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RESEARCH & DEVELOPMENT (R & D) – THE SIGNIFICANT TAX BREAKS

How does the R&D scheme work?

The Research and Development (R&D) scheme is a tax relief which can secure substantial tax repayments, even for loss making companies which have paid no corporation tax.

R&D tax relief is designed to give companies (and other entities within the scope of corporation tax) an extra tax boost if they carry out innovative Research and Development. This is an incentive to encourage businesses to do R&D and a way of giving them extra funds to help with the costs involved.

There are two different schemes depending on whether your company is:

A SME (small and medium enterprise)
A Large Company

Currently, a small or medium company is defined as:

- Annual turnover under €100M
- A Balance Sheet total under €86M; and
- Number of employees less than 500.

These 'size' criteria for the two schemes are liable to variation, so should always be checked.

What are the tax breaks and how do they work?

If a company has spent £100,000 on R&D in an accounting period, an additional £130,000 CT deduction is allowable (on top of the £100,000 already received – giving a total relief figure of £230,000).

The full £230,000 reduces your taxable profits or creates or increases your tax loss. Thus, you effectively save tax at 20% (current rate) for the previous or current accounting year or for future years.

The £230,000 could alternatively be surrendered to obtain a tax credit of £33,350 (£230,000 x 14.5%) payable to the company. Note if you surrender the claim in order for HMRC to pay you a tax credit, the rate of relief you get is 5.5% lower but as you get cash back (as opposed to simply a reduction of your tax bills (past, present or future), this can be important for cash flow – for example so you can continue to trade or do more R & D work.

An R&D claim does not affect your accounting profit.

What conditions must you meet to qualify for these R & D tax breaks?

To qualify, a company must meet three important criteria:

1) Firstly, the company must be aiming to, or achieving, an advance in technology. A technological advance may simply be making an ***appreciable technical or scientific improvement*** to an existing product, material, service, device or process. The improvement must be borne out of a ***technological*** advancement and not simply a *commercial* innovation. The simple use of technology would not qualify for R&D relief – the company has to be making an advance.

2) Secondly, in making the technological advance, a company must also be overcoming ***technological uncertainties***. Technological uncertainty exists when knowledge of whether something is scientifically or technologically feasible, or how to achieve it in practice, is not readily deducible by a competent professional working in the field.

3) Thirdly, the project must not be readily deducible by a competent professional. In practice, the easiest way to ensure that this is not the case is the length of time of a project takes to complete. As a general rule, qualifying projects last at least three months. If projects last a shorter period of time, it is likely that insufficient uncertainty existed at the start of the project (and was therefore readily deducible).

What specific costs qualify for R & D relief?

Once the project(s) which meet the above criteria have been identified, there is the need to determine how much the company has spent on qualifying R&D.

The allowable costs are split into five categories as follows:

1. **Staff costs** – for each individual involved in the R&D process a relevant percentage of their time can be included in the claim. This can include people that are designing the product or making the product and those testing it. It wouldn't include people working on cosmetic elements of design or staff doing market research / customer evaluations. The allowable staff costs are:

    a. Gross annual salary
    b. Employers national insurance contributions for the employee
    c. Any pension contributions made by the company on behalf of the employee
    d. Any bonuses even if they are not related to the R&D work

    Directors can be included, but only their salary counts towards the R&D costs - dividends and benefits in kind are not allowable.

    For each individual involved, HMRC then want the relevant percentage of that person's time spent on the project. There is no need for time sheets but it needs to be a sensible and reasonable estimate.

2. **Sub-contractors** – payments made to sub-contractors are allowable provided the work they are doing is contributing to the R&D project. If you sent your products for testing, for example, this would be allowable. The testing may be well established and routine and on its own would not be R&D but the subcontracted work will count as R&D from the perspective of your company, because it is one component of a larger project that is R&D.

The key difference between staff costs and sub-contractors is that the staff costs start at 100% of salary and are restricted by the level of involvement of the individual. Sub-contracted costs are automatically restricted to 65% of the amount paid and then further adjusted to reflect the amount of time spent on qualifying projects.

3. **Externally provided workers** – this category doesn't often get used but it is for things like agency staff, people from universities, individuals employed by one member of a group but who do work for another group member. These costs are restricted to 65% in the same way as sub-contractors.

4. **Consumables** – these are defined by HMRC as items that are 'consumable or transformable' materials and are no longer available to use or be sold after the R&D work. Common examples would be prototypes or electronic components that are changed and tested. The one quirk of this category is that you can claim for costs of any software licences that are used solely for the purpose of R&D activities. The full costs of these materials are allowable.

5. **Light, Heat & Power** – these are the only overheads that are allowable. Rent and rates cannot be included. Ordinarily we will add up the figures for the first three items and if that comes to, say, 20% of the total staff costs then we will claim 20% of the Light, Heat & Power costs shown in the accounts.

What are the time limits for making an R & D claim?

Companies can claim R&D relief retrospectively for two years from the end of the accounting period.

Therefore for example, a company with a 31st March year end can retrospectively claim for the 2015 and 2016 accounting periods. It is too late to claim for the YE 31 March 2014 as we have missed the 2 year time limit now that we have already passed 31 March 2016.

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