Tax Treatment of Research and Development Expenditure

Summer 2013
Introduction

Successive Governments have recognised that encouraging businesses to undertake Research and Development (R&D) activities in the UK is vital for the health of the UK economy. The Finance Act 2000 introduced revised legislation to further encourage R&D investment and the tax benefits on offer have become steadily more attractive. Despite this, there are many eligible companies that are still not claiming the benefit of these very generous reliefs.

There are separate reliefs depending on whether the company is an SME (small or medium-sized enterprise) or a large company. Under the SME scheme, a company can claim a deduction of 225% against its taxable profits for qualifying R&D expenditure. Additionally, if the R&D claim results in a tax loss, the loss can be surrendered in exchange for a cash payment from HM Revenue & Customs (HMRC).

Under the large company scheme, a company can claim a deduction of 130% against its taxable profits for qualifying R&D expenditure. The Government is also considering the introduction of an above the line credit for large companies which may allow for losses arising from R&D claims to result in cash repayments.

What is the definition of research & development?

HM Revenue & Customs uses the same basic definition of research and development as used in the Accounting Standards although this is amplified in Department of Trade guidelines. It must be creative or innovative work in the field of science or technology with a view to extending scientific or technological knowledge and producing new or substantially improved materials, devices, products, processes, systems or services before commercial productions starts.

The definition distinguishes research and development activity from non-research activity by the presence of an appreciable element of innovation.

Additionally any development work carried out by a company on well established products and processes which does not extend the knowledge base in the relevant industry sector would not be R&D, even though it may improve the company's understanding of them.
Activities that would normally be included in R&D

- Experimental, theoretical or other work aimed at the discovery of new knowledge, or the advancement of existing knowledge
- Searching for applications of that knowledge
- Formulation and design of possible application for such work
- Testing in search for, or evaluation of, product service or process alternatives
- Design, construction and testing of prototypes and models and development batches primarily to test R&D hypotheses
- Design of products, processes, services or systems involving new technology or substantially improving those already produced or installed
- Construction and operation of prototypes and pilot plants
- Indirect supporting activities such as maintenance, security, administration and clerical activities and finance and personal services insofar as undertaken for R&D

Activities that would normally be excluded from R&D

- Testing analysis of equipment or product for the purposes of quality or quantity control
- Periodic alterations to existing products, services or processes even though these may represent some improvement
- Operational research not tied to specific research and development activity
- Cost of corrective action in connection with break-downs during commercial production
- Legal and administrative work in connection with patent applications, records and litigation and the sale or licensing of patents
- Activity, including design and construction engineering, relating to the construction, relocation, rearrangement or start-up of facilities or equipment other than those whose sole use is for a particular research and development project
- Market research

Research & Development Allowances

Research & Development Allowances (R&DAs) is the renamed version of the old Scientific Research Allowances (SRAs).
What revenue reliefs are available?

Small and medium companies (SMEs)

From 1 April 2012 for small and medium-sized enterprises relief of 225% (200% for expenditure incurred prior to 31 March 2012), is available on qualifying revenue-based research and development expenditure as long as the amount of expenditure charged to the profit and loss account is £10,000 or more per year for accounting periods ending on or before 31 March 2012.

Where the corporation tax account period is less than 12 months the *de minimis* limit of £10,000 was reduced on a pro rata basis.

Therefore if the company charges to the Profit and Loss Account qualifying R&D revenue expenditure of £30,000 then it can subtract an amount of £67,500 (£30,000 x 225%).

Conditions required for 225% relief (200% to 31 March 2012)

The expenditure must satisfy the following five conditions:

1. It must be of a revenue nature
2. It must relate to a company’s trade, an extension of that trade, or a trade that will be derived from that expenditure
3. It must relate to staffing costs, consumable stores, subcontracted R&D expenditure, externally provided workers, certain computer software, power, water and fuel employed directly in relevant R&D
4. Any intellectual property created from the R&D expenditure, such as Know How, patents, etc., must vest in the company or jointly with the company and other persons
5. The expenditure does not relate to activities which have been contracted out to the company by any person

For accounting periods ended from 1 August 2008 onwards

To qualify as a small or medium sized enterprise, the business must have during the period in question:

- 500 employees or fewer; and
- annual turnover of €100m (approx £81m at Oct 12) or less; or
- gross asset total of €86m (approx £69m at Oct 12) or less
Where an enterprise has interests of 25% or more in other enterprises or where itself is owned 25% or more by other enterprises, it may be necessary to take account of employment, turnover and assets of those other enterprises when deciding if it is an SME.

In addition no more than 25% of the claimant business’s capital or voting rights must be held by enterprises that are not small or medium sized.

**Tax repayment for R&D surrenderable loss**

If the SME’s tax relief gives rise to a trading loss there are two methods available for claiming relief:

1) The R&D tax relief is incorporated into that loss enabling it to be used in the normal way (set sideways against other income from that period, carried back to the preceding accounting period, carried forward against future profits from the same trade or surrendered as group relief).

2) An R&D tax credit cash payment can be claimed based on any loss still unrelieved after taking into account any loss relief claimed (or which could have been claimed) as set out in 1 above up to a maximum of the 225% R&D deduction claimed (200% to 31 March 2012).

