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# R&D Tax Benefits for Small and Medium-Sized Enterprises



# Contents

Introduction

What is the relevance of establishing SME status?

How is SME status defined?

What benefits are available under the scheme?

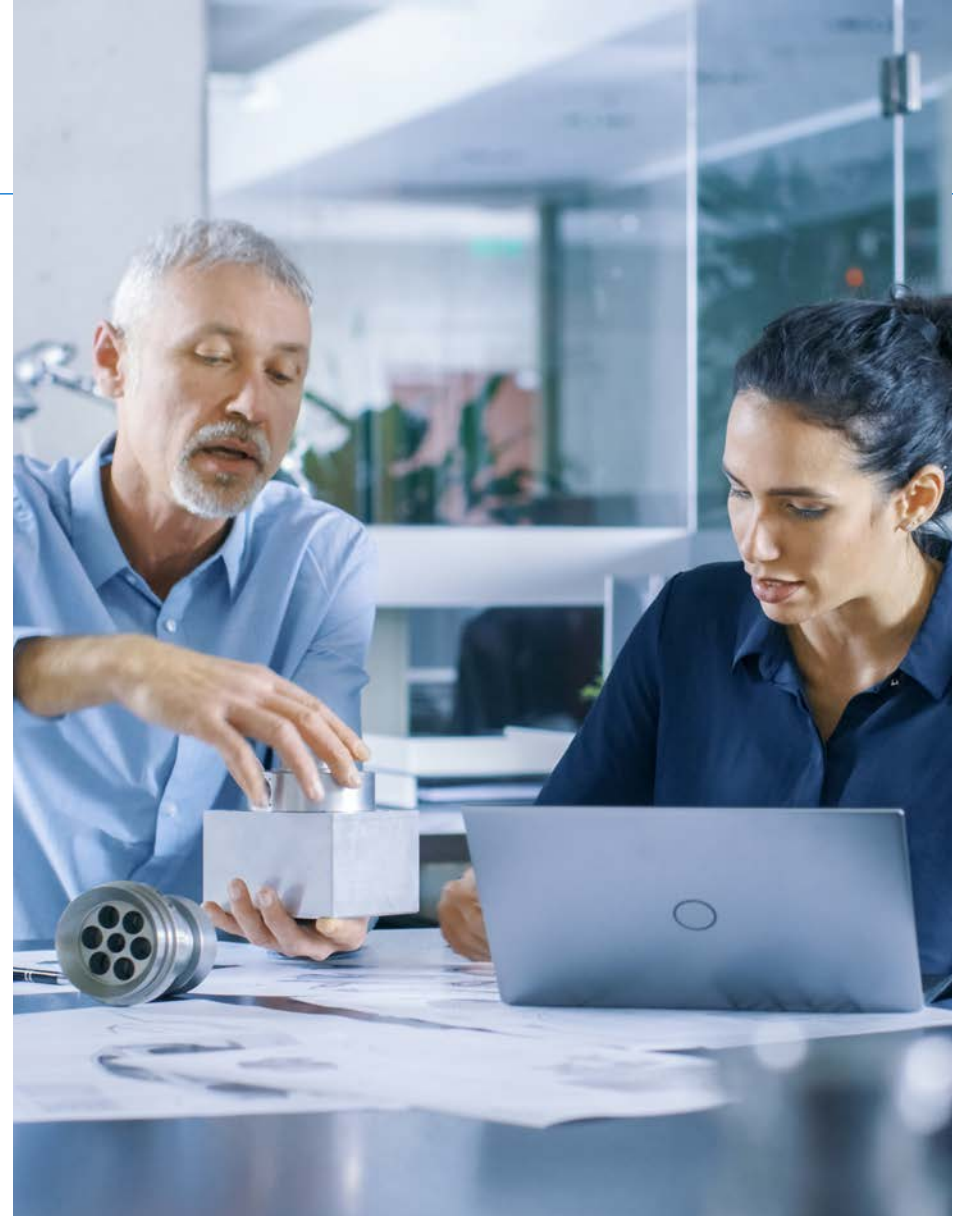
What activities are eligible?

