# Briefing Note

## RESEARCH & DEVELOPMENT (R&D) TAX RELIEF

R&D tax credits provide potentially substantial tax incentives for companies that incur expenditure on research and development (see below). The tax benefits are different depending on the size of the company.

### Why are R&D tax credits important?

For small or medium sized companies (SMEs), for every £1.00 of qualifying expenditure incurred, the company can claim an additional deduction from its taxable profits of £1.30. This means that if a company incurs £100,000 of qualifying R&D expenditure it can claim enhanced relief of £230,000.

Additionally, loss-making SMEs can choose either to increase the value of their losses carried forward, or to surrender these for tax credits in the form of a cash payment at 14.5%. This gives relief at 33.35% on the actual expenditure incurred.

For large companies, the relief is a percentage of R&D costs to generate a (taxable) cash sum, an above the line credit (see below).

### What is R&D?

There is a lot of confusion over what constitutes R&D, essentially you have to be doing something new to try and resolve a scientific or technological uncertainty. That covers a lot of areas - see below for some examples.

### What is a small or medium-sized company?

A company is small or medium-sized if it has fewer than 500 employees and either:

- An annual turnover of not more than €100 million (around £88 million – but check current exchange rates); or
- Total assets on its latest balance sheet of not more than €86 million (around £76 million, but again check current exchange rates); or
- If another entity owns more than 25% of the company some or all of the figures for that entity and possibly other linked entities need to be aggregated.

### Which costs qualify for R&D tax credits?

All companies can claim R&D tax credits on their costs of:

- Employing staff for R&D;
- Software or consumables used for R&D (including power, fuel and water but excluding expenditure on items making up the finished product or used in the production process which results in items being sold); and

- Externally provided workers.

SMEs only may also claim on the cost of subcontracting R&D although such claims are restricted and special rules apply where the company and the subcontractor are connected.

Large companies only may be able to claim relief for expenditure on independent research.

## Other conditions for small and medium-sized companies

The costs do not qualify if they are part of a project which receives another form of notifiable state aid. If a grant or other receipt is received which is not notifiable state aid the claim will be restricted. HMRC have confirmed that receipt of any Coronavirus Job Retention Scheme grant is not state aid because it is available to all businesses and therefore will not affect a company's ability to claim R&D tax relief.

The company must be a going concern at the time when the claim is made.

| Here is an example of the impact of the relief for SMEs: | £ |
|---|---|
| Qualifying labour costs | 75,000 |
| Qualifying direct costs | 20,000 |
| Attributable overheads | 5,000 |
| | 100,000 |
| R&D uplift | 130,000 |
| Tax rate 19% | |
| Potential additional reduction in CT liability | £24,700 |

## Assurance

It is possible for small companies to seek advance assurance from HMRC that they qualify for R&D provided certain tests are met.

The company must:

- not have claimed R&D tax relief before;
- Have an annual turnover of £2m or less; and
- Have less than 50 employees.

If the company does receive assurance, it can claim R&D relief for the subsequent three accounting periods without HMRC raising an enquiry.

## Above the line credit

This R&D relief is compulsory for large companies. SMEs may claim this relief if preferred or because they are not eligible for the small company relief (e.g. receive subsidies).

There is no change in the definition of qualifying R&D or qualifying expenditure. However, rather than claiming an enhanced deduction against profits or a tax credit repayment, a credit equal to 13% (from 1 April 2020) of the qualifying expenditure can be claimed and used to set against the company's tax liabilities subject to a cap equal to the PAYE and NIC liability of the same period. Initially the offset is made in the same accounting period but any balance remaining can then be carried forward and set against any corporation tax liability of another period. If the company is a member of a group, it may surrender the amount remaining for a corresponding accounting period.

The pursuable credit element remaining can be applied to discharge any remaining tax liability of the company.

The credit itself is taxable and is included as income in the company's Profit and Loss account, so the effective rate of the relief is 10.53% (corporate tax rate is 19%).

## Research & development – some areas to consider

Very broadly, the more common types of business potentially qualifying for R&D include manufacturing, pharmaceuticals, software, engineering and food.

Here are just a few examples of where we have agreed with HMRC that tax relief is due under the R&D provisions. These are not necessarily businesses that are typically regarded as being in the R&D area:

- Making balloons and bunting – looking to mechanise and streamline processes;
- Tuning cars to improve performance – software, brakes, suspension, etc.;
- Time spent on improving processes for waste disposal;
- Developing new, more environmentally friendly, sandwich packs;
- Creating a new light bulb;
- Creating food coatings and marinades by taste, ingredient, meat type and customer;
- Customising emergency vehicles in terms of interior specification, animal crates, safety features, etc;
- Bespoke software development – developing specific, individual software including the changes made to an 'off the shelf' package.

## Changes for SMEs

New rules introduced for SME's for accounting periods starting from 1 April 2021 have the effect to prevent abuse of the payable credit.

The credit will be capped at three times the company's total PAYE and NICs liability for that year.

HMRC has stated that 'genuine companies are not the intended target of the cap' however, some companies operating genuine commercially structured business models will be impacted.

Qualifying categories of expenditure for SMEs for R&D tax credits are staffing costs, consumables, externally provided workers and sub-contracted R&D. As the cap is based on the PAYE and NICs liability of the company, any business with R&D expenditure primarily in categories other than staffing costs is at risk of its claim being restricted.

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