# Unlock innovation for SMEs

**JENNY TRAGNER** shows how R&D tax credits can boost innovation and stimulate growth in small and medium-sized enterprises.

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In this year's spring Budget, after consultation with the business community, Chancellor of the Exchequer Philip Hammond stated that research and development (R&D) tax incentives are helping the UK to maintain its position as a globally competitive place to start and grow a business. This is good news for small and medium-sized enterprises (SMEs). But, in announcing measures to reduce administrative burdens and improve awareness of R&D tax credits among SMEs, the Treasury suggested there is still work to be done to improve accessibility to the scheme.

## Appetite and access

A recent study from ForrestBrown, *Igniting Innovation*, shed light on the scale of the challenge the tax industry faces (tiny.url.com/mu664j8). Fully 1,000 UK business leaders from companies of all sizes expressed the extent to which they were incentivised by government funding for innovation, including R&D tax credits, and gave their views on where future support would be best targeted.

The study revealed a clear gap between the views of small businesses and those of companies in general (see ***Appetite for innovation***). Some 80% of businesses with more than 50 staff said innovation was either essential or a high priority; but less than half of smaller businesses said this was true for them.

### KEY POINTS

- Many businesses believe they are not eligible to claim research and development tax relief.
- Any size business can qualify even loss-making ones.
- Discuss development work with a company's technical staff rather than the finance team.
- Four main types of costs qualify: those on staff, contractors, materials and software.

Innovation was not a high priority for more than 50% of the UK's smallest companies (those with between one and 50 employees).

Rather than avoiding innovation, our view is that smaller companies do not give it the same priority as large companies because they have neither the time nor resources to dedicate to it. Their uptake of government incentives is similarly low: almost three-quarters (73%) of the small businesses surveyed had not used direct support for innovation, compared with just 13% of larger companies. Low take-up suggests start-ups and small businesses are subject to a lack of awareness. Research and development tax incentives are designed to encourage companies to invest further in innovation; they cannot achieve this if eligible companies are unaware of their existence.

Although the government has committed to removing some of these barriers to access, tax advisers can take a more active approach to educating their clients on R&D tax credits as a valuable source of funding.

## Identify eligible businesses

The complexity of the R&D tax legislation can deter companies and advisers, while many clients say they have missed out on claims due to a lack of awareness. Not every company will be able to claim, but R&D tax credits are not just for niche sectors. Advisers can do more to close the gap between those who innovate and those who claim.

The following checklist could help advisers who want to make an initial assessment of whether their client might qualify before approaching them. To qualify, the business must:

- Be subject to UK corporation tax because R&D tax credits are claimed through the corporation tax system – but they can be any size, in any sector, and even be loss-making.

- Have undertaken work that attempts to resolve technological or scientific uncertainty – this terminology is from the definition of R&D for tax purposes.
- Have spent money on this work – expenditure on staff, subcontractors, materials, and some utilities are potentially qualifying costs that can be included in a claim.

It is relatively simple to identify whether the first of these criteria is relevant but, given the complex nature of R&D tax legislation, the second and third can be more challenging.

