Eligibility for R&D tax relief

Large Corporate OMB

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Two recent R&D cases, finding in favour of the taxpayer, revolved around whether R&D activities were subcontracted or subsidised, impacting the eligibility for tax relief.

Key Points

What is the issue?

The Finance Act governs R&D tax relief rules, including definitions and claimable costs. Despite no legislative changes, HMRC updated its guidance in 2021, altering interpretations of subcontracted and subsidised R&D.

What does it mean for me?

The changes led to inconsistencies between HMRC and taxpayers' interpretations, causing confusion and disputes, as illustrated in the recent First-tier Tribunal cases of *Collins Construction* and *Stage One Creative Services*.

What can I take away?

The tribunal rulings, though not setting a binding legal precedent, provide clarity and reassurance for taxpayers. HMRC's decision not to appeal suggests a potential shift towards more nuanced definitions of contracted R&D, benefiting future claims under the SME and RDEC schemes.

In November, the First-tier Tribunal recorded the second significant taxpayer victory in research and development (R&D) cases in a matter of weeks. HMRC had taken both cases – *Collins Construction Ltd v HMRC* [2024] UKFTT 951 and *Stage One Creative Services Ltdv HMRC* [2024] UKFTT 1059 – to the tribunal on the argument that the activity claimed had been subcontracted to the taxpayer by customers and/or had been subsidised indirectly by related revenues.

However, in both instances, the judge found that the pertinent facts did not meet the definitional threshold for these classifications and allowed the claims as they had originally been submitted.

Following these eagerly awaited First-tier Tribunal results, we shall examine why these claims reached this point, how the results impact HMRC's recent and new positions, and what it means for any live enquiries tied up on this topic.

The legal framework and changes to HMRC's guidance

The R&D tax relief rules are set out in Part 13 of Corporation Tax Act 2009. Everything from the rates of relief, claimable costs and even the definition of R&D are all stipulated within this legislation and related guidance.

Prior to major scheme overhauls in 2023, the rules on subcontracted and subsidised R&D – stipulated within the Corporation Tax Act 2009 ss 1138 (for SMEs), 1052 and 1053 – hadn't changed. One might think, then, that HMRC's stance on the subject would have remained consistent throughout that time.

Despite this, on 30 November 2021, HMRC updated its Corporate Intangibles Research and Development (CIRD) Manual with new guidance. CIRD 84250 and 81650 – their interpretations of the Corporation Tax Act text around subcontracted and subsidised costs – were amended, significantly changing their meaning.

This change in guidance is the core reason for such turbulence regarding subcontracted and subsidised R&D and has surely led to an inconsistency between the HMRC and taxpayers' interpretations of the presiding legislation. Here, we take a look at the previous and updated texts from HMRC's CIRD Manual, and why they have caused so much ambiguity.

The scope of R&D activities

The changes have created confusion and uncertainty around the scope of R&D activities eligible for tax relief, especially in industries like construction, creative services and engineering, where R&D may be embedded within larger commercial projects.

Consider a construction company which is contracted to design and build a new high-rise tower. It may need to carry out R&D in order to manifest an innovative structure that achieves an architect's design concept. Under the earlier guidance, the contract for services would include designing and building the building; and the R&D activity (researching and developing methods to achieve a concept structure) would be distinct from this. This would mean that the construction company could claim for the R&D under the SME scheme (large company measures allowing).

Under the new guidance, as there was a contract in place whilst the R&D occurred, even though the R&D wasn't the subject or focus of the commercial agreement, then the activity would be classed as contracted to the builder, preventing the builder from claiming under the SME scheme (or perhaps from claiming at all).

Subsidised expenditure

This is mirrored in the approach to subsidised expenditure. In the 2021 updates, HMRC provided more information on what it considered to be subsidised, stating: 'Payment received for undertaking a contract will be considered to meet expenditure incurred in undertaking that contract.'

This is a very broad statement and provides scope to apply this rule widely to individual projects with very different commercial dynamics. Further, this is in direct contradiction to a 2021 First-tier Tribunal judgment, which was decided against HMRC shortly before these changes to the CIRD Manual were made.

In *Quinn (London) v HMRC* [2021] UKFTT 437, HMRC claimed that costs incurred on R&D were 'met … indirectly' by Quinn's clients; and were therefore subsidised by virtue of Corporation Tax Act 2009 s 1138(1)(c) 'to the extent that it is otherwise met directly or indirectly by a person other than the company'.

Quinn argued that the contracts it engaged in were contracts for services (i.e. finished building works); that it was liable for the workmanship, adequacy of materials and insurance liabilities; and that it needed to meet these obligations through its own expenditure.

