Rewarding innovation

Many companies could be missing out on financial support via tax incentives for their research and development work, writes Richard Lewis.

In an increasingly global marketplace, the leading developed economies are recognising the importance of innovation to the health of their economies. Studies have demonstrated conclusively that increased levels of innovation drive economic growth, prompting governments to introduce incentives to stimulate research and development activity. The two most common forms of incentives are grants and – the subject of this article – r&d tax incentives.

Tax incentives in support of r&d are available in most major nations. The form of incentive varies from country to country, but typically it might be an additional deduction from the tax payable on profits (sometimes called a "superdeduction"), accelerated tax deductions for capital expenditure or in some cases actual cash for companies that are not currently tax-paying.

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The latter is often used for start-up companies that usually incur losses in their early years, although not always. France, for example, provides for a payable credit for any size of company, although it is capped at €8m.

Another distinguishing feature between countries is whether the relief is given on all r&d expenditure, or as a credit based on incremental spend over and above a base amount. The UK and Canada both operate systems based on total r&d spend, whilst the USA and the Czech Republic work on the basis of incremental relief. Additionally, some countries have a hybrid scheme – Spain, for example, has had a 30% tax credit on volume with an additional 20% on incremental spend, thus making it one of the most attractive r&d tax incentives in the world, although recent changes mean it is to be progressively phased out.

Claiming r&d incentives normally involves a multi-stage process, beginning with identifying the eligible activity, then capturing the associated costs incurred, leading to preparation and submission of the claim to the tax authorities and, if necessary, defending the claim if audited by them.

The definition of r&d used by different countries is very similar, since most base it on a model developed by the OECD, which is commonly referred to as the Frascati manual.

The costs that may be included in the claim can vary widely from country to country, however. Some countries such as Canada allow general overheads to be claimed, whilst other countries such as the USA and the UK restrict it to certain specific costs such as employment costs, materials consumed and certain subcontract payments.

RELIEF IN THE UK

The UK is a relatively late entrant to the international r&d tax incentive arena, having introduced a scheme for small and medium sized (SME) companies in 2000 and for large companies in 2002.

Whilst both the SME and large company systems provide a superdeduction for qualifying r&d expenditure, the SME rate is the more generous and goes further in providing a payable credit for loss-making companies, worth up to 24% of the qualifying expenditure. For large companies, which normally pay corporate tax at 30%, the extra 25% tax deduction generates a tax benefit of 7.5% – provided they have taxable profits, of course.

For both SMEs and large companies, the costs against which r&d relief can be claimed must be revenue in nature (capital r&d expenditure is excluded) and fall into the following categories: staffing costs; agency workers; and software and consumable items.

For capital expenditure, although not eligible for r&d tax credits, a 100% deduction is allowed in place of the usual tax depreciation spread over a number of years.

SMEs can claim payments to subcontractors, whilst large companies can only claim subcontract payments to non-taxpaying bodies such as universities and scientific research organisations. Contributions to these bodies to fund independent r&d can also be claimed by large companies.

The definition of r&d used for UK tax purposes is based around the seeking of an advance in science or technology. The start and end point of an r&d project are defined by the identification, and ultimately the resolution, of scientific or technological uncertainty. Thus the activities that contribute to resolving the uncertainty, and thus the advance in science or technology, make up the project for tax purposes.

This model can then be applied to the categories of qualifying cost in order to calculate the total r&d spend for the claim. In the case of staffing costs – the most common element of an r&d claim – the company needs to identify the time spent by employees directly contributing to the resolving of uncertainty to calculate the appropriate proportion of their salaries together with social security and pension contributions.

In drafting the r&d definition, the UK government has responded to consultation from industry and avoided statements that might prejudice particular industries. The definition is therefore deliberately sector-neutral. It also makes clear that r&d still takes place even if the sought-for advance is not actually

achieved, or if another company has already accomplished it but the advance is a trade secret. The key test is whether the solution would be readily available to, or deducible by, a competent professional working in the particular field.

In the UK, an r&d tax relief claim is made in the company's annual corporate tax return – there is no separate filing process. Indeed, the UK has avoided being prescriptive about the form of supporting information required. Although there is no statutory requirement to file anything other than a number in the tax return, tax inspectors have the right to raise enquiries and generally will do so if no information accompanies the return. They expect to be able to see original documentation evidencing the nature of the advance sought and the uncertainty to be overcome, such as project plans and test reports.

However, the reality is often that original documents do not highlight the advances and uncertainties, and are written for a different audience, so it is usually necessary to prepare an additional project description for the claim. Unlike some countries (for instance Canada and Australia), the UK does not employ engineers or scientists to review claims, so it is the regular tax inspector whose job it is to decide whether an advance in science or technology has been sought. This means that whilst the documentation will naturally be technical in nature, it must also be capable of being understood by a lay person.

Activities in the metal industries that might qualify include the development of new metal products with superior qualities such as strength or resistance to corrosion, the development of new processes in areas such as heat treatments or metallurgical coatings, or investigation into the physical properties of new metal alloys. Often, eligibility can arise in work carried out as part of everyday customer-funded projects, where a new process has to be developed to cater for a specific situation not encountered before.

Improvements to existing products and processes can also qualify, even if the amount of improvement achieved is incremental rather than a quantum leap. The important point is that eligible activity is not confined to "pure" research, performed by people working in designated r&d facilities, but includes a great deal of developmental work that might not be obvious r&d.

UNDERSTATED

Many companies are missing out on the benefits owing to the way the claim is approached. Often it is seen purely as a tax project, with minimal involvement of the technical departments who may have been sent questionnaires to fill in and return to their tax colleagues. This "low profile" approach invariably leads to an understated claim and very often problems later on if the claim is audited by the tax authorities, since the claim's success depends primarily on its technical justification.

In a large company, an r&d claim can be a time-consuming exercise, especially in the first year, so it is important that a structured methodology is in place to ensure accurate identification of the eligible activity and the associated costs. This is where the assistance of specialist r&d tax credit advisers is very useful – they will bring experience of assessing r&d portfolios and will have developed effective methodologies for scoping the claim and involving the right people, including those from outside the core r&d function.

R&d tax credit schemes are intended to boost the level of innovation in industry, thereby maintaining a country's competitiveness and economic health. The metals industry, as an important constituent of the industrial base in many countries, should be taking advantage of such tax incentive programmes now, not just as a tax strategy but as a contribution to companies' development budgets.

For each firm, it is an issue that requires those in charge of the tax function to work closely with their technical colleagues to ensure that that the company receives the support that its r&d investment warrants.

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UK r&d tax incentives for SMEs and large companies compared

	SME	Large company
Rate of superdeduction	150%	125%
Repayable credit available?	Yes – up to 24%	Not available
Available if grants received?	No – but can claim under large company scheme	Yes
Available on contracted-in r&d?	No – but can claim under large company scheme	Yes
Intellectual property ownership required?	Yes	No