

International Business Review

Research and development tax incentives Small and medium sized enterprises

The UK government has a generous Research & Development (“R&D”) tax credit system for companies undertaking qualifying R&D. This has been designed to encourage investment in R&D and to make the UK an attractive location for innovative businesses.

There are two regimes, depending on the size of the company. A company qualifies for the small and medium sized enterprise (“SME”) regime if it has:

- fewer than 500 employees; and
- either an annual turnover not exceeding €100 million or a balance sheet total not exceeding €86 million.

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 an SME under the above definition is a ‘large’ company for R&D purposes.

This factsheet summarises the SME regime. A separate factsheet has been prepared to outline the R&D regime for companies that qualify as large for this purpose.

Definition of R&D

HM Revenue & Customs (“HMRC”) and the Department of Trade Business, Energy and Industrial Strategy have issued guidance on the meaning of R&D for tax purposes. In broad terms, for R&D activities to qualify for relief, they should aim to achieve an advance in science and technology through the resolution of a scientific or technological uncertainty. HMRC has indicated that the definition should be applied to all branches of science and technology, including software development.

An advance in science or technology includes work that:

- generates scientific or technical knowledge;
- creates a process, material, device, product or service which is new to the field; or

- appreciably improves something which already exists through scientific or technological change.

The R&D should not be seeking to create what is already available (except if it is a trade secret) or could readily be made available by a competent professional working in the relevant field.

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.

How it works

SMEs can claim a tax deduction equal to 230% of their qualifying R&D expenditure. For companies that have tax losses, a payable cash credit of 14.5% of the surrenderable loss can be claimed. This is a cash repayment from HMRC of up to £33.35 for every £100 spent on R&D.

SME tax relief is available in respect of the following types of expenditure:

- the cost of staff directly involved in the R&D work;
- 65% of the cost of subcontracting specific elements of the R&D work to a third party, provided the two parties are not connected. If the parties are connected, the qualifying expenditure will be restricted to the lower of the subcontractor payments made and the qualifying R&D expenditure of the subcontractor;
- 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; and
- the cost of software and consumable items, including fuel, power and water.

For expenditure to qualify for R&D relief it must relate to the trade of the company and must not be capital in nature. However, capital allowances of 100% are available on expenditure on capital assets, excluding land, used for R&D activities.

The R&D claim is included in the claimant company's corporation tax return and must be made within two years of the end of the accounting period in which the expenditure was incurred.

Grants

The receipt of grant funding may limit the availability of the SME R&D regime. However, it may still be possible for the

company to make a claim under the R&D regime for large companies.

Subcontracted R&D

A company cannot claim SME relief where the R&D has been subcontracted to it by another company. However, where the R&D has been subcontracted by a large company or a company outside the scope of UK tax (e.g. an overseas parent company), the subsidiary may be able to claim under the large company regime. This is particularly relevant to overseas groups with UK based subsidiaries or operations.

Worked examples

Profit making SME

	No R&D claim £	R&D claim made £
Taxable profit before R&D expenditure	55,000	55,000
Qualifying R&D expenditure	(20,000)	(20,000)
R&D enhanced deduction (130%)	—	(26,000)
Taxable profit	35,000	9,000
Tax at 19%	6,650	1,710

Loss making SME

	No R&D claim £	R&D claim made £
Taxable loss before R&D expenditure	(25,000)	(25,000)
Qualifying R&D expenditure	(10,000)	(10,000)
R&D enhanced deduction (130%)	—	(13,000)
Taxable loss	(35,000)	(48,000)
Loss surrendered	—	23,000
Loss carried forward	(35,000)	(25,000)
Cash refund received*	—	3,335

*The company's taxable loss of £48,000 exceeds the total R&D deduction of £23,000 (£10,000 x 230%). The surrenderable loss is therefore equal to the full £23,000. The company can apply for a tax credit of 14.5% of the surrenderable loss (14.5% x £23,000 = £3,335). This equates to 33.35% of the qualifying R&D expenditure.

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