ICAEW
REPRESENTATION 23/24

RESEARCH AND DEVELOPMENT TAX RELIEFS: NEW CONTRACTING OUT RULES AND OVERSEAS RESTRICTIONS – DRAFT HMRC GUIDANCE

Issued 29 February 2024

ICAEW welcomes the opportunity to comment on the Research and development tax reliefs: new contracting out rules and overseas restrictions – draft guidance published by HMRC on 9 February 2024, a copy of which is available from this link.

For questions on this submission please contact our Tax Faculty at taxfac@icaew.com quoting REP 23/24.

This response of 29 February 2024 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

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KEY POINTS

1. The guidance on the new contracting out rules is much clearer than the previous version and we appreciate the changes HMRC has made in response to our earlier comments. We believe that there remain a few areas where further clarity would be helpful. We have indicated these as comments added to the wording of this guidance which has been replicated in appendix 2.
2. In particular, we do not believe that the changes help to fully clarify what happens when an arrangement between the customer and the contractor is governed by multiple contracts (signed on different dates) and how this impacts the need to test whether the contractor contemplated the R&D at the time of the contract.
3. We would also appreciate greater clarity on a requirement stated in the guidance that the carrying on of R&D needs to be the primary objective of the customer (A) in engaging the contractor (B).
4. We believe that the guidance relating to overseas expenditure is now relatively clear but could be made stronger where it makes reference to the two excluded conditions, 'cost of the R&D activity' and 'availability of workers to carry out the R&D activity'. Section 6.2 makes it clear that where there are also other factors in determining whether the conditions necessary for the R&D are in the UK, then, provided the other conditions at s1138A (2) CTA 2009 are met, this would not prevent the relevant overseas expenditure from being disallowed. We believe that this needs to be made clearer in other parts of the guidance.

SPECIFIC POINTS

OVERSEAS EXPENDITURE

Section 3.2 (Evidence to support a claim)

5. Could HMRC provide more details on the sort of evidence it would expect companies to keep to demonstrate that the UK R&D test is met?

Sections 4 and 5 (Overseas expenditure)

6. Example 2 in section 4.1 and example 3 in section 5 appear to reflect a more relaxed attitude by HMRC as to circumstances in which it is wholly unreasonable for a company to replicate conditions in the UK that are present overseas. Has HMRC softened its approach in this regard?
7. In example 4 it says: "If there is time pressure and UK facilities are available but are fully booked on the required timescale, the condition at (2)(c) would apply if the activity were undertaken outside the UK". Just to confirm, does this mean that the expenditure would, or would not qualify?
8. The examples are generally very helpful. In addition, we would appreciate more examples which show expenditure being restricted on the basis that it would not have been unreasonable to replicate in the UK conditions that existed overseas.

Section 6.1 (Conditions)

9. The inclusion of the bullet point "centres of human expertise such as university or other research groups" Is potentially quite confusing. Looking at 6.2 and the relevant examples, we are struggling to see how this could be a valid 'condition'. Could HMRC include examples to illustrate this?
10. Immediately following Example 15 there is a sentence which reads: 'The exclusion in CTA09/1138A(3)(b)(ii) does not extend to other "people related" factors such as location

close to key investors or to a leading university research group which might provide advice or guidance, unless these individuals are workers carrying out R&D.'

11. We take this to mean that the presence in that overseas place of the people doing the R&D is excluded, but the presence of people who may support (indirectly) those people doing the R&D is possibly a valid condition. Is that correct?

Section 6.2 (Excluded conditions)

12. The paragraph immediately before Example 13 includes the sentence: 'For example, the cost of constructing or adapting the facility referred to above may or may not be a cost of the R&D, depending on whether it is a cost of the R&D.' This doesn't seem to add any clarity and might be better expressed.
13. The cross referencing has gone awry in Example 17, this refers back to 'Example 2.4' which doesn't exist.
14. Example 17 could probably be qualified in relation to the expression 'training of staff would take too long'. Earlier in the guidance (near the start of 6.2) we are told that: 'where cost is a factor, it will often not be the only one. For example, if time pressures mean that R&D cannot wait until a new facility is developed in the UK, the fact that the staff to operate the facility are in short supply, and therefore expensive to employ, does not mean that CTA09/1138(3)(b)(i) and (ii) prevent the conditions in 1138A(2) being met.' Might that not be a relevant argument here that the R&D needs to be done now and there is no time to train new staff? Otherwise, these two parts of the guidance appear to contradict each other.

