

## SME relief for R&D costs (Lecture B1284 – 22.15 minutes)

### *Definition of R&D*

The legislation defines research and development (R&D) as activities that fall to be treated as R&D in accordance with generally accepted accounting practice. Thus we need to look at FRS 102 or IAS 38 for the definition.

FRS 102 distinguishes R&D activity from non-research activity by the test of whether there is presence of an appreciable element of innovation. If the activity departs from routine and breaks new ground it is normally included; however, if it follows an established pattern it is normally excluded.

The guidelines state that:

- 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.
- Certain qualifying indirect activities related to the project are also R&D. Activities other than qualifying indirect activities which do not directly contribute to the resolution of the project's scientific or technological uncertainty are not R&D.
- An advance in science or technology means 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). This includes the adaptation of knowledge or capability from another field of science or technology in order to make such an advance where this adaptation was not readily deducible.
- An advance in science or technology may have tangible consequences (such as a new or more efficient cleaning product, or a process which generates less waste) or more intangible outcomes (new knowledge or cost improvements, for example).
- A process, material, device, product, service or source of knowledge does not become an advance in science or technology simply because science or technology is used in its creation. Work which uses science or technology but which does not advance scientific or technological capability as a whole is not an advance in science or technology.

A project will be R&D which seeks to, for example—

- (a) extend overall knowledge or capability in a field of science or technology; or
- (b) create a process, material, device, product or service which incorporates or represents an increase in overall knowledge or capability in a field of science or technology; or
- (c) make an appreciable improvement to an existing process, material, device, product or service through scientific or technological changes; or

- (d) use science or technology to duplicate the effect of an existing process, material, device, product or service in a new or appreciably improved way (e.g. a product which has exactly the same performance characteristics as existing models, but is built in a fundamentally different manner)

Even if the advance in science or technology sought by a project is not achieved or not fully realised, R&D still takes place.

If a particular advance in science or technology has already been made or attempted but details are not readily available (for example, if it is a trade secret), work to achieve such an advance can still be an advance in science or technology.

However, the routine analysis, copying or adaptation of an existing product, process, service or material, will not be an advance in science or technology.

#### *Small and medium sized companies*

A company incurring qualifying Research and Development (R&D) expenditure will be able to claim a deduction equal to 230% of the costs incurred in calculating its taxable total profits, for expenditure incurred.

The usual effect of this is that the further 130% of the R&D expenditure needs to be deducted in arriving at the adjusted profits for tax purposes.

To qualify as a small or medium sized enterprise (SME) the company must have:

- (i) less than 500 employees; and
- (ii) either annual turnover of less than €100m or an annual balance sheet figure of less than €86m.

There is an upper limit of €7.5 million on the total amount of aid you can receive on any one R&D project.

#### *Qualifying R&D*

Certain conditions have to be met in relation to the expenditure:

- (i) it must be revenue not capital in nature;
- (ii) it must be related to a trade carried on or to be carried on by the company;
- (iii) it must be incurred on:
  - (a) staff costs;
  - (b) software;
  - (c) relevant payments to the subjects of clinical trials;
  - (d) consumable or transformable materials;
  - (e) subcontracted R & D costs; or
  - (f) externally provided workers.

- (iv) It is not incurred in the carrying on of activities which are contracted out to the company by any person
- (v) It is not subsidised, (although an SME is allowed large company R&D relief - see separate session on RDEC).

### *Staff costs*

Staff costs comprise:

- (i) all emoluments of whatever nature paid out to the directors or employees other than benefits in kind;
- (ii) secondary Class 1 NIC paid by the company;
- (iii) contributions to pension funds paid by the company for the benefit of directors and employees;
- (iv) The compulsory contributions paid by the company in respect of benefits for directors or employees of the company under the social security legislation of an EEA State (other than the United Kingdom) or Switzerland;

Only staffing costs for directors and employees directly and actively involved in R&D will qualify. Where someone is partly engaged in R&D, their time is apportioned so that only staffing costs incurred on R&D activities can be included. The cost of staff who provide support to R&D staff do not qualify, for example secretaries or administrative staff.

