



Research and Development

Introduction

There has been much press comment in recent years about the tax reliefs which are available to companies which incur expenditure on Research and Development (“R&D”) as part of their trading activities.

The R&D tax relief regime is now familiar to most companies but there are still many companies who do not truly appreciate the cash value of the benefits which can be secured. Whilst the rules are complex with a little guidance, and some attention to procedures and processes, the reliefs can be unlocked.

This briefing sets out the main details of the reliefs available and details to identify the most important issues for a company to address when considering an R&D claim.

Overview

Only companies can claim tax relief for R&D expenditure.

Which projects qualify?

A company can only claim for R&D relief if an R&D project seeks to achieve an advance in overall knowledge or capability in a field of science or technology through the resolution of scientific or technological uncertainty - and not simply an advance in its own level of knowledge or capability. The R&D project must be related to the company’s trade - either an existing one, or one that it intends to start up based on the results of the R&D.

What is R&D?

There are guidelines that define all the following terms, and it is important to understand these concepts before attempting to reach a view on whether a company has an R&D project for tax purposes:

- Project;
- Advance in science or technology;
- Science;
- Technology;
- Directly contribute; and
- Scientific or technological uncertainty.

H M Revenue & Customs (“HMRC”) have suggested that the following questions, if answered when making a claim, will aid proper consideration of the claim:

What is the advance in science or technology?

The main consideration is what scientific or technological advance is being sought? This focuses attention on the project's aim for an advance, which is the key issue in judging whether, for tax purposes, R&D is being undertaken.

Science does not include work in the arts, humanities and social sciences (including economics).

It's not enough that a product is commercially innovative.

What were the scientific or technological uncertainties?

Scientific or technological uncertainty exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, is not readily available or deducible by a competent professional working in the field.

Uncertainties that can be resolved through relatively brief discussions with peers are routine uncertainties rather than technological uncertainties. Technical problems that have been overcome in previous projects on similar systems are not likely to be technological uncertainties.

How and when were the uncertainties overcome?

A detailed description of the work undertaken, the outcomes, and the effect on the project will aid the understanding.

Why was the knowledge being sought not readily deducible by a competent professional?

It might be publicly known that others have attempted to resolve the uncertainties and failed, or perhaps others have resolved the uncertainties but precisely how it was done is not in the public domain. In either case a valid technological uncertainty can still exist.

Alternatively, if the project is one where there is little public information available, a company will need to show that the persons leading the R&D project are themselves competent professionals working in the relevant field. This might be done by outlining their relevant background, professional qualifications and recent experience, then have them explain why they consider the uncertainties are scientific or technological uncertainties rather than routine uncertainties.

Which costs qualify for R&D Relief?

To qualify as R&D, any activity must meet the definitions set out by Department for Business, Innovation and Skills in their guidelines dated December 2010. These updated the original guidelines dated March 2004 which were issued by the Department of Trade and Industry. The guidelines state that the activity must contribute directly to seeking the advance in science or technology or must be a qualifying indirect activity.

HMRC in their updated guidance on R&D have given more information about R&D which is undertaken as part of a production process.

Both sets of guidance need to be reviewed carefully before an R&D claim is made.

If a company and the project both meet the necessary conditions, then a claim for tax relief can be made in respect of the revenue expenditure.

Employee costs - employing staff directly who are actively engaged in carrying out R&D itself. The staff must be employed under a contract of employment directly with a company - not consultants, agency workers, or staff/directors whose contracts of employment are with other companies. However, these others may qualify under either the rules for externally provided workers or subcontractors.

Externally provided workers - paying a staff provider for staff provided to the company who are directly and actively engaged in carrying out R&D. The staff provider needs to contract with the individual whose services they supply - not through another person.

Materials - consumable or transformable materials used directly in carrying out R&D. These are actual physical materials that are consumed in the R&D. Care is needed where the consumables form part of a product which is created as part of a production process where R&D has been involved. An apportionment may be necessary in certain situations.