CONTRACTED OUT EXPENDITURE

15. See appendix 2.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).

APPENDIX 2

ANOTATED VERSION OF HMRC'S DRAFT GUIDANCE ON CONTRACTED OUT R&D EXPENDITURE UNDER THE MERGED SCHEME

7.1 BASIC PRINCIPLE

The objective of the R&D reliefs is to increase the overall levels of R&D in the UK economy to generate productivity growth by reducing the cost of R&D, counteracting a market failure would otherwise reduce the amount of R&D taking place. This market failure arises because the value of R&D to the broader economy exceeds the immediate economic benefit of the R&D, and because of the risky and uncertain nature of R&D. To ensure that the relief is effective in this, it is important that the company making the decision to undertake R&D gets the relief for that expenditure. Allowing the decision maker to claim best incentivises decisions to undertake more R&D.

To meet this objective, where R&D is carried out under a contract, the new R&D expenditure credit, and the enhanced support for lossmaking R&D intensive SMEs from April 2024, both give the right to claim for contracted-out R&D to the customer, subject to certain exceptions. R&D is defined as contracted out where it is reasonable to assume that the customer intended or contemplated this sort of R&D would be done. Such a contract might cover an entire commercial project (including R&D and other activities), an entire R&D project or aspects of an R&D project. The rules apply equally to all three cases. The legislation also generally excludes claims for expenditure by the contractor, but with important exceptions. See below for more detail on both points.

However, if a company is contracted to do work for a customer, the company does related R&D and – having regard to all the relevant circumstances – it is not reasonable to assume that the customer intended or contemplated R&D of the sort carried out should be done, then (subject to meeting the other rules of the relief) the contractor can claim. This is not R&D contracted to the company under the new rules, because the decision to initiate R&D will have been taken by the contractor, which is important for the reasons set out in section. The contractor has been engaged to carry on specified work for the customer, not contracted to carry out R&D, so the R&D they do is initiated of its (the contractor's) own volition.

Is there a reference missing here?

It is worth noting that in this context, 'contemplated' does not indicate a minor or fleeting consideration but a more substantial intention[footnote 1]. See section 7.2 below. "Intended or contemplated" goes beyond mere awareness that R&D will take place and requires a specific appreciation of what R&D will be done and therefore the ability to understand and specify that. While the exact details of who should claim the relief will depend on the specific contract and the circumstances around it, this potential for the contractor claiming is a departure from the previous rules in the R&D SME scheme.

Example 18

A company, B, is contracted to provide a product or service which is not R&D, such as constructing a building or developing a software product. From the contract, and the nature of the negotiations to agree it, it is clear to all parties that the customer, A, had no understanding or intention that any R&D should take place. If B undertakes R&D in delivering that product or service, it would be able to claim relief even though it is undertaking R&D on an activity contracted out to it.

Regardless of which party is able to claim, for a claim to succeed it will also of course need to satisfy all the other normal rules (for example, expenditure must be revenue and it must satisfy one of the qualifying categories such as staff costs).

In the amended legislation, CTA09/1133 defines when R&D is contracted out, and when it is not, for sections 1042D, 1042E, 1042F, 1052, 1053 and 1053A, which set out what expenditure a company can claim for.

In particular, there are cases where the contractor can claim even where the conditions of CTA09/1133 would not be met (for example where the customer is not a UK taxpayer, so would not be able to claim itself). These are covered at section 7.5 and on below. However, the interpretation of CTA09/1133 is generally key to who can claim in a given situation and to ensuring that there is not double claiming.

Regardless of which party is able to claim, for a claim to succeed it will also of course need to satisfy all the other normal rules (for example, expenditure must be revenue and it must satisfy one of the qualifying categories such as staff costs).

