CORPORATE AND BUSINESS TAX

# Research & Development

***Is your company claiming R&D tax credits to fund its innovative projects? Research and development (R&D) by companies is being actively encouraged by the Government through a range of tax incentives. These include an increased deduction for R&D revenue spending and a payable R&D tax credit for companies not in profit. The Government views investment in R&D as key to economic success. It is committed to driving innovation in the economy by encouraging more companies to claim R&D tax relief. Eligible businesses can benefit from up to 33% of qualifying expenditure, or a cash grant.***

Here we consider how the incentives work.

**What are the tax reliefs available for SME companies?**

Just as a reminder, an SME is defined as a UK limited company subject to UK Corporation Tax (CT) where the company (or the group to which it belongs) employs 500 or fewer full time equivalent members of staff AND

- Has a turnover of less than €100m or
- Has balance sheet totals of less than €86m

So you must be a limited company and registered to pay Corporation Tax in the UK. A company can claim enhanced deductions against its taxable profits for expenditure which is qualifying R&D expenditure. This means you can deduct an extra 130% of qualifying costs from your yearly profits, as well as the normal 100% deduction, equalling 230% total deduction. R&D enhanced relief represents an additional corporation tax reduction of 24.7% of the expenditure incurred.

If the R&D claim creates a tax loss, then the company may be able to surrender the loss for a cash repayment. This is currently calculated at 14.5%. A surrendered loss could therefore give a repayment of up to 33.35% of the expenditure.

Where the company incurs qualifying R&D expenditure before it starts to trade, it can elect to treat 230% of that expenditure as a trading loss for that pre-trading period. The pre-trading loss created by the R&D relief can then be surrendered, as above, which could provide much needed cash flow for new companies.

Qualifying R&D capital expenditure incurred by a company would be eligible for 100% Research and Development allowance. Details of this allowance are not provided in this summary.

**Example of R&D claim**

A company has adjusted net profits of £50,000 before an R&D claim and allowable R&D expenditure of £70,000.

The enhanced claim is therefore £70,000 x 130% = £91,000.

Deducting this from the adjusted profits gives a loss of £41,000.

The company decides to surrender this loss for a cash repayment. The amount they would receive is £41,000 x 14.5% = £5,945.

**Preventing abuse of the R&D tax relief**

The government has capped the amount of R&D tax credit payable to an SME at £20,000 plus 300% of its total PAYE and NICs liability from April 2021. It says this is to help prevent abuse of the R&D tax relief by artificial corporate structures.

A company is exempt from the cap if:

- its employees are creating, preparing to create or managing Intellectual Property (IP) and
- it does not spend more than 15% of its qualifying R&D expenditure on subcontracting R&D to, or the provision of externally provided workers (EPWs) by, connected persons.

**Qualifying projects for R&D relief**

HMRC has a set of criteria for qualifying projects. R&D relief can be claimed by companies that have incurred expenditure on qualifying R&D projects which are relevant to the company's trade. A project should address an area of scientific or technological interest and be innovative. The innovation needs to be an improvement in the overall knowledge in the relevant field of research, not just an advancement for the company. For example, qualifying projects could include those which:

- increase the life of a battery.
- create a new type of material in an item of clothing.
- develop new spark plugs for use in an existing engine.

An important point to appreciate is that the activity does not have to create something completely new from scratch. It could include:

- developing a product that exists but where there is some technological uncertainty which can be improved.
- making an appreciable improvement to a product or process eg: exploring new, cost-effective materials which will allow a product to perform better.

Companies should document the uncertainties and planned innovation at the start of a project to provide evidence to support an R&D claim.

**Relevant activities on R&D**

Once the company is comfortable that R&D is taking place, then the next step is to identify the activities of the business that relate to the R&D activity.

There are essentially two types of activities:

- those that contribute directly to achieving the advancement.
- certain activities that contribute indirectly to achieving the advancement.

Examples of direct activities are:

- scientific or technological planning.
- scientific or technological design, testing, and analysis.
- activities which design or adapt software, materials or equipment.

Examples of indirect activities are:

- information services eg: preparation of R&D reports.
- indirect supporting services to the R&D project eg: maintenance, security, clerical.
- ancillary services eg: leasing laboratories and equipment.

Indirect activities all have to be undertaken for the R&D project.