Payments to clinical trials volunteers - the cost of relevant payments to subjects of clinical trials.

Utilities - power, water, fuel used directly in carrying out R&D, but not items such as telecommunication costs and data costs.

Software - computer software used directly in the R&D.

Subcontracted R&D expenditure - if a company is claiming relief under the Small or Medium-sized ("SME") Scheme, then it may be able to claim back 65 per cent of what it spends on certain R&D activities carried out for it by a subcontractor. But if the subcontractor is connected to the company, and it has jointly elected for connected parties treatment, special rules apply. If the company is not a SME, it can only claim expenditure on activities that are undertaken directly on its behalf by certain specific kinds of subcontractor.

Capital expenditure

Although R&D relief is only available for 'revenue expenditure', if a company is involved in R&D and it spends money on capital assets, it may be able to claim R&D capital allowances and in particular a 100% First Year Allowance.

Amount of relief

The amount of relief, and the mechanism for securing it, depends on whether or not the company is a SME company or a 'large company'.

What is the definition of an SME for R&D?

A SME is a company which does not exceed the following thresholds:

- Fewer than 500 employees;
- An annual turnover not exceeding €100 million; and
- A balance sheet value not exceeding €86 million.

A company may not be a SME if it is part of a larger group that, taken as a whole, would fail these tests. Thus, care is needed when considering the status of companies which are part of a group structure. The tax team at Friend Partnership Limited can assist in helping assess which regime is appropriate for any company.

Please note that the SME definition given above is not necessarily the same as that used for other taxation provisions.

SME Scheme

The SME scheme is only available to those companies which meet the definition given above.

The SME scheme has higher rates of relief than the scheme for large companies. From 1 April 2015, the tax relief on allowable R&D costs is 230%, that is, for each £100 of qualifying cost, a tax deduction of £230 is available.

If instead the company has an allowable trading loss for the period, this can be increased by 130% of the qualifying R&D costs. Thus, for every £100 of allowable R&D costs an additional deduction of £130 is available to increase the available losses. This increased loss can be carried forward or back in the normal way, but only if the company chooses not to convert it to tax credits.

If a company makes a loss, it can choose to receive its tax relief by way of tax credits - a cash sum paid to the company by HMRC.

The amount of the tax credit is currently 14.5% of the 'surrenderable loss'. The surrenderable loss is the lower of the trading loss for the year and the total of the enhanced R&D expenditure. Thus, if a company has a trading loss of £100 following the uplift for R&D costs and has spent £100 on R&D the surrenderable loss is £100 as this is lower than the total enhanced R&D cost of £230.

In certain specific situations, even if the company meets the definition of a SME, it may not be able to claim relief under the SME scheme. However, it may be able to claim under the Large Company Scheme.

As an example, a company cannot claim R&D Relief under the SME scheme if it is a subcontractor - that is, if the company has been subcontracted to do the work on behalf of somebody else. But, even if the company is a SME, it may still be able to claim, as a subcontractor, under the Large Company Scheme.

If the company is a SME, then a claim is only possible if the company is a going concern when it makes the claim and is not in administration or liquidation at that time. If the company ceases to be a going concern after making a claim, but before any credit is paid, HMRC treats the claim as if it has not been made such that no credit is available.

Subsidies and grants

Where a company has received a subsidy, or grant for an R&D project, this may affect how much tax relief it can claim. If the subsidy or grant is a 'State Aid' recognised by the European Commission, then it can't claim anything under the SME Scheme. For any other type of subsidy or grant, the R&D expenditure that can be claimed is reduced by the amount of the subsidy or grant received.

The company may be able to claim under the Large Company Scheme instead in respect of the subsidised expenditure. But the company can only do this if:

- The expenditure would have been allowable under the Large Company Scheme if the company was 'large'; and
- The expenditure is ruled out of the SME Scheme only because it was subsidised or because the amount received exceeds the €7.5m limit for a particular project under the SME R&D rules.

If the company does claim under the Large Company Scheme, then the large company rules apply.

