Additional support

Although the research and development tax relief is well known, MARIA KITT explains the lesser-known research and development allowances.


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Recent statistics show that a record number of innovative UK companies are claiming research and development (R&D) tax reliefs, grants and indirect support for pioneering scientific and technological projects. This is a good thing and exactly what the reliefs were designed to encourage.

By way of contrast, there is very little uptake for a special scheme of capital allowances – 'research development allowances' – despite their 100% rate of relief and the fact that they are open to all types of business. In part, the generosity of conventional first year capital allowances such as the 'annual investment allowance' may be a causal factor. Whatever the reason, the allowances remain 'obscure', replacing their predecessor, 'scientific research allowances', and seem beyond the reach of eligible businesses investing in R&D.

Given the 12% rise in the UK's capital expenditure on R&D facilities both across its network of 4,200 UK science and technology parks and the investment by UK R&D companies in low-cost labour centres abroad, the allowances are more relevant than ever.

One advantage may be where the annual investment allowance has been used in full; another may be the wider range of eligible expenditure.

Definition of R&D

The terms 'research' and 'development' follow the familiar tax relief definition of 'R&D' for companies claiming SME or large company revenue reliefs. This begins with expenditure recognised as such in the trader's accounts. The expenditure must then be linked to projects that seek to advance scientific or technological capabilities or knowledge through the resolution of technical uncertainty, as set out in the ***BIS Guidelines*** (December 2010) which can be found at tinyurl.com/kmq3ll9.

Common examples of eligible projects would therefore be:

- the acquisition or build of dedicated laboratories and/or R&D facilities, including staff welfare amenities and any additional VAT duties arising from a purchase;
- capital expenditure on infrastructure costs supporting the R&D facility;
- the purchase of plant and equipment within the R&D facility; and
- the purchase of cars, computers and other capital equipment for R&D purposes.

Allowances are also available for capital expenditure linked to oil and gas exploration.

KEY POINTS

- Companies are increasingly claiming R&D tax relief.
- R&D capital allowances may easily be overlooked.
- These capital allowances are not limited to companies.
- Qualifying expenditure may encompass costs that are not eligible for plant and machinery allowances.
- Cessation of ownership will trigger a disposal event.
- The reliefs are available for worldwide expenditure.

BIS GUIDELINES

The basic definition of research and development as set out in the BIS Guidelines.

'R&D for tax purposes takes place when a project seeks to achieve an advance in science or technology.

'The activities which directly contribute to achieving this advance in science or technology through the resolution of scientific or technological uncertainty are R&D.

'Certain qualifying indirect activities related to the project are also R&D. Activities other than qualifying indirect activities which do not directly contribute to the resolution of the project's scientific or technological uncertainty are not R&D.'

The *BIS Guidelines* (tinyurl.com/kmq3ll9) go on to explain the terms used above in more detail.

Who may claim RDA – 'traders'

A review of CAA 2001 shows that the research development capital allowances, unlike the revenue R&D reliefs, are not restricted to companies. The restrictions present in mainstream R&D reliefs at CTA 2009, s 1039 do not feature in the capital allowances regime. Instead, the allowances are open to all entities preparing UK tax computations for a 'trade', with the exception of professional and vocational entities.

We must look in particular at the extraction of the terms 'person', 'trade' and 'trader' in CAA 2001, Pt 6. There is no prescription that the capital allowance is used in 'ascertaining liability to corporation tax'. Similarly excluded are the specific limitations of CTA 2009, Ch 2 to Ch 7, which restrict the conventional revenue R&D reliefs to 'a company which is either a small or medium-sized enterprise or a large company' (CTA 2009, s 1039).

RDA may therefore be claimed by:

- sole traders;
- owner-managed businesses;
- partnerships;
- SMEs and large companies; and
- conventional corporate and group organisations.

"CAA 2001 shows that the research development allowances are not restricted to companies."

The trading requirement

Again, in contrast to the revenue R&D reliefs, CAA 2001 goes into specific detail about the quality of the organisation's trade and the relevance of expenditure apparently linked to it. This is underlined in the decision of *Gaspet v Ellis* [1987] STC 362.

In *Gaspet*, a UK company (G) was a subsidiary of a Norwegian partnership, another subsidiary of which (S) was a member of two syndicates holding oil exploration licences. The actual exploration was done by other members of the syndicates, but S was obliged to pay a proportion of the syndicate expenditure. G agreed to pay S's share of the syndicate costs in return for a share of the oil, and claimed capital allowances on the expenditure. The Revenue rejected the claim, considering that the expenditure had not been 'directly undertaken' on behalf of G within the meaning of what is now CAA 2001, s 439(1).

The Court of Appeal unanimously dismissed G's appeal. Kerr LJ held: 'The requirement that the research must be directly undertaken by or on behalf of the taxpayer claiming the allowance is intended to be restrictive in its effect and to denote a close and direct link between the claimant and the work undertaken.' Here the exploration was undertaken on behalf of the members of the syndicate, but it was not undertaken on behalf of G, which was not entitled to the allowances.

This case shows that, for allowances to be given, the R&D must be both relevant and directly linked to the trade concerned. This includes pre-trading expenditure, where the trader is incurring preparatory capital expenditure.