What expenditure qualifies?

What other conditions apply?

How is a claim made?

How do I get further information?



# Introduction

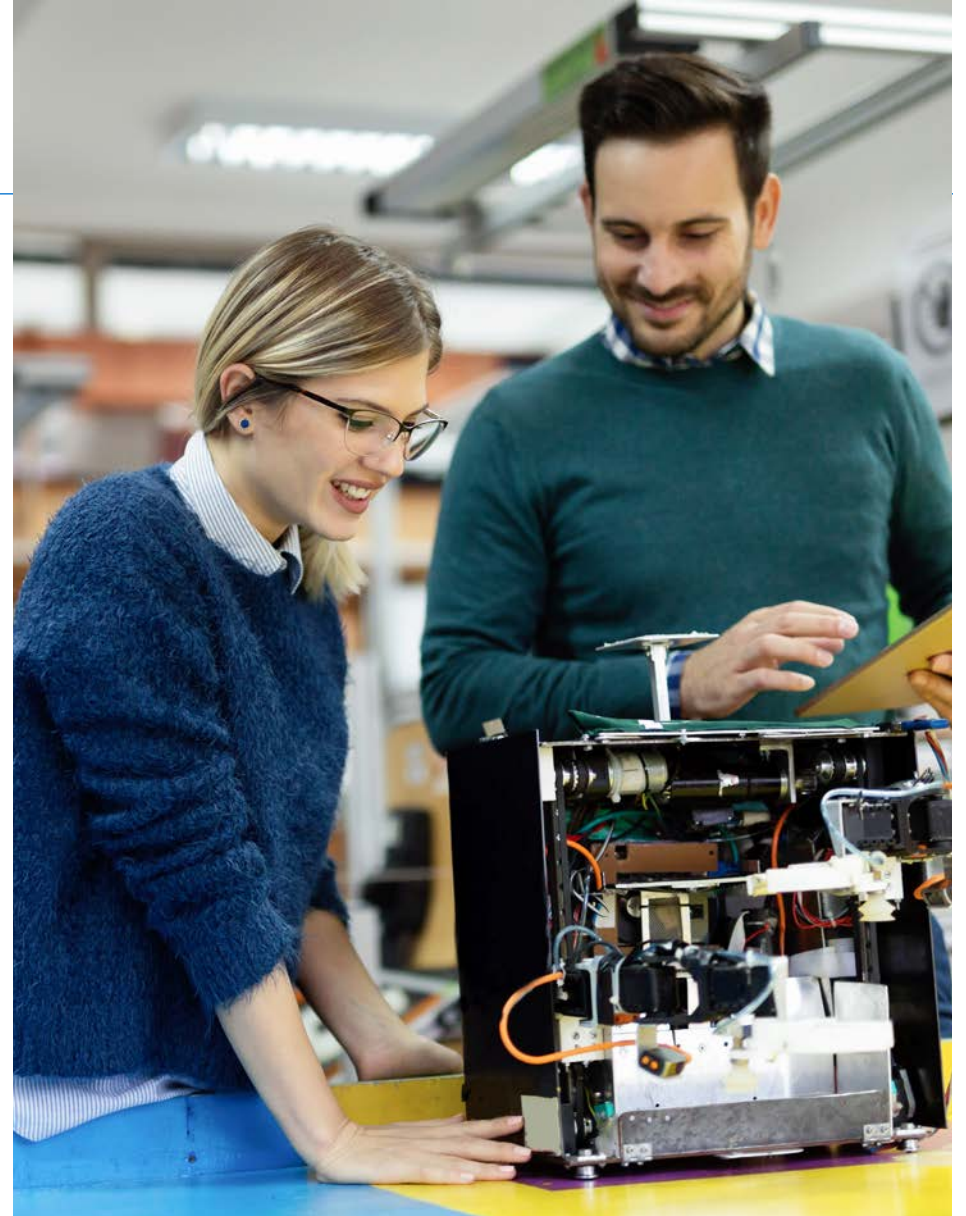
This brief guide gives an overview of the Government's research and development tax relief programme as it applies to Small and Medium-sized Enterprises (SMEs).

