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Research & Development (R&D) Tax Credits

Government response
and further consultation,
10 June 2011



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Further to the changes announced at the 2011 Budget, the Government has now responded to other open R&D matters addressed in the 2010 consultation published as part of the corporate tax reform agenda. The Government response can be found [here](#).

The Government's willingness to continue discussion of significant improvements to the R&D regime is welcome although it should be stressed that most of the topics covered below are subject to further consultation with a view to possible legislation in Finance Bill 2012, rather than representing any firm commitment.

The key topics are as follows:

1. External provided workers (EPWs)

A company with insufficient staff to carry out its own R&D may pay a staff provider to supply temporary staff. Not all expenditure on EPWs will be eligible for the R&D relief, often due to factors outside the claimant company's control. The Government has accepted that the current rules on EPWs are overly restrictive and intends widening the qualifying conditions so that more such workers may qualify. It proposes issuing draft legislation this Autumn for Finance Bill 2012. This will be welcome to all those companies whose claims to R&D relief have been reduced in respect of EPWs because the contract relations between the EPWs and the staff providers do not meet the statutory requirements. It could have a significant impact on a large number of claims particularly in the software and engineering sectors where the use of service companies by individual temporary workers is common.

2. Production issues

One topic that was consulted on was the question of whether production expenditure qualifies as R&D. The issue has caused particular difficulty when companies are carrying out manufacturing trials, or are developing a saleable prototype. The Government has announced that it does not propose changing the definition of R&D, but will produce revised draft guidance on the topic this month, which we anticipate will show significant movement from the previous HM Revenue & Customs (HMRC) position that the prospect of sale prevents an activity from qualifying as R&D. We shall be awaiting this draft guidance with great interest.

3. Payable large company credit

It has been suggested that making the large company R&D relief into a payable credit, and structuring it so that it could be recognised above the line in accountancy terms would give the relief a more significant incentive effect. If introduced this would replace the current enhanced deduction from taxable profits. This would be of particular interest to large companies carrying out R&D that do not anticipate having sufficient taxable profits to make use of the enhanced deduction from taxable profits currently available. It would also have implications for any company claiming large company R&D relief as the new credit might be grossed up and taken above the line for accounting purposes, which could have knock on effects elsewhere. The proposal remains tentative, subject to effectiveness in encouraging R&D, cost, accounting issues, and the complexity of any structural changes required, all of which remain to be reviewed.

4. Eligibility of qualifying indirect activities (QIAs)

Recently HMRC accepted that expenditure on certain support activities carried out for R&D purposes was also eligible for the R&D relief. However, many found claiming the relief complex as the legislative position was unclear and HMRC often requested a lot of supporting information about these activities. The Government is now considering removing qualifying indirect activities from eligible expenditure for the purposes of R&D tax relief. The issue of concern is whether the scale of benefit justifies the added complexity of claims where it is included. The question will be of particular interest to companies claiming R&D relief that have the potential to claim significant amounts of QIAs, and they may wish to respond to the consultation to make sure their interests are not overlooked or unduly discounted. Our view is that the position could be made a lot simpler by clarifying the legal position.

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5. Subcontracting between unconnected large companies

The Government is aware that if large company A subcontracts a part of its R&D project (e.g. testing of the prototype product) to unconnected large company B, then B will not be able to claim R&D relief on its own expenditure, unless the subcontracted work amounts to an R&D project in its own right. This is often not the case.

The Government would like company B to be able to claim the R&D relief, if its work is part of A's R&D project. The issue on which it wishes to consult is how B can establish that its work is part of an R&D project of A, and it has indicated it would not wish to proceed on this if there was not widespread support. One area of concern is how to avoid double claims being made in respect of the same R&D.

This proposed change is likely to be of particular interest to large companies which carry out scientific or technological testing activities on behalf of clients.

6. Removal of PAYE/NICS cap, and de minimis rule for SME R&D relief

There is currently a limit on the amount of payable credit under the SME R&D relief scheme which is set by the amount of PAYE and NIC paid by the company in the period. There is also a de minimis threshold requiring expenditure of at least £10,000 in an accounting period before this becomes eligible. Both of these restrictions are to be abolished from 1 April 2012. This will be welcome to very small companies, and to loss making SME companies carrying out R&D, but without sufficient PAYE/NIC to frank their payable credit claims. The PAYE/NIC cap was originally an anti-avoidance device to deter fraudulent claims, as you could only get out as much cash as you put in, and so HMRC wish to consult about how to minimise the risk of fraud if the safeguard is removed.

7. Other qualifying costs

The Government has announced that apart from the EPW change, it does not intend further widening the list of qualifying expenditure types for R&D relief. It is perhaps disappointing that it has decided not to simplify the regime by abolishing the exclusion of benefits in kind from qualifying staff costs, as this would remove a layer of complexity from the claims. It is likely that cost and stability were more important considerations.

8. Going concern definition

The SME R&D relief and the Vaccine Research Relief are both State Aids. There is a requirement that a company has to be a "going concern" to be eligible, and the current R&D test for this is based on its last filed set of accounts. The Government is consulting on whether companies would welcome a stricter requirement in line with that used for Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) purposes, and based on a "company in difficulties test", which includes quantitative measures such as specified losses in capital over the period.

The measure would be of interest to companies claiming under the SME regime that are incurring losses and, as such companies are unlikely to be seeking tougher tests and this was not raised in the consultation, it would seem possible that this may be a restriction being sought by the European Commission as part of their State Aid approval regime.

9. Vaccine Research Relief (VRR) for SMEs

The Vaccine Research Relief is an additional relief for developments of vaccines or medicines for specified illnesses. As announced, this will be abolished for SMEs in order to permit the higher rates of relief to be introduced for the general SME R&D relief. However VRR will be retained for large companies as the consultation showed it did have an incentive effect for the limited number of companies that claimed.

10. R&D pre- approval regime

A pilot scheme is to be started on a voluntary basis in one of the HMRC specialist offices to see if consideration of the qualifying status of the R&D work in advance of it being carried out would be helpful. The pilot will apply to small start up companies and small companies which have not previously claimed R&D tax relief.

Comments have been requested on the points subject to further consultation by 2 September 2011.

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For more information contact

David Woodward

Partner – London

Tel. +44 (0)20 7694 4171

david.woodward@kpmg.co.uk

Gavin Bate

Senior Manager - London

Tel. +44 (0)20 7694 1191

gavin.bate@kpmg.co.uk

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