Repetition of earlier paragraph

7.2 CTA09/1133

Purpose

Section 1133 CTA09 ensures that the costs of contracting out R&D by a customer to a contractor can attract relief for the customer. Where the customer is not contracting out R&D, the contractor can claim relief, if it carries out relevant R&D.

CTA09/1133(1)

This applies the section for the purposes of Part 13, that is, it applies equally for the reliefs provided by Chapter 1A (the merged expenditure credit) and Chapter 2 (the enhanced support for R&D intensive loss-making companies).

CTA09/1133(2)

Subsection (2) defines where a person (the customer) contracts out R&D, and therefore also when another person (the contractor) has R&D contracted to it Unless all three parts of the definition in subsection (2) are satisfied then the customer cannot claim for any payments it makes to the contractor – but the contractor may be able to claim, if it carries out R&D.

CTA09/1133 introduces three conditions, set out in subsection (2), all of which must be met for R&D to be considered contracted out. Together these identify who was the decision-maker for the R&D, and who may claim relief.

Amended. This is easier to understand than a double negative

CTA09/1133(2)(a)

The first condition, at s1133(2)(a) is that there must be a contract. This could be a wider contract for provision of a product or services to include R&D, or it could be a more specific contract solely for R&D activities themselves. In either case any claim for relief by the customer will only be on the expenditure attributable to the R&D.

Does this need to be in writing or can it be oral?

(2)(a) is not addressing whether or not R&D is specified – simply requiring that there is a contract. However, it follows that if there is no contract, then even in a situation where a company (Company A for simplicity) is funding another company (B) which performs R&D, A cannot claim R&D relief in respect of its payments. In such a scenario, unlike the previous SME scheme but like the previous RDEC scheme, company B may be able to claim for any R&D it does despite the fact that A funds it, as there is no prohibition on claiming for funded or subsidised activity.

CTA09/1133(2)(b)

The second condition, at (2)(b) is that to meet the obligations under the contract, R&D is undertaken. If for example company A and company B agree a contract for provision of software in the expectation that specified R&D will be needed but, in the event, the R&D is not carried out (for example because it was found not to be needed) then company A cannot claim for its payments. (If the R&D had been carried out, Company A might be able to claim, subject to (2)(a) and (2)(c) also being met).

CTA09/1133(2)(c)

The third condition, in subsection (2)(c), is that it is "reasonable to assume" that the customer (i.e. Company A) "intended or contemplated" that R&D would be undertaken to meet the obligations of the contract, and that this is R&D of the sort that is referred to by subsection 2(b).

The words "Intended or contemplated", with the specification as to the sort of R&D that is envisaged, carry a greater weight than mere belief, or even knowledge, that R&D will be required. The nature of the R&D that is to be undertaken (such as a statement of the advance in science or technology and what uncertainties need to be addressed) would need to be articulated to show that it is intended or contemplated that R&D of a particular sort should be undertaken. This goes beyond listing project challenges and constraints, to specify specific R&D action.

This might be done in the contract itself, or in discussions leading to the contract, or in internal customer documents showing how the activity was required as part of the wider R&D. Because the activity might be a particular part of the customer's wider R&D, or indeed commercial, project, the customer may not consider it necessary to share this with the contractor. A customer will be able to claim, under both reliefs, for activity which is in the contractor's hands "routine" but which is R&D as part of the customer's project. (For example, a standard test. In a case like that there is little chance of the contractor considering that this is R&D it might claim for, and it should be clear if necessary from a review of the customer's project documentation why it meets the condition. In cases where this is less obvious, the party claiming should ensure that it can if necessary justify the claim. It may be helpful to discuss with the other party if this would help to resolve any doubt, although HMRC recognises that this may not always be possible.

Understanding and articulating the nature of the R&D means that Company A will need to have or draw on some technical capability (whether in-house or from elsewhere) though having this capacity is not in itself the condition that the legislation sets. Mere speculation or acceptance that R&D may be needed will not be sufficient to satisfy 1133(2)(c).

Therefore if the customer, Company A, is indifferent, albeit knowing that work to be taken under the contract could require R&D, then they do not intend or contemplate that it be carried out.

