

International Business Review

Research and development tax incentives

The UK government provides some significant tax incentives for companies undertaking research and development work (R&D). The aim is to encourage investment in R&D and to make the UK an attractive location for overseas companies to undertake their R&D activities.

There are two schemes depending on the size of the company. A company qualifies for the small and medium company scheme if it has:

- fewer than 500 employees; and
 - either an annual turnover not exceeding 100 million Euros or a balance sheet total not exceeding 86 million Euros.
- In broad terms, where a company is a member of a group, the holding company and all companies in the group must together meet this definition.

Any company which is not small or medium sized under the above definition is a large company for R&D purposes.

Small and medium sized companies (SME)

Small and medium sized companies can claim a tax deduction for 175% of their R&D expenditure. For companies which have tax losses an R&D tax credit can be claimed. This is a cash repayment from HM Revenue & Customs (HMRC) of up to £24 for every £100 spent on R&D. The repayment is capped at the amount of payroll taxes and social security paid for the accounting period. This repayment is not taxable income for the company.

The following expenditure qualifies for the R&D tax relief:

- the cost of staff directly involved in the R&D work;
- 65% of the cost of externally provided workers such as agency staff engaged by the company to work on the R&D project provided the two parties are not connected;
- the cost of software and consumable items such as fuel, power and water; and

- 65% of the cost of subcontracting specific elements of the R&D work to a third party, provided the two parties are not connected.

The R&D work must not be subsidised by grants and must not relate to R&D subcontracted to the company by another person. For expenditure incurred in an accounting period ending on or after 9 December 2009, the condition that the company must also own the intellectual property rights arising from the R&D has been abolished.

If the above conditions are not met, the company would qualify for the large company rate of deduction.

Where the SME has received a grant, say £100,000 for £500,000 of staffing costs, the SME can claim 175% of £400,000 but only 130% of £100,000 under the large scheme.

Large companies

Large companies can claim a tax deduction for 130% of their R&D expenditure.

The following expenditure qualifies for the R&D tax relief:

- the cost of staff directly involved in the R&D work;
- 65% of the cost of externally provided workers such as agency staff engaged by the company to work on the R&D project provided the two parties are not connected;
- the cost of software and consumable items such as fuel, power and water;
- amounts paid to certain organisations, e.g. universities and hospitals for R&D undertaken on the company's behalf; and

- contributions to independent research undertaken by certain organisations providing it is relevant to the trade of the company.

There is no requirement for the company to own the intellectual property rights arising from the R&D.

Where an overseas parent company subcontracts the R&D work to its UK subsidiary, the latter will only qualify under the scheme for large companies.

For both schemes, qualifying expenditure on R&D work in a 12 month period must be at least £10,000. Furthermore, the expenditure should not be capital and should relate to the trade of the company. In addition, capital allowances of 100% are available on expenditure on capital assets, excluding land, used for R&D activities.

The claim is included in the tax return and must be made within two years of the end of the accounting period in which the expenditure was incurred.

Company as a subcontractor

A company (SME and large) can claim 130% under the large scheme for the R&D work subcontracted to it. The work must be subcontracted by a large company or a person with no taxable trading profits. However, in the case of an SME, the work can be undertaken by the SME itself or others e.g. charities, individuals.

Definition of R&D

HMRC and the Department of Trade and Industry have issued some guidance on the meaning of R&D for tax purposes. In broad terms, for an activity to be considered as R&D it should aim to achieve an advance in science and technology through

the resolution of a scientific or technological uncertainty. An advance in science or technology includes work which:

- generates scientific or technical knowledge;
- creates a process, material, device, product or service which is new to the field; and
- appreciably improves something which already exists through scientific or technological change.

The R&D should not be something which is already available or could be made available by a competent professional working in the relevant field.

HMRC has indicated that the above definition should be applied to all branches of science and technology including software development. However interpretation of the definition is subjective and will become clearer over time when more information regarding the application of the definition to software is available. In the meantime companies should ensure that they have sufficient records and documentation available to demonstrate how the work which they have done falls within the definition of R&D.

Vaccine research relief (VRR)

VRR at the rate of 140% of expenditure is available for qualifying revenue expenditure to both small and large companies. The qualifying expenditure is as set out below but a claim for subcontracted R&D is only permitted where the subcontractor is a charity, university or a specified scientific research organisation. VRR is available for work relating to vaccines and medicines for the:

- prevention or treatment of tuberculosis;
- prevention or treatment of malaria;
- prevention of the onset or treatment of acquired immune deficiency syndrome resulting from infection by human immunodeficiency virus in prescribed clades.

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