Judge Morgan found in favour of Quinn, on the basis that there was an 'absence of a clear link between the price paid by the client/customer and the expenditure on R&D'. In other words, there was a dissociation between what the customer was paying for and the R&D costs – there was no intrinsic link between the two – and so the expenditure had not been 'met directly or indirectly by a person other than the company' as per CTA 2009 s 1138(c).

The approach of Judge Morgan was adopted in the Upper Tribunal case of *HMRC v Perenco UK Ltd* [2023] UKUT 169. Although *Perenco* concerned a different statutory regime, the judges applied a similar approach as Judge Morgan, stating that 'para 8 [pertaining to subsidies] does not encompass a payment made in return for the provision of goods or services'.

The recent R&D findings

Given this ambiguity around subcontracted and subsidised status, two lead cases were recently decided at the First-tier Tribunal, with many more standing behind them.

The case of *Collins Construction*

In the case of *Collins Construction*, HMRC's case for subsidised expenditure reflected the same arguments as those it made in *Quinn*. Given that the legislation (s 1138(1)(c)) on subsidised expenditure states that expenditure shall be classed as subsidised 'to the extent that it is otherwise met directly or indirectly by a person other than the company', HMRC submitted that Collins' customers had paid for the R&D activity indirectly, since Collins had received payments at an agreed price for a service or product (construction activity) that it provided using the relevant R&D.

Judge Sukul stated that HMRC seemed to consider s 1138(1)(c) as not being ‘constrained, coloured or shaped’ by reference to ss 1138(1)(a) or (b). This would mean that ‘expenditure otherwise met directly or indirectly’ would include expenditure covered by revenues from R&D derived outputs, rather than referring to grants, state aid or other less conventional forms of subsidy.

However, Judge Sukul ruled that the ‘natural interpretation of these provisions … is not intended to apply in circumstances such as those in this case’. She particularly drew attention to the need for a clear link between the revenues that the claimant received and their expenditure on R&D. She stated that in ss 1138(1)(a) and (b), the wording ‘obtained … in respect of’ sufficiently indicates that an intrinsic link between the revenues received and the R&D costs should exist, in order for that expenditure to be deemed subsidised.

She goes on to say that, in the case of Collins’ projects:

‘The price which is then agreed may or may not in fact be sufficient to cover the costs actually incurred … with the appellants simply factoring costs such as those relating to R&D into the price it wishes to charge in order to seek to achieve its desired commercial return.’

The case of *Stage One Creative Services Ltd*

These sentiments were echoed in the *Stage One Creative Services Ltd(SOCS)* result.

In this case, Judge Scott cited that while the agreed ‘price might, and clearly sometimes did, change’ throughout the duration of a project, it also was relevant to consider that ‘it also might not suffice to cover the costs incurred when fulfilling the contract’.

What was very important here is that SOCS made an outright loss on one of the three example projects analysed. Specifically, the R&D project required more man-hours for prototyping and testing than had been anticipated, increasing the costs, which were not passed on to the customer. Such facts clearly demonstrated that there was no intrinsic link between the R&D activity and the revenue that SOCS received, and therefore the costs had not been ‘met directly or indirectly by a person other than the company’.

Although the subsidised category is discontinued in the merged R&D Expenditure Credit (RDEC) scheme, Judge Scott's view here aligns with the view of project ownership taken in the merged RDEC scheme, where technical knowledge, IP ownership and understanding of specific technical challenges are all pertinent points of consideration when determining the rightful claimant to a project.

Subsidised expenditure across industries

For those claims currently tied up in an enquiry on this argument, and those yet to be submitted under the SME and RDEC schemes, these rulings might be seen as highly generous to the claimant, particularly for certain industries. One might be able to see how the facts of the cases match with HMRC's recent CIRD Manual guidance on subsidised expenditure. However, as described later in the article, Judge Scott was aware of this alteration in opinion within HMRC and instead applied the logic of HMRC's previous guidance notes.

Having reviewed the cases of *Quinn*, *Collins* and *SOCS*, it seems likely that the majority of construction and engineering activities would not be deemed subsidised, given the lack of connection between prices charged for services and the costs of specific R&D activities. However, for other industries, such as software development, where time is more likely to be charged out to customers at an hourly rate which is recorded and billed, there is more likely to be an intrinsic connection between the money flows, and these costs could be more likely to be classed as subsidised.

Somewhat surprisingly, the contracted argument received much less explanation in the conclusion notes of both Judge Sukul and Judge Scott.

