Subcontracting expenditure: merged R&D rules

Large Corporate OMB

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We consider changes to the rules surrounding subcontracting expenditure to be introduced under the new merged R&D tax relief scheme.

Key Points

What is the issue?

The introduction of the new merged R&D tax relief scheme will attempt to finally clarify the rules surrounding subcontracting expenditure. This has historically presented a challenge for companies as it is not defined in the legislation.

What does it mean for me?

The new rules are designed to better incentivise R&D by ensuring the company making the decision to undertake R&D can receive the relief for that expenditure.

However, while some companies will benefit, others will find that their R&D claims are substantially reduced or that they are no longer eligible for relief.

What can I take away?

Many companies have been undertaking R&D and making claims for R&D relief for many years but will have to review their operations and the underlying contracts carefully to assess whether they will be eligible to claim for expenditure incurred on their R&D activities in the future.

The introduction of the new merged R&D tax relief scheme will attempt to finally clarify the rules surrounding subcontracting expenditure, an area that has historically presented a challenge for companies as it is not defined in the legislation.

What are the existing rules?

SME R&D tax relief scheme: Under the SME R&D tax relief scheme, payments to subcontractors attributable to relevant R&D undertaken on behalf of the company are a qualifying category of R&D expenditure.

R&D Expenditure Credit: By contrast, under the R&D Expenditure Credit (RDEC) scheme, subcontracted costs may only be included within a company’s qualifying R&D expenditure where the work is contracted to be undertaken by a qualifying body, an individual or a partnership (each member of which is an individual).

Subcontracting company: To prevent double claiming, if a company undertakes R&D that has been subcontracted to it by a third party, it is unable to make a claim under the SME scheme. Relief may, however, only be claimed under the RDEC scheme if the R&D has been subcontracted out to it from a large company or from a person otherwise than in the course of carrying on a chargeable trade (Corporation Tax Act (CTA) 2009 s 104C).

How is qualifying R&D expenditure calculated?

Different rules apply to the calculation of the qualifying R&D expenditure depending on whether the contracting party is connected (see CTA 2010 s 1122) or unconnected. These apply regardless of whether the subcontractor is resident in the UK or overseas.

For SMEs, if the R&D claimant and the subcontractor are unconnected, the claimable amount is 65% of the amount paid to the subcontractor for undertaking activities that are part of the company's R&D.

If the company and the contractor are connected, the company can claim the lower of:

- the payment that it makes to the subcontractor; and
- the relevant expenditure of the subcontractor.

The relevant costs are those incurred in delivering the R&D; however, the rules do not provide for a connected party subcontractor to further subcontract the work (CTA 2009 s 1134), so any such expenditure is excluded.

A company and unconnected subcontractor may also jointly elect to be treated as connected. This offers the potential to increase the R&D claim if the gross margin on the R&D work is less than 35%. However, this is rarely seen as few third parties would be willing to disclose their costs in this way (CTA 2009 s 1135).

If a large company or one that is undertaking R&D that has been subcontracted to it makes a claim under the RDEC scheme, subcontractor payments made can be included without the above restrictions (CTA 2009 ss 104E and 104K). By contrast, an SME claiming under the RDEC scheme because the R&D project was subsidised will have to apply the rules under CTA 2009 ss1134-1136.

What is the issue?

As noted, there is no specific definition of subcontracting in the current legislation and so it takes its common meaning. To fill this void, the HMRC guidance suggests that: 'Where there is a contract between persons for activities to be carried out by one for the other, and those activities form the whole of an R&D project or are part of a wider R&D project, then R&D activities have been subcontracted.'

In recent years, however, HMRC has taken a more aggressive stance. It has sought to expand this definition, stating that: 'Any activities carried out in order to fulfil the terms of a contract (whether for R&D or for wider commercial activity) are considered to have been contracted to the company.' This has created considerable uncertainty for SMEs, as a similarly uncommercial approach applied to the subsidised rules was rejected entirely by the First-tier Tribunal in *Quinn vs HMRC* [2021] UKFTT 437.

Furthermore, substantial changes are proposed to the R&D rules with the introduction of the new merged R&D scheme. As a result, while some companies will benefit, others will find that their R&D claims are substantially reduced or that they are no longer eligible for relief.

