

Research and Development Relief and Tax Credits

INTRODUCTION

The Finance Act 2000 introduced changes to the "Scientific Research Allowance" renaming it Research and Development (R & D). This permits revenue spending on scientific research either directly by the company or through research associations. The percentage that can be claimed in respect of spending in this area is increased and R & D tax credits have been introduced which give a measure of relief for losses created as a result of the expenditure. The changes do not affect the rules for Scientific Research Associations.

Under the rules, relief for qualifying spending on R & D is increased from 100% to 150%. This is known as R & D relief. Companies not in profit will be able to obtain a cash payment known as R & D tax credit. Special rules apply which also mean that a company not yet trading may also qualify for the payment.

From 1 April 2002 R & D has also been introduced for large companies, they will be able to claim 125% on qualifying R & D expenditure. The Finance Act 2000, Schedule 20, legislation will continue for small and medium sized enterprises (SMEs) with minor amendments to include all companies, and new legislation for the treatment of large companies, and of SME subcontractors working for large companies is now in Finance Act 2002. The changes in the 2003 Budget will take effect for large companies from 9 April 2003 and for SME's from 27 September 2003.

WHO QUALIFIES?

R & D relief on qualifying expenditure is *not* available to sole traders or partnerships. It is available for SMEs, as defined by the European Commission for State Aid purposes, and for large companies with accounting periods ending on or after 1 April 2002.

A SME is defined as a company that, together with any other company in which it holds more than 25% of the capital or voting rights, has

- Less than 250 employees

And either or both of

- An annual turnover of not more than Euro 40 million (approx. £25 million)
- An annual balance sheet total of more than Euro 27 million (approx. £17 million)

Conditions apply where a company has more than 25% of its capital or voting rights held by a company which is not, itself an SME.

A large company is defined, not surprisingly, as a company that is not an SME.

OTHER CONDITIONS

The revised rules apply for accounting periods ending on or after 1 April 2000 for SME's and 1 April 2002 for large companies.

Qualifying R & D expenditure must not be less than £25,000 in a 12 month accounting period, and it is proposed in the 2003 Budget to reduce this to £10,000. Where the accounting period is more or less than 12 months the amount is proportionately adjusted and where an accounting period straddles 1 April 2000, only the period after that date will qualify under the new rules.

R & D expenditure does not need to have been incurred in the UK to qualify for relief.

QUALIFYING EXPENDITURE

For an amount to qualify as R & D expenditure there are a number of statutory conditions.

For a large company the expenditure has to be; -

- on direct research & development that it carries out itself or as a sub-contractor, sub-contracted to certain organisations or contributions to certain independent research & development organisations.
- Where a company incurs expenditure carrying out activities contracted out to it, the expense will not qualify as R&D unless the contracting out was done by a large company or a person not in the course of a trade or profession assessable under case 1 or 2 of schedule D.

For an SME the expenditure has to be; -

- attributable to relevant R&D.
- Any intellectual property created as a result of the R&D to which the expenditure is attributable has to be vested in the company.
- The company does not incur expenditure as a sub-contractor
- The expenditure is not subsidised

Other conditions are for all companies are: -

- It is not capital expenditure
- It must be incurred on staffing costs or consumable stores

Capital expenditure on R&D will get the 100% research and development allowance.

“RELEVANT” RESEARCH AND DEVELOPMENT

“Relevant” means the expense incurred must relate to the trade carried on by the company making the claim. If the company is not yet trading, it will be the trade in which it intends to carry on.

The main definitions of R & D are set out in Accounting Standard SSAP 13 and follow generally accepted accounting practice. The activity must also fall within guidelines issued by The Department of Trade and Industry.

In order to qualify, the R & D project has to be creative and innovative. It must seek to achieve or resolve a scientific or technological advancement or uncertainty and be by way of systematic investigation, with an aim to result in the extension of scientific or technical knowledge. It can range from theoretical or “blue skies” research, to applied research and experimental development towards a practical aim or product. However, normal commercial development is not R & D. Any period after the investigative stage for R & D would no longer qualify. For example the period after the completion of a prototype, where the research qualified for R & D would no longer qualify as it then enters a pre-production stage. Other examples of the boundaries for R & D are given below.

Trading Activities	Included	Excluded
Medicine	Special investigations into the effectiveness of new cancer treatments to set a programme for research.	Routine testing – i.e. blood tests, autopsies and body scanning.
Physical Phenomena	Investigating climate change to devise improved methods for measuring temperature and pressure, or develop new materials, as well as the evaluation and analysis of such data.	Routine monitoring of temperature and pressure, or quality control on material composition.
Engineering	Development of and research in innovative prototypes, or pilot plants	Standard design work for existing products or tools, or promotional sales work

The Government is currently in consultation on the definition of R & D and to extend the definition to include software licenses.

STAFFING COSTS AND CONSUMABLE STORES

Staffing costs of those directly and actively engaged in the R & D activities will qualify. Secretarial or administrative services in support of the activities carried on by others are unlikely to be seen as directly involved in the research. It is proposed from the 2003 Budget that staffing costs paid for workers, that work for a third party but are doing the R & D work for the company, will now be included as a staff cost.

The payments that are included in allowable staffing costs are all salary, wages perks etc other than benefits in kind. Also included are secondary Class 1 NIC and employer contributions to a pension scheme.

Presently, if staff are engaged in R & D for more than 80% of their time, the whole cost relating to the employee is allowable, otherwise the correct proportion can be claimed. Staffing costs are not included if the staff are engaged in R & D work for less than 20% of their time. However the 2003 Budget abolishes this rule and staff costs will be apportioned as to the time actually spent on the R & D work.