The amount of the payment that can be claimed as an R&D tax credit cash payment is 11% equivalent to 24.75 pence for every £1 actually spent, (12.5% to 31 March 2012) of the surrenderable loss or, for accounting periods ended prior to 1 April 2012, if lower, the total PAYE and Class 1 NI contributions paid by the company in respect of all staff for that period.

From 1 April 2008 for ‘large’ companies (i.e those not classified as SMEs), relief of 130% is available and is based on the same format as the allowance for SMEs. The minimum annual spend is £10,000 for accounting periods ending prior to 1 April 2012.

Generally if a large company subcontracts work to others it will not be able to claim the tax credit unless the other is:

- A university or other higher education institute
- A charity
- A scientific research organisation
- An NHS body
- An individual or partnership of individuals

There is no requirement for a company making a claim to retain the intellectual property rights from the R&D.
‘Above the Line’ Tax credit for large companies

From 1 April 2013, a new regime has been introduced for large companies. Instead of claiming an enhanced deduction against profits, a large company is now entitled to a payable credit equal to 10% of the company’s qualifying R&D expenditure.

The ATL credit is taxable, resulting in an effective rate of tax relief of 7.7%. This will rise to 8% from 1 April 2015 when the corporation tax rate drops to 20%.

Frequently asked questions

What if the company has not started to trade?

The company may elect to have the qualifying R&D expenditure in the period it was incurred treated as if it were a trading loss and claim R&D tax relief.

The options available to this ‘trading’ loss are:

- set against other profits of the period (such as interest)
- surrendered as group relief
- cashed in for the payable R&D tax credit
- Any unused losses can be carried forward as if they were losses of the trade and used against future profits from the same trade

What if the R&D is carried out through a joint venture or collaborative arrangement?

If the intellectual property that is created is owned by a joint venture company then it is the joint venture company that will be able to claim any R&D tax credit.

If two or more enterprises collaborate on an R&D project then the share of the R&D tax credits that each enterprise can claim will depend on their share of any intellectual property that the project creates.
What if some of the qualifying expenditure has been provided by a grant or subsidy?

For SMEs if part or all of the expenditure of a company’s R&D project is met by a Notified State Aid then none of the cost of the project’s R&D qualifies for R&D tax relief if incurred prior to 9 April 2003. Examples of notified State Aid for an R&D project are the Smart and LINK awards given by the DTI.

However, if a company incurs qualifying R&D expenditure on two separate R&D projects where the first has been partly or wholly met by a notified State Aid and the second has not then the second project qualifies for R&D tax relief.

If the subsidy, grant or other payment is not a notified State Aid then R&D relief cannot be claimed on that part of the qualifying expenditure incurred prior to 9 April 2003 which is met by the subsidy, etc. The remaining part of the qualifying R&D expenditure therefore does qualify.

After 9 April 2003, the above restrictions do not apply to the Large Companies R&D Scheme. An SME can therefore make a claim under the Large Companies scheme on unrelieved expenditure provided it qualifies under that scheme’s rules.

Conditions required for 100% initial allowance

Where a company incurs qualifying capital expenditure, it can claim an initial allowance, for capital allowance purposes, of 100%. This is known as a Research and Development Allowance (R&DA).

Qualifying expenditure includes all expenditure on plant, buildings etc incurred for carrying out R&D and providing R&D facilities, but no relief is available for the cost of the land.

Frequently asked questions

What if expenditure qualifies for more than one capital allowance?

If expenditure qualifies for more than one capital allowance, say R&DAs and IBAs (Industrial Buildings Allowances), it is possible to claim for only one allowance. Any of the qualifying allowances can be chosen but once a choice has been made it will not be possible to claim for another allowance.
What if the asset is only partly used for qualifying research and development?

If the asset is only partly used in research and development then only that part of the asset qualifies for R&DAs.

If no part of the asset is used exclusively for either purpose then the cost of the asset should be apportioned to reflect the use of the asset as a whole for the purpose of research & development.

What if included in the cost of the expenditure is an element of land or dwelling?

In the case of land a portion of the expenditure reflecting the value of the land should be excluded from the amount on which the RD&As are based.

If a dwelling is included in the expenditure this too should not be included in the amount on which the R&DAs will be based.

However if the dwelling is part of a larger building, and that building is used for R&D, then the element of expenditure associated with the dwelling, if it is not more than a quarter of the whole cost of the building, can be ignored. In this case the whole amount can be treated as allowable for R&DAs.

Can R&DAs be claimed on qualifying research and development expenditure that has been provided by a grant or subsidy?

In general no allowances will be available on expenditure provided by grants or subsidies from the persons listed below:

- the Crown
- any Government
- any public or local authority
- any person other than the person incurring the expenditure

Where these grants or subsidies provide only a portion of the qualifying research and development expenditure then it should be deducted from the total in order to arrive at the amount allowable for R&DAs.

The following grants are exceptions and thus allowable to qualify for R&DAs:

- a regional development grant made under part II of the Industrial Development Act 1982
- a regional development grant made under part I of the Industrial Development Act 1972
How we can help

We have extensive experience in helping our clients to successfully make R&D claims and in reaching agreement to claim with HMRC.

We can work with you either on a project by project basis or as part of an on going tax compliance engagement.

We would be delighted to speak to you to discuss how we can help your company to maximise its R&D relief claims.

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If you would like further information about enterprise management incentive, the Tax Department or any aspect of HW Fisher & Company, please contact Toby Ryland, Brian Lindsey, or any of our partners.

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