Ireland as an attractive location for venture capital or hedge funds

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Note on 15% CGT rate for certain venture fund managers

Irish tax legislation (Taxes Consolidation Act 1997, s 541C) provides for the taxation of returns ("carried interests") on certain venture capital investments to be treated as capital gains subject to capital gains tax at reduced rates of 15% or 12.5%, where investor companies are involved in R&D type activities. This is attractive to corporate and individual investors who would be subject to capital gains tax at 33% or income tax at the marginal 40% tax rate. A carried interest, or "carry", is a share of the profits of a successful partnership paid to the manager of a private equity or hedge fund as an incentive with a view to maximising the performance of the fund and which cannot exceed 20% of the total profits of a qualifying venture capital fund.

A "carried interest", in relation to a qualifying venture capital fund, is defined as the share of profits received by a company, partnership or individual in respect of the management of the fund. The share of profits in question will be the amount resulting from the share ratio agreed at the commencement of the fund.

A "qualifying venture capital fund" is an entity structured in the form of a partnership the main purpose of which is to make relevant investments and where the investors in the partnership are either limited partners or general partners (as defined in the partnership agreement) who are obliged under a legally binding agreement to provide capital sums for investment purposes over a period of time.

A "relevant investment" is an investment in unquoted shares or securities of a private trading company located in an EEA State where the qualifying venture capital fund retains shares or securities in the company for a period of at least three years from the date of the initial investment and that company is carrying on a business of research and development activities or innovation activities (development of new technological, telecommunications, scientific or business processes).

It is not stated above that the investee company is required to be a company whose business is "wholly or mainly" the carrying on of research and development or innovation activities, or indeed that there should be any minimum level of such activities carried on by it.

"Research and development activities" are systematic, investigative or experimental activities in a field of science or technology, being one or more of the following:

(a) basic research, namely, experimental or theoretical work undertaken primarily to acquire new scientific or technical knowledge without a specific practical application in view;

(b) applied research, namely, work undertaken in order to gain scientific or technical knowledge and directed towards a specific practical application; or

(c) experimental development, namely, work undertaken which draws on scientific or technical knowledge or practical experience for the purpose of achieving technological advancement and which is directed at producing new, or improving existing, materials, products, devices, processes, systems or services including incremental improvements thereto.

Activities will not, however, be R&D activities unless they are intended to achieve scientific or technological advancement, and involve the resolution of scientific or technological uncertainty.

The legislation operates to treat a "carried interest received by an individual, company or a partnership to be an amount of chargeable gains subject to capital gains tax. The rate of capital gains tax in respect of chargeable gains from the receipt of a carried interest is:

(a) 15% where received by an individual or partnership, and

(b) 12.5% where received by a company.

Ireland is a very attractive location for the exploitation of intellectual property (IP). Significant tax reliefs are available to companies which carry on such activities, including, but not limited to, tax relief for costs associated with the acquisition of IP, the knowledge development box (KDB) tax regime, and the R&D tax credit regime. Key features of these reliefs are as follows:

1.Tax relief for costs associated with the acquisition of IP

Capital allowances are available for capital expenditure incurred by companies on "specified intangible assets" to be used in a trade. The categories of assets in question are listed in the legislation and the tax regime applies to assets that are recognised as intangible assets under generally accepted accounting practice (GAAP). Allowances will reflect the standard accounting treatment of intangible assets and are based on the amount charged to the profit and loss account of the company for the relevant accounting period in respect of the amortisation and any impairment of the specified assets. A company may opt instead for allowances over a fixed write-down period of 15 years at a rate of 7% per annum for 14 years and 2% for the final year.

The disposal of an intangible asset more than 15 years after the beginning of the accounting period in which it was first acquired will not result in a claw-back of allowances, provided the disposal does not result in a connected company claiming allowances in respect of capital expenditure on that asset.

The aggregate amount of any allowances and related interest expense in an accounting period may not exceed the amount of the trading income from the relevant trade for that period. Any excess allowances and/or interest expense will, however, be available for carry forward for offset against trading income of the relevant trade for succeeding accounting periods. There is a corresponding restriction on the amount of interest relief which may be claimed by an investing company providing funds to a company to acquire a specified intangible asset.

Because of the continued availability of allowances for capital expenditure on the provision of computer software, the intangible assets scheme does not apply to such software. As patent rights and know-how are included in the scheme, the existing reliefs for capital expenditure on patent rights and know-how are being discontinued for companies, but with provision for companies to opt for these reliefs for an additional two year period.

2. Knowledge development box (KDB) tax regime

Under a new tax regime applying to income earned for accounting periods commencing on or after 1 January 2016, companies will be subject to corporation tax at an effective corporation tax rate of 6.25% on income qualifying for the Knowledge Development Box (KDB). Profits qualifying for the KDB will be calculated by reference to the proportion that a company's qualifying R&D expenditure bears to the overall expenditure on qualifying assets.