It describes:

- what is meant by 'SME'
- the level of tax relief offered.
- the criteria used to determine the eligibility of R&D projects.
- the categories of qualifying expenditure; and
- the process of submitting a claim.

By so doing, we hope that the document provides a useful introduction to the scheme.

It must be remembered, however, that in many cases the combination of the technical justification and the tax situation can become complex and we recommend that detailed advice be sought prior to the preparation of any claim for credit under the scheme.



## What is the relevance of establishing SME status?

The R&D tax relief programme distinguishes between SMEs and 'Large Companies'.

Although the benefits in either case are significant, the level of tax relief available to SMEs is higher in recognition of the fact that, while they are often undertaking important innovative work, they generally have greater resource constraints.

## How is SME status defined?

To be able to make a claim under the R&D tax relief scheme for SMEs, a company has to meet a definition of SME set down by the EC.

The definition requires the company, together with certain related enterprises such as companies in the same group, to have fewer than 500 employees and either annual turnover not exceeding €100m or annual total balance sheet assets not exceeding €86m.

The definition provides exemptions in some circumstances from the inclusion of data associated with certain types of investor companies, including universities.

The operation of this exemption can prove complex in some cases. Further, the capital structures of small companies, particularly early-stage enterprises, can be complex.

It is important, therefore, that establishing a company's SME status involves a thorough and careful review of the business.



## What benefits are available under the scheme?

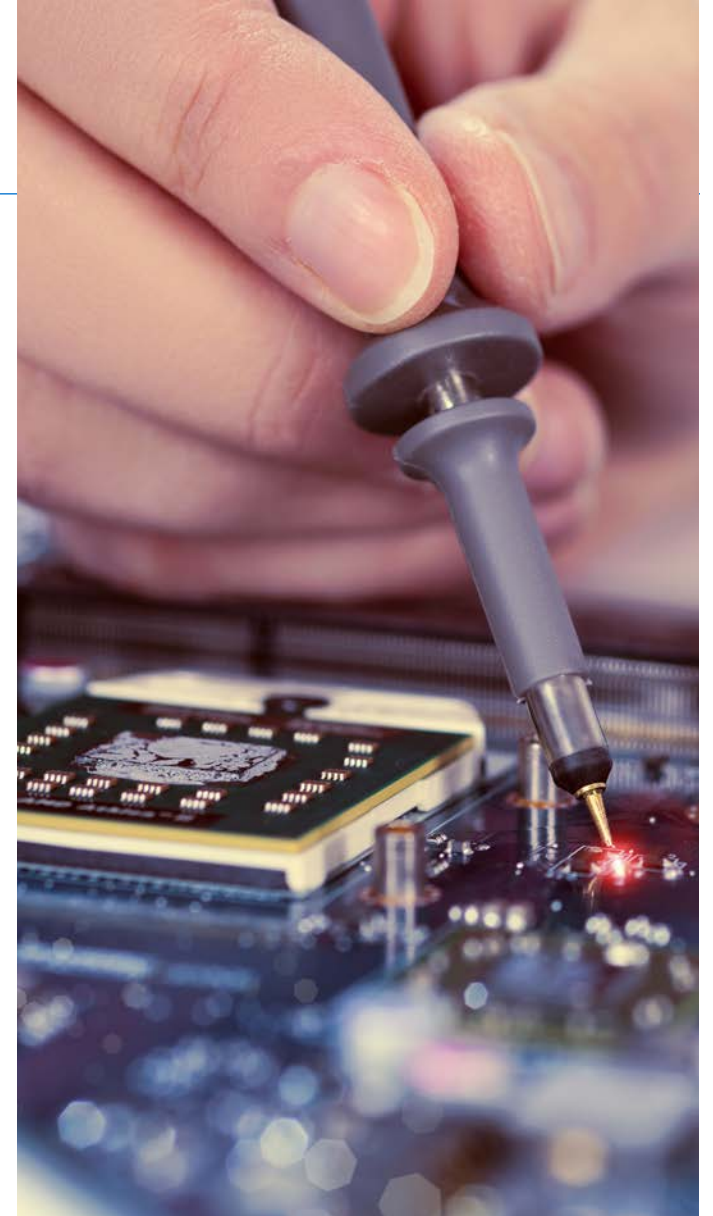
The R&D tax credit for SMEs currently allows an additional 130% deduction (known as a “superdeduction”) from taxable profits for qualifying expenditure incurred on an eligible R&D project.

