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Chartered accountants & business advisers

Research and development tax reliefs

supporting you and your business

Companies conducting qualifying development work can claim government backed tax reliefs of up to a third of the associated costs

The meaning of R&D for tax purposes - how to decide if you qualify

It is a common misconception that R&D is only carried out by scientists in white coats, engaged in 'blue sky' research. The reality, at least for the purposes of tax relief, is that it is much broader in scope than you might think and extends to almost any industry sector.

The official guidelines on the meaning of the definition of R&D for tax purposes are fairly hefty but fortunately can be distilled into some key criteria against which the activities of a company may be measured to conclude whether or not qualifying R&D has taken place. In particular, the fundamental definition of R&D is re-stated on the next page - the bulk of the guidelines are taken up by further explanation of this definition and the key terms highlighted.

R&D for tax purposes takes place when a **project** seeks to achieve an **advance in science or technology**. The activities which **directly contribute** to achieving this advance in science or technology through the resolution of **scientific or technological uncertainty** are R&D.

It follows that for a project to qualify for relief, it must be seeking a scientific or technological **advance** through the resolution of scientific or technological **uncertainty** – both must exist and be demonstrable in any claim submitted.

Advance in science or technology

To decide if a project is seeking a scientific or technological advance a comparison must be made against the current state of the art in that particular field of science or technology and if one would conclude that objective of a project represents an appreciable improvement to an existing process, material, device, product or service then it is likely that there is a qualifying advance.