Qualifying expenditure

Qualifying expenditure therefore includes all capital expenditure incurred by the trader for carrying out R&D or providing facilities to do so. If property is purchased, the allowances are not available for the acquisition of rights in or arising out of R&D, such as intellectual property rights, licences, know-how and other intangible assets.

Similarly, the acquisition of land and/or land rights is specifically excluded from the calculation (CAA 2001, s 440). The cost of buildings and/or plant and equipment on the land is not counted towards this exclusion. Neither is the purchase of specific staff welfare or medical facilities. Consequently, costs may be eligible for relief as R&D allowances that would not qualify for the annual investment allowance. Likewise, the acquisition of a dwelling is specifically excluded from the research development allowance expenditure calculation if the purchase or construction cost exceeds 25% (excluding VAT where charged) of the overall capital expenditure concerned.

The allowances are given as a trading deduction in the year-end accounts as illustrated in ***Big Idea Co***.

BIG IDEA CO

Big Idea Co is attracted to the UK and purchases a site for R&D operations that it intends to be operating by 2020. Its capital expenditure on the UK premises totals £2.5m for laboratories, including medical and canteen provision for staff and plant and equipment.

The site cost includes £150,000 for lease extension rights and the land acreage was valued at £350,000. A reverse premium of £300,000 becomes payable by the landlord to Big Idea Co if it stays on site for five years.

Analysis

The aggregate capital expenditure of £2.5m can be broken down as follows:

	£	£
Aggregate expenditure		2,500,000
Less: Excluded expenditure:		
Land	350,000	
Rights and easements	150,000	
Total excluded expenditure		500,000
Qualifying expenditure		2,000,000
RDA tax deduction in chargeable period		£2,000,000

The reverse premium of £300,000 might be regarded as business income or a chargeable gain depending on its precise terms. But see, generally, the special code for the taxation of reverse premiums in ITTOIA 2005, s 99 to s 103 (for corporation tax see CTA 2009, s 96 to s 100). It will not affect how much RDA is available.

LABCORP PARTNERS

LabCorp Partners disposes of its laboratory for £500,000, having originally claimed RDA of £750,000 upon its £1m purchase.

Analysis

The unclaimed RDA is:	£250,000
The balancing charge is:	£250,000

The balancing charge is calculated as the lower of:

- the difference between the sale price and unclaimed RDA: £250,000
- the RDA given: £750,000

Disposal of RDA assets

Ceasing to own the research development allowance asset will trigger a 'disposal event' which may claw back some of the allowances claimed. Outgrowing premises and obsolescent machinery are regular features of the R&D cycle for many innovative businesses and it is useful to understand the potential tax trigger.

INNOVATION LTD

Innovation Ltd has the following transactions on capital expenditure incurred for research and development.

	Asset C	*Asset D*
	£	£
Cost on 1 September 2010	20,000	20,000
Both assets were destroyed on 1 December 2015 after being used throughout for research and development		
Insurance proceeds	1,400	1,400
Scrap proceeds	1,000	1,000
Cost of demolition, etc.	600	4,000

The following allowances and deemed trading receipts or deductions arise.

	Asset C	Asset D
Accounting period ended 31December 2010		
	£	£
Allowance	20,000	20,000
Accounting period ended 31December 2015		
	£	£
Insurance proceeds	1,400	1,400
Scrap proceeds	1,000	1,000
Disposal value before demolition costs	2,400	2,400
Less: Demolition costs	600	4,000
Disposal value	1,800	(1,600)
Balancing charge	£1,800	
Allowance		£1,600

The balancing charge occurs if the RDA assets are:

- disposed of;
- destroyed or demolished; or
- ownership ceases.

Interestingly, there is no charge applicable to a change of use of the asset.

The computation of the balancing charge brings into account research development allowance previously claimed and potentially claimable. The charge is limited to the smaller of the two; the balancing charge is the lower of:

- the amount by which the sale value/disposal value exceeds unclaimed RDA; and
- the amount of RDA given over the asset lifetime.

> ***"Ceasing to own the research development allowance asset will trigger a 'disposal event' which may claw back some of the allowances."***

The disposal of a research development allowance asset is illustrated by ***LabCorp Partners***.

As mentioned above, a disposal event may also result from the destruction or demolition of an asset. In the latter case, the demolition costs will reduce or extinguish the disposal value. If these costs exceed the disposal value the excess is qualifying expenditure at the time of demolition or immediately before the trade was permanently discontinued. This is subject to the condition that the asset had not been used for purposes other than research and development related to the trade.

This is illustrated by ***Innovation Ltd***.

Note that in such circumstances, the demolition costs cannot be treated as expenditure for capital allowances purposes on any replacement property.

Conclusion

The availability of additional support for UK R&D businesses is well established (CAA 2001), but there is now some uncertainty for the scientific and technology community, committed as it is to a range of long-term European relationships. Capital allowance reliefs are generous and written in broader terms than the R&D revenue reliefs, making research development allowances available to a wider range of businesses engaged in R&D. Notably, the reliefs are available for worldwide expenditure, mirroring the non-territorial nature of conventional R&D revenue reliefs.

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