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RESEARCH AND DEVELOPMENT – TAX RELIEF

Introduction

There has been much press comment in connection with 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 seeks to set out the main details of the reliefs available and 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 state 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 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 R&D for tax purposes 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 actually 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 that others have resolved the uncertainties but that 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 the Department of Trade and Industry ("DTI"). (Now known as the Department for Business, Innovation and Skills). These guidelines state that the activity must contribute directly to seeking the advance in science or technology or must be a qualifying indirect activity.

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 staff providers or subcontractors.

Staff providers - 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, and not things like telecommunication or data costs.

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 things like 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, 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.

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 a SME for R&D?

A SME is a company with fewer than 500 employees and either of the following:

- an annual turnover not exceeding €100 million; or
- a balance sheet value not exceeding €86 million.

A company may not be considered to 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. Friend 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 2012, the tax relief on allowable R&D costs is 225%, that is, for each £100 of qualifying cost, a tax deduction of £225 is available.

If instead the company has an allowable trading loss for the period, this can be increased by 125% of the qualifying R&D costs. Thus for every £100 of allowable R&D costs an additional deduction of £125 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 – if the company has PAYE and National Insurance contributions liabilities for that period.

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. 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 rate of tax relief is lower, and the company cannot convert the relief into payable tax credits.

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

From 1 April 2008, the tax relief on allowable R&D costs is 130 per cent - that is, for each £100 of qualifying costs, a tax deduction of £130 is available. If instead there is an allowable trading loss for the period, this can 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.

'Above the Line' R&D expenditure credit

The Large Company Scheme includes an 'above the line' credit which has been introduced for expenditure incurred on or after 1 April 2013. It will initially be optional, running alongside the enhanced-deduction scheme which it will replace in April 2016.

Amount of expenditure

Relief is given as a taxable credit on the amount of qualifying R&D expenditure. The rules for identifying qualifying R&D activity and calculating R&D expenditure remain unchanged.

Rate of Relief

From 1 April 2013 relief is given at 10 per cent of the qualifying R&D expenditure.

Amount of expenditure

With effect for accounting periods ending on or after 1 April 2012 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 give up the enhanced relief 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.

Summary

There is no doubt that the R&D regime has given a sizeable number of companies a welcome boost whether as a result 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 or not the R&D project is one which falls within the HMRC definitions.

At Friend we can help:

- in identifying which projects fall within the definition;
- in determining the qualifying costs;
- in helping reconfigure the company's accounting systems to aid in the identification of qualifying costs; and
- in preparing, submitting and agreeing all necessary claims with HMRC.

If you have any questions in connection with this briefing please contact Simon Littlejohns, Tax Partner, on 0121 633 2007 or your usual contact at Friend.

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