Two become one

Maria Kitt considers the planned changes to research and development incentives and reliefs in the 2023 Autumn Statement.


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Twenty-three years ago, an obscure allowance, a 'scientific research allowance' was swept aside in favour of a new 'research and development' (R&D) tax deduction, intended to encourage more investment in R&D by innovative UK companies. The 'development' leg of the incentive produced a huge rise in the number of small and medium-sized enterprise (SME) claims. Last week, in his Autumn Statement, chancellor of the exchequer Jeremy Hunt announced measures to take the initial R&D incentive schemes relief almost full circle, back to where it had begun in 2000, with a 'one size fits all' UK R&D incentive scheme effective from 1 April 2024.

If we are to regard this move as something 'new', cast back to 1995, when the Parliamentary Office for Science & Technology was devising the UK's first R&D tax incentive scheme, and note in particular the consideration of a 20% tax credit award, similar to the US, and territorial concerns aired in the first briefing documents form which the UK R&D incentive scheme began (tinyurl.com/mvb7jk43).

What's new?

For accounting periods beginning on or after 1 April 2024, SME companies and 'large' companies may claim a tax credit of 20% of their eligible R&D spend. This is a merger of the distinct SME R&D relief and R&D expenditure credit (RDEC) schemes. The current R&D tax relief for SMEs is set out in CTA 2009, Part 13 as amended by successive Finance Acts, and the RDEC scheme is provided for in CTA 2009, Part 3 Ch 6A.

The proposals, which now begin their legislative journey through parliament, need to be understood by advisers and innovative companies, because the generosity of the scheme and the preceding schemes for bona fide claimants remains hugely significant, particularly for 'break-through' fledgling SME companies engaged in work constituting a technological or scientific advance. With the additional proposed removal of restrictions linked to grant funding, the relief is ever more valuable. The aim of this article is to answer the key 'who, what, where, when, why' questions at a glance.

Key points

- A new 'one size fits all' UK research and development (R&D) incentive scheme will take effect from 1 April 2024.
- The definition of R&D activities for tax purposes remains unchanged.
- The mechanics of the new scheme provide a taxable credit of 20% on a company's eligible R&D costs.
- New 2024 scheme will simplify the rules relating to the PAYE cap.
- Administrative changes include having to notify in advance that a claim is to be made.

Who?

As we know, the UK R&D incentive schemes may only be accessed by *companies* subject to UK corporation tax. The claimant company must bear the critical staff, subcontractor, software and consumable costs directly, and have a UK trading entity engaged in R&D project work that benefits its own commercial or technical objectives, or furthers outright research programmes it may be performing. Cross-charges and management charges are not allowable deductions, and all eligible costs must be shown directly in the claimant's accounts.

A group-wide exception applies, should a centralised group payroll be administered instead of one by individual group members. Should third parties be involved with the SME financially, for example through the provision of grants or subsidies for the project work, relief is potentially void (if considered to be state aid), or provided at the reduced RDEC rate – pre financial year (FY) 2024.

R&D tax definitions require a group-wide headcount of employees and potentially balance sheet and turnover thresholds. This is to include 'linked' and 'partner' enterprises under the company's direct control or associated by mutual ownership and investment stakeholders.

Unincorporated entities, partnerships and sole traders may not claim R&D tax reliefs, but may claim R&D capital allowances. The 2024 single credit scheme takes this entity definition forward unchanged apart from amendments to the subsidisation of R&D which are yet to be drafted. The definition of R&D activities for tax purposes also remains unchanged, and an in-depth discussion on what this may comprise can be read in my article 'Eureka!', *Taxation*, 17 May 2011.

Subcontracted R&D activity

A common question in R&D circles is who should actually claim the UK relief and what are the limitations in an international situation? At the moment, large companies must 'directly perform' their own R&D operations and cannot contract in R&D work, save for work assigned to it by individuals, academic institutions or professional bodies (CTA 2009, s 104D, s 104E).

By contrast, an SME company can subcontract out R&D activity without territorial limitations and those costs are capped at 65% of the amount paid together with an overall PAYE cap introduced by FA 2021, Sch 3. It can also subcontract in R&D activity, and obtain relief at a reduced rate, but this area is a source of frequent confusion.