## What is R&D?

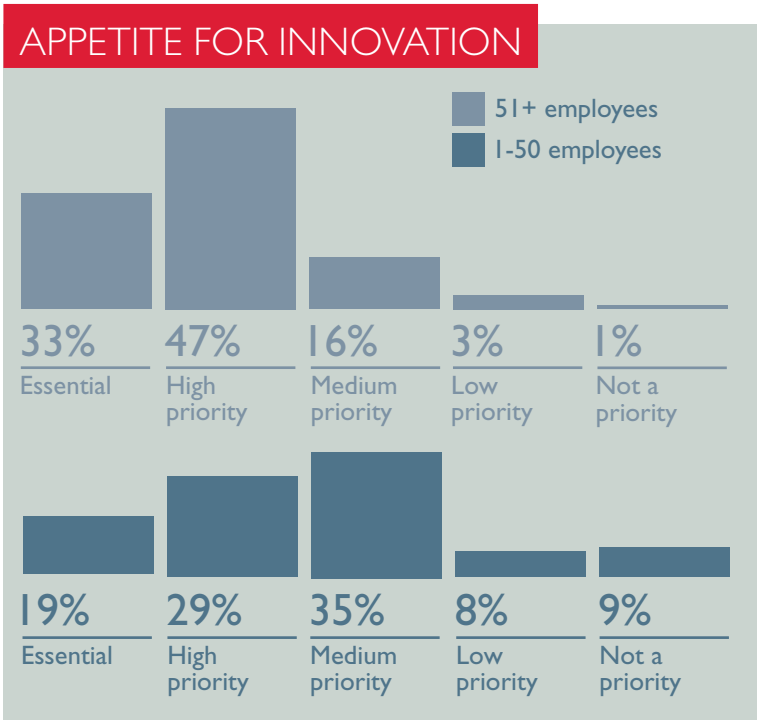
One of the most pervasive misconceptions in this area is that R&D tax incentives are only for those who undertake scientific research in a laboratory. We attribute this to the terminology that makes up the definition of R&D for tax purposes, which was written by the now defunct Department of Trade and Industry in 2004. For example:

> 'Research and development … takes place when a project seeks to achieve an advance in science or technology … through the resolution of scientific or technological uncertainty.'

The definition confuses businesses because they cannot easily relate their business and qualifying R&D projects to this terminology. But what it really means is that, if a business was not sure whether a project was scientifically or technologically possible, or they did not know how to achieve it in practice, it could be carrying out R&D.

The definition is deliberately broad so that it can be applied to any industry – not just laboratory-based ones. Remember that R&D does not need to have been successful to qualify, and that work undertaken on behalf of a client can also be considered.

### APPETITE FOR INNOVATION




For tax advisers trying to assess whether a client could qualify, it is important to be open-minded to R&D potentially taking place in any sector. A client might have designed and built the world's largest disco ball, created proprietary in-app push notification technology or engineered an exact replica of a sports trophy in crystal glass. Rather than trying to identify specific sectors that might qualify for R&D tax credits, it is necessary to review the types of activities being undertaken by a specific business case-by-case. The definition is based on an assessment by a 'competent professional' in the relevant field of science or technology. So it is necessary to discuss the work with the company's technical staff, its developers, engineers or scientists, rather than the finance team to determine whether eligible activities have been carried out.

Often, even technical staff may be put off by the terminology in the definition, so these questions are a useful framework for assessing whether a client's work might meet the definition. Answering 'yes' to any of these does not guarantee a claim, but it does suggest further investigation is warranted.

- Has a client done something to differentiate itself within its sector?
- Has a client taken on something particularly challenging?
- Has a client taken on risk in trying to achieve something?
- Has a client invested time and effort into making efficiency-gains?
- Does a client operate in a market that is specialist, niche or highly regulated?
- Does a client employ highly skilled or qualified technical staff?

## How R&D tax credits work

Most companies, including start-ups, fall into the SME R&D tax credit scheme and can claim up to 33p for every £1 of qualifying expenditure. They can receive a cash benefit – even if their business is loss-making.

For many, R&D tax credits are an important source of funding: one that can spark the next big project or fund the final push in creating something remarkable. Small and medium-sized enterprises claiming R&D tax credits report that they have been able to hire staff, open new offices and change the culture of their business.

If eligible, a company can typically look back to claim R&D tax relief for its previous two completed accounting periods. The total value of the incentive is based on a business's R&D expenditure, its profit or loss for the year and and the corporation tax rate. See ***Total value*** (on page 20) for a calculation based on £250,000 of qualifying R&D expenditure.

The difference between the effective tax saving in the example for loss-making versus profitable SMEs may at first seem counter-intuitive. However, it should be recalled that a profitable SME has already been able to reduce its taxable profits by 20% of the R&D expenditure under general corporation tax rules. The total relief on R&D expenditure is therefore 46%.