The legislation requires that this assessment is made "having regard to the terms of the contract and any surrounding circumstances". The language of the contract is therefore important, as a source of evidence in assessing what Company A intended or contemplated, but so are the surrounding circumstances. HMRC would expect that where R&D is intended and contemplated, a number of commercial factors will align with that and form part of the "surrounding circumstances" referred to in the legislation. It is necessary to look at these overall circumstances in the round, to determine whether Company A's primary objective is to have a project completed (whether construction of a building or infrastructure, or development of software) or whether Company A's primary objective is to have some R&D performed.

This wording is confusing and potentially contradictory to the point made in example 24. Where this mention's A's primary objective, what is this referring to? Is this the overall commercial arrangement with B? In example 24, A's primary objective would, presumably, still be for the widget to be developed, not for R&D to be carried out. Would there need to be a separate contract in example 24 for the R&D and then another contract for the rest of the work?

This distinction is extremely important. Is the legislation intended to a) only give relief to A where it's primary objective in engaging B is for R&D to be carried out or b) could it also apply where R&D is only a small part of what B will be doing for A? In the absence of this paragraph, this guidance seems to suggest that b) is a possibility but with the paragraph it seems that only a) is possible.

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

- intellectual property (IP) ownership,
- financial risk in undertaking the work
- autonomy in how the activity is executed
- means by which the R&D is ultimately to be exploited
- the decision-making process (for example whether the motivation to undertake the R&D flows from the customer's wider strategy or an immediate tactical challenge recognised by the contractor)
- the experience and seniority of decision-takers
- nature of the parties (for example whether it is evident that B specialises in providing R&D services and the contract is typical of those R&D activities).

These circumstances will not necessarily all be equally relevant or helpful in every case – for example, the question "who bears the risk" can be complex with bespoke, complex risk-sharing arrangements in some sectors such that unpicking who bears the R&D risk will not give a simple unambiguous answer (and the answer may well vary for different aspects of R&D on a single project).

Example 19

A manufacturer (Company A) contracts a third party (Company B) to provide specialist tooling and knows that R&D is likely to be required to develop this. The contract however is just for the provision of the prototype tooling.

These products form part of a wider R&D project of Company A. Although Company A understands that R&D is required and provides a detailed specification of product requirements, it does not possess the specialist expertise in this specific area of engineering.

Company B retains significant financial risk associated with the contract as it is undertaken at a loss (in the hope that Company A's R&D project progresses through to manufacturing, which would ultimately result in large orders being made to Company B).

Although Company A understands that R&D will be required by Company B to fulfil the contract, Company B undertakes the associated economic risk. Furthermore, Company A does not specify for Company B, or set out internally, the R&D required (it is unable to as it lacks the expertise in this area) Company B would therefore (assuming it meets all other conditions) be in a position to claim the R&D relief.

Example 20

Company A (in the Chemical sector) has a product which requires an intermediate to be produced which is combined to form the final product. Company A has one source of supply for this intermediate but commercially this is a risk point, and so contracts Company B to produce the intermediate. The contract is for supply of X tonne at a cost of £Y/ tonne. Company B has a completely different process train (equipment) from that which Company A developed its process for the intermediate and different again from the current CMO supplier. Company A is aware of the difference in Company B's process train, and understands at a high level that Company B will need to develop a process to deliver the intermediate in the quality, quantity and cost of goods required.

Company A may be aware of the requirement for R&D by Company B in order for it to fulfil the contract. Importantly however, Company A is unable to specify the R&D that would be required. Company B would be in a position to claim for the relevant expenditure.

High level wording in a contract that R&D was required would not be enough to satisfy 1133(2)(c). This could be added by a customer which wanted to reserve to itself the right to claim (and thereby deny the contractor this right) should any R&D actually be needed.

In such a case, looking at the wider circumstances, it might be that Company A could not substantiate what R&D was to be done or why it was needed. It would not therefore be reasonable to assume that A intended or contemplated that R&D of the sort that took place would be undertaken.

The condition is that it must be reasonable to assume that R&D was "intended or contemplated", not that "the contract says X". Just as mere formal language in the contract does not mean A has contracted out R&D, so the lack of that language should not be determinative that it has not.

