

In a significant enhancement to Ireland’s IP tax regime, Finance Act 2015 has introduced a “knowledge development box”. The KDB is the first OECD approved patent box and adopts the modified nexus approach of seeking to align the preferential tax treatment of certain IP income with the carrying on of qualifying R&D activities within the EEA. The KDB provides for an effective 6.25% corporation tax rate in respect of income arising directly from certain copyrighted software and patented inventions, provided some or all of the R&D activity giving rise to the IP is undertaken by a company within the charge to Irish corporation tax. The regime ring-fences the income arising from such qualifying IP assets by reference to the proportion by which “qualifying expenditure” bears to “overall expenditure”.

Qualifying expenditure means expenditure incurred by a company wholly and exclusively in the carrying on by it of R&D activities, where such activities lead to the development, improvement or creation of the qualifying asset (i.e. the relevant IP). Expenditure incurred by the company in the EEA is qualifying expenditure if it is tax deductible in Ireland. Excluded from the definition of qualifying expenditure are acquisition costs in relation to the IP. Payments to a group member for R&D (including cost-sharing arrangements) are also excluded. However, payments to non-related third parties to carry on R&D activities on behalf of the company are considered to be qualifying expenditure.

To take account of excluded expenditure, an additional uplift in the amount of qualifying expenditure is provided for as the lower of:

(a) 30% of the amount of the qualifying expenditure; or
(b) the aggregate of the acquisition cost of IP and group outsourcing costs.

The profits eligible for relief are calculated using the following formula:

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\text{QE} + \text{UE} \times \text{QA} / \text{OE}
\]

Where:
- QE is the qualifying expenditure on the qualifying asset
- UE is the uplift expenditure
- OE is the overall expenditure on the qualifying qualifying asset
- QA is the profit of the trade relating to the qualifying asset

The relief operates by providing for an allowance of 50% of the qualifying profits to be treated as a trading expense of the company resulting in an effective 6.25% tax rate on such profits.

Relief under the KDB applies to accounting periods which commence on or after 1 January 2016 and before 1 January 2021. Profits ring-fenced within the KDB can also avail of capital allowances relating to specified intangible assets and R&D tax credits.
Deductions for Interest Expenses

Deductions for interest paid on loans to acquire IP are available in Ireland. Similar to capital allowances available for IP, interest deductions are ring-fenced and available only against income from the "relevant trade" (i.e. managing, developing or exploiting specified intangible assets, including from the sale of goods or services that derive the greater part of their value from the IP). As noted above the aggregate amount of interest paid on funding to acquire IP plus capital allowances claimed in respect of IP cannot exceed the amount of the income from the relevant trade. Unused interest deductions may be carried forward.

Interest may be paid by Irish companies free from withholding tax (currently applied at a 20% rate) where the recipient is a body corporate and is tax resident in an EU Member State (other than Ireland) or a jurisdiction with which Ireland has signed a double tax treaty and that jurisdiction generally taxes foreign source interest.

Credit for Withholding Tax on Royalties Received

Withholding tax is generally levied on payments of royalties made by companies established outside of Ireland.

Ireland's wide treaty network can usually eliminate or reduce foreign withholding taxes on inbound royalties from treaty countries. Under the EU Interest and Royalties Directive no foreign tax may be withheld on royalties paid by a company resident in another EU Member State to an Irish resident company where the companies are connected through a 25% shareholding and certain other conditions are met.

To the extent foreign tax is withheld in respect of royalties paid by a foreign company to an Irish resident trading company, a tax credit may be claimed against the Irish tax payable. As the Irish tax rate is relatively low, the effect of this treatment is usually that no additional Irish tax is suffered in Ireland on royalties received.

Summary

A combination of the incentives outlined above, including the newly introduced KDB regime, offer significant advantages to companies looking to locate, exploit and develop IP in Ireland. Coupled with a wide range of legal protections for the creators / owners of IP rights, and a long history of R&D investment, Ireland affords significant opportunities for existing and prospective IP holding and development companies.

Contacts

For further information please speak with your usual contact or:

Petrina Smyth
Partner
T: +353 1 470 6626
E: petrina.smyth@walkersglobal.com

Jonathan Sheehan
Partner
T: +353 1 470 6639
E: jonathan.sheehan@walkersglobal.com

Brendan O'Brien
Of Counsel
T: +353 1 470 6653
E: brendan.obrien@walkersglobal.com

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