For example, if a company has £200,000 of qualifying R&D expenditure it can deduct that expenditure from its taxable income under usual tax principles, with the R&D tax relief enhancement then giving an additional £260,000 deduction.

This means that, if the company pays corporation tax at 19%, the additional enhancement will generate a tax benefit of £49,400, reflected in a reduction in the company’s annual corporation tax bill.

For SME companies incurring losses the scheme goes further; such companies can surrender the right to carry forward the enhanced losses for use against future profits in exchange for a cash payment. The cash payment amounts to 14.5% of the lower of (a) the enhanced qualifying R&D spend or (b) its total enhanced losses (after other loss reliefs such as setting off against interest income).

Another way of expressing this cash payment is that it amounts to 33.35% of the actual R&D spend, subject to there being sufficient losses available overall. However, the Government plans to introduce an overall cap on the payable R&D tax credit of three times the company’s PAYE and NIC liability from 1 April 2021, subject to certain exemptions.



# What activities are eligible?

Usually, the aspects of the claim process that companies find most difficult are:

- judging the eligibility of projects against the definition of R&D; and
- ensuring that all eligible work is included.

The general principle is that an activity will qualify as R&D for tax purposes if it would be treated as R&D under normal accounting practice and meets the definition set out in the Guidelines issued by the DTI. The fact that a company has not actually disclosed its expenditure on R&D within its accounts need not, however, prevent it from qualifying.

Of course, a key pre-requisite is that there is in fact an activity in a field of science or technology - “research” or “development” in other areas such as social sciences, as well as innovation in purely a commercial sense, do not qualify.

However, the Guidelines are neutral as regards different fields of science or technology, giving, at least in theory, a level playing field, whether a project is in nanotechnology, life sciences, engineering or software. In practice the DTI Guidelines usually form the sole basis for assessment of eligibility by HMRC and they should be considered in full when making a claim.

In summary, the Guidelines state that an eligible R&D project is one that meets two key criteria:

- (1) It must be seeking to achieve an advance in science or technology. This requires that the work is aimed at increasing the overall knowledge or capability in a field of science or technology. It may have a tangible outcome, such as a new or appreciably improved product or process, or more intangible consequences, such as new knowledge alone. Catching up with the industry generally is not regarded as an advance, although attempting to replicate an advance that has already been made elsewhere, but where the solution is not in the public domain, can qualify.
- (2) It must seek to resolve scientific or technological uncertainty. Uncertainty exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve a desired result in practice, is not readily available or deducible by a competent professional working in the field. This includes system uncertainty, where the components in a complex system might be well-known and established in themselves, but where their integration gives rise to scientific or technological uncertainties. It is important to be able to show that the project is carried out as a systematic process of experimentation and that staff with the appropriate technical qualifications (i.e. who are themselves competent professionals working in the field) are engaged in the work. However, a key point is that success in achieving the technical goals is not essential - it is the attempt and the way in which the work was conducted that counts. In fact, since failure is frequently indicative of technical challenges and a departure from the routine, unsuccessful projects are often good candidates for an R&D claim.

## What expenditure qualifies?

Once it has been established that the company carries out eligible activities, the next stage is to identify the associated qualifying expenditure to include in a claim for the superdeduction.