There are several factors to consider. If a business has received a grant or subsidy, is connected to other

## TOTAL VALUE

| Loss-making SMEs = 33% | Profit-making SMEs = 26% |
|---|---|
| £250,000 x 130% (enhancement rate) = £325,000<br>£250,000 + £325,000 (enhancement) = £575,000 (enhanced expenditure)<br>£575,000 x 14.5% (surrender rate) = £83,375<br>£83,375/£250,000 = 33% | £250,000 x 130% (enhancement rate) = £325,000<br>x 20% (corporation tax rate) = £65,000<br>£65,000/£250,000 = 26% |

enterprises or undertakes R&D for others, some or all of the claim might fall under the R&D expenditure credit scheme for large companies, which has a less generous tax credit rate (9%). They may not prevent a company claiming, but they will require advice to ensure expenditure is treated correctly within the claim.

## Identifying qualifying expenditure

There are four main types of costs that can be included in an SME R&D tax credit claim:

- Expenditure on staff, including wages and salaries, employers' National Insurance and employer pension contributions.
- Expenditure on subcontractors, agency workers and freelancers.
- Expenditure on materials and consumables (including heat, light and power) that are used up or transformed by the R&D process.
- Expenditure on some types of software.

Before apportioning these costs to calculate the client's benefit, it is worth investing time to analyse the money that has been spent on R&D and review the records available to support the claim. Properly scrutinising a company's qualifying expenditure can be the making of a claim: only by identifying more qualifying costs can the value of the credit be increased. Robust record-keeping for R&D expenditure is also important to ensure claims stand up to scrutiny should HMRC raise an enquiry.

## Clients' accounts

Many companies carry out eligible R&D activities for several years without realising that this work qualifies for relief, so it may not be an obvious change in the expenses incurred that warrants investigation into R&D tax credits. The best way to identify an eligible company is through understanding its business, its appetite for innovation and the work that it does. However, there are triggers to look out for when gathering financial information to prepare the accounts.

Typically, the largest element of a company's R&D claim relates to salaries for staff carrying out projects. These costs may be difficult to distinguish when preparing the accounts, because eligibility depends on the role of the person, not the size of their salary. However, if there is a significant increase in headcount this could be a sign of a major project kicking off during the period, and therefore be worthy of investigation.

An unexpected jump in subcontractor costs, particularly in administrative expenses (as opposed to cost of sales), could be evidence that the company has had to engage some external resources to support a project. This is a common way to make fast progress in the development process, giving the company time to complete feasibility studies before making the commitment to hire additional staff.

Identifying relevant R&D expenditure early in the accounts preparation process can help to maximise the R&D claim by ensuring that this expenditure is easily identifiable from general business expenses. One solution is to set up an R&D subcontractors ledger instead of booking all supplier costs into 'purchases'. Do not leave it until tax return time to discuss R&D claims with clients.

There are some instances when accounting treatment can have a significant impact on the R&D claim. Generally, the expenses eligible for R&D tax credits are operational costs and will already have been expensed to the profit and loss account or income statement. However, because many development projects involve significant cost outlay in lieu of future income, companies and accountants sometimes book R&D costs to the balance sheet to match the expenditure to the associated revenue flows.

To address this, there are special provisions that allow a company to deduct, for tax purposes, revenue expenditure on R&D that has been treated for accounting purposes as an intangible fixed asset. In effect, these rules result in the company being in the same tax position as if it had expensed the costs.

Problems can occur when development costs are inadvertently treated as tangible assets. At worst this can prevent the expenditure being included in an R&D claim; at best, it complicates the tax treatment or delays the benefit of the claim. Again, the message is to make sure R&D tax credits are discussed early so that accounting decisions can be made in full understanding of the nature of the expenditure.

## Conclusion

Research and development tax incentives are an essential part of the government's business strategy; they help to nurture home-grown talent and attract global investment into the UK. But their effects will not be fully felt if they do not reach their intended targets. For this reason, raising awareness for R&D tax credits and addressing misconceptions on eligibility should be a priority. A successful claim requires a detailed assessment of the activities and expenditure against the R&D tax legislation. Anything less is not in the best interests of clients or the future of R&D tax incentives. ■

**Jenny Tragner** is a director at R&D tax credit consultancy ForrestBrown and is a member of the UK R&D consultative committee. ForrestBrown was named 'Best Independent Tax Consultancy Firm' at the 2016 Taxation Awards. Contact: hello@forrestbrown.co.uk.