Merged R&D rules

The government published the draft legislation for its new merged R&D scheme on 18 July 2023. Despite the representations of the professional bodies that this was 'too much, too quickly', it was confirmed in the Autumn Statement that the government would be implementing these measures with minor modifications for periods starting on or after 1 April 2024. We expect to see this laid before Parliament in the Budget this month.

The headline measure is that relief under the merged R&D scheme will be delivered through a taxable expenditure credit, in a similar way to the existing RDEC scheme for all eligible companies, with separate rules for loss-making R&D intensive SMEs based on the existing scheme. However, both schemes see significant changes to the subcontracting rules that are, if anything, more significant.

How does this affect subcontracting costs?

The treatment of contracted out R&D expenditure under both schemes would be more aligned with the rules for the current SME scheme:

- Subcontracted expenditure will be a qualifying category of R&D expenditure for all companies undertaking R&D (Finance Bill 2023-24 adds CTA 2009 ss 1042E and 1053).
- Companies undertaking R&D that has been subcontracted to them from a third party will be unable to make a claim under the new rules, unless the

contracting party is an ‘ineligible body’ or a person not acting in the course of a trade, profession or vocation within the charge to tax (Finance Bill 2023-23 adds CTA 2009 ss 1042F and 1053A).

It should be noted that subcontractor expenditure will be calculated using CTA 2009 ss 1134-1136 and so may be less in some cases. The definition of an ineligible body follows that of a qualifying body (CTA 2009 s 1142). However, it has been extended so that group companies may jointly elect for a contracting party to be considered ineligible so that a contractor can claim instead. This allows groups in which the R&D is undertaken by multiple companies which all claim relief under RDEC to continue to do so.

How do I know whether the R&D has been contracted out?

There has been a welcome attempt to bring clarity to the subcontracting rules by replacing CTA 2009 s 1133 with a new definition of ‘contracted out’ that aims to determine who was the ‘decision-maker’ for the R&D, and thus who is entitled to claim relief.

‘(2) A person “contracts out” research and development if:

a) the person enters into a contract under which activities are to be undertaken for it (whether by another party to the contract or by a subcontractor);

b) the activities undertaken in order to meet the obligations owed to the person under the contract include research and development; and

c) it is reasonable to assume, having regard to the terms of the contract and any surrounding circumstances, that the person intended or contemplated when entering into the contract that research and development of that sort would be undertaken in order to meet those obligations.’

All three conditions must be met for work to be contracted out, with the R&D that is contracted out limited to ‘the research and development referred to in sub-section (2)(b), to the extent that sub-section (2)(c) is satisfied in relation to it’. Thus, if the nature of the R&D undertaken differed from that initially intended, the right to claim R&D would rest with the contractor, because the decision to carry out the work would have been undertaken of the contractor’s own volition.

The key to this is when it is reasonable to assume that the person engaging the subcontractor intended or contemplated that R&D would be required to meet the obligations of the contract. This may not be easy to determine after the event, and the temptation for many contracting parties will be to use their size and power to argue that any R&D required was never intended. To forestall this, HMRC has issued detailed guidance on the new rules.

In this, it clarifies that the words ‘intended or contemplated’ carry a greater weight than mere belief, or even knowledge, that R&D will be required. For R&D to be contracted out, the customer will need to show a ‘specific appreciation of what R&D will be done and therefore the ability to understand and specify that’, going as far as stating the advances in science or technology sought and any uncertainties to be addressed. Simply noting the challenges faced by a project or speculating or accepting that R&D may be needed will not suffice. While not a condition of the legislation, HMRC therefore infers that the company will have to be able to draw on significant technical expertise to understand the work required.

What evidence will be required?

It is clear that these rules will place significant demands on companies to document any R&D activity contemplated prior to entering into a contract. Regardless of whether the contracting company asserts they intended the R&D would be required, or whether the contractor claims to have undertaken the R&D of their own volition, it is easy to envisage HMRC asking companies for a significant degree of evidence to support this.

Any assessment should be made ‘having regard to the terms of the contract and any surrounding circumstances’. HMRC has confirmed that while the contract wording is important, it recognises that it may not contain full details of any R&D contemplated. Further evidence may therefore be provided by any documentation leading up to the contract or by internal project documentation such as contemporaneous minutes or project plans.