Consumable stores are the materials used up in the R & D work.

SUB CONTRACTOR PAYMENTS

A large company that sub-contracts R&D to individuals or organisations that cannot get R&D relief can still claim the R&D relief as long as the sub-contracted R&D is directly undertaken on behalf of the

Company, i.e. not sub-contracted again to a third party, and the expenditure is relevant R&D in relation to the company and is not capital expenditure.

If in a group of companies R&D work is done by other group members, if the activities would have qualified in the contractor company the sub-contractor company will be able to claim the R&D tax relief.

A SME (the principal) may claim relief for payments to a sub-contractor for relevant R&D work it contracts to that person but the treatment of the payment depends on whether the two parties are connected or not.

Connected

For the principal to claim the relief in the accounting period in which payment is made the sub-contractor must include the payment and expenses incurred in carrying out the work in its accounts for the period ending not more than 12 months after the end of the principal's accounting period in which it makes the payment. The principal claims the lower of

- The payment that it makes to the sub-contractor, and
- The amount that the sub-contractor actually spends on staffing costs and consumables when it carries out the work for the principal in its accounting period ending not more than 12 months after the end of the principal's accounting period in which the payment was made.

Not connected

The principal may claim R&D tax relief on 65% of the payment it makes to the sub-contractor. This percentage is taken to cover an element of profit for the sub-contractor and any other non-qualifying expense that may occur.

As they are not connected a joint election can be made to treat them as if they were connected. The election must be in writing and be made within 2 years of the end of the principal's accounting period in which payment is made.

Work sub-contracted to an SME

Under the SME scheme, a SME cannot claim R&D Tax relief for work it does as a sub-contractor but in some cases it may be able to claim under the large company scheme where the relief goes to the company that does the work rather than the company that pays for the work to be done. The SME obtains the tax relief at the large company rate if it sub-contracts to a non-SME. This could be a large company or a Government department or university.

GIVING THE RELIEF

Trading

A company is entitled to R&D tax relief for an accounting period, where it is carrying on a trade in that period, and has qualifying R&D expenditure that is allowable as a deduction in computing, for tax purposes, the profits of the trade for that period. It may treat that qualifying R&D expenditure as if it were an amount equal to 150 % for a SME's and 125% for a large company, of the actual amount. The company must claim the tax relief as far as possible in the Corporation Tax Self-Assessment return for the relevant accounting period. The overall time limit for a claim to be made is within 6 years from the end of the accounting period to which it relates.

Pre trading

If a company would otherwise qualify but for the fact that they did not trade in that period it would normally be treated as a pre trading expense, i.e. brought into account on the first day of trading. However, the company can elect to be treated as if it traded, and incurred a trading loss in the accounting period equal to 150% of the amount that qualifies for an SME. The election should be made in writing to the Inland Revenue and must be given within 2 years from the end of the company's accounting period to which the election relates.

R & D LOSS AND TAX CREDIT

A tax credit can be claimed where there is a "surrenderable" loss, i.e. a loss that can be surrendered in favour of a tax credit payment. The amount of loss that can be surrendered for tax credit is the lower of:

- For an SME the total 150% deduction for qualifying R & D expenditure.
- The total loss of the trade in which the R & D is carried out for the accounting period. This must be reduced by losses that have or could be set against profits of the same accounting period, or loss relief already obtained by the company in respect of the loss, including group or consortium relief.

The maximum amount of tax credit payment a company can claim for an accounting period is 16% of the amount of the surrenderable loss for the period (which is equivalent to 24% of the actual expenditure).

However, the tax credit cannot exceed the total amount of the company's PAYE and National Insurance (NIC) liabilities for all payment periods ending in the accounting period.

A payment period ends on the 5th day of a month and the company is liable to account for income tax and NIC to the Inland Revenue. For the purposes of R & D tax credit, you disregard any authorised deductions for statutory sick pay, statutory maternity pay, working family tax credit and disabled persons tax credit.

A company's trading losses to carry forward, for a period in which it claims an R & D tax credit, are treated as reduced by the amount of the loss surrendered.

In the 2003 Budget it is intended that SME's will be able to claim the R&D tax credit where they receive state aid or subsidies as well, under existing legislation they are unable to do this as the tax credit is a state aid approved by the European Commission. This will bring them into line with large companies, as a tax credit to a large company is not a state aid.

CLAIMING THE R & D TAX CREDIT

R & D tax credit paid is not counted as income of the company for any tax purpose.

A claim must be included in the company tax return for the accounting period for which the claim is made. It can be on the original return or an amendment. It must specify the amount of the relief due, and quantify the credit claimed.

A claim for an R & D tax credit may be made, amended or withdrawn at any time up to the first anniversary of the filing date of the company SA return for the accounting period for which the claim is made. There is a clause, which gives the Revenue power to allow a later claim.

However, the Revenue can withhold or postpone payment of R & D tax credits in the following circumstances: -

- It may discharge any liability to corporation tax rather than make a payment of R & D tax credit.
- No payment of R & D tax credit need be made for an accounting period before the company has met their PAYE and NIC obligations.
- No payment of R & D Tax credit need be made until any open enquiries into the company's tax return are completed.

APPEALS

An appeal against a Revenue decision to disallow the claim will be heard by the General or Special Commissioners, in line with other forms of appeal.

PENALTIES

There are provisions for penalties to be levied, if a company fraudulently or negligently makes a claim for R & D tax credit, or discovers that a claim was made that was incorrect, but fails to remedy the error without unreasonable delay. In addition to reclaiming the excess tax credit given, the maximum penalty can be an amount equal to the credit claimed which was not due.

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