Client Resource

# Research and Development and Patents Tax Incentives

A guide for clients

BWM, Castle Chambers, 43 Castle Street, Liverpool, L2 9SH
www.bwm.co.uk 0151 236 1494

### R&D and patents

Research and development (R&D) and patent expenditure are treated generously for tax purposes.

The main provisions are:

- R&D relief
- Capital allowances for R&D
- the patent box.

### What is R&D?

Tax relief in respect of qualifying R&D expenditure by limited companies has been available since April 2000 for SME's but take up rates on these credits has been surprisingly low, largely due to many businesses being unaware of what qualifies as R&D expenditure.

For accounting purposes, R&D is largely defined as expenditure that cannot qualify for tax relief unless it can first be accounted for as R&D against certain standards. Although this is the primary starting point, expenditure qualifying as R&D under UK GAAP does not automatically qualify for R&D tax relief as there is a wide range of tax guidance and legislation which must be satisfied.

### R&D projects

The key to a successful R&D tax relief claim is being able to prove to HMRC that the particular project falls within the definition of R&D established by the BSI guidelines (which came into effect on 1 April 2004).

This definition can be summarised as: activities which directly contribute to achieving an advance in science or technology through the resolution of technological or scientific uncertainty.

This can include the adaptation of knowledge or capability from another field of science or technology in order to make such an advance where this adaptation was not readily deducible.

The aim of the R&D project can be to create a new product, a material, or change or improve a process. For example, finding a way of speeding up a production line.

Many innovative ideas don't actually work. That doesn't matter; a failed R&D project still qualifies for tax relief.

As long as the company can show it was pushing the boundaries of knowledge or capability in the fields of science or technology (not just for the particular company), the project should qualify for R&D tax relief.

Computer programming projects can qualify as R&D, especially where the company is striving to make previously unrelated computer systems work together.

The key to qualifying as R&D is that no one else has done it yet or if they have attempted to solve the same problem, their work hasn't been made public.

**Tip**

If your company has not made an R&D claim before, make sure to apply for advance assurance from HMRC to check whether the R&D project and the company will both meet the conditions for the relief. We can help you with this.

**Costs**

Not all costs incurred during an R&D project will qualify for relief. The qualifying costs are broadly those which fall into the following categories:

- direct staff costs (but not employment related benefits)
- consumables
- software
- payments to clinical trial volunteers.

In addition, 65% of the costs can be claimed on subcontracted R&D work or externally provided staff.

Capital expenditure, and rent for premises do not qualify for relief.

**Who can claim?**

Only companies can claim R&D tax relief; it is not available to unincorporated businesses.

The company must have no more than 500 employees and satisfy one or both of the following conditions in the current accounting year or the previous year:

- annual turnover of no more than €100 million
- balance sheet total of no more than €86 million.

The company must also be a going concern at the time the R&D claim is made. If its last published accounts were prepared on a going concern basis, and nothing in the accounts suggests that its trading status depends on its receiving R&D relief or tax credits, HMRC will accept that this condition is met.

A company in administration or liquidation cannot make a claim to R&D relief.

The company does not have to spend a minimum amount on R&D projects in the accounting period in order to claim R&D relief.

**R&D relief**

Additional relief is available for certain R&D expenditure. This relief is sometimes called a 'super-deduction' as the amount allowed exceeds the actual expenditure. This relief may be claimed by a company of any size, provided it is carrying on a trade or intends to carry on a relevant trade after incurring the expenditure. The R&D must be relevant to the trade.

The treatment depends on whether a company is defined as 'large' or 'small or medium-sized' (SME). Large companies may claim tax relief amounting to an additional 30 per cent of qualifying expenditure incurred. SMEs may claim an additional 130 per cent. Thus R&D expenditure may be worth deductions of 130 per cent and 230 per cent respectively (previously 225 per cent pre April 2015).

A SME may claim the additional relief against profits. Alternatively, in loss-making circumstances it may be able to surrender some or the entire claim for a cash payment known as the R&D tax credit. The applicable the rate is 11 per cent. This means that a company with a £100,000 claim can either:

- offset it against profits taxed at 20 per cent – saving £20,000 tax
- claim R&D credit of 14.5 per cent – a cash payment of £14,500

In practice, the company usually claims the cash payment only when it has yet to make a profit.

Until 31 March 2016, a large company can choose whether to claim the additional relief as a super-deduction (as above), or claim above-the-line credit. For claims from 1 April 2016, only the latter is available.

Above-the-line credit is given as 11 per cent of the expenditure. It increases the reported profits, making the tax benefit more obvious in the accounts.

The latter system can be more generous as the following example shows:

A company spends £5 million on a R&D project, of which £3 million is eligible for R&D relief. The project generates £7.2 million income. The main rate of corporation tax is 20 per cent.

| | **Super-deduction** | **Above-the-line** |
|---|---|---|
| | £,000 | £,000 |
| Turnover | 7,200 | 7,200 |
| R&D expenditure | (3,000) | (3,000) |
| Above-the-line credit (at 11 per cent) | - | 330 |
| Other expenditure | (2000) | (2000) |
| Profit | 2,200 | 2,530 |

***We can make sure that you claim the maximum amount of allowable R&D relief.***

**R&D capital allowances**

All allowable expenditure qualifies for a first year allowance of 100 per cent. Thus the whole of the expenditure may be deducted from taxable profits in the year the expenditure is incurred. This allowance is in addition to capital allowances for plant and machinery.

### Costs of patents and know-how

A company may acquire a patent or pay for a licence to use a patent. For tax purposes, these are treated similarly. The cost of obtaining your own patent is not included within the scope of the R&D regime referred to above, but will usually qualify for tax relief under other tax provisions.

