Research & Development in the manufacturing sphere

Kingston Smith

A summary of the UK R&D tax credits scheme

The UK's R&D tax credit regime is one of the most attractive in the world. There is now evidence of the significant impact that the scheme has had, since its inception in 2000.

The Government's on-going drive to encourage businesses to invest in research & development has resulted in increased rates of tax relief available to UK companies with Finance Act 2014 increasing the repayable credit under the SME scheme from 11% to 14.5% effective from 1 April 2014.

The scheme gives higher rates of corporation tax relief on allowable R&D costs. It also includes a repayable tax credit in some cases, which can often be a lifeline to early stage businesses.

The rates of deduction for qualifying expenditure changed effective from 1 April 2015, as set out in the table below:

Deduction rates on qualifying expenditure

SME scheme			
	Post 1/4/11	1/4/12 - 31/3/15	Post 1/4/15
	200%	225%	230%

SME Scheme tax credit repayment available

SME scheme			
	Pre 1/4/11	1/4/12 - 31/3/14	Post 1/4/14
	12.5%	11%	14.5%

Large scheme 'above the line' tax credit (gross)

Large company scheme		
	1/4/13 - 31/3/15	Post 1/4/15
	10%	11%

For example, a small company investing £100,000 in qualifying R&D activities now obtains a £230,000 tax deduction. If this company received the tax credit available, this would generate a repayment of £33,350 which is an effective 33.35% subsidy on their R&D qualifying spend.

From 1 July 2016, companies claiming more than €500,000 of relief per annum under the SME scheme will have their details published on the European Commission website.

'Above the line' tax credit

Companies claiming relief under the Large Company Scheme are subject to a separate Above the Line (ATL) regime.

The ATL regime was originally introduced as an optional regime effective from 1 April 2013 alongside the previous super deduction regime. From 1 April 2016, ATL has become mandatory and replaced the super deduction alternative.

Under the ATL regime, rather than providing a deduction from taxable profits only, it is applied in the company's profit and loss account, i.e. 'above' the profit line, reducing the cost of qualifying expenditure. An ATL credit will be available at a rate of 11% for expenditure incurred from 1 April 2015, this will, however, be subject to corporation tax at the main rate (19% from 1 April 2017), giving a net credit of 8.8%.

For example, a large company investing £100,000 in R&D qualifying expenditure can claim a taxable ATL credit of £11,000 (£8,910 net of corporation tax at 19%). This will give the company a net credit of 8.91% and tax relief of £8.91 for every £100 spent on qualifying R&D.

Some restrictions will apply, which will cap the maximum credit available to a company by reference to PAYE and NIC paid in respect of the staff involved in the qualifying activity.

What is qualifying R&D?

To qualify for R&D, your project must fulfil the HM Revenue & Customs definition. They look at four key aspects:

- What is the scientific or technological advance?
- What were the scientific or technological uncertainties involved in the project?
- How and when were the uncertainties actually overcome?
- Why was the knowledge being sought not readily deducible by a competent professional?

Advance Assurance

HMRC now has an Advance Assurance process available for use by certain companies seeking to claim R&D tax relief for the first time.

Applying for Advance Assurance is voluntary and will give a company comfort that their R&D claim for the first three periods will be processed without further enquiry, provided the claims are in accordance with details provided in the original application.

The Advance Assurance is only available to certain companies which meet the following criteria:

- They have not claimed R&D tax relief before;
- They have an annual turnover of £2m or less;
- They have less than 50 employees.

It is therefore ideally suited for small start-up companies who want more certainty on whether their activities fit within the rules in advance of undertaking detailed analysis of expenditure and incurring professional fees in preparing claims.

The application for Advance Assurance is required to be made in a prescribed format by completing the appropriate form and providing certain documents and details of the R&D activities.

Qualifying expenditure

The R&D tax relief is limited to costs incurred on qualifying expenditure as set out in the following table.

Qualifying expenditure

Type of expenditure	Nature of expenditure
Staffing costs	Only staffing costs of directors or employees directly and actively engaged in relevant R&D activity can be qualifying expenditure. This includes both those directly and actively engaged in activities which directly contribute to achieving the advance in science or technology and those directly and actively engaged in "qualifying indirect activities" to the extent that such activities are relevant R&D. For example, wages and salaries, bonuses, pensions and other benefits. Staff members must be employed under a contract of employment directly with the company. Consultants, agency workers, or staff/directors whose contracts of employment are with other companies do not qualify for relief under this category. However, they may qualify under either the rules for externally provided workers or subcontractors.
Externally provided workers	Paying a staff provider for staff provided to the company who are directly and actively engaged in carrying out R&D. The staff provider needs to contract with the individual whose services they supply and not through another person. A person is an externally provided worker if the following conditions are satisfied: • they are an individual (not a company) • they are not a director or employee of the company • they personally provide, or are under an obligation personally to provide, services to the company • they are subject to (or to the right of) supervision, direction or control by the company as to the manner in which those services are provided • their services are supplied to the company by or through the staff provider • they provide, or are under an obligation to provide, those services personally to the company under the terms of a contract between themselves and the staff provider • the provision of those services does not constitute the carrying on of activities contracted out by the company. This does not include the recruitment cost of staff provided by employment agencies. The expenditure must be for the provision of staff and not for other services. Hence, it does not include payments to self employed consultants.
Subcontracted R&D expenditure	If the company is claiming relief under the SME scheme, then the company may be able to claim back 65% of the expenditure on certain R&D activities carried out by a subcontractor.
Consumable Items - Materials	Consumable or transformable materials used directly in carrying out R&D. These are actual physical materials that are consumed in the R&D and not things like telecommunications or data costs. For example, a laboratory chemical used in the R&D process or electronic components that are integrated into a larger assembly. Note production raw materials or components are excluded as they fall outside the scope of consumable items. As a result of changes made in 2014 Autumn statement, HMRC have restricted the costs that can be claimed on materials and other consumable items. From 1 April 2015, companies will no longer be able to claim the cost of materials which are incorporated into products or services that are then sold to customers.
Consumable items - Utilities	Power, water, fuel used directly in carrying out R&D, but, like materials, not things like telecommunication costs and data costs.
Software	Computer software used directly in the R&D.
Capital expenditure	R&D relief is only available for 'revenue expenditure' (generally, day-to-day running costs, as opposed to capital expenditure). If the company is involved in R&D and money is spent on capital assets, the company may be able to claim R&D capital allowances.