Even if a contract is not explicit that R&D is needed, it may be reasonable to assume that it was intended or contemplated, for example having regard to factors such as those listed above.

Involvement by competent professionals may be relevant to this, for example, if the customer is to meet the condition that it was reasonable to assume that it intended or contemplated that R&D of the sort undertaken should be done, then it is likely to wish to draw on the expertise of its competent professionals (i.e. employed by it or brought in to advise on the issue) to inform the requirements of the contract. This may result in it specifying results that clearly required specific R&D.

We think it should be recognised that a less sophisticated customer might rely on the contractor's competent professionals during this contract discussion/specification phase. In such a scenario the customer could still be making a decision to contract out the R&D.

While the presence of competent professionals may be relevant, Company A just having competent professionals does not mean that it is entitled to the R&D claim. What occurs in practice is key in determining the decision maker, including their role. Have they shaped the requirements of the contract, as described above? Is their role to ensure that B's methods and outputs fit the specification (and therefore might have little to do with understanding the process of the R&D)?. Company A may sign off on the plans (and may engage competent professionals to check and approve proposals) but B may still initiate, lead and direct the R&D.

Equally, the fact the customer has no competent professionals of its own (which the guidance recognises could be third party advisers) isn't proof that it isn't entitled to make the R&D claim. It may be using the contractor's competent professionals to advise its thinking, for example.

Example 21

Company A, whose trade is letting accommodation in buildings, commissions Company B, a construction firm, to supply a landmark new building. The building's size, location, and required performance parameters (carbon neutrality, safety features, lifespan etc) mean that company B will need to conduct R&D.

While company A appreciates this, it does not, in contract negotiations or the eventual contract itself, specify this work in anything but a general sense. It does not state what it requires to be done or how this should be done (and it neither uses internal expertise nor seeks external input, for example from consultants or partners, on this). What is important to Company A is the result, ie that the building performs as required. In approaching contract negotiations with potential suppliers, Company A takes expert advice on Company B's capability to carry out the required work, looking at their track record and general proposals. But it does not take advice on the detail of the R&D, nor does it plan or scope the R&D and it would not be able, for example, to state what advances might need to be sought or how that is to be done. It does not have an R&D project.

Company A is not in a position to intend or contemplate that R&D of a particular "sort" (as referred to in section 1133(2)(c) will be undertaken. In this instance Company A does not therefore meet the definition for contracting out R&D and any claim would rest with Company B.

Example 22

Company A is a software developer which undertakes qualifying software development, and requires a bespoke building to house its development team. Company A included the input of its competent professionals into the contractual requirements of the landmark building being delivered by Company B to ensure the computer laboratory and server room met their requirements. However, this would still not necessarily be evidence that Company A was intending or contemplating R&D of the sort undertaken to execute the contractual obligations.

The competent professionals of Company A are not competent professionals with reference to construction technology, and so in this scenario we would not expect Company A to claim any contracted out R&D to Company B, the construction company. Conversely, as outlined in Example 2a, Company B could make a claim in respect to the R&D they undertake.

Is this example 21?

Example 23

Company A is a construction company albeit one that does not have the required resource to design elements of the landmark building in Example 2a which meet certain net zero criteria, then where competent professionals of company A input into the contractual requirements for the work contracted out to Company B, this may be considered evidence that Company A was clearly intending or contemplating R&D was required (on the basis that those individuals providing input from Company A are considered to be competent professionals in the specific area of R&D that will be undertaken by Company B).

It's not clear what point is being illustrated by this example.

The drafting of subsection (2)(c) also ensures that it is the position at the time that the contract was entered into which is key – not assessing the work done with the clarity of hindsight. This principle extends to there being a series of contracts. At any particular moment, the position of the companies is governed by a contract or contracts and what matters for the application of s1133 is those contracts. If contracts are renegotiated or varied the answer may change for work done after that point.

This doesn't wholly answer our earlier concerns. The guidance seems to suggest that it is the time of the contract that is important but what if the position changes on the making of a series of contracts? Is it the position at the time of the most recent contract that is key? What we were referring to in our earlier concerns was the situation where the arrangement could be the subject of a number of different contracts all concluded at different times.