Income will only be eligible for the preferential KDB rate where the R&D activity which generates the underlying IP assets is predominantly undertaken in Ireland. The KDB will not apply to costs incurred in connection with the acquisition of IP or which are related party outsourcing.

The KDB is intended to be accessible for certain SMEs (companies with a global turnover of less than €50m and which derive annual income of less than €7.5m from IP assets). In particular, SMEs that develop assets that are not patent protected may still be eligible for the scheme, provided they receive formal certification from an independent government agency.

Qualifying profits of a "specified trade", ie profits from copyrighted software and inventions ("qualifying assets") of a company within the charge to Irish tax, to the extent that they relate to R&D undertaken in an EU Member State by that company, will be subject to tax at an effective rate of 6.25%, that rate resulting from an allowance equal to 50% of the qualifying profits.

The amount of the profits arising from the qualifying assets that may avail of the relief will be determined by the proportion that the company's R&D expenditure ("qualifying expenditure") bears to the total R&D expenditure (overall expenditure) incurred on the qualifying assets.

Qualifying expenditure includes the cost of R&D outsourced to unrelated parties but excludes expenditure on R&D performed by group companies (related parties) as well as the cost of acquired intellectual property. To take account of such excluded expenditure, qualifying expenditure may be increased by an "uplift", being the lower of 30% of qualifying expenditure and the aggregate of acquisition costs and group outsourcing costs. The excluded expenditure will be included in overall expenditure in calculating the profits qualifying for relief.

From 1 January 2016, detailed records are required to be maintained for the purpose of verifying a company's entitlement to the relief. There are transitional arrangements for qualifying expenditure incurred before 1 January 2016.

Large companies must comply with Irish transfer pricing rules in determining the overall income qualifying for relief as well as in relation to any inter-company transactions that are relevant to the relief. Smaller companies are not subject to transfer pricing rules but must nevertheless apportion income, where required, on a "just and reasonable" basis.

Where a company incurs a loss from activities that qualify for the relief, these losses are available for relief against other trading profits but on a 50% reduced basis.

3. R&D tax credit regime

To encourage expenditure on R&D, a credit of 25% of the amount of the expenditure incurred by a company may be set against its corporation tax liability for the accounting period in which the expenditure is incurred. Expenditure on R&D means expenditure incurred by a company on R&D activities carried on by that company in the European Economic Area (EEA). The expenditure must qualify for tax relief in Ireland and, in the case of an Irish-resident company, must not qualify for tax relief in any jurisdiction other than Ireland.

Where a company has a corporation tax liability in the accounting period preceding the accounting period in which the R& D expenditure giving rise to the tax credit arises, it may use any excess credit to reduce the corporation tax of the preceding accounting period. Any remaining excess can continue to be carried forward indefinitely for use against future corporation tax liabilities.

Alternatively, where there is a remaining excess credit after covering the corporation tax payable for the current and preceding accounting period, the company may claim to have that remaining excess paid to it.

A company may not carry forward any excess which has been used to reduce the corporation tax of the preceding accounting period or any part of the excess which has been paid to it by virtue of the alternative claim mentioned above.

The repayment (the amount of which is limited to the greater of (i) the corporation tax payable by the company for accounting periods ending in the 10 years prior to the period of the claim or (ii) the payroll liabilities for the period in which the expenditure giving rise to the claim is incurred) operates as follows:

1. An initial payment of 33% of the excess is made not earlier than the date on which the corporation tax return for the period of the R&D expenditure in question is due.
2. Any remaining excess is used to reduce the corporation tax for the accounting period following the accounting period in which entitlement to the credit arises. If there is any further remaining excess, a second instalment equal to 50% of that excess will be paid. The

second payment will be made not earlier than 12 months from the date on which the corporation tax return of the R&D expenditure in question is due.

3. Where any excess still remains, it will be used to reduce the corporation tax for the second accounting period following the accounting period in which entitlement to the credit arises. If any excess is then still unused, a third instalment equal to that remaining amount will be paid. The third payment will be made not earlier than 24 months from the date on which the corporation tax return of the R&D expenditure in question is due.

A group may elect as to the basis on which the credit is to be shared among the group members.

A company may surrender all or part of the R&D credit to which it is entitled to one or more key employees as it may specify.

The R&D tax credit is in addition to any tax relief that may be available by way of a deduction in computing trading income or as a charge on income, or as a deduction for revenue expenditure on scientific research, or by way of capital allowances in respect of expenditure on plant and machinery under the capital allowances regime.

A company which incurs expenditure on the construction or refurbishment of a qualifying building which is to be used for the carrying on by it of R&D activities is entitled to a tax credit of 25% of the cost of construction or refurbishment. The credit is allowed against the company's corporation tax liability over a period of four years.

Excess credits related to expenditure on qualifying buildings may be used in a similar way as for R&D expenditure as outlined above.

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