

# ACTIVE PRACTICE UPDATES

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# STERLING GROVE

## R&D TAX CREDITS IN PRACTICE

Tax breaks for innovative businesses.

The UK tax system is complicated but research and development (R&D) tax credits can be especially tricky to understand.

That's partly because what counts as R&D, and what amounts to true innovation, is judged on a case-by-case basis against criteria that can seem almost abstract.

For example, to qualify as R&D for tax purposes, your project must contribute to a wider understanding in a particular field. It can't just be a superficial change to existing technology.

Clearly, making this judgement requires expert scrutiny. There's simply no way to run it as an automated box-ticking exercise.

At the same time, the validity of your claim depends on what else is going on in your sector.

Even a claim that is perfectly valid in its own right can be cancelled out if another company turns out to have done essentially the same work, reaching a similar solution.

Understanding what may or may not be in scope is perhaps best explained with case studies and examples, but first what exactly are R&D tax credits?

### A QUICK GUIDE TO R&D TAX CREDITS

In their present form, R&D tax credits allow small companies to deduct an extra 130% of their qualifying costs from any profits, on top of the existing 100% of qualifying costs that can usually be deducted – a total potential deduction of 230%.

This relief was launched by the UK government in 2000 with the intention of boosting innovation.

The idea was to encourage businesses already working in this territory and, more importantly, to incentivise those not already actively pursuing innovation.

Successive governments have held this ambition because it's in everybody's interest to position Britain as an economy built on technology, engineering and design rather than on manufacturing industries, as in the past, or on services and retail, as seemed to be the previous direction of travel.

They wanted to see more firms like electrical appliance giant Dyson and Arm, the Cambridge-based company that makes computer chips used in electronic devices around the world.

Your claim for R&D tax credits is made as part of your annual corporation tax return. It then takes typically around 30 working days to process that claim.

In practice, it might take much longer if your business is large, if your claim is especially contentious, or if HMRC has had a high volume of R&D tax credit claims in a given year.

Fortunately, there is also an option to run your first claim past the Revenue in draft form to get an initial read-out of whether it's a non-starter, potentially saving everyone a lot of time.

### COULD YOU CLAIM R&D RELIEF?

To claim R&D tax relief under the SME scheme, your company should have a turnover of no more than €100 million or less than €86m on the balance sheet, and you will need less than 500 full time staff. You don't have to be in the technology or engineering sector to be an innovator.

As long as your company undertakes scientific or technological projects developing new products or processes, or substantially improving existing ones, it's possible you might be eligible for R&D tax breaks.

Regardless of the sector you work in, there are some questions you can ask yourself that will give you a rough idea of whether your work might be eligible.

First, does your research intend to achieve a technological advance? To qualify for relief, it can't just be about tinkering, cosmetic improvements or superficial innovations.

A new shape for an existing product is unlikely to count, even if that is 'commercially innovative', and your work can't be about advances in economics, social sciences, arts or humanities.

Secondly, does it achieve an advance in overall scientific or technological knowledge? Unless people outside of your business learn from your work and build upon it, then it probably won't qualify for R&D tax relief.

Thirdly, and arguably most importantly, does the project address an uncertainty that a knowledgeable professional in your field couldn't quickly and easily work out for themselves?

In plain terms, reaching a solution has to be hard work or need painstaking research and you ought to go into it unsure of success – you should know what you want to achieve, but not whether it is scientifically possible or feasible.

If you answered 'yes' to the above, your project may be viable and your business could get a well-earned financial boost.

There are various other technicalities to bear in mind, however, and the best thing to do is sit down with one of our experts who can talk through the qualifying criteria in full.

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## EXAMPLES

In 2004, Andre Geim and Kostya Novoselov of the University of Manchester succeeded in producing sheets of graphene – a substance only a single atom thick, 300 times stronger than steel, nearly transparent and amazingly good at conducting heat and electricity. The global market for graphene is expected to be worth something like £170m by 2025.

In that context, it's no wonder the development of advanced materials is one area for research focused on innovation.

Imagine a company that ships bananas. The management team realises it could save on shipping costs, and reduce its carbon footprint, with a light, biodegradable plastic substitute that helps control ripening, using banana fibres from its own waste.

It sells this material to other businesses specialising in handling delicate fruit requiring controlled ripening, such as avocados.

For R&D purposes, the innovating company might incur qualifying expenditure in overcoming uncertainty during development of the new material.

If it undertakes further research to improve the performance of this new packaging material in wet environments, the cost of this extra work might qualify for further relief.

More generally, research which leads to environmental benefits is likely to be looked upon favourably.

At the other end of the scale, from the physical to the virtual, it is also possible to claim R&D credits for software development.

This can seem especially complicated to non-experts, however, because there is no physical product – no 'invention', in traditional terms.

That means that, by definition, HMRC has to assess how innovative, or otherwise, a body of code might be.

The example it gives is of a game developer devising a new system for the interaction of 3D objects on screen which reduces the amount of code and processing power required to achieve the same output.

That's an underlying improvement – not just about how the game looks or its gameplay mechanism.

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## DON'T FORGET THE RDEC

If your business is too big to qualify for the SME scheme, or is ineligible because you are a subcontractor undertaking work on behalf of another company, there is another R&D tax break to which you might be entitled.

The research and development expenditure credit (RDEC) scheme came into effect in 2015 and offers a taxable credit at 12% of qualifying R&D expenditure for certain companies engaged in R&D but ineligible for the SME scheme.

There are seven steps to determine how the Revenue will deal with the RDEC.

In summary, HMRC will look to offset it to discharge any existing tax liabilities the company has and when such avenues have been exhausted will pay the balance remaining as a cash credit to the company.

It's limited to PAYE and the national insurance liabilities of the staff included in the RDEC claim.

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## GIVE IT SOME THOUGHT

Because R&D tax relief is complicated and abstract, it can really help to talk it through with us.

At its best, this incentive can help companies identify new opportunities and, indeed, completely change course.

 [Talk to us about R&D tax credits.](#)