Example 24

Company A and Company B enter into a contract for development of a widget. Little consideration is given to the need for R&D, as neither party considers this necessary for the widget to meet the required tolerances. Company B, the contractor, later realises that by doing some R&D, it can simplify the design and reduce the cost. The R&D was not included in the contract and is not reflected in the price and if it fails, Company B will carry the risk. Company B is therefore the decision maker in these circumstances and if it decides to proceed, it, not Company A, will potentially be able to claim relief.

Commercially it is possible that in these circumstances, before proceeding, Company B would seek to renegotiate the contract, with the R&D specified, producing a contract which then does contract out R&D to it, and for which A could claim relief – A has now entered into a contract with B that requires B to do specific R&D for A, A did not have to do this – it could have let things proceed

under the previous contract with B doing the R&D or not as it wishes. Therefore it has decided that the R&D should be done (and presumably funded it).

We believe that this example needs to be more clearly explained. At first sight, it looks like what HMRC is saying is that if the two parties increase the price of the contract to reflect the R&D carried out then suddenly A can claim the relief. There must surely be more to this. How involved does A need to be in order to show that it now contemplated the R&D to be done? Can it just take B's word for it that the work is qualifying R&D? We also suggest that a new contract is required because, if the terms of the original are merely amended, then A did not contemplate or intend R&D to be done at the time of that contract. To what extent would the R&D need to be specified and described in the new contract for A to be entitled to the relief?

The legislation operates to prevent the same R&D expenditure being claimed for by both Company A and Company B.

In many cases (both contracting out of routine activities that form part of the customer's R&D project, and contracts whose goal is to have a significant and defined piece of R&D done) it should be clear that the customer, only, will claim, meeting this objective. In other cases, discussion between the parties may be helpful. Whether or not that takes place, it is incumbent on all claimants to assess all available information and to be able to justify their reasoning based on this.

Where HMRC identifies that both Company A and Company B have claimed for the same expenditure, it will address this via compliance activity. Typically this will take the form of fact finding into both claims, with a view to examining the full fact pattern to determine which of Company A or Company B satisfies s1133(2)(c).

HMRC accepts that, for contractual and other reasons, it may not have been possible for the parties to share information including about their tax position and will not reject or question claims simply because this has not been done.

It is important to recognise that there can and will be cases where both parties are claiming for different expenditure relating to the same commercial project, because R&D has arisen for the contractor of a sort that the customer did not intend or contemplate.

Example 25

Company A is a UK automotive OEM developing a new vehicle, where the activities meet the definition of R&D. It subcontracts a variety of testing requirements to Company B, an unconnected UK Test House. Company A intends to claim the expenditure paid to Company B for the subcontracted testing activities. Although in their own right these are expected to be routine in nature, these testing activities would be eligible for Company A to claim, as they are necessary as part of their R&D project, to confirm if any technological uncertainties remain.

Company B begins to execute the routine testing activities for Company A, which do not constitute R&D for Company B. In undertaking these routine tests, Company B identifies that the advances in vehicle technology evidenced by Company A indicate they will need to redevelop some of their testing methodologies to measure certain parameters to higher levels of accuracy than currently possible.

Company B decides to instigate a new R&D project to advance their own testing methodologies, and uses some of the testing cycles required to perform the testing activities for Company A to validate and test these new methodologies. It is anticipated that these new testing methodologies will have broader application and use outside the services provided to Company A.

In this scenario Company A would be able to claim on the contracted out testing, and Company B would be able to claim on the activities undertaken to develop a new testing technique. Where Company B uses testing cycles contracted out by Company A to validate some of its own R&D activities, under s1133(7) the costs of those cycles would be excluded from Company B's claim.

In this scenario, it is possible that both Companies may disclose R&D related to the same testing criteria / application.

Example 26

In a slightly different scenario, Company A is again a UK automotive OEM developing a new vehicle, where the activities meet the definition of R&D. It subcontracts a variety of testing requirements to Company B, an unconnected UK Test House. As part of the contracting process, Company A identifies that the advances in vehicle technology will require the development of new testing methodologies to measure certain parameters to higher levels of accuracy than currently possible.