Historic guidance favoured by judges

In the case of *Collins*, HMRC's position was that since Collins had entered into contracts including 'design, manufacture and construction obligations' and the expenditure was incurred to fulfil those obligations, the activity should be deemed as contracted to them. This was supported by numerous examples of requirements that should be delivered by Collins as part of their contract with their customer to a fairly high degree of specificity; for instance, brass cladding to several fire escape

doors on one of the sites.

Collins' position was that since the R&D activities specifically were not required by the terms of the contract, nor did the parties reasonably know that they were needed at the time of signing, then the activity itself was not contracted to them. This position is in line with HMRC's historic view on subcontracted activity, and very much in line with HMRC's upcoming view of contracted R&D under the merged RDEC scheme and the enhanced R&D intensive support (ERIS) scheme.

Judge Sukul also supported Collins' position in her decision. She used the fire escape doors as an example – incorporating brass into the doors reduced their resilience to fire, and R&D was conducted to improve this resilience whilst still incorporating the brass. The R&D needed to achieve this was not contracted to Collins.

Collins stated that they hadn't known this R&D was needed at the time of the contract; that the customer had no technological expertise to understand the issue; and that they themselves retained the IP generated from the exercise. Furthermore, many specifications within these contracts led to R&D activities being 'indistinguishable from those that did not lead to R&D'.

Judge Scott took much the same view in her assessment in the case of *SOCS*.

Both Judges Sukul and Scott were careful to review the purpose of the contracted R&D provisions, including preventing market failure associated with enhanced reliefs hitting large companies, and the more common prospect of double claiming. However, Judge Scott states:

'[Since] SOCS' clients did not know the detail of any R&D or the extent, if any, of R&D there could not be competing claims for R&D. In circumstances where SOCS owned the intellectual property at all times, we heard no evidence as to how a client could claim for R&D in that regard.'

In both cases, the claimant's customers couldn't argue an entitlement to claim themselves; therefore, both judges deemed that the claimants owned the R&D activity. They denied HMRC's view that the activity had been subcontracted and awarded that the claims could remain in full under the SME scheme.

Once again, these decisions have been taken based on historic HMRC guidance on the topic.

The new guidance states 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.’

However, instead of agreeing with the new guidance, Judges Sukul and Scott took a nuanced approach based on myriad transactional factors such as knowledge and understanding of the activity, awareness of the extent of the activity, financial risk and intellectual property ownership.

One wonders whether HMRC would have carried these cases this far had it not changed the CIRD Manual to these new definitions.

The key difference between *Collins* and *SOCS*

The *SOCS* case differed from *Collins* in a key way. HMRC was pursuing discovery against SOCS for prior accounting periods, arguing that SOCS’s tax returns contained an under-declaration of tax due to a mistake in the returns in relation to the prevailing general practice of the time. In other words, HMRC was attempting to extend the enquiry, and therefore tax repayment, to the two prior accounting periods. It was trying to do so based on its current published view on subsidised and subcontracted R&D, which – as already discussed – changed dramatically in 2021.

Ryan’s Director of Tax, Nigel Holmes, was brought as a witness to attest to HMRC’s change in interpretation. Much evidence was given on the matter of ‘the practice generally prevailing’, including witness examination and cross-examination, reviews of minutes and notes from HMRC’s own meetings of the Research and Development Communication Forum, as well as an assessment of contemporaneous literature.

To summarise all this evidence, the important facts laid out by Judge Scott were that, despite its claims to the contrary, HMRC’s altered Corporate Intangibles Research and Development guidance did remove the nuance from the assessment, and ‘made it clear that only freestanding R&D [that not instigated by the needs of an end customer] could qualify’. Furthermore, regarding the guidance on subsidies, where the old guidance said that ‘there had to be a clear and direct link’, the updated guidance notes said instead that ‘payment under a contract would be such a link’.

Judge Scott concluded that there had been a practice generally prevailing based on the earlier version of the CIRD and that SOCS' returns had been submitted in accordance with it. Her conclusions will be helpful for many claimants embroiled in enquiries on this topic.

Conclusion

The justifications for the rulings are clear and understandable, and underpinned by a logic not dissimilar to HMRC's own rules on contracted R&D in the merged RDEC and ERIS schemes. It might seem that HMRC's shift back towards the nuanced definition of contracted R&D is for the best. Hopefully, it will bring clarity and consistency back into what has been an unclear and contentious topic. Surely the removal of the subsidised category will contribute to such a movement.

Either way, although First-tier Tribunal cases don't set a binding precedent, HMRC has chosen not to appeal either of them, so the many enquiries still resting on this will hope that HMRC applies these rulings and closes in the claimant's favour. And, for those yet to claim under the SME and RDEC schemes, hopefully this brings certainty and reassurance to claim submissions.