

Update on research and development tax relief

October 2009



Significant changes are currently taking place to the UK research and development (R&D) tax relief regime mainly as a result of new draft guidance issued by HM Revenue & Customs (HMRC).

This new guidance will replace the existing guidance within the Corporate Intangibles Research & Development (CIRD) manual. The draft guidance is currently under consultation and whilst no changes are expected to the legislation, the new guidance is expected to have a significant impact on many claimants. This R&D update outlines the main changes.

Qualifying indirect activities

HMRC has taken a change of view on the type of activities that qualify for R&D tax reliefs. Previously it was only accepted that activities directly contributing to the R&D qualified for relief. HMRC now accepts that qualifying indirect activities (which are activities which form part of an R&D project, but do not directly contribute to the resolution of the scientific or technological uncertainty) can be included in a company's R&D claim. Examples of qualifying indirect activities are:

- time spent by R&D staff in training related to the R&D;
- the time a maintenance engineer spends repairing equipment used in the R&D (but not time spent maintaining production equipment);

- secretarial time spent supporting the R&D staff (but not time spent supporting those undertaking indirect activities such as the maintenance engineer or non-R&D personnel);
- finance and payroll activity to the extent it relates to the R&D staff.

HMRC has confirmed that if a company is within the statutory time limit for amending a claim, then a claim already submitted can be amended to include qualifying indirect activities. A company is entitled to make or amend an R&D claim within two years of the accounting period end, for example, a company with a 31 December year end is still within the deadline to amend R&D claims made for the year ended 31 December 2007. Final guidance on how claims will be made is still under consultation.

This is a much welcomed change from HMRC and for many companies carrying out R&D this could substantially increase the level of their R&D tax relief claims. Many companies could benefit from a cash tax saving either by way of a tax refund from HMRC or additional tax credits as part of the small and medium-sized enterprise (SME) tax credits.

Production

The legislation in relation to the meaning of R&D (as per the Department for Trade and Industry (DTI) guidelines) has always stated that production activity does not qualify for R&D relief. What is unclear, and remains unclear following the issue of the draft guidance, is precisely what 'production' comprises. The new draft guidance includes a purpose test whereby if a purpose is production then the whole of the activity will be disqualified irrespective of whether the outcome is successful or not. This is best illustrated by an example:

A business is seeking to make working prototypes which if successful will be delivered to a customer. Under the new guidance, the labour and material cost in making the prototype will be disqualified for relief even in the situation where the development of the prototype is unsuccessful.

This is a change from existing practice and in some situations may exclude the sort of activities that result in development of technology. We have raised these concerns with HMRC.

SME update: Intellectual property vesting

Under the SME regime, one of the key requirements to qualify for relief is that the intellectual property (IP) generated from the R&D expenditure "vests in the company, alone or with others".

The revised draft guidance on the application of the legislation seems to suggest a tightening up of the rules in relation to IP ownership. For example, the new guidance states that where a patent has been filed in relation to

R&D, a claim can only be made if the claimant continues to hold the existing patent. This could affect just the types of business that the SME R&D tax relief rules are aimed to help, particularly in the biotech sector.

Take a situation where a professor undertakes research creating new knowledge which they then protect by filing a patent. A company may then be formed to continue the research under licence. Based on the draft guidance, the new company would not be able to make a claim as it does not own the existing patent.

We have informed HMRC of our concerns regarding the proposed changes to the guidance and we understand this part of the redraft of the guidance has for now been put on hold.

GAAP

The R&D legislation states that the R&D definition is derived from GAAP (SSAP 13 being the relevant UK accounting standard) and then modified for tax purposes by the definition within the DTI guidelines.

Traditionally, HMRC and claimants have generally only focused on the DTI guidelines when determining whether an activity is R&D. The new guidance seems to suggest that a stronger emphasis is now being placed on the GAAP definition of R&D and, whilst it is not necessary for a GAAP disclosure to be included in the accounts, it appears that HMRC may start to look at R&D in light of both definitions. We are not expecting this to impact on many claims as the definitions are very similar.

If you believe your R&D claims could be affected by any of these issues, please contact your local PwC R&D tax adviser or one of the individuals in your area listed below:

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