

Chapter 1

Research and development tax relief

INTRODUCTION

The SME Scheme

1.1 Research and Development ('R&D') tax relief was introduced for qualifying expenditures incurred on relevant R&D work from 1 April 2000. This legislation was introduced specifically for companies that qualified as small or medium-sized enterprises ('SMEs'). In this book we refer to R&D tax relief legislation that applies to SMEs as the SME Scheme (Schedule 20 to the Finance Act 2000).

The Large Company Scheme

1.2 The R&D tax relief legislation for large companies was introduced for qualifying expenditures incurred on relevant R&D work from 1 April 2002. Large companies are defined as companies that do not qualify as SMEs. In this book we refer to R&D tax relief legislation for large companies (and for SMEs that don't qualify for relief on certain expenditures under the SME Scheme) as the Large Company Scheme (Schedule 12 to the Finance Act 2002).

History of the programme

1.3 Prior to the introduction of R&D tax relief legislation UK companies would only qualify for Schedule D Case I or II deductions for their revenue expenditure on R&D or Research and Development Allowances on their capital expenditure on R&D.

The R&D tax relief rules have changed for both Schemes since their introduction. These changes have resulted in a change to the expenditure categories eligible for relief, the qualification criteria for these expenditures, the corporate structure required for relief, the definition of a SME, changes to the source of GAAP for UK purposes, and the interpretation of the meaning of R&D.

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Between April 2000 and April 2006 around 22,000 claims for R&D tax relief in the UK were made with almost £1.8 billion of support claimed. About 19,000 of these claims were made under the SME Scheme and 3,000 made under the Large Company Scheme.

A multi-disciplined approach

1.4 R&D tax relief claims are made on corporate tax returns or on amendments to a corporate tax return. These claims are then assessed by Her Majesty's Revenue and Customs ('HMRC'). Because they are filed on a tax return, the preparation of a claim is often left to the person that is responsible for preparing the corporate tax return. That person is either in the finance or taxation group of a company, or is an external advisor that draws on that group for information. However, successfully claiming R&D tax relief requires an understanding of three disciplines:

- 1 Tax (UK, European and International).
- 2 Finance and costing.
- 3 Science and technology.

This multi-disciplined programme often creates headaches for claimants, advisors and inspectors as a full and thorough understanding of each area is required to properly prepare and assess a claim. Scientific and technological personnel need to develop an understanding of the meaning of R&D for tax purposes so they can determine which activities would qualify as R&D activities. They in turn must provide the results of their determinations to costing personnel. Costing personnel must develop an understanding of what types of expenditures qualify as R&D in the time period for which the claim was made so the cost of activities can be determined. Appropriate cost centres must be established so costs are collected on a contemporaneous basis. Taxation personnel must make an assessment to determine the scheme (SME Scheme or Large Company Scheme) that is relevant to the company, and the costs claimed by the company. They must also apply the various taxation rules and regulations that govern the programme in a manner that insures the benefit of the claim is maximised, and they must affect the required tax filings within the appropriate time limits.

HMRC have recognised the unique nature of the R&D tax relief programme and in 2006 announced the opening specialist units in Cambridge, Croydon, Leicester, Maidstone, Manchester, Southampton and Cardiff. These units will comprise dedicated teams of R&D tax relief officers.

HMRC also created the Corporate Intangibles Research and Development Manual ('CIRD') to assist claimants, advisors and inspectors in understanding HMRC's interpretation of the R&D tax relief programme.

Approach in this book

1.5 This book is designed to be used by finance, costing, taxation, scientific and technological personnel. In it we will shed some light on the complex legislation, technical terms and interpretation anomalies. We do this by consolidating the legislation (which comes from a variety of different sources), interpreting it and supporting this interpretation through examples.

In this book we provide readers with the tools needed to complete a claim within the six broad areas of compliance.

- 1 Identify whether the claimant enterprise is defined as a SME (see Chapter 8).
- 2 Identify whether the compliance cost of making a claim outweighs the expected relief bearing in mind you can claim retrospectively (see Chapters 2, 3 and 12).
- 3 Identify whether the company is performing R&D (see Chapters 4, 13, 14, 15 and 16).
- 4 Identify whether the company meets the general R&D tax relief claim requirements (see Chapter 5) and the specific requirements of the SME Scheme (see Chapters 6 and 9) or the Large Company Scheme (see Chapters 7 and 10).
- 5 Identify which expenditure can be claimed as R&D in the accounting period in question (see Chapter 11).
- 6 Submit a claim before the deadline (see Chapter 12) by qualifying and quantifying the expenditures incurred and the relief claimed and by providing evidence that the research and development undertaken meets the meaning of R&D for tax relief purposes (Chapter 4).

Chapter summaries

1.6 This book is divided into the following chapters that will help the reader address the six broad areas of compliance.

