

ALLOWANCES FOR RESEARCH AND DEVELOPMENT

This fact sheet covers various tax reliefs that are available in respect of revenue expenditure on research and development (R&D) incurred by small and medium sized (SME) and large companies. The relief and credit is not available to partnerships or individuals. Only a brief summary is given and you are strongly advised to obtain professional guidance before proceeding. Please also note many references to the HMRC manuals are provided throughout this help sheet, to access these you will need to enter the manual numbers provided in the search box on the HMRC website.

What is research and development?

There is a definition of R&D in the legislation which can be found on Section 837A ICTA 1988, however activities are treated as R&D if normal accounting practice treats them as such **and** they satisfy the conditions set out in Guidelines produced by the DTI (further guidance is available on HMRC manual *CIRD81900*). The accounting definition of R and D is in a statement of accountancy practice, SSAP13 and the definition for tax purposes follows that.

HMRC have also put their interpretation of R&D on their website under *CIRD80150*, as shown below:

“Generally a project will be an R&D project if the project seeks, through the resolution of scientific or technological uncertainty, to achieve an advance in overall knowledge or capability in a field of science or technology, not a company’s own state of knowledge or capability alone.”

Therefore if a company has incurred expenditure on R&D that is **relevant to their trade** (*CIRD81400*) providing they meet the other conditions, they will be able to claim enhanced relief on the expenditure.

Capital or revenue expenditure

Enhanced R&D relief is available to companies who meet the conditions and incur Revenue expenditure. We will go into greater detail with regards to Revenue expenditure on the following page. However, the treatment differs for Capital expenditure as this incentive is available to all traders who incur qualifying expenditure and examples of this can be found on HMRC manual *CA60300*. Qualifying capital expenditure will be eligible for 100% capital allowances to encourage investment.

The same general rule applies to the distinction between Capital and Revenue expenditure described in previous help sheets, however further guidance can be seen on *BIM35030* onwards.

In addition, the calculation of capital allowances follows the general rules described in the fact sheet *Capital Allowances*.

For the remainder of this help sheet, we will be looking at the enhanced reliefs available solely in relation to Revenue expenditure on R&D for companies.

How the relief works

Essentially there are two separate reliefs available for both Small and Medium Enterprises (SME's defined below) and larger organisations.

An SME can claim up to 175% relief on qualifying revenue expenditure, i.e. an extra 75% on top of what they have actually spent for expenditure after 01 August 2008, however prior to this the relief was 150%.

For accounting periods spanning 01 August 2008 the expenditure must be split between pre and post 01 August 2008 and further information on this is available with examples on (*CIRD90500*).

A large company can claim relief at 130% on qualifying expenditure. Effectively for both SME's and larger companies this will reduce their taxable profits and therefore the amount of tax payable to HMRC.

To be eligible for the enhanced relief a company must spend at least £10,000 on qualifying R&D expenditure in a 12 month accounting period; again HMRC manual *CIRD81600* discusses this in greater depth.

In addition, the time limit to make a claim for R&D relief is the first anniversary of the filing deadline for the tax return that contains the claim. This applies to both the SME and large companies' scheme. Further guidance can be found on *CIRD81800*, with regards to making a claim for enhanced relief.

A comparison of the key differences between larger companies and SME's can be found under *CIRD80250*.

SMEs

A small or medium-sized enterprise (SME) is defined as an enterprise which has:

- Fewer than 250 employees, and
- Either:
 1. An annual turnover not exceeding €50 million
 2. Gross assets of less than €43 million

The definition is primarily obtained from EU recommendation 2003/361/EC, which can be found under *CIRD92800*. However, please note that Qualification A1, FA 2000, Sch 20, Para 2 doubles all of these figures for the purposes of considering whether a company can claim SME R&D tax relief on expenditure after 01 August 2008.

A large company is a company that does not qualify as a small or medium-sized enterprise.

For a group of companies where each is more than 25% owned by each other or controlled by the same person or group of people, the total profit/assets/employees of the group must be considered.

Qualifying expenditure

Qualifying expenditure is revenue expenditure incurred on items such as staffing costs paid to or in respect of directors and/or employees directly involved in carrying out the R&D.

Moreover, consumable stores i.e. materials and equipment used up in the R&D activity and not incorporated in the product of the R&D and also payments to externally provided workers (for expenditure incurred on or after 27 September 2003).

An SME can also make a claim in respect of expenditure on R&D which it has contracted out to another person on behalf of the company.

