

The BIA guide to R&D tax credits for SMEs



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The BIA guide to R&D tax credits for SMEs

This note provides guidance on the tax treatment of R&D costs incurred by bioscience companies, based on the legislation in force from 1 January 2018. It has been prepared by Confluence Tax and FTI Consulting with input from other members of the BIA Finance and Tax Advisory Committee.

Further guidance can be found on the HMRC website.¹ Professional tax advice should always be sought on particular issues and circumstances.

What is R&D tax relief?

R&D tax relief is a UK Corporation Tax relief that may reduce a company's tax bill or entitle it to receive a cash tax payment from the UK tax authorities (HMRC). Companies of all sizes are eligible for relief at different rates but this guide will mainly focus on SMEs.

An SME for the purposes of R&D tax relief is defined as a company with fewer than 500 employees and either of the following:

- an annual turnover not exceeding €100 million; or
- a balance sheet not exceeding €86 million

All group companies are included when determining whether you meet these size criteria. However, where there is an institutional or venture capital investor, they do not need to be included in the calculation as long as their percentage holding is below 50%.

What counts as R&D?

R&D for these purposes is defined in a set of guidelines that can be found on the HMRC website, known as the BIS Guidelines.²

Put simply, R&D occurs when there is a project which seeks to achieve an advance in overall knowledge or capability in a field of science or technology through the resolution of scientific or technological uncertainty - and not simply an advance in the company's own state of knowledge or capability.

This test can be broken down into the following criteria:

- The R&D is a defined project;
- It is an attempt to achieve an advance in science or technology; and
- There is fundamental uncertainty at the outset of the project about the steps to be undertaken.

HMRC have provided guidance on the application of the above to the pharmaceutical industry.³

¹ <https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird80000>

² <https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird81900>

³ <https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird81920>

What costs qualify?

Listed below are the more common **qualifying costs** for R&D relief purposes.

Employee costs – that is, employing staff directly who are actively engaged in carrying out the R&D itself. For example a company will normally include in its R&D claim the R&D portion of salary costs of the Chief Scientific Officer and their staff and a relevant percentage of the costs of other staff directly supporting R&D related activities.

Externally Provided Workers – individuals working under the direction of the company. The payment must be to an agency or personal service company and not directly to the individual. The qualifying cost is restricted to 65% of the amounts paid.

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 items such as telecommunication or data costs.

Payments to clinical trials volunteers – the cost of any payments to subjects of clinical trials.

Utilities – power, water, fuel used directly in carrying out R&D.

Software – computer software used directly in the R&D.

Subcontracted R&D expenditure – the claim can also include 65% of what the company spends on R&D activities carried out by a subcontractor. The subcontractor does not need to be a UK resident and there is no requirement for the subcontracted R&D to be performed in the UK. Equally, the actual work carried out by the subcontractor need not be R&D when looked at in isolation. For example a company might, as part of its R&D activities, need to subcontract analytical testing of a material to another person. 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 the claimant company, because it is one component of a larger project that is R&D.

How much can I claim?

Under the SME scheme, the total qualifying costs are 'uplifted' or multiplied by 230%, to provide an increased UK Corporation Tax deduction - that is, for each £100 of qualifying costs, the company can reduce its Corporation Tax bill by an additional £130 on top of the £100 spent. Two examples are given on the next page.



Example 1 – R&D relief for expenditure of £1,000,000 where the company has made an accounting loss of £2,000,000

Calculation step	Amount
R&D expenditure	£1,000,000
R&D enhancement	$£1,000,000 \times 130\% = £1,300,000$
Normal trading loss	£2,000,000
Trading loss enhanced by R&D Relief	$£2,000,000 + £1,300,000 = £3,300,000$
Loss available to carry forward or back for Corporation Tax purposes	£3,300,000

Alternatively, if your company makes a loss, you can choose to receive your tax relief by way of cash tax credits - a cash sum paid to you by HMRC, as per example two below. In this case 230% of the R&D spend is surrendered to HMRC in exchange for cash of 14.5% of 230%.

Example 2 - Converting R&D Relief on expenditure of £1,000,000 to a tax credit payment

Calculation step	Amount
R&D expenditure	£1,000,000
R&D enhancement	$£1,000,000 \times 130\% = £1,300,000$
Normal taxable loss	£2,000,000
Trading loss enhanced by R&D Relief	$£2,000,000 + £1,300,000 = £3,300,000$
R&D loss surrendered	£2,300,000
Payable tax credit	$£2,300,000 \times 14.5\% = \mathbf{£333,500}$
Losses available to carry forward or back	£1,000,000

The loss which can be surrendered is the lower of the tax loss for the year (as enhanced by R&D relief) and 230% of the qualifying R&D spend.

