Research and Development

Research and development (R&D) by UK companies is being actively encouraged by Government through a range of tax incentives. The government views investment in research and development ('R&D') as a key to economic success. It is therefore committed to encouraging more smaller and medium sized ('SME') companies to claim R&D tax relief

The incentives are only available to companies and include:

- increased deduction for R&D revenue spending and
- a payable R&D tax credit for companies not in profit.

The government is committed to improving access to R&D highlights the need for more SME companies to understand what relief is available and how the process of claiming tax relief works. Recent changes to R&D scheme rates have increased the relief available so a clear understanding is needed to ensure that companies are aware of how the tax rules work.

In the Autumn Statement 2016 the Chancellor highlighted that research and development is a key driver for economic growth and has committed to an extra £2 billion a year of additional funding by 2020/21.The government will also review ways to build on the 'above the line' tax credit which is covered in the section on Research and Development Expenditure Credit scheme below.

What are the tax reliefs available for SME companies?

A company can claim enhanced deductions against its taxable profits for expenditure which is qualifying R&D expenditure. The amount of the enhancement has increased over the years. The rate was 125% for expenditure incurred before 31 March 2015 and has increased to 130% from 1 April 2015. This amount is in addition to the actual expenditure (ie a 230% total deduction from 1 April 2015). R&D enhanced relief represents an additional corporation tax reduction of 26% 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 14.5% for expenditure incurred on or after April 2014. 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.

Research and Development Expenditure Credit scheme (RDEC)

R&D relief under the SME scheme is not available if the R&D project has had the benefit of a grant or subsidy. There may, however, be an alternative claim available to the company. This is known as the Research and Development Expenditure Credit scheme (RDEC). RDEC allows the SME to claim a taxable credit of 11% of eligible expenditure. As this amount is taxable it is known as an 'above the line' credit. This 11% rate is for expenditure incurred on or after 1 April 2015. Prior to that date the rate was 10%.

The credit received is 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.

The RDEC relief is also available to an SME for expenditure incurred on R&D that is contracted to it by a large company.

Qualifying projects

R&D relief can only be claimed by companies that have incurred expenditure on qualifying R&D projects that are relevant to the company's trade. A project should address an area of scientific or technological uncertainty 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. 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 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 indirectly contribute 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 eg maintenance, security, clerical
- ancillary services eg paying staff, leasing laboratories and equipment.
- Indirect activities would all have to be undertaken for the R&D project.

Once the project begins to be involved in the production process, any R&D activities are treated as having stopped as development has finished. It is therefore beneficial for companies to keep a timeline of activities and their purposes to detail when the business starts to move into the production phase and therefore optimise their claims.

Types of expenditure

Qualifying expenditure which 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.

Staffing costs

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

The indirect activity list included 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 change this for any directors involved in R&D.

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.

For expenditure on or after 1 April 2015, any consumables or transformable materials that are included in a product that is sold, transferred or hired out will not be qualifying expenditure for R&D relief.

Costs of work subcontracted out and externally provided workers

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

Methods of claiming tax relief

Companies can claim R&D tax relief in the tax return for the period when the expenditure is charged in the accounts of the company. HMRC have specialist offices which are able to offer advice on R&D claims.

Helping smaller companies

Following consultation, the government introduced in November 2015 a voluntary Advanced Assurance scheme for small businesses making their first claim. Successful applicants will receive assurance that HMRC will allow their first three years of R&D tax relief claims without further enquiry.

In addition, there will be new bespoke guidance aimed at smaller companies and more direct communication between HMRC and companies that are already claiming, or thinking about claiming, R&D tax relief.

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How we can help

There are a number of areas in this briefing where you may need specific advice depending on the circumstances of R&D activities and expenditure so please do not hesitate to contact us.

FOR MORE INFORMATION CONTACT:

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