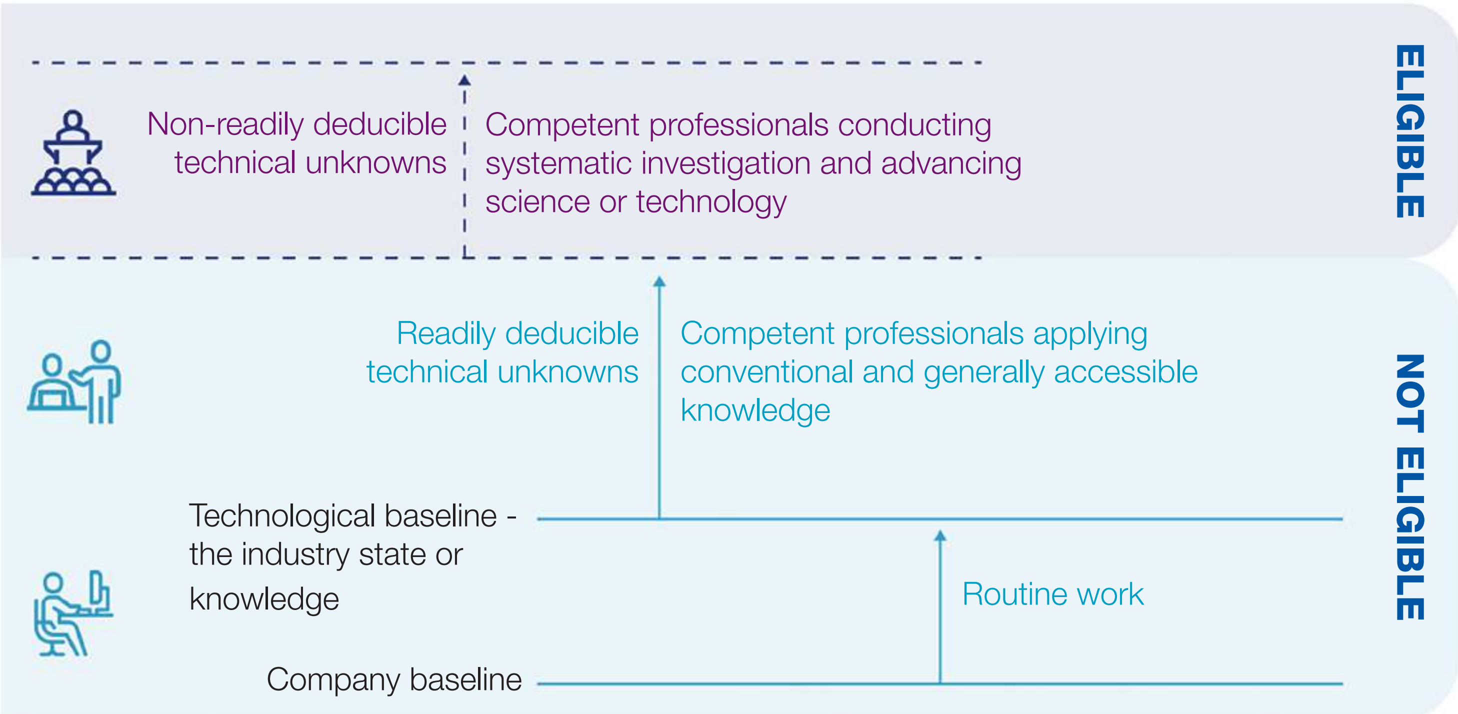
Scientific or technological uncertainty

An advance, by itself, is not sufficient to prove that R&D has taken place. You must also be able to demonstrate that there was scientific or technological uncertainty. That is, where there is uncertainty over whether the advance is feasible or how to achieve it is not readily deducible to a competent professional working in the field. This can include system uncertainty which often arises as a result combining components (that may already have been developed) into a system for the first time.

Appreciable improvement

The important points to note are that the advances must be appreciable and the solutions to the uncertainties must not be readily deducible. Improvements should go further than minor upgrades, tweaking or optimisation and should represent something that would generally be acknowledged by someone working in the field as genuine non-trivial improvements which would not be readily deducible by an expert in the field.

These principles are nicely illustrated in the diagram below:



If you are in any doubt as to whether you have been involved in qualifying R&D then we would encourage you to get in touch and we can help you decide.

The challenges of claiming R&D tax relief in the software industry

Whilst R&D claims from the 'information and communication' sector (which includes software development) account for a quarter of all R&D tax relief claims submitted to HMRC, they can be some of the most complicated to prepare and assess. Much of the challenge stems from applying the definition of R&D for tax purposes to what can be quite an abstract and difficult to appreciate industry for those not familiar with software development. Consequently, there is much inconsistency in the preparation and assessment of software R&D tax relief claims.

To address this problem, HMRC is scrutinising software claims more closely and has started to consult its in-house 'technology office' to check that the projects included in claims meet the definition of R&D. The technology office includes specialists with backgrounds in, amongst other things, databases, mobile technology, software architecture and networks. In addition to providing input on a case by case basis, the technology office has also begun a programme to educate the wider R&D specialist teams in software development in the context of the BIS guidelines on the meaning of R&D.

The intention for HMRC is to bring greater consistency for claimants - and greater confidence for itself - that relief is only being awarded to deserving cases. As a result and in practice, we are seeing queries raised on increasing numbers of software claims making it all the more important to ensure that eligible projects are accurately identified and adequately described in the context of the strict definition of R&D.

HMRC has stated that it will be looking for much more substance in its review of technical descriptions and has offered the following advice to those identifying and describing projects:

- Ensure that the requisite advance identified is technological or scientific in nature rather than business related;
- Be specific in identifying technological or scientific uncertainty and where possible, these should be directly related to the associated advance in technology; and
- It is helpful to explain why the solutions ought to address the technological uncertainty explaining why normal approaches are not adequate.

If your company is involved in software development and you are claiming or think you might be eligible for tax relief, we would encourage you to get in touch with our specialist innovation incentives team who would be happy to help you ensure that robust claims are prepared and will stand up to the increased level of scrutiny we are seeing from HMRC.

