



Research & Development Tax Relief

R&D - the background & the importance

Historically, UK spending on Research & Development (R&D) lagged behind many other developed countries. As part of an agenda to build a modern economy and promote private sector investment in innovation, the UK Government introduced a variety of tax incentive regimes at the turn of the 21st century, including the R&D Tax Incentive Regimes.

The UK Government recognises that encouraging innovation is a vital component in a strategy for improving the UK's productivity, performance and competitiveness. As a result, the relief available under the R&D Tax Incentive Regimes for both small and medium size enterprises (SMEs) and large companies has been enhanced in recent years to encourage and reward greater innovation in the UK.

Does my company qualify?

To qualify for relief under the R&D Tax Incentive Regimes, a company must be undertaking, or have undertaken, a project which qualifies as R&D for tax purposes.

The definition (defined in the **BEIS guidelines**) hinges on two key criteria:

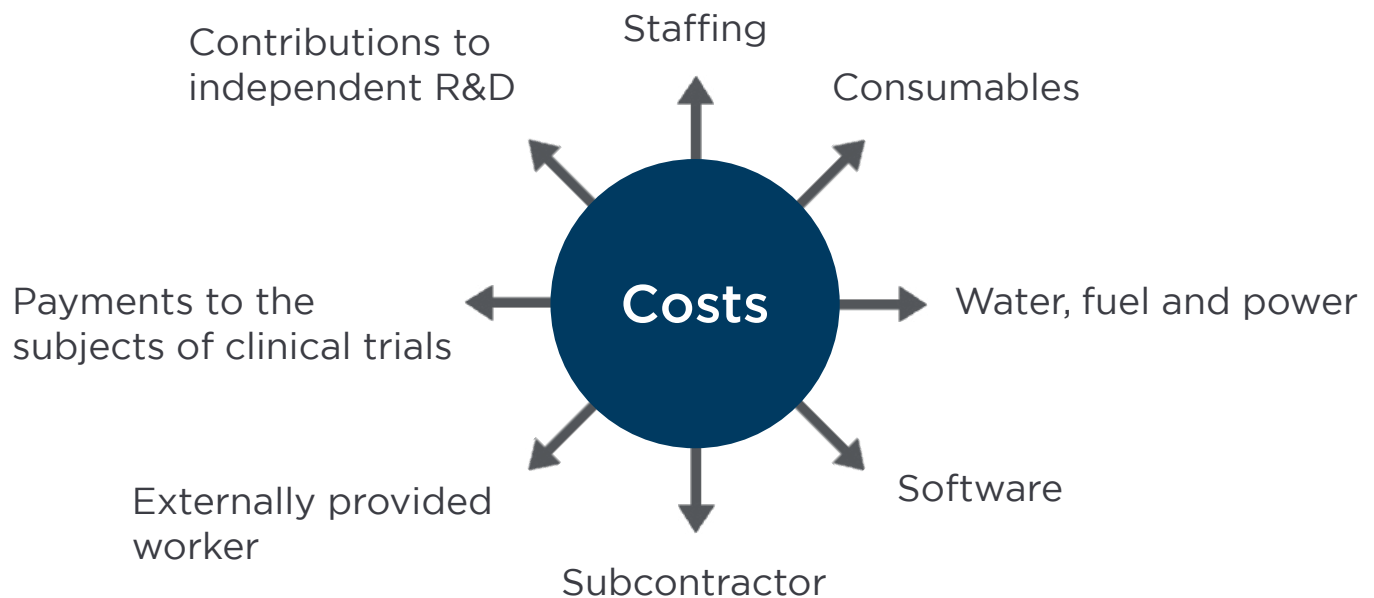
- The Company must be seeking to achieve an advance on the baseline state of knowledge and capability in a relevant field of science or technology, as measured by reference to publicly available information. This may be through the new development or the appreciable improvement of a product, process or system, leading to an increase in overall knowledge in the relevant field.
- Seeking to achieve the relevant advance, must require the resolution of associated scientific or technological uncertainty. This is measured by reference to a competent professional in the field, i.e. someone with relevant skills and expertise. For the project to qualify, there must be scientific or technological challenges that cannot be readily resolved by the relevant competent professional.

This R&D definition can be difficult for the non-specialist to interpret and apply, but our Innovation Taxes Team can help you understand the areas of work within your company that are eligible and evidence these to HMRC.

What costs can be claimed for and how does the relief work?

If your company is eligible, the level of relief available is based on several factors, including the size of the company or group and the funding arrangements relating to the relevant R&D. SMEs can claim under the R&D tax credit scheme, whereas large companies (and SMEs carrying out funded or contract R&D) can claim under the Research and Development Expenditure Credit scheme (RDEC). SMEs can claim up to 33p for every pound of eligible expenditure on in-house, unfunded R&D, and can receive a cash payment even if they are loss-making or pre-trading. Relief under the RDEC regime can provide a net cash benefit of approximately 10p for every pound of qualifying expenditure incurred.

The categories of cost that should be considered when preparing an R&D claim are as follows:



With regards to the categories of qualifying expenditure, there are slight differences between the costs that can be claimed for between the two schemes, and the mechanics of how the qualifying expenditure is calculated. For example, only large companies can claim in respect of contributions made to independent R&D. Another example would be the 65% statutory restriction that applies to unconnected subcontractor costs claimed for under the SME scheme.