Minimum claim

There is no minimum expenditure requirement, which will allow more companies into the scheme and save on paying salaries purely to trigger reclaims.

Scientific or technological advance

Rather than stating the name of the product, process, functionality, etc. being developed, you should consider what scientific or technological advance is being sought. This focuses attention on the project's aim for an advance, which is the key issue in judging whether R&D for tax purposes is being undertaken.

Science does not include work in the arts, humanities and social sciences (including economics).

It's not enough that a product is commercially innovative. You can't claim in respect of projects to develop innovative business products or services that don't incorporate any advance in science or technology.

Scientific or technological uncertainty

Scientific or technological uncertainty exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, is not readily available or deducible by a competent professional working in the field.

Uncertainties that can be resolved through relatively brief discussions with peers are routine uncertainties rather than technological uncertainties. Technical problems that have been overcome in previous projects on similar systems are not likely to be technological uncertainties.

You should set out at a high level, in a form understandable to the non-expert, what these uncertainties were and when they started and ended.

Overcoming uncertainties

Describe the methods adopted to overcome the uncertainties and the investigations and analysis undertaken. This should not be in great detail, simply sufficient to show that the matter was not straightforward. Describe the successes and failures and the impact of these on the overall project. If the uncertainties were not overcome, explain what happened.

Competent professional test

It might be publicly known that others have attempted to resolve the uncertainties and failed, or perhaps that others have resolved the uncertainties but that precisely how it was done is not in the public domain. In either case, a valid technological uncertainty can still exist.

Alternatively, if the project is one where there is little public information available, you'll need to show that the persons leading the R&D project are themselves competent professionals working in the relevant field. This might be done by outlining their relevant background, professional qualifications and recent experience. Then, have them explain why they consider the uncertainties are scientific or technological uncertainties rather than routine uncertainties.

Whichever is appropriate, set out the details and have evidence available if needed.

How we help our clients

In making a R&D claim, there are three main areas to think about:

- project qualification
- satisfactory documentation
- a clear, effective methodology.

Dealing with HMRC is key, and a well presented supported claim is far more likely to succeed than the minimum legal requirements. Our use of a technology document and standard HM Revenue & Customs tools helps both maximise the R&D claim itself and maximises the chances of it being agreed by HM Revenue & Customs.

Focus on R&D for Manufacturers:

Can Manufacturing qualify for R&D?

Many Manufacturing businesses are missing out on claiming valuable relief; this unfortunately happens because the term 'R&D' is synonymous with white lab coats and test tubes. The definition is much broader and includes developing new manufacturing processes.

OUR USE OF A TECHNOLOGY DOCUMENT AND STANDARD HM REVENUE & CUSTOMS TOOLS HELPS BOTH MAXIMISE THE R&D CLAIM ITSELF AND MAXIMISES THE CHANCES OF IT BEING AGREED BY HM REVENUE & CUSTOMS

Here are some of the manufacturing activities that would be eligible for the credit:

- designing the process to fabricate the metal to reduce shrinkage and increase its quality
- programming CNC machines
- developing and testing of prototypes
- designing and developing of specialty tooling and fixtures
- considering alternative metals to improve the product
- considering different metal thicknesses
- developing engineering drawings
- developing weld procedures
- bending of metal (e.g. sheet metal) has to consider the stressing and stretching;
- considering strength of final product for application (meets specifications).

Case study

We were approached to advise a large multinational aerospace company, with a global turnover of £400 million on the possibility of one of its subsidiaries claiming R&D enhanced expenditure relief in the periods prior to its acquisition.

The multinational actively manages its worldwide tax exposure and was keen to make use of reliefs where possible. The subsidiary had not previously been aware that it could claim an enhanced deduction for its R&D work and, consequently, had incurred tax liabilities as it made profits.

The solution

Our specialist R&D team visited the subsidiary's premises and undertook a review of the R&D and record keeping with the management team. We assisted the client with preparation of a technical report on the R&D they had undertaken and identified allowable expenditure. Amended corporation tax returns were submitted to HM Revenue & Customs claiming a deduction of 150% of the cost of the subsidiary's qualifying R&D costs and, within one month, their tax liability for the period had been reduced to nil.

How we can help

As a top 20 firm of Chartered Accountants, we have the capabilities to support you as your business develops both in the UK and overseas. Our team of specialists have developed a deep understanding of the processes and issues businesses face, which enables us to offer practical, realistic advice and share areas of best practice to help our clients succeed.

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