These must be supported by the commercial and organisational details of the R&D project. As with many areas of tax, it is necessary to look at these overall circumstances in the round, to form a balanced view on which party is the decision maker for the specific R&D activity.

These circumstances might include (but are not necessarily limited to):

- intellectual property ownership;
- financial risk in undertaking the work;
- autonomy in how the activity is executed;
- how the R&D is to be exploited;
- the decision-making process;
- the experience and seniority of decision takers; and
- the nature of the parties (e.g. typical work undertaken).

Is overseas expenditure to be restricted?

The introduction of the merged scheme also takes the opportunity to reintroduce the proposed restrictions on overseas R&D expenditure that were deferred at the last Budget. Relief for subcontracted R&D will be limited, based on where the activity takes place, subject to certain specific exceptions.

Expenditure on payments to contractors must either be:

- 'UK expenditure' on R&D undertaken in the UK; or
- 'qualifying overseas expenditure' undertaken outside the UK in certain specific circumstances.

It should be noted that R&D is undertaken in the UK to the extent that the activities which are part of the R&D project actually take place in the UK, regardless of where any factors used for the R&D project (such as materials) are sourced. If activity takes place partly in the UK, it should be apportioned appropriately.

Overseas expenditure on contracted out R&D may, however, qualify for relief if: the conditions necessary for the R&D are not present in the UK; they are present in the location where the R&D is undertaken; and it would be wholly unreasonable for the company to replicate the conditions in the UK (CTA 2009/1138A(2)).

This may be due to geographical, environmental or social factors (for example, the presence of specialist test facilities) or due to legal or regulatory requirements (for example, clinical trials); and it is reasonable to consider timeliness when considering whether it is reasonable to replicate the conditions in the UK. However, the cost of the work and availability of workers are specifically excluded as factors enabling expenditure to be qualifying overseas expenditure (Finance Bill 2023-24 Sch 1 para 9(12)).

This will particularly have implications for more mobile sectors, such as technology, as well as industries that rely on pockets of specialist expertise globally, such as the space industry. Multinational groups will also have to consider how they structure projects to minimise any elements of R&D projects undertaken by fellow group companies (or their staff) overseas.

In addition, further guidance is required from HMRC regarding how the rules will be interpreted, in particular concerning qualifying overseas expenditure. HMRC agree that a company that needs to use a particular facility for R&D purposes which is not available in the UK on a reasonable timescale would qualify. However, there is a lack of clarity in determining whether the overseas subcontractor is the only available provider with the necessary skills or experience in the field. HMRC may argue that staff can be trained or relocated more easily than a facility, but this is not a practical or timely option in many cases. In such cases, we would advise companies to carefully document the reasons for carrying out any overseas R&D, and why it would be unreasonable to replicate these conditions in the UK.

In summary

The new rules benefit large companies and those at the top of supply chains. While the ‘decision makers’ behind the project should still be assessed on an individual basis, the wording of the new subcontracting test will enable many to claim for a greater number of projects than they previously realised and for a wider range of subcontracted expenditure than under the old RDEC scheme.

Conversely, the view for many smaller companies that make up their supply chains is less positive. The new scheme represents a further small reduction in R&D rate to 15% for companies at the main rate of corporation tax and to 16.2% for the small companies rate.

Many companies have been undertaking R&D and making claims for R&D relief for many years but will have to review their operations and the underlying contracts carefully to assess whether they will be eligible to claim for expenditure incurred on their R&D activities in the future. Worst affected will be those SMEs that have been claiming under the RDEC scheme for contracted out projects, as they may now be ineligible for relief.

The news is not all bad for SMEs, as the removal of the restrictions on subsidised expenditure may enable lossmaking companies in R&D intensive industries that have received grants to claim tax credits under the R&D intensive scheme.

Given the scope of these changes, and the additional work required to satisfy HMRC, agents should engage with clients as soon as possible to help them understand the new rules and address these in their contracts and project documentation. Otherwise, the risk is that many firms may find themselves unable to claim or simply opt not to, investing in more R&D friendly jurisdictions instead.