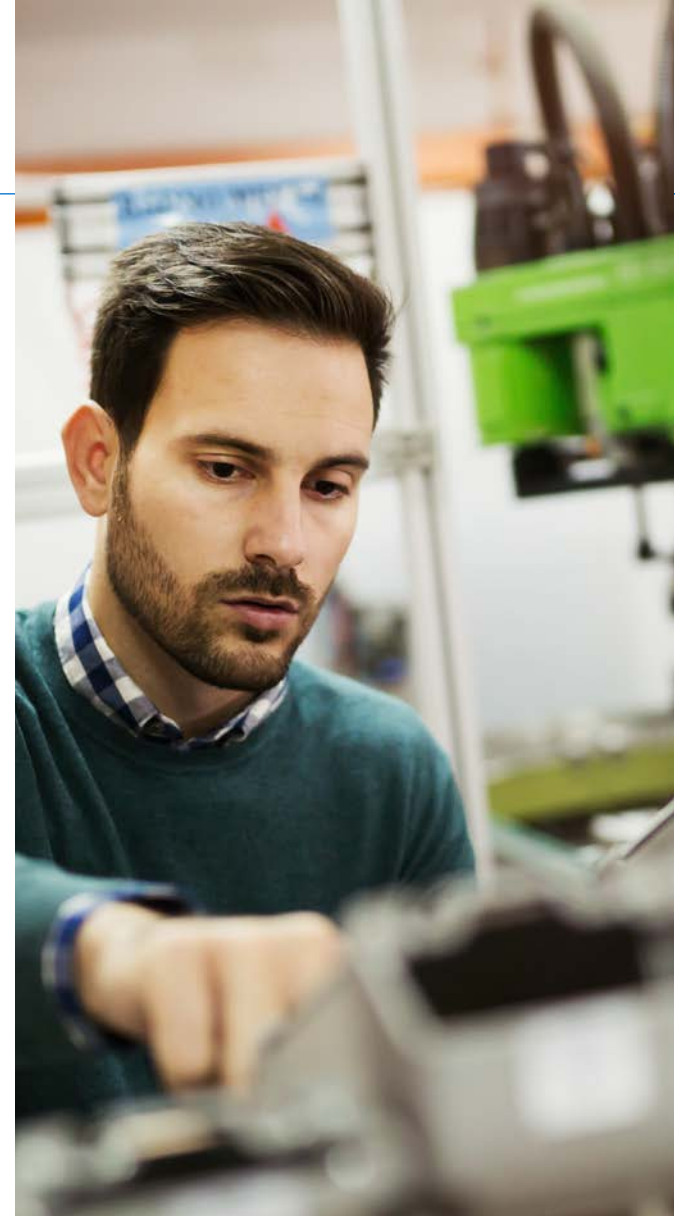
Qualifying expenditure for SMEs, which must be revenue in nature, comprises the following:

- Staff costs of employees directly and actively engaged in R&D, comprising salaries, bonuses, employer's NICs and employer's pension contributions including contributions paid under approved pension schemes in the EU and EEA.
- Expenditure on consumable or transformable items, i.e. materials used up during the R&D process and not reflected in the final product or sold to any third party. This category will normally include expenditure on prototypes but specifically includes water, fuel and power, as well as software.
- Payments made for externally provided workers, i.e. staff provided by agencies or other third parties who work on R&D projects under the supervision, direction or control of the claimant company. Normally only 65% of payments for externally provided workers qualifies. However if the supplier of the externally provided workers is connected to the paying company, for example they are under common control or are in a group, then the qualifying expenditure is the lower of the actual payment made or the qualifying staff costs incurred by the provider itself. Where both parties are unconnected the claimant company and the provider can make an irrevocable election for the same treatment as connected parties.
- Payments for subcontracted R&D, where the company makes payments to third parties to carry out all or part of the R&D activity on their behalf.
- Contributions to fund R&D carried on by qualifying bodies listed above.
- The cost of paying clinical trial volunteers.