Company A prescribes that Company B will develop these testing methodologies and use the testing cycles required to perform the testing activities for Company A to validate and test these new methodologies. This is detailed in the contract and the terms of said contract reflect this.

Company A is in a position that it intends Company B to undertake R&D activities on its behalf and Company B is being compensated for this. As such, Company A is in a position to claim the costs (assuming all other conditions are met) as contracted out R&D on the development of the new testing methodology and execution of the testing itself.

7.3 Section 1133(3) - (6) CTA09: Subcontracting chains

For simplicity the discussion above has assumed that there are only two parties (Company A and Company B) involved. In reality there may be more, and the legislation allows for this.

Subsections 1133(4) and (5) set out that research and development remains contracted out (and claimable by the ultimate customer, not the contractor) if it meets the conditions of subsection s1133(2), even if the immediate contractor subcontracts it on (and so on down the chain).

A person to whom activity is contracted on is referred to in s1133(4)(b) specifically as a sub-contractor (which is why the legislation and guidance use the term “contractor” in general).

Likewise, where any parties in the chain instigate their own R&D to fulfil the contract, they can claim for the R&D instigated by them

Example 27

Company A commissions a construction firm, Company B, to supply a new landmark building. Under the terms of the contract with A, Company B is responsible for the design and build of the structure, ensuring that the programme and performance requirements have been met. Company B engages an engineering consultancy, Company C, to assist with the design and build of the new building.

Company B engages Company C to design the façade of the structure. During the design stage, Company C encounters significant technical problems with designing the façade. An R&D project is undertaken to develop an alternative design solution for the façade. Company B collaborates with Company C to fully resolve the uncertainties associated with developing the new façade design.

Company A does not have the knowledge or capability to understand how the façade will be constructed, in anything but a general sense. Its contract with Company B did not address the need for the R&D required for the façade, which was not understood or known about at that stage]. Company B’s competent professionals collaborate with Company C, reviewing design iterations and assessing the technological feasibility of the R&D design proposals. Even though Company C is the party that has identified that R&D may be required, it is reasonable to assume that Company B contemplated R&D of this sort may have been required, given its close involvement in undertaking the R&D. In this instance, Company B is entitled to claim:

- *Company A has not contracted out R&D to Company B as it did not meet the condition of s1133(2)(c), Company B is entitled to claim.*

- *Company B has contracted out R&D to Company C as it the conditions at s1113(2) are met, Company C is not entitled to claim because Company B is the customer.*

7.4 CTA09/1133(7) and (8)

Subsection 1133(7) provides that a payment that is only partly for contracted out R&D should be apportioned on a just and reasonable basis for the purposes of s1133(6). This reflects that a claim may be for the whole or part of a project, and that the conditions of s1133(2) may be met for part of a payment but not for all.

7.5 Sections 1042F and 1053A CTA09: Exception: where the customer cannot claim

The exception mentioned at section 7.1 above applies to some specific circumstances where the customer, Company A, cannot claim, even if it would otherwise satisfy s1133(2). In these specified circumstances the contractor, company B, may still be able to claim even if R&D has been contracted to it. This is intended, so far as possible, to ensure that relief is given for the R&D.

Qualifying expenditure in these circumstances is defined at sections 1042F (for the new merged reliefs) and 1053A CTA09 (for the enhanced relief for R&D intensive loss-making SMEs).

Three conditions must be met for expenditure to qualify. First (see section 1042F(2)/ section 1053A(2)) R&D must be contracted to company B, following the rules in section 1133. That is, the situation must be the sort in which, according to section 1133, Company B would not normally be able to claim. (If the R&D is not contracted to Company B, but initiated by it according to section 1133, then Company B would of course be able to claim anyway under either section 1042D or 1042E or section 1052 or 1053 as appropriate).

Secondly, Company A, the customer, must be either an ineligible company or not contracting out the R&D in the course of a trade, profession or vocation within the charge to tax. Company A might, for example, be an overseas company not within the charge to CT, or a UK Government Department. (The requirement is that every person contracting out the R&D to Company B satisfy one of these conditions – see section 7.3 and onwards for chains of subcontractors).