Dos and Don’ts

Identify R&D projects early, ideally at the planning stage. If you are proactive in identifying projects that potentially qualify as and when they begin then you are less likely to miss them and you will be better prepared to record the associated qualifying costs

Beware grants. Any project in receipt of a notified state aid (no matter how small) is precluded in its entirety from tax relief under the SME scheme. When applying for any grants always consider whether the SME tax relief might be more valuable or perhaps whether the part of the project you are seeking funding for could be ring-fenced to avoid it tainting the wider project

Don’t miss an opportunity to claim under the large company regime, if you are precluded from claiming under the SME regime because a project has been subcontracted to you, been subsidised or received a government grant

Consider all of the options. A loss making SME will have the option of surrendering the loss relating to the R&D expenditure in exchange for a repayable credit or carrying an enhanced loss forward to be relived against future taxable profits. Most SMEs will prefer the cash flow of claiming the payable credit but it is worth noting that a greater amount of tax will likely be saved in the long term by carrying forward – especially given the declining rate of corporation tax

Don’t submit a claim without providing supporting information. Whilst there is no statutory requirement to prepare and submit supporting information with a claim (which is included in the corporate tax return) HMRC will expect it and is likely to enquire if evidence of the eligibility is not provided

Research and development tax credit statistics

HMRC recently published its annual review on the number of companies claiming R&D tax credits and its cost to the Exchequer. The underlying statistics were compiled from claims reported on the corporation tax (CT) return forms up to the 2015/16 fiscal years and provide some interesting insight into take up of the scheme by sector and geographical location.

- The total number of claims increased in 2015/16 to 26,255, an increase of 19% from 2014/15 driven primarily by a rise in the number of SME claims. This is a steep increase suggesting that although awareness and uptake is improving there are likely to be eligible companies still not claiming.
- The total amount of R&D support claimed also rose to nearly £2.9bn in 2015/16, an increase of £470m (20%) from the previous year and representing a significant amount of support for technology companies and the wider UK economy.
- R&D claims tend to be concentrated in companies with registered offices in London, the South East or the East of England (46% of all claims and 62% of the total amount claimed). Interestingly, despite a strong technology base, claims from the South West of England accounted for just 8% of all claims submitted suggesting there are still many South West firms missing out.
- The manufacturing, professional, scientific & technical and information & communication sectors continued to have the greatest volume of claims, responsible for a total of 73% of claims and 75% of the total amount claimed for 2015/16.

In summary the schemes continue to provide a valuable incentive for companies to invest in R&D. And as the schemes have increased in generosity there has never been a better time to make a claim. Between 2000/01 (when the R&D tax credit schemes were introduced) and 2015/16, over 170,000 claims have been submitted and £16.5bn in tax relief claimed!

Record keeping

In accordance with the general corporate tax self-assessment requirement to keep sufficient records and in order that accurate accounts and VAT returns may be prepared, a company should already be keeping records of expenditure. While these financial records can be useful in supporting the costs of particular elements of a claim they will not, for example, necessarily reveal the proportion of an employee's time spent directly and actively on R&D. Nor will they normally provide any information with which to determine whether relevant R&D is taking place. Ideally, a company should be able to demonstrate the existence of the R&D projects through documentation that shows they were undertaken in a systematic and structured way. For example there should be planning documents, reports and accounting records with specific project codes. Nevertheless, HMRC understands that for the smallest of companies R&D may be carried out in a less structured way and should be pragmatic and flexible in what it will accept as supporting information. We have provided below some examples of the forms of record that could be kept to support an R&D claim for each of the qualifying categories of cost:

Staffing costs

Staffing costs will almost certainly be the largest component of any claim for relief but are commonly subject to the most judgement and subjectivity in determining the qualifying proportion. Accordingly, they draw the most scrutiny from HMRC. The holy grail of supporting information will be timesheets especially if they have been set up such that staff book their time to individual project codes. However, timesheets aren't necessarily appropriate for some smaller companies and HMRC wouldn't expect such companies to start using them purely for the purpose of making an R&D claim. In the absence of timesheets are there any other records that can help you estimate the amount of effort spent on projects? For example, project management documentation, meeting minutes or even a review of staff calendars. Ultimately, some degree of judgement is going to be required but you should be able to demonstrate that you have taken steps to be as objective as possible in your assessment.