The R&D project begins when the work on the scientific or technological uncertainty starts and ends when that uncertainty is resolved. It is therefore beneficial for companies to keep a timeline of activities and their purposes, to show when the business starts to move into the production phase, to optimise their claims.

**Types of expenditure**

Qualifying expenditure that is incurred on activities which are either directly or indirectly related to the R&D project fall into different categories. These are as follows:

- staffing costs
- software
- expenditure on consumable or transformable materials
- costs of work done by subcontractors and externally provided workers
- costs of clinical trial volunteers.

To be eligible, expenditure must be revenue in nature and paid by the time that the R&D claim is accepted. This means any accruals for expenditure have to be monitored carefully after the year end to make sure that they are paid and not written back to profit.

Further detail on some of these categories is provided below. You cannot claim for rent, rates, patents, trademarks or the production and distribution of goods and services.

### Staffing costs

Staff costs include those of employees and director staff ie: salaries, employer pension contributions, employers' NIC but not non-cash benefits-in-kind or dividends. Where an employee or director only spends part of their time on an R&D project, the costs are apportioned. The relevant staff are those involved in the direct and indirect activities highlighted above.

The indirect activity list includes categories for 'supporting' and 'ancillary' services. The staff who perform these services should be providing supporting or ancillary services for the R&D project and not for the other people who are directly involved in the R&D project.

### Examples

- The salary costs of a maintenance worker working full time on maintaining laboratory equipment used for R&D can be claimed.
- The salary costs of an accountant keeping a record of the maintenance work done, including the laboratory maintenance, cannot be claimed.

If directors are taking dividends from the company rather than salaries it may be more beneficial to consider reviewing this for any directors substantially involved in R&D projects.

### Consumable transformable materials

Materials that are consumed or transformed in the R&D activity are eligible expenditure. Items included would have to be items which were consumed or transformed so that they were no longer usable in their original form. This would therefore include:

- water
- power
- fuel
- a chemical substance which is transformed
- an electrical component.

Any consumables or transformable materials that are included in a product that is sold, transferred or hired out are not counted as qualifying expenditure for R&D relief.

### Costs of work subcontracted out and externally provided workers

Where the SME subcontracts qualifying R&D work, it can claim a deduction for the cost of that subcontractor work. The amount that can be claimed depends on whether the SME is connected to the subcontractor but generally it is up to 65% of qualifying costs. Similar rules apply to externally provided workers.

### Methods of claiming tax relief

Companies can claim R&D tax relief up to two years after the end of the accounting period it relates to. This means for expenditure on a qualifying project identified after the Corporation Tax return has been filed with HMRC there remains a window to make this claim. You will need to file an amended Corporation Tax return.

**Example of the R&D claim window**

A company has an accounting period running from 1 April 2018 to 31 March 2019.

The CT return is filed by the due date of 31 March 2020.

Later a qualifying R&D project is identified as running from 1 June 2018 to 31 December 2019.

The previously filed CT return can be amended at any time up to 31 March 2021, to include the expenditure incurred in the accounts period ended 31 March 2019.

The expenditure incurred to the end of the project on 31 December 2019 is claimed as usual in the CT return due to be filed by 31 March 2021.

HMRC has specialist offices which are able to offer advice on R&D claims. HMRC also offers an Advance Clearance Service for R&D.

**Research and Development Expenditure Credit scheme (RDEC)**

The SME scheme is not available if the R&D project has had the benefit of a grant or subsidy or if the company (or group) does not meet the SME criteria above. There may, however, be an alternative claim available to the company - the Research and Development Expenditure Credit scheme (RDEC).

RDEC is aimed at larger companies but as a smaller business you can claim it if you've been subcontracted to do R&D work for a large company.

Since 1 April 2020, RDEC allows the company to claim a taxable credit of 13% of eligible expenditure. As this amount is taxable it is known as an 'above the line' credit. The credit received may be used to settle corporation tax liabilities of the current, future or prior periods subject to certain limitations and calculations. Where there is no corporation tax due the amount can be used to settle other tax debts or can be repaid net of tax.

**How we can help**

Obtaining tax relief for companies incurring R&D expenditure can only be achieved if the relevant conditions are met. It is therefore vital that professional advice is sought at an early stage. If you would like assistance, the Wise & Co Team would be pleased to help.

*Last updated in July 2021.*