- Chapter 1: Introduction

In this chapter we introduce you to the R&D tax relief programme and the areas of analysis that this book covers. This includes introducing you to the two schemes under which the R&D tax relief programme operates (the SME Scheme and Large Company Scheme), the multi-disciplined approach needed to take full advantage of this government initiative and the six broad areas of R&D tax relief compliance.

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- Chapter 2: SME Scheme: What incentives are available?
This chapter covers the R&D tax relief that companies can expect if they successfully claim under the SME Scheme. Even companies that do not pay tax can claim relief in the form of a refundable 'R&D tax credit'. To claim SME Scheme relief readers need to understand whether the claimant company qualifies as a SME, whether it meets the general and specific qualification criteria under the SME Scheme and whether it is performing R&D that qualifies as such under the R&D tax relief programme.
- Chapter 3: Large Company Scheme: What incentives are available?
This chapter covers the R&D tax relief that companies can expect if they successfully claim under the Large Company Scheme. To claim Large Company Scheme relief readers need to understand whether the claimant company does so as a large company or a SME, whether the company meets the general and specific qualification criteria under the Large Company Scheme and whether it is performing R&D that qualifies as such under the R&D tax relief programme.
- Chapter 4: The meaning of R&D for tax purposes
This chapter is dedicated to analysing the meaning of 'research and development' as it relates to the R&D tax relief programme.
- Chapter 5: Common factors affecting both the SME and Large Company Schemes
This chapter covers general eligibility requirements that relate to both the SME and Large Company Schemes. Claimant companies will need to satisfy these requirements in order to successfully claim under the R&D tax relief programme.
- Chapter 6: The SME Scheme
This chapter covers the specific eligibility requirements and the expenditure categories available for relief for companies who claim under the SME Scheme. Only companies that meet the definition of a SME can claim under the SME Scheme.
- Chapter 7: The Large Company Scheme
This chapter covers the specific eligibility requirements and the expenditure categories available for relief for companies who claim under the Large Company Scheme. Companies which do not meet the definition of a SME (ie large companies) can claim under the Large Company

Scheme. In certain cases some SMEs can also claim under the Large Company Scheme.

- Chapter 8: What is a small or medium-sized enterprise ('SME')?
In this chapter we discuss the requirements that enterprises need to satisfy in order to meet the definition of a SME. Only companies that meet the definition of a SME can claim under the SME Scheme. Companies that do not meet this definition are termed 'large companies'. Large companies, and in certain cases SMEs, may be eligible to claim under the Large Company Scheme. This chapter will also analyse how the definition of a SME has changed since the SME Scheme was first introduced and the effective dates of these changes.
- Chapter 9: SME Scheme: Retrospective analysis
This chapter takes a look back at the SME Scheme as it stood when first introduced on 1 April 2000. This chapter also discusses the various changes to the SME Scheme since its introduction and the effective dates to these changes.
- Chapter 10: Large Company Scheme: Retrospective analysis
Chapter 10 looks back at the Large Company Scheme as it stood when first introduced on 1 April 2002. This chapter also discusses the various changes to the Large Company Scheme since its introduction and the effective dates to these changes.
- Chapter 11: Qualifying expenditures at a glance
This chapter summarises the qualifying expenditure categories for both the SME and Large Company Scheme. These expenditure categories are summarised by the effective dates of their respective introductions.
- Chapter 12: Time limits and submission requirements
Many claimant companies miss R&D tax relief available on R&D expenditure because they miss the required date for the R&D tax relief claim submission. R&D tax relief claims can be applied for in the corporate tax return (or amendment thereof) or they can be in the form of a general claim submission. The application type can mean a different deadline for its submission. This chapter discusses these issues and recourses for late claims.
- Chapter 13: Computer software
In this chapter we discuss the meaning of R&D under the R&D tax relief programme as it applies to the development of computer software. Examples of projects likely and not likely to be R&D projects are

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provided. Record-keeping requirements, IP ownership and capital/revenue divide issues are also addressed.

- Chapter 14: Aerospace

In this chapter we discuss the meaning of R&D under the R&D tax relief programme as it applies to R&D work in the aerospace industry. Specific issues of concern to the aerospace industry are addressed including the determination of project start and stop dates, the eligibility of processes towards certification, and the eligibility of design work. Lists are provided of projects that would likely or likely not qualify as R&D. This chapter also addresses the issue of subsidised expenditures.

- Chapter 15: Automotive

In this chapter we address issues that are often encountered in determining the eligibility of activities within the automotive industry. We discuss issues surrounding the start up of new equipment and systems, cost constraints, and the scientific or technological uncertainty surrounding the compatibility of new combinations of technologies, and the complexity of a system.

- Chapter 16: Pharmaceutical Industry

In this chapter we discuss whether the activities involved in the four stages of development typical to the pharmaceutical industry are R&D for tax purposes. We also discuss the implication of regulatory requirements.