However, no such restriction applies to qualifying unconnected subcontractor costs claimed for under the RDEC regime by large companies or SMEs undertaking contract R&D.

These differences highlight the intricacies associated with each part of the R&D tax credits legislation.

Capital or revenue?

Costs can only be included in an R&D tax credits claim to the extent that the expenditure is revenue in nature, from a legal perspective.

So, how do we determine whether expenditure is revenue in nature from a legal perspective? Whilst the accounting treatment is not conclusive, it is one of the factors that should be considered. Other relevant criteria include the anticipated 'useful life' of the technology being developed and whether there is associated 'organisational change'.

Payment requirement

For some cost categories, as well as the requirements that the expenditure is revenue in nature and deductible for Corporate Tax purposes, there is the additional requirement that the amount has been paid (rather than simply accrued) before R&D relief can be claimed.

Rate of relief

SME status - what does this mean?

R&D relief at the most generous rate is only available to companies that meet the definition of a Small or Medium Sized Enterprise (SME) in the relevant claim period, as defined by EC regulations.

> 500 employees **turnover not < €100m or gross balance sheet assets not < €86m**

This sounds like an easy test to apply but, as with anything when it comes to the R&D Incentive Regimes, there are complexities lurking beneath the surface.

R&D undertaken in relation to commercial contracts

Under the rules governing the R&D tax credits regime, a distinction is drawn between companies carrying out contract R&D and companies carrying out in-house R&D. Relief in respect of costs incurred in undertaking activities which constitute contract R&D must be claimed for under the RDEC regime, whereas relief for costs incurred in undertaking in-house R&D may be claimed for under the more generous SME scheme. There is also a distinction drawn where a company's R&D expenditure has been subsidised.

Taking advantage of other funding opportunities

The availability of R&D tax relief under the more generous SME scheme can also be impacted if the relevant R&D expenditure is subsidised. On the face of it, this sounds very straightforward, but unfortunately it's not as easy as looking at the extent to which your costs have been physically met by grants or subsidies received by the company. Instead, the precise impact of any grant or subsidy will be determined by the nature and level of funding received.

One of the reasons for this is that the SME rate of R&D tax relief is a form of State Aid. There are rules such that no company can receive two forms of State Aid in respect of a single project. So, if your company has received a form of notified State Aid, for example a Scottish Enterprise SMART grant, in respect of a project, then the entirety of the spend on that project, whether the costs are met physically by the cash received or not, is barred from qualifying at the most generous rate.

It is important to emphasise that we understand the importance that grant funding can have to a company, indeed it can represent a valuable and absolutely essential form of income. We have seen many companies benefit greatly from both R&D tax relief and grant funding. However, we have also seen many situations in which companies have ended up in a net negative position as a result of taking a grant, when considering the knock-on consequences this has had to the availability of R&D tax relief at the most generous rate.

There are steps that can be taken at the grant application stage, or when drafting a contractual arrangement with a customer, to mitigate the associated impact on the level of R&D tax relief available.

R&D and pre-trading expenditure

Where a company is pre-trading for UK Corporation Tax purposes, expenditure would normally be treated as having been incurred on the first day that the company commences a trade, thus potentially delaying the receipt of any R&D relief associated with the expenditure. However, where a company is pre-trading and has incurred expenditure that qualifies for relief under the SME scheme, it can make an election to calculate a deemed trading loss in the period in which the expenditure was incurred.

There is no such equivalent election that can be made in respect of expenditure which falls to be claimed for under the RDEC regime. This highlights the importance of fully considering the factors above in structuring a company's R&D arrangements.

R&D undertaken in a group company context

R&D is often undertaken in the context of group company scenarios. Companies planning to undertake R&D in such situations need to be aware of the prescriptive requirements of the UK R&D Tax Incentive Regimes, some of which have been highlighted above, and structure their arrangements accordingly. This will include the terms on which the claimant company engages individuals and procures services.

To support a claim, it will be important to be able to evidence the intragroup contractual and commercial terms, including: the ownership of IP; ability to direct the R&D; and assumption of economic risk. The business plan and intended means of commercialising the technology under development should also be agreed and documented.

For international groups, it is also important that the factual position in support of the R&D tax relief claim is reflected consistently in the transfer pricing policies adopted.



Get in touch

The UK's Research & Development scheme is complex and needs expert advice to navigate the legislation and guidance to ensure that you both receive the maximum relief available to you and also to ensure that your claim is prepared using a robust and defensible methodology that will stand up to potential scrutiny, whether by HMRC or as part of a future due diligence process.

Our **Innovation Taxes** team can help you through the process of making a R&D claim from start to finish.



As well as helping you understand the areas of work within your company that are eligible, we can assess and determine whether your expenditure, in respect of R&D projects, should be categorised as revenue expenditure, and provide relevant evidence to HMRC.

Should other funding options be a consideration for your company, we can advise on grants and contractual arrangements, including the drafting of the relevant documents and modelling the interaction between the available support and R&D Tax Incentives, so that you can assess the net support available under different options.

We can also assist with reviewing and advising on the impact of changes in company ownership, VC investments and shareholder agreements in order to help you understand the potential implications.

For more information on the R&D process or how we can help you, don't hesitate to get in touch.



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