Client Resource

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The tax benefit for innovative companies

A guide for clients

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The lowdown on this relief for innovation.

Research and development (R&D) tax credits were once a little-known tax incentive for companies which invested in innovation. But after rule changes in recent years, and a push by many tax advisers, they are now much more widely understood and used.

They may no longer be much of a secret, but they are still a remarkably effective way for innovative companies to get something extra back from the tax system. Here's a look at how they work, what the benefits are and what the future might hold for R&D tax credits.

There are two R&D tax credit schemes – nominally, one for smaller companies called the SME scheme, and one for larger companies called RDEC (that's short for research and development expenditure credit).

Actually, RDEC can also be of use as a fallback option to smaller companies that do not qualify for the SME scheme on a technicality.

The SME scheme

The definition of an SME in R&D terms may surprise you. It is a company with fewer than 500 employees, and either less than €86 million in gross assets or €100m in turnover.

As you can imagine, by this standard, most companies in the UK are SMEs. And the good news is that the SME scheme is more generous than RDEC.

If you make a profit, it allows you to claim back on average an extra 25p in the pound for qualifying R&D expenditure, and potentially as much as 33p in the pound if you are loss-making.

So if you spent £20,000 on qualifying R&D, that would equate to a £5,000 R&D tax credit benefit if you were in profit and a £6,600 benefit if you made losses. Very handy for cashflow and reinvestment in the business – and average SME claims are actually much higher. In 2018/19 the average was worth £57,228.

You may be able to hire a new technical expert to help with future R&D or invest in new equipment with this windfall.

RDEC

If you employ more than 500 people, and either have more than €86m in gross assets or €100m in turnover, then RDEC is for you.

RDEC provides a flat rate benefit of 13% for qualifying expenditure, regardless of whether you make a profit or a loss. Because it is primarily for larger companies, the expenditure (and therefore the cash sums involved) tend to be bigger.

So if you spent £1m on qualifying R&D, you would be able to claim back £130,000. In 2018/19 the average RDEC claim was worth £632,931.

How does my company qualify for R&D tax credits?

You have to be a limited company, and you have to be spending money on research and development. This is because the benefit is administered through the corporation tax scheme and is calculated as an enhanced deduction on your expenditure.

As R&D tax credits are claimed through the tax return, they are received retrospectively to the R&D activity taking place. You can claim back for two consecutive accounting periods, so if it is your first claim but you have been innovating for some time, fear not. You can get two years' worth of R&D tax credits at once.

Assuming you meet the above criteria, the next two questions should be: "What counts as R&D?" and "What expenditure can I include?".

What counts as R&D?

The answer to the first question is the eye-opening part, and why this tax incentive has been so underused previously. For tax purposes, research and development is not limited to rocket science, white-coat lab research – far from it.

HMRC's definition of R&D is that you are taking a risk in trying to resolve scientific or technological uncertainty. This means limited companies in just about any sector have the potential to be carrying out qualifying R&D if they are being innovative. For example, you could be:

● A food manufacturer trying to modify an existing recipe to make it vegan.

● A digital agency trying to build a new app which connects to a complicated legacy system.

● An engineering firm experimenting with materials to meet a new specification.

● A virtual reality hardware designer trying to overcome feelings of motion sickness in users.

You can think of the risk and uncertainty elements in the definition as being that your research and development project might not work. Interestingly, this means your innovation does not have to be successful for it to qualify – so you can recover some costs on a failed project.

Don't overlook that there has to be a technological or scientific element to your project. However, the innovation can be in modifying existing products, services or processes as well as developing new ones.

What expenditure can be included in a claim?

Once you have identified that qualifying R&D is taking place, the next job is to work out which costs can be included in your claim.

The biggest costs which can be included are often the staffing costs. You can calculate the proportion of relevant people's salaries, employer's national insurance, pension contributions and reimbursed expenses. And you can add to that freelancer or subcontractor costs associated with the project.

Then you can consider the materials and consumables (like power, light and heat) which are used up or transformed during the R&D process. Some types of software costs can also be included.

If relevant, payments to people taking part in clinical trials are within the scope too.

The future for R&D tax credits

The Autumn 2021 Budget included some tweaks to the R&D tax credit schemes.

The bigger picture is that they are not under threat, with the Chancellor reaffirming a commitment to increase Government R&D expenditure from 0.7% of GDP in 2020 to 1.1% of GDP in the future. This included sticking to a target of spending £22 billion per year by 2026/27.

Rishi Sunak also announced that from April 2023 both cloud computing and data storage costs would be added to the list of qualifying expenditure which is good news for many claims. However, he is limiting the schemes to R&D conducted in the UK, whereas previously it was available for worldwide costs.

There has been a growing concern from HMRC (and amongst the wider industry) regarding the extent to which the R&D tax credit schemes are being abused by fraudulent claims. HMRC has already bolstered its R&D tax credit team with new tax inspectors to put more claims under scrutiny.

One proposal from the Government is that companies are required to pre-notify HMRC of their intention to claim R&D tax credits for their innovation. This has been met with resistance from professional bodies.

They agree that something needs to be done to crack down on abuse, but fear that advance notification will disproportionately impact smaller and newer firms. This is because, in many cases, they will not have the resources or know-how to act in time.

We await confirmation of the action that HMRC will take.

If you would like help identifying whether you are doing qualifying R&D and submitting a claim, contact us.

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