The new single scheme leaves this situation unchanged until 1 April 2024, with legislation to be introduced to limit relief on non UK situs subcontractor costs and to distinguish the role of subcontractors in the R&D scenario. New rules will be added which will set out how any work that is contracted out is to be treated or relieved. These rules seek to combine the existing rules: setting out where a person is contracted to undertake R&D or R&D activities (and so is unable to claim relief for the work done because the customer is claiming relief as part of their R&D project) and where they are contracted to provide a service which, if they undertake R&D to complete, is relievable on the contractor.

What R&D relief will be available?

Before the Autumn Statement, we were familiar with the SME tax credit position creating a surrenderable loss or reduction in corporation tax liability as in ***Legacy SME incentive scheme to FY 2024***. Large companies are already within the RDEC scheme from FY 2016, as set out in the principal legislation CTA 2009, s 104M. The position for RDEC claimants as we know, has gone from strength to strength since FA 2019 with the rate climbing from its initial 9% rate to 20% from FY 2023. RDEC companies made up the 'lion's share' of the Treasury fiscal funding for R&D historically, but recent data has almost reversed the trend, showing a huge upsurge in the provision of relief to SME companies.

For large companies, the RDEC relief will continue as before, the mechanics of which can be seen in ***Profit maker SME post 1 April 2024***. The rates of RDEC relief have progressively increased since the introduction of the credit scheme in 2016 which came in response to the incentive becoming ineffective via the creation of unusable corporation tax losses. See ***RDEC rates – changes by Finance Act***.

Single credit scheme

The new RDEC relief for SME will apply for accounting periods beginning on or after 1 April 2024.

The mechanics of the new scheme provide a taxable credit of 20% on a company's eligible R&D costs. This is best seen by a comparative example of how the relief will work after 1 April 2024, and how it worked for SME companies before that date. See ***Profit maker SME post 1 April 2024***.

RDEC rates – changes by Finance Act

Expenditure incurred on or between	*RDEC*
1.4.2013 and 31.3.2015	10%
1.4.2015 and 31.12.2017	11%
1.1.2018 and 31.3.2020	12%
1.4.2020 and 31. 3.2023	13%
1.4.2023 +	20%

Legacy SME incentive scheme to FY 2024

Dev Co 1, accounts period ended 31/3/2023
Profits £50,000
R&D eligible costs £70,000
(The company has carried out eligible project work in the period, the current SME R&D incentive calculation is:

31.3.2023 R&D spend	*Rate of relief*	*R&D relief*	*PCTCT** £50,000 adjusted loss*
£70,000	130%	£91,000	Loss £41,000*

*Development Co 1 may surrender the FY 2023 loss by way of:

- group relief surrender;
- an untaxable SME repayment credit at 14.5%, or
- retain the loss as a carry forward against profits of the same trade.

** Profits chargeable to corporation tax (PCTCT)

Profit maker SME post 1 April 2024

31.3.2025 R&D spend £100,000	*y/e 31.3.2025 RDEC*	*y/e 31.3.2024 'old scheme' SME R&D relief*
Profits £100,000.	£100,000	£100,000
Previous R&D enhancement FY 2023 86%	-	£86,000
RDEC calculation 20%	£ 20,000	-
Total profits	£120,000	£14,000
Tax at 18%*	£ 21,600	£2,520
Less RDEC**	£ 20,000	-
Corporation tax due	£ 1,600	£2,520
Without RDEC/RDTR		
PCTCT	£100,000	£100,000
Corporation tax due	£ 18,000	£18,000 (18% SCR)

*The small company rate of corporation tax (SCR) applies to the notional RDEC tax deduction.
** The RDEC may also be used alternatively, to

- set off of group wide liabilities (Inter group surrender); or
- set off from other tax liabilities and contract settlements.

For a loss maker – using the same method as above any resulting 'loss' credit can be taken as a cash payment of the credit from HMRC.

Accounting periods spanning the SME rate change

Assume Dev Co's accounting period ends 30.9.2023 (spanning 1 April 2023).

It invests in £100,000 R&D throughout the accounting year, its profits are £200,000, it is an R&D Intensive SME company.