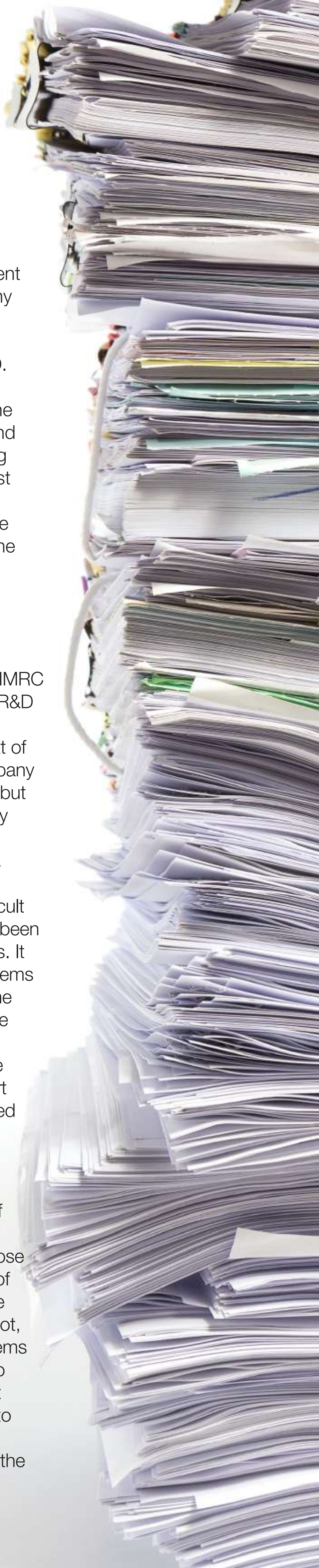
In addition to the records of time spent there will also need to be records of the associated costs. In most cases this should come from the payroll information which you should certainly have a record of.

Externally provided workers and subcontracted R&D

Another area that can be scrutinised by HMRC is distinguishing between subcontracted R&D and externally provided workers (EPWs). This is particularly important in the context of companies claiming under the large company regime where EPW costs qualify for relief but subcontracted R&D does not. Accordingly your records will need to be sufficient to distinguish the two different types of cost. For larger companies, where the issue is more relevant this can sometimes be difficult especially where both types of cost have been booked to the same code in the accounts. It may therefore be wise to set up your systems so that a decision can be made at the time of payment and recorded separately in the books. And should that decision ever be questioned then you should also have the underlying contracts and terms to support your conclusion that the costs were treated as either EPW or subcontracted R&D.

Consumable items and software

It is likely that you already keep records of all the company's third party transactions but is it straightforward to extract from those records all those that meet the definition of consumable items and whether they were incurred on qualifying projects or not? If not, you should consider setting up your systems such that transactions can be recorded to a specific R&D code (and ideally a project as well). You should also be able to refer to the underlying invoices to prove that they were indeed items that were 'used up' in the development process.



The Autumn Budget 2017

In his autumn Budget, the Chancellor increased the tax relief for large companies (and small and medium sized enterprises in some cases) that carry out qualifying R&D and claim the RDEC (R&D expenditure credit).

The RDEC (also known as the 'above the line' credit) is a standalone credit that is brought into account as a receipt in calculating profits. The general rate was set at 11% of qualifying R&D expenditure. This will increase from 11% to 12%.

The increase in the RDEC rate will have effect for expenditure incurred on or after 1 January 2018.

There were no changes to the SME regime, which remains with a 130% enhancement and a loss surrender rate of 14.5%. The scheduled reduction in the corporation tax rate to 17% in 2020 means that further changes to these rates will need to be introduced to maintain the current level of benefits.

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