## What other conditions apply?

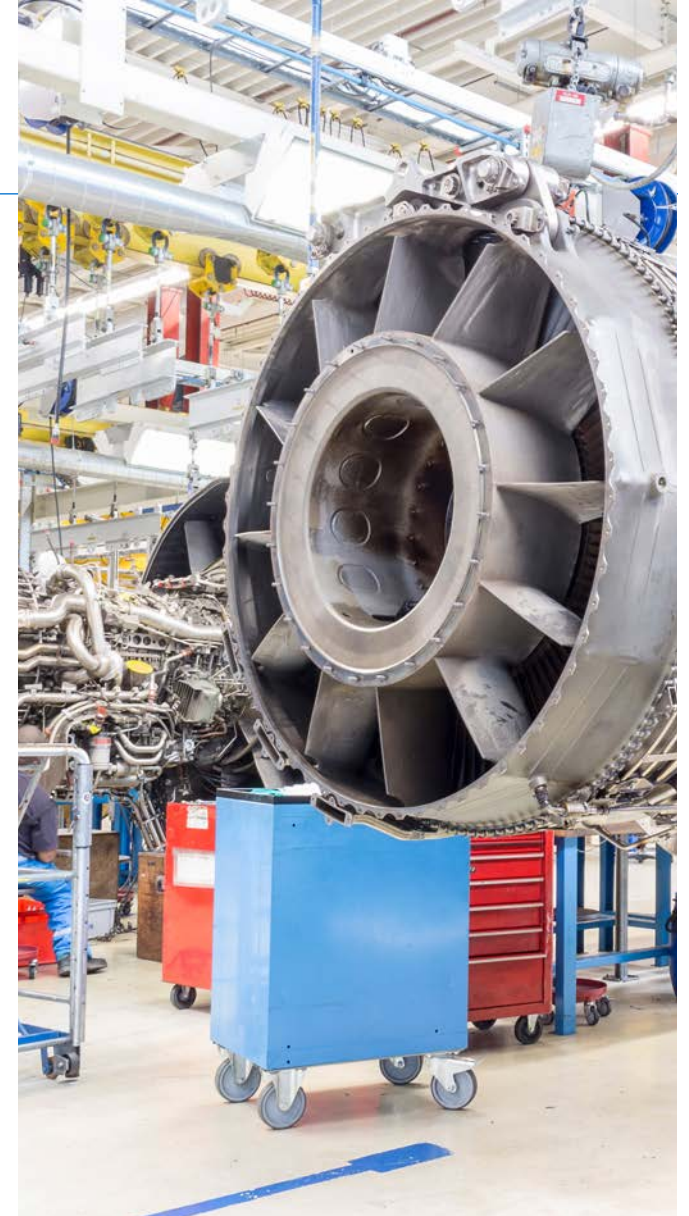
- The R&D must be relevant to the company's existing trade or to a trade that the company is intending to carry out.
- The expenditure must not be capital in nature. However, expenditure that is revenue for tax purposes but put to a balance sheet account is also capable of qualifying. Expenditure that is recorded on the balance sheet as part of the cost of an intangible asset can qualify when incurred. Note that in some instances, expenditure may be properly treated as revenue in the accounts but may still be capital for tax purposes. This can often be a complex area and should be considered carefully.
- A separate relief is available for R&D expenditure that is actually capital for tax purposes, giving a 100% deduction in the year of expenditure in place of the more usual capital allowances that are given over several years. This can include expenditure on buildings and such claims can therefore result in an absolute tax saving since buildings do not often qualify for any allowances otherwise, especially given the phasing out of Industrial Buildings Allowances.
- The expenditure must not be subsidised, broadly meaning that it must not be met by a third party. All expenditure on a project will be treated as subsidised if any proportion of the project's total costs (even if they are not within the categories of qualifying costs for R&D purposes above) is met by a notified State aid.