Y/e 30.9.2023	*Expenditure*	*Scheme/ rate of relief.*	*SME R&D relief*
R&D expenditure pre 1.4.2023	£50,000	SME 130%	65,000
R&D expenditure post 1.4.2023	£50,000	SME 86%	43,000
Total			108,000
Tax position			
PCTCT pre R&D			£200,000
Deduct R&D tax relief			108,000
PCTCT			£92,000
CT due			£17,480
Value of relief			£20,520

Accounting period spanning the RDEC change

Calculation of RDEC for accounting periods spanning 1 April 2023.

Assume for the accounting period ended 31 May 2023 Company A incurred qualifying expenditure of £800,000 the RDEC available becomes:

FY 2022 (1.1.2023 to 31.3.2023) £600,000
FY 2023 (1.4.2023 to 31.5.2023) £150,000

Total expenditure		*RDEC change 1.4.2023*	*RDEC*
FY 2022	640,000	13%	83,200
FY 2023	160,000	20%	32,000
RDEC 31.5.2023 value	800,000		£115,200 14.4%

Transitional period

Before we arrive at the new single credit in 2024, FY 2023 claims must span a change in SME R&D rates effective from 1 April 2023, and also consider the concept of an 'SME intensive' company. See ***Accounting periods spanning the SME rate change*** and ***Accounting period spanning the RDEC change***.

RDEC on qualifying expenditure may only be calculated at the rate which applied at the time that the expenditure was incurred, therefore the change in RDEC rates must be reflected by the following steps:

- Identify each tranche of qualifying R&D expenditure claimed in the accounting period on the basis of which rate applied when the expenditure was incurred. In some circumstances the RDEC rate may be neither 13% or 20%.
- While the rate is 20% for expenditure from 1 April 2023 onwards, increased from 13%, different rates applied before that and expenditure incurred in an earlier accounting period, and which is amortised or impaired to the profit and loss in the later period allowing a claim, might have been incurred when a different rate applied.
- Apply the relevant rate of RDEC to each tranche of qualifying expenditure to calculate the RDEC which the company may claim for FY 2022 and FY 2023.
- The tax profit/loss for the whole accounting period is calculated, including the RDEC calculated above which should be treated as a receipt.
- The steps described in CTA 2009, s 104N should be applied to the RDEC. Where step 2 is relevant, the net value of the credit is calculated by applying the main rate of corporation tax for the accounting period. Here, the main rate should be apportioned on a time basis.

The small print

As ever, the detail within the draft legislation requires consideration.

SME intensive companies

If Development Co is in fact a loss maker and its R&D spend of £70,000 accounts for 30% or more of the overall costs in the accounting period, no restriction on the FY 2023 14.5% tax credit is required. Legislation has been introduced in the autumn Finance Bill 2023 amending CTA 2009, s 1039, s 1043, s 1044 and s 1045 (relief for SMEs on the cost of R&D) to provide the (14.5%) higher rate of payable credit for R&D intensive SMEs, to define R&D intensive SMEs and provide for a one-year grace period should abnormal costs or profit need to be recognised skewing the result.

The condition to be added at s 1045 will broadly state that a company meets the condition if its relevant R&D expenditure for the accounting period amounts to at least 40% of its total relevant expenditure for the accounting period for FY 2023, and 30% from 1 April 2024.

PAYE cap

The RDEC 'old' rules prior to 1 April 2024 contain complicated set off rules and restrictions restricting the credit to PAYE contributions linked to R&D personnel reflected in the claim

The autumn Finance Bill promises the new 2024 scheme will simplify this stream of set offs and apply the more generous 'SME PAYE cap' rules introduced in FA 2021.

Cost of externally provided workers

The new scheme promises simpler rules and quantification of 'agency' type staff costs will be drafted.

The identification of R&D costs on a project by project basis continues as before, following first of all the tax definitions of R&D (BIS Guidelines 2010), and financial reporting standard 104 referring to the recognition of costs in the accounting period concerned. This includes the broadened cost recognition changes for cloud computing costs and the costs of data sets.

Administrative changes 2023 and 2024

Before the Autumn Statement, a number of administrative clarifications and changes followed on from Finance (No 2) Act 2023. Claims within the new single credit scheme must comply with these requirements.