Does it matter if I also receive subsidies and grants?

If a company has received a subsidy or grant for an R&D project, this may affect how much tax relief it can claim. If the subsidy or grant is a 'notified State Aid' then the company cannot claim any expenditure on that particular project under the SME Scheme. For any other type of subsidy or grant, the R&D expenditure included in the SME claim is reduced by the amount of subsidy or grant received. Two examples are provided below.

Amounts normally received from Innovate UK, such as Biomedical Catalyst grants and Innovation Loans, meet the definition of State Aid and prevent a claim on that particular project under the SME R&D relief scheme.

An EU Grant does not usually meet the definition of State Aid as it is received directly from the EU and not a member state. A company may claim R&D relief on qualifying expenditure less the amount received from the EU.

The expenditure which cannot be included in the SME claim can be included in a claim under the less generous R&D Expenditure Credit ('RDEC') scheme, which is explained further below.

HMRC may consider collaboration agreements or other full-time equivalent reimbursement as a subsidy and hence it is always worthwhile obtaining specialist advice in this area.

Can I claim if I am conducting sub-contracted work?

One of the conditions for a company to make a claim under the SME scheme is that the expenditure is not incurred in carrying on R&D activities as a subcontractor for someone else. Instead, it must be R&D work done on the company's own account. However a claim can be made under the RDEC scheme.

Collaboration agreements may be considered by HMRC to represent a sub-contractor relationship and hence could potentially restrict the ability to claim R&D credits.

What is the R&D Expenditure Credit ('RDEC') scheme?

The RDEC scheme is for large companies but can apply to SMEs in some circumstances. A company is considered 'large' by exception and is eligible for the RDEC:

- if it fails to satisfy the SME conditions as detailed above by virtue of size; or
- for R&D which is subsidised; or
- for R&D sub-contracted to the company by other parties.

Depending on whether the company is profit or loss making the credit may be used to discharge a Corporation Tax liability or receive a cash payment. For qualifying R&D expenditure incurred from 1 January 2018 the credit will be given at 12%, or 11% if before that date. The credit is taxable, so the amount received will be reduced by the relevant tax rate at that time.

Qualifying expenditure is largely the same under both regimes, but one notable difference is only R&D sub-contracted to a qualifying body (such as a hospital or university), an individual, or a partnership (where the partners are individuals) can be included in the claim. The costs paid to an individual who operates through their own company cannot be included. Qualifying subcontractor costs under RDEC are included at 100% and not restricted to 65%.

Further guidance on what types of expenditure qualifies and how to claim RDEC can be found at on the HMRC website.⁴

When and how do I claim?

A claim is made in the company's Corporation Tax Return. The normal time limit for making the claim is two years after the end of the relevant Corporation Tax accounting period.

Although it is not a legal requirement, HMRC encourages companies to:

- tell them why the company considers its project(s) to be allowable as R&D (as defined in the section above) and
- provide a summary of the costs incurred on the R&D and how the figures in the return were arrived at.

In addition, it is recommended that the company confirms to the Revenue that:

- It has read the R&D guidelines;
- It is an SME, given its ownership and group structure; and
- It has not received any grants or subsidies. If any grants or subsidies have been received, details of how they have been included in the claim should be provided.

How can I be sure my R&D project costs will qualify before I claim?

HMRC have now introduced advance assurance for companies applying for R&D relief under the SME scheme. Advance assurance gives companies a guarantee that their R&D claim will be accepted by HMRC provided it is on the basis agreed in advance with HMRC. The assurance will cover the first three accounting periods of the company. Further guidance on the requirements can be found on the HMRC website.⁵

What happens if HMRC dispute my claim? Who can I talk to for help?

Many issues can be discussed with HMRC if the company knows the identity of their Corporation Tax Inspector.

Alternatively you can contact the BIA on 020 7630 2180.

If we cannot answer your question directly, we have a number of contacts who we can refer you to.

⁴ <https://www.gov.uk/guidance/corporation-tax-research-and-development-tax-relief-for-large-companies>

⁵ <https://www.gov.uk/guidance/research-and-development-tax-relief-advance-assurance>

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