The subcontracted R&D must be directly undertaken on behalf of the company, meaning that the subcontractor must do the work itself, not further subcontract it to a third party. This is dealt with further on HMRC manual *CIRD84200*.

Expenditure incurred by an SME cannot be subsidised, so that any portion covered by a Government grant is excluded. Nevertheless, it may still be eligible for the large companies' rate of relief if incurred by an SME in an accounting period beginning on or after 9 April 2003.

The company, either alone or with others, must retain all rights to the intellectual property such as patents, know-how, trade marks etc created as a result of the R&D. However, this is not a requirement for a large company. Other conditions for an SME to qualify are shown on *CIRD90100*.

Furthermore, R&D does not have to be carried out in the UK to be eligible for relief, (*CIRD84200*).

Larger companies

In the case of large companies, qualifying expenditure also includes direct R&D expenditure, expenditure subcontracted by the company to an individual, partnership, university, charity or other qualifying body, and contributions to individuals, partnerships and qualifying bodies or independent R&D which is relevant to the company.

Where a large company subcontracts work to an SME, the SME may claim R&D relief of 130% of the qualifying expenditure after 01 April 2008 or 25% before this; this is confirmed on HMRC manual *CIRD88500*.

Examples of R&D

Activities which can be accepted as R&D include:

- Experimental or theoretical work aimed at the discovery of new knowledge or the advancement of existing knowledge.
- Searching for applications of knowledge.
- Design and formulation of such applications.
- Testing in the search for, or the evaluation of alternative approaches to, exploitation of the research.
- Design and testing of prototypes and models.
- Design of products incorporating new or substantially improved technology.
- Construction and operation of prototypes and pilot plants.

Activities not included are:

- Quality control testing.
- Periodic changes to existing products, services and processes, even where there is some improvement.
- General operational research.
- Cost of breakdowns during commercial runs.
- Administration of patents and licenses.
- Costs of redesign of facilities except those devoted specifically to research and development.
- Market research.

The categories of qualifying R&D expenditure are covered in the Revenue's manuals *CIRD82000* onwards and contain further information on software which is discussed below.

Software

Software purchased for direct use in R&D is a type of qualifying expenditure for enhanced relief. This is confirmed in *CIRD82500*; however software that is not used directly in R&D is excluded from the relief.

Capitalised revenue expenditure

For accounting periods beginning on or after 1 January 2005, expenditure of a revenue nature that is capitalised as part of the cost of intangible assets can qualify for R&D tax reliefs. FA2004 s53.

Disputes

Any dispute as to whether any particular project or expenditure is R&D can only be resolved by the Department for Business, Innovation and Skills. If you have incurred expenditure on R&D and expect it to be qualifying expenditure, it may be worth getting a report from a technical consultant within the industry.

Surrender of losses – R&D tax credits

An SME carrying on R&D before they start to trade may treat the R&D relief as a trading loss; however an election would be required to do this, see (*CIRD90200*). For large companies pre-trading expenditure is normally treated as incurred on the day that trading begins.

Where an SME has an unrelieved trading loss for the year, it may surrender the loss for a payable tax credit from HMRC if they meet the conditions below:

A company has a surrenderable loss if in an accounting period the company (*CIRD90500*):

- is entitled to R&D tax relief under FA00/SCH20, and
- is carrying on a trade and
- has qualifying R&D expenditure that is allowable as a deduction in calculating the profit from that trade, and
- has sustained a trading loss in the period in that trade, and
- has claimed an R&D tax relief

The surrenderable loss for an accounting period is the lower of:

- 175% (150% before 31/07/2008) of the qualifying R and D expenditure, and
- the unrelieved trading loss

The amount of payable tax credit is calculated as the lower of:

- 14% (16% on expenditure before 31/07/08) of the surrenderable loss for the period, and
- the company's PAYE and NIC liabilities for the payment periods ending in that accounting period.

A company with profits of less than £1.5 million will be paying tax at a maximum rate of 21%, and on the next £1.5m at 29.75% from April 2008, so taking the credit can be more tax-effective than carrying forward a loss at the lower profit level. Nevertheless, if the company decides against this, the normal methods of loss reliefs will still be available.

This fact sheet was prepared by **Abbey Tax Protection**. It is intended only as a guide and is not to be regarded as a substitute for consultation with one of our Tax Advisors, since every case will ultimately turn on its own particular facts and circumstances. Should you require tax advice please contact the **Tax Advice Line** on **08450 727 727**. ***If you are driving when using the advice service, please make sure it is safe and legal to do so.***