Similarly, a company may pay to acquire know-how. Know-how includes industrial information and techniques used in manufacturing, mining or agriculture but excludes commercial information such as client lists. It can include information about marketing, packaging and distribution.

Such expenditure is regarded as intellectual property. This expenditure can be written off over several years. In general, the tax treatment follows the accounting treatment.

***We can advise you on how to show such expenditure in your accounts and tax returns.***

### Patent box

The patent box is a regime which allows companies to pay less tax on income derived from patents (and from similar botanical and medical innovations). Use of the patent box is voluntary.

The patent box regime is being phased in over five years starting from 1 April 2013, with 60 per cent of the benefit available in that year, increasing by 10 percent each year. When fully introduced, the regime will impose an effective corporation tax rate of 10 per cent on the relevant income. The company calculates its taxable profit in the usual manner and then subtracts a figure. The legislation allows the 10 per cent rate to be changed.

There are strict rules to ensure that only qualifying income is subject to the regime. In particular, the rules are designed to exclude:

- income the company would have earned if it had not held the patent (or equivalent)
- value attributable to the brand rather than the patent.

The scope of income subject to the regime is wide. It may include:

- licensing or sale of the patent rights
- sales of the patented invention
- sales of products that include the patented invention
- use of the invention in the company's trade
- proceeds or compensation for patent infringement.

The patent box is intended primarily for patents registered with the UK Intellectual Property Office or the European Patent Office. However, the scope is wide enough to include other forms of intellectual property such as plant variety rights and supplementary protection certificates. It also includes inventions for which a patent would have been issued but for national security considerations. It is also possible to claim if a company holds licences to use third party technology, although in practice this option is limited.

Income extends to parts intended for a product incorporating a patent even though the part itself is not patented. An example provided by HMRC is a bespoke but non-patented ink cartridge for a computer printer that is subject to a patent.

The calculation of relevant intellectual property profits then involves seven steps set out in tax law. There is an alternative small claims election that may be made for companies whose profits are small. There is also another alternative approach known as streaming and, in some circumstances, this can be mandatory.

The above is a very brief summary of a complex regime. It is intended merely to help you consider whether you may be entitled to benefit from these reliefs.

**Record Keeping**

There's no specific record keeping requirement for R&D tax relief claims. But the general Corporation Tax requirement to keep sufficient records to support the entries on your Corporation Tax return still applies.

HMRC doesn't expect you to create new primary business records just for an R&D tax relief claim. But you may need to maintain your business records in a different way, so you can access the information you need easily.

Before you make your claim, you may want to involve your R&D staff in the process. This will help you identify qualifying activities and expenditure.

HMRC may ask to see your company or organisation's records when they make a compliance check into your Corporation Tax return or R&D tax relief claim made separately from a return.

You can read more detailed guidance on keeping records for R&D claims in the Corporate Intangibles Research and Development Manual on the HMRC website: www.gov.uk/hmrc

**Advance assurance**

HMRC is keen to encourage more companies to apply for R&D tax relief by providing them with an advance assurance that their company will qualify. This procedure can be used by small companies which haven't claimed R&D tax relief before, and which have:

- fewer than 50 employees; and
- annual turnover of no more than £2 million.

However, where the company is part of a group the tax history for the group must be examined. Where another member of the group has claimed R&D tax relief in the past the advance assurance won't be given. This doesn't bar the company from claiming R&D tax relief, it just blocks access to the advance assurance procedure.

The main benefit of advance assurance is that the company has a guarantee that HMRC won't raise further questions about the initial R&D claim, and for R&D claims submitted for the next 2 accounting periods. It is effectively a guarantee that R&D claims will be accepted for 3 consecutive accounting periods. We can help you with this advance assurance process.

**Making a claim**

The R&D tax relief claim should be included on the company's corporation tax return. There is detailed guidance on which boxes of the return to complete for this claim within HMRC's guide: research and development tax relief. Again this is an area where our experts can help you.

**Deadline for claims**

The deadline for submitting a claim for R&D tax relief is 2 years from the end of the accounting period in which the costs were incurred.

Before submitting an R&D tax relief claim for an earlier year, calculate whether that claim will create a trading loss for the year. If a loss is expected, the company should consider disclaiming capital allowances for that year or for a later year, in order to use the loss created by the R&D tax relief claim.

A capital allowance claim can be made or amended within 2 years of the end of the relevant accounting period, the same period during which the R&D tax relief claim can be made.

**How BWM can help you**

We can:

- Help you to interpret the qualification criteria – many companies incorrectly rule themselves out by failing to recognise qualifying activities and costs.
- Pull together a detailed and comprehensive claim that is based on proven experience and success.
- Submit the claim, track progress from start to finish and answer any HMRC questions or information requests.

Speak to us to find out whether your company qualifies for a share of these funds. It does not need to be something radical, it may be that you develop your own products or services, or aim to appreciably improve or enhance existing products, processes or services with the uncertainty of whether they will be a success.

**Please contact John Elliott for more information.**

**FOR GENERAL INFORMATION ONLY**

Please note that this helpsheet is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

## About Us

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We are one of the leading, independent chartered accountancy practices in Liverpool. At BWM we provide a wide range of accountancy and business support services to organisations and individuals throughout the North West of England and beyond. Our experienced and skilled partners and their teams are ready to support you with high quality, individual yet affordable services however complex your personal or business needs.

For more details of how we can help you transform your business, please visit www.bwm.co.uk or call us on 0151 236 1494