

THE R&D TAX CREDIT SCHEME

The following rules apply to small and medium-sized enterprises (SMEs). SME is defined for these purposes at the Appendix.

Commencement

Qualifying R&D expenditure incurred on or after 1 April 2000.

Definition of R&D

Following a formal Consultation exercise that began in 2003, the Department of Trade and Industry (DTI) issued revised guidance on its interpretation of the meaning of R&D on 5 March 2004, which was subsequently given legal force for tax purposes.

The new DTI guidelines can be found at <http://www.dti.gov.uk/rd-guide/rd-guidelines-2004.htm>.

The previous guidelines' requirements for novelty and innovation have been replaced by the requirement to demonstrate an advance in science or technology, which is considered to be a more objective test.

Application of the new guidelines

The new guidelines apply to accounting periods ended on or after 1 April 2004, although companies may use them immediately as a guide to interpretation of the old guidelines.

Qualifying expenditure - The expenditure must satisfy the following conditions to be treated as qualifying R&D expenditure:

- £10K or more per year (reduced from £25K per annum with effect from 27 September 2003). This figure is reduced proportionately for an accounting period of less than 12 months.
- Revenue in nature, as opposed to capital (NB - the latter may qualify for R & D Capital Allowances, which are outside the scope of this note).
- Attributable to R&D undertaken directly by the SME, on its behalf or, in certain circumstances, sub-contracted to the SME.
- Represent the cost of **staff** carrying out the R&D (including agency workers and those spending only part of their time on R&D), **materials** consumed or transformed during the R&D, **water** and **fuel** (including gas and

electricity) consumed during the R&D and **software** that is used directly and actively in the R&D.

- Not be funded by government grants e.g. Smart or LINK (see overleaf for more detail).

The basic relief

The SME claims a "super deduction" of 150% of the qualifying R&D expenditure via its Corporation Tax return (NB - reduced to 125% where R&D is sub-contracted to the SME).

The payable R&D Tax Credit

Where an SME incurs a trading loss and has claimed the R&D "super deduction" in that period, it may surrender that loss in exchange for a cash payment up to a theoretical maximum of 24% of the actual qualifying R&D expenditure. (equivalent to 16% of the super deduction). Alternatively, it may use the trading loss in accordance with the normal rules.

How to claim

Claims for R&D tax relief may be made via the SME's tax return at any time within 6 years of the end of the accounting period to which the claim relates.

However, claims for the **repayable R&D tax credit** must normally be made within **two** years of the end of the accounting period to which the claim relates.

Grants and subsidies

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"There are situations where companies receive assistance with the cost of their R&D. Relief is limited depending on the assistance received.

If part or all of the costs of a company's research project is met by a notified State Aid then none of the cost of the project's R&D qualifies for R&D tax relief, even if the aid only meets part of the cost. The restriction applies where a State aid is received for any expenditure attributable to the R&D project.

Examples of notified State aid for a R&D project are the Smart and LINK awards given by the Department of Trade and Industry. If, for example, 30% of the cost of a company's R&D project is funded by a Smart award, the company cannot claim R&D tax relief for any costs associated with that project. But it could still claim R&D tax relief on qualifying R&D spending on a different project it may be carrying on at the same time that is not part of the award.

If the subsidy, grant or other payment is not a notified State aid, then R&D tax relief cannot be claimed on that part of the qualifying expenditure which is met by the subsidy etc. For example, a subsidy, which meets 30% of the costs of a project, would limit the R&D tax relief based on to the remaining 70%

of the costs. Thus, in so far as the R&D expenditure is met by a person other than the company the relief is restricted accordingly.

It is quite common for subsidies and grants to be for specific projects and so they can be readily identified as can the expenditure they cover. But where the subsidy etc is not specifically allocated to particular expenditure then it is to be allocated on a just and reasonable basis."

Experience to date

The Inland Revenue is known to have used the distinction made by the previous guidelines between innovation and mere commercial development to challenge some R&D claims. In the 2004 Spring Budget, the Revenue announced that it will issue improved guidance on the operation of the R&D Scheme in advance of the 2004 Pre-Budget Report to reflect its experience of claims made to date, followed by a programme to improve delivery of the credit. These changes are to be welcomed.

Definition of SME

An SME is defined as follows for R&D Tax Credit purposes.

- Less than 250 employees and either (or both) of the following:
 - Annual turnover not more than 40m Euros
 - Annual balance sheet total not more than 27m Euros.

The UK tax rules adopt the European Commission's definition of SME for State Aid purposes on the basis that the UK's R&D Tax Credit is itself a Notified State Aid.

(NB - the above turnover and balance sheet thresholds are to be increased to 50m and 43m Euros respectively with effect from 1 January 2005).