SME relief and credit rate changes from 1 April 2024

	Expenditure incurred pre 1.4.2023	*Expenditure incurred on or after 1.4.2023*	*Single R&D credit 1.4.2024*
Small company rate of corporation tax FY 2022/FY 2023, 2024	19%	18%	18%
RD enhancement rate	130%	86%	-
SME R&D tax credit rate	14.5%	10%	20% RDEC
SME intensive limit FY 2023/FY 2024	-	40%	30%

- *Digital notification of claim details* – From 10 August 2023 it has been compulsory for any claim to be preceded by the filing of 'additional information' in digital format to HMRC. Without this, the claim will be invalid (F(No 2) A 2023, Sch 1 para 13 (amendment to FA1998, Sch 18 para 83EA). Annoyingly the portal is still in a junior state of development and no scientific annotation or diagrammatic data can be presented. Strangely, this must be submitted (without any legal justification) before the submission of the CT600 claiming the relief or the company will be notified its claim has been removed from the R&D scheme. In order to file compliantly, the agent must be authorised by HMRC or one of the professional bodies. A formal receipt is provided by HMRC, but there is no opportunity to supplement or amend this information once filed.
- *New claimants* – Both SME and RDEC claims must be preceded by an 'advance notification of the intention to claim reliefs within six months of the start of the accounting period'. Schedule 1 para 1 amends CTA 2009, Ch 6A (the rules relating to RDEC) and para 2 amends CTA2009, Part 13 (the rules relating to SME reliefs).
- *Tax credit claim time limits* – For clarity, the time limits prescribed in the originating legislation for the scheme, FA 1998, Sch 18 para 83E are defined to confirm companies should make R&D relief claims within two years of the end of the accounting period unless the period is longer than 18 months, in which case the limit is 42 months from the start of the accounting period.

Where to?

Currently, and since the introduction of the R&D schema in 2000, there has been no territorial limit on where R&D expenditure is incurred. In the UK and EU science communities, this has been a positive for clinical trials and simpler development tasks which can be done in cheaper labour centres, minimising otherwise expensive development costs. PhD students have been able to contribute to significant research projects in the UK, and vice versa, bringing expertise and frontier knowledge from around the world. It is no surprise that the UK is the third most ranked country for contribution to internationally recognised scientific research programmes, including novel vaccination and bioscience programmes.

Why?

Finally, in response to 'why?' it is essential to understand the intended stability provided by the redesign, the 2021 Treasury report *R&D Tax Reliefs* provides a roadmap for the transition of the schemes to a single R&D credit. The review seeks to both encourage R&D investment within the economy and counteract abusive claims, protecting HMRC from fraudulent or incorrect claims. The report can be read here: tinyurl.com/HMTRDTR21.

In the build up to the 2021 report, SME claims had reached dramatic proportions, with the estimated total number of R&D tax credit claims for FY 2022 rising to 90,315, reflecting 79,205 SME claims (compared to 35,000 in 2015). The estimated amount of total R&D tax relief support claimed for the tax year 2021-22 was £7.6bn, an increase of 11% from the previous year, corresponding to £44.1bn of R&D expenditure, 8% higher than the previous year. The numbers are clearly very significant and here, tax policy must be tempered by risk management as well as incentivisation. It is counter-intuitive that the most significant scientific and research programmes receive less than half of the tax funding provided for a science and technological based incentive – the scheme by 2022, had become unrecognisable.

As for the sectoral impact of the merged scheme, from a strategic G7 and Organisation for Economic Co-operation and Development point of view, there is no doubt at all that the companies engaging in major R&D operations and who make up the lion's share of the R&D incentives, are positively affected, by successive increases in RDEC rates. The greatest amount of R&D relief has historically been attributable to 'large' companies operating in the following sectors, and that picture is likely to strengthen further with inward UK R&D investment flows:

- Pharmaceutical;
- Bio life sciences (£1.8bn FY 2022);
- Information and communication (£1.7bn FY 2022); and
- Advanced manufacturing, including robotics (£1.78bn FY 2022).

The new credit will continue to play its part in the direct and fiscal incentives aimed at strengthening UK science and technology. For bona fide SME claimants now transitioning to the new credit, there is a generous, simpler scheme whereby the incentive should be more easily understood and less susceptible to change, but watch this space.

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