



Where Credit's Due: Getting the Most from R&D Tax Credits

Wouldn't it be great if the taxman gave you money for investing in new products and services? Well, that's just what happens under a Government scheme called R&D Tax Credits. West Midlands ICT SMEs can benefit from this scheme – provided they persevere with the paperwork and keep good records.

What are R&D tax credits?

R&D tax credits are a Government incentive in the form of tax relief designed to encourage businesses to invest more in research and development (R&D). They can either reduce a company's tax bill, or for some small or medium-sized companies not in profit, provide a cash sum.

The aim of the tax credits is to encourage companies to invest more in business R&D, hence resulting in an improvement in the rate of innovation in the UK. Since the tax credits were introduced in April 2000, over 18,000 claims have been made with over £1.3bn of support claimed by R&D companies.

How do R&D tax credits work?

The R&D tax credit works by allowing companies to reduce their corporation tax bill against qualifying expenditure on R&D activities. All companies spending over £10,000 per annum on R&D (as defined for tax purposes) are entitled to a deduction when calculating their taxable profits of:

- 150% of qualifying expenditure for small and medium-sized companies, and
- 125% of qualifying expenditure for larger companies.

There is no upper limit on the amount of the claim.

Almost all significant R&D activity carried out by SMEs is undertaken by companies. Hence, the tax credit is not available to individuals or partnerships.

What is qualifying R&D?

A basic definition is "work to resolve scientific or technological uncertainty aimed at achieving an advance in science or technology".

Advances include new or improved products, processes and services.

To qualify for the tax credit, the R&D must be treated as R&D under generally accepted accountancy practice, and fall within the guidelines on the meaning of R&D for tax purposes issued by the Secretary of State for Trade and Industry.

What is qualifying expenditure for R&D tax credit purposes?

Companies can claim R&D tax credits for their revenue expenditure on:

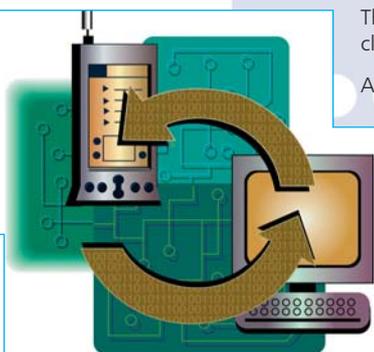
- employing staff directly and actively engaged in carrying out R&D;
- paying a provider for staff provided to the company who are directly and actively engaged in carrying out R&D;
- consumable or transformable materials used directly in carrying out R&D (broadly, physical materials which are consumed in the R&D); and
- power, water, fuel and computer software used directly in carrying out R&D.

Since claims relate to specific accounting periods it is necessary to prove start and end dates. Good written records are essential for this. Documenting the work will also help prove to HM Revenue and Customs that it qualifies as R&D in terms of factors such as 'appreciable improvement' and 'uncertainty'.

What are the main characteristics of the two R&D tax credit schemes?

The main differences between the SME and large company schemes are listed in the table below.

For SMEs, the most important criteria are how the R&D is funded. You cannot claim credit for any expenditure funded by someone else, such as another business. And you must not have been contracted to carry out the activities. However, you may still be able to make a claim under the large company scheme.





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SME scheme	Large company scheme
150% rate of enhanced deduction	125% rate of enhanced deduction
Payable credit at £24 for every £100 of qualifying expenditure on R&D	No payable credit
Company can claim for expenditure on R&D it sub-contracts to others	Company can only claim for expenditure on R&D it carries out itself, unless it sub-contracts R&D to universities, charities or public sector research establishments
Company cannot claim for contributions to independent research	Company can claim for contributions to independent research
Claim can be reduced if the R&D project is subsidised or a grant is received in respect of it	No reduction for grant or subsidy
Company must own the intellectual property arising out of the R&D	Company need not own the intellectual property arising out of the R&D

How can I claim the tax credit?

A company claims R&D tax credits in its company tax return (Form CT600). For your first claim, you may want to seek professional advice.

Note, a claim for SME R&D tax credits cannot be made for a project funded under the DTI's Grant

for R&D programme (Research Project grants and Development Project grants). However, a claim can be made for such projects under the 'large company' R&D credits scheme, including R&D funded by this grant, subject to meeting all the general eligibility criteria.

Case Study: When is R&D not 'R&D'?

A company investigates a potential opportunity for a new type of DVD player. Market research to inform this assessment is not R&D. However, the company identifies a potential project to create a DVD player incorporating a number of technological improvements which its R&D staff (who are competent professionals) regard as genuine and non-trivial. This project would be seeking to develop an appreciably improved DVD player and would therefore be seeking to achieve an advance in science or technology.

Elements of the development activities which directly contribute to resolving the project's scientific or technological uncertainties (such as the system uncertainty associated with an improved control mechanism for the laser that 'reads' the DVD) are R&D. Other elements of the plan which do not contribute directly to resolving the project's scientific or technological uncertainties – such as obtaining intellectual property protection or cosmetic design decisions – do not qualify as R&D.

The scientific or technological work culminates in the creation of a series of prototype DVD players, and ultimately a 'final' prototype is produced and tested which possesses the essential characteristics of the intended product (circuit board design, performance characteristics, etc.). All the activities which directly contributed to resolving the scientific or technological uncertainty of creating the DVD player up to this point (such as the testing of successive prototypes) are R&D. Similarly, adjustments made to the prototype as a result of consumer testing qualify as R&D if they involve substantial changes (i.e. there is scientific or technological uncertainty).

Useful Links

Detailed information about the R&D tax credits is available from **HM Revenue & Customs**, www.hmrc.gov.uk/randd/. Information is also available from your local tax office, trade associations and professional networks, and company accountants and financial advisers.

Business Link, in partnership with HM Revenue and Customs and DTI, has developed a new interactive tool to help companies assess their eligibility: see www.businesslink.gov.uk