The Large Company Scheme

If a company is not a SME, then a claim under the Large Company Scheme may be possible.

Rate of tax relief

For expenditure incurred prior to 1 April 2016, the tax relief on allowable R&D costs was 130 per cent - that is, for each £100 of qualifying costs, a tax deduction of £130 was available. If instead there was an allowable trading loss for the period, this would be increased by 30 per cent of the qualifying R&D costs - £30 for each £100 spent. This loss can be carried forwards or back in the normal way. No payable tax credit was possible with the Large Company Scheme. However, a repayable credit is possible, subject to certain limitations with the RDEC scheme detailed below.

'Above the Line' R&D expenditure credit ('RDEC')

For expenditure incurred on or after 1 April 2016 an 'above the line' regime must be adopted by large companies.

Amount of and mechanism for relief

The RDEC is calculated at a rate of 11% (12% for expenditure incurred on or after 1 January 2018) of the qualifying R&D expenditure. The RDEC is added to the company's taxable profits and then deducted from the total tax payable, which will have increased because of the inclusion of the RDEC.

There are some complex rules to deal with the situation should the RDEC be more than the tax payable by the company in the year in question. The specific detail is beyond the scope of this Briefing Note and detailed advice should be sought if this is the case.

Amount of expenditure

There is no minimum expenditure requirements for either scheme.

How and when to claim

The claim for R&D Relief is made in the company tax return or amended return. The normal time limit for making a claim is two years after the end of the relevant corporation tax accounting period. Appropriate entries can be made if the company wants a payable tax credit.

Although it's not a legal requirement, HMRC encourages companies to:

- Tell them why the company considers its project(s) to be allowable as R&D (as defined above); and
- Provide a summary of the costs incurred on R&D and how the figures in the return were arrived at.

If a company is simply claiming relief, this will reduce the company's profit chargeable to corporation tax for the relevant accounting period. If a company has chosen to surrender R&D losses to receive tax credits instead, or if the company has submitted a claim to carry back a loss to be set off against profits of a previous accounting period, to create a repayment, then HMRC will make the payment after they receive the company's return.

Record keeping for R&D Relief

There is no specific record keeping requirement for R&D relief claims. However, the general corporation tax requirement to keep sufficient records to support the entries on the company tax return still applies.

HMRC doesn't expect a company to create new primary business records just for an R&D relief claim. However, a company may need to maintain its business records in a different way, to allow it to access the information it needs easily.

Advance assurance

For certain SMEs, it is possible for them to seek advance assurance from HMRC that the R&D activity they are undertaking, or are about to undertake, will qualify for R&D tax relief.

If HMRC give positive assurance then the company's R&D claim will be accepted without question for three accounting periods.

The assurance can be sought where the company has:

- Turnover less than £50 million;
- Fewer than 50 employees; and
- Made no previous claim for R&D relief.

Summary

This Briefing Note has given an overview of the main provisions about R&D tax relief. The detailed provisions need to be reviewed carefully before a claim is made. If all the necessary conditions are met the R&D regime can give very valuable tax reliefs for companies.

There is no doubt that the R&D regime has given a sizeable number of companies a welcome boost whether because of a direct cash injection or reduced corporation tax bills.

Whilst the rules may be complex with a little expert guidance the relief can be relatively easy to secure. HMRC are now well geared up to deal with R&D claims. If claims are presented well this will ensure that HMRC do not need to waste time on basic issues, such that claims can be considered and agreed more quickly and stand every chance of success.

In many ways, the first step is perhaps the most difficult - deciding whether the R&D project is one which falls within the HMRC definitions.

At Friend we can help you to:

- Identify which projects fall within the definition;
- Determine the qualifying costs;
- Help reconfigure the company's accounting systems to aid in the new identification of qualifying costs; and
- Prepare submit and agree all necessary claims with HMRC.



If you have any questions regarding this Briefing Note please contact:

**Simon Littlejohns, Head of Tax
Friend Partnership Limited**

T: 0121 633 2007

E: simon.littlejohns@friendllp.com