## What other conditions apply?

- Many government grants usually count as notified State aid, but it is best to check with the provider whether a grant is classified as such. Where other forms of subsidy are involved, it is only to the extent that they offset the expenditure that the claim is reduced. Subsidised expenditure may, however, qualify for an incentive called R&D Expenditure Credit which can take the form of a payable credit of approximately 10%. The other difference to the SME scheme is that there are some limitations in the categories of qualifying costs related to subcontractors.
- R&D activities that have been contracted to the company by a third party do not qualify for the SME rate of relief. Such expenditure may, however, qualify under the regime for large companies as with subsidised expenditure referred to above.
- 'Companies in difficulty' are prevented from claiming tax relief under the SME scheme. A company is regarded as being 'in difficulty' if its latest published accounts are not produced on a going concern basis, or it has gone into administration or liquidation.
- A company will also be prevented from claiming relief if its going concern status is based on the expectation of it receiving SME R&D relief or tax credits. If a company ceases to be a going concern after making a claim to SME R&D relief it will be treated as if the claim had not been made and the tax relief or tax credit payments will be denied. In addition to the above, a cap of €7.5 million has been introduced on the total amount of SME R&D aid - in the form of both payable credits and tax savings - a company can receive in respect of a particular R&D project.
- It is unlikely that many companies will be affected by this restriction, and companies on the borderline should give careful consideration to the scope of the project.



## How is a claim made?

A claim for relief under the scheme is made in the company's annual corporation tax return (CT600). Returns can be re-filed to make claims covering prior years although the ultimate deadline is two years from the end of the company's accounting period.

Although the statutory filing requirements are minimal, it is best practice to submit details of the claim with the return in the form of a formal claim document. HM Revenue & Customs expects evidence of the scientific or technological advance and uncertainty to be apparent from original documentation prepared as part of the project itself.

In practice, however, additional documentation invariably needs to be prepared for the claim in order to bring the supporting facts - the technical justification, the company's tax status and the schedule of qualifying expenditure - together.

Although HM Revenue & Customs has set up a network of specialist offices dealing with R&D tax relief claims, it does not employ scientists or technologists to review claims.

This means that it is essential that the project information is carefully presented in order to be understandable to a lay person, while still technical in nature.

The inspector has the power to enquire into the claim and to withhold payment of the payable credit until the enquiry is complete.

The most common reasons for making an enquiry include:

- Requiring further evidence that the project meets the criteria to be treated as R&D
- Queries regarding the company's status as an SME; and/or
- Concerns that incorrect categories of expenditure have been claimed.

In the past, enquiries were normally conducted by correspondence although today it is more usual for the Inspector to request a face-to-face meeting with the company's technical staff, which often proves a more effective way to answer his or her queries and secure agreement.



## How do I get further information?

For further information on making an R&D tax relief claim, please speak to your usual contact at Pronovotech or e-mail us at [info@pronovotech.com](mailto:info@pronovotech.com).







## About Pronovotech

Pronovotech specialises in the implementation of the government's scheme of tax incentives for research and development (R&D) work, helping technology companies to claim their entitlement to this important benefit.

Our approach combines the technical and tax expertise required for this very specialised aspect of the tax system; our services range from support for specific aspects of the claim process, working with your accounting or tax advisory firm, to management of the entire claim lifecycle, including liaison with the HMRC inspectors.

Our aim is to:

- Reduce the overall cost of the claim process for you.
- Ensure that all of your eligible work is included.
- Speed up the process and acceptance of your claim by HMRC.
- Maximise the probability of success.

We also transfer the knowledge required for future claims to be managed largely in-house.

Whether you are already familiar with the process and claiming successfully, have a specific issue with a claim or have not yet considered your eligibility for the benefit, we would be delighted to see if we can help you.

Pronovotech Limited  
St John's Innovation Centre  
Cowley Road  
Cambridge CB4 0WS

w: [www.pronovotech.com](http://www.pronovotech.com)  
e: [info@pronovotech.com](mailto:info@pronovotech.com)  
t: +44 (0)1223 422237

[in linkedin.com/company/pronovotech-limited](https://www.linkedin.com/company/pronovotech-limited)

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