### *Sub-contracted R & D*

Where the SME subcontracts R&D work to a third party, the SME may claim large company R&D relief. The treatment varies depending on whether the two parties are connected.

Where the payment is to a connected company, which draws its accounts up under GAAP, the whole of any payment up to the amount of the connected company's expenditure is allowable.

In any other case 65% of the payments made can be claimed. However a joint irrevocable election can be made for connected company treatment. The time limit for the election is two years from the end of the first accounting period in which the contract is entered into.

### *Externally provided workers*

Where a company makes a payment to another person for the provision of workers, several conditions apply in order to get relief for the payment. An externally provided worker must:

- (i) be an individual;
- (ii) not be also a director or employee of the company;
- (iii) be obliged to provide services to the company personally;
- (iv) be under the control of the company.

As with the company's own staff, the externally provided workers must be directly and actively involved in R&D. Secretarial and administrative services are specifically excluded.

Where a worker is partly engaged in R&D, the expenditure must be apportioned. HMRC generally do not accept that a worker can spend 100% of their time on R&D and any claims made on this basis are likely to be challenged.

If the externally provided workers are not provided by a connected company 65% of the payment made will be qualifying expenditure. However, the company and the staff provider can jointly elect in writing for the connected company rules to apply. The election is irrevocable and must be made within two years from the end of the first accounting period in which the contract is entered into.

Where the workers are provided by a connected company and that company draws up its accounts in accordance with GAAP then the whole of the payment up to the staff provider's cost of the workers can be claimed.

#### *Subcontractors and R&D relief*

You cannot claim R&D Relief under the SME Scheme if you are a subcontractor - that is, if you have been subcontracted to do the work on behalf of somebody else because the SME itself will be claiming R&D relief on the cost of the subcontract work.

But, even if your company is small or medium-sized, you may still be able to claim, as a subcontractor, under the Large Company Scheme.

This will be where the R&D has been contracted out by either a large company or a person otherwise than in the course of a trade profession or vocation the profits of which are chargeable to tax.

The expenditure must be relevant R&D expenditure, must be revenue in nature and be incurred on either:

- consumable items
- consumable stores
- software
- staffing costs
- externally provided workers
- subjects of clinical trials

or: work contracted by the SME company to be directly carried out by a qualifying body (institution of higher education such as a university, a scientific research organisation or a health service body) , an individual or a partnership made up of individuals

#### *R&D Tax Credits*

An SME company with a trading loss that has incurred qualifying R&D can surrender all or part of the loss as follows.

Firstly, the amount available to surrender must be calculated.

This is the smaller of:

- (i) the unrelieved trading loss; and
- (ii) 230% of the qualifying R&D expenditure

For these purposes an unrelieved trading loss means the trading loss of the period reduced by any actual *and potential claims* for relief for that loss in the current period and any other actual loss relief claims made in respect of the loss. No account is taken of losses brought forward or carried back to this accounting period.

Since 1 April 2021, repayable R&D credits are generally capped at a total of

- £20,000 (pro-rata if the CAP is less than 12 months), plus
- 3 x 'relevant expenditure'

#### *Relevant expenditure*

1. PAYE and NIC liabilities of the claimant for the payment period, plus
2. Relevant proportion of any PAYE and NIC costs incurred by a connected company in providing R&D workers for the company, plus
3. Relevant proportion of any PAYE and NIC costs incurred by a connected company in undertaking contracted out R&D of the claimant

#### *Example*

A loss-making SME has R&D spend of £100,000 which would attract an enhanced deduction of £130,000 giving total R&D costs of £230,000.

Its losses exceed this amount so the tax credit which could be claimed is 14.5% of the surrenderable losses so without the cap, £33,350.

The R&D claim includes £50,000 of payments to a connected company for externally provided workers

- The actual payment made for those workers is £60,000 but the connected company's costs are only £50,000
- The total PAYE and NIC liability of that company is £5,000

Assume that the claimant company has no PAYE and NIC liability itself.

The cap therefore limits the amount which can be claimed to:

Minimum	£20,000
Plus 3 x (£5,000 x 50,000/60,000))	<u>£12,500</u>
	<u>£32,500</u>

*Contributed by Malcolm Greenbaum*