Finally, the expenditure claimed for must be expenditure that would qualify under section 1042D or 1042E (or 1052 or 1053) but for being contracted to the company.

7.6 CTA09/1142 - Ineligible companies

An ineligible company is defined in section 1142. It includes charities, institutions of higher education, scientific research associations, health service bodies and any other body prescribed by the Treasury as ineligible.

Example 28

A UK Contract Research Organisation (CRO) carries out clinical trials for both UK and overseas pharma companies. Trials carried out for overseas companies, which are not within the charge to CT, satisfy the conditions of section 1042F or 1053A, if they constitute R&D, and the UK CRO can therefore claim relief for its expenditure. (Where the work is contracted to the CRO by a UK pharma company, who can claim will depend on the application of s1133 – see above).

Two companies which are members of the same group (s1140A CTA09 provides that the definition of group is the same as that in Part 5 CTA2010) may jointly elect under s1142(5) that, in respect of particular R&D contracted by one (A) to the other (B), Company A is to be considered ineligible, so that Company B may be able to claim rather than A. This is a relaxation intended to enable groups in which the R&D is carried on by specified companies which have previously all claimed relief for this under RDEC to continue to do so. (An overseas member of the group will in any case be ineligible so this election would not be necessary for that company).

The election will not affect A's ability to claim for any other R&D (ie R&D undertaken on its own behalf, or contracted to another person other than the named group members).

Alternatively, without an election, the effect of s1133 could be to consolidate the claims in the hands of A, avoiding the need to submit many claims across the group. To facilitate this, where such an election is in force, in determining whether activity is research and development for the purposes of this Part, anything done by one of those companies under the contract is treated as if done by the other to the extent that this makes a difference to what is R&D.

An election for this purpose needs to be made in writing – for example as a letter sent to a relevant officer of HMRC, such as the CRM, either before or at the same time as any claim that depends on it.

Example 29

In a large group, Company A commissions a number of R&D projects carried on by Companies B, C and D, which have all previously claimed RDEC, in some cases making use of the previous deeming which allowed A's R&D to be R&D of B, C or D. Following introduction of the new rules in s1133, A, B, C and D jointly write to the group's CRM, electing that A should be treated as an ineligible company in respect of any R&D commissioned by it from B, C or D. The election is made before B, C or D make their first claims under the new rules.

7.7 Interaction with CTA09/1042F and CTA09/1053 (claims by contractor where customer cannot receive relief)

As set out above in section (3) of this guidance, in some circumstances a contractor may be able to claim for R&D it carries out even where it has been contracted to do that work. Sections 1042F and 1053A both require that, for the contractor to be able to claim, all the parties contracting out the work to that company must satisfy the conditions of those sections.

Example 30

Company B is contracted to carry out a piece of R&D work directly by a UK Government Department, Department A. If the work had been contracted by another UK company, Company B would not be able to claim. However, Company B can claim R&D relief, as Department A is not carrying on a chargeable trade.

If Company B were contracted to by an intermediate contractor between it and Department A, it might not be able to claim because the intermediate contractor might not satisfy the conditions of ss1042F or 1053A (for example, because the R&D is in respect of a trade not chargeable to corporation tax). However, if Company B were working for Department A on a 'pass through' contract via a prime contractor, P, i.e. a contract where Company B is the sole party carrying out R&D, where the R&D programme was agreed between Company B and Department A, and P is just providing a procurement service/ route on behalf of Department A, Company B may still be able to claim R&D relief.

Section 1133(4) states that

(4) Research and development contracted out by a person is contracted out "to"—

(a) the party to the contract who undertakes the obligations referred to in subsection (2)(b), and

(b) any sub-contractor who undertakes contractual responsibility

for the activities needed to meet those obligations.

Depending on the terms of the contract or contracts, it may be possible that the intermediate P meets neither condition, so the R&D is not contracted out "to" P but to Company B . So P is not contracting anything (in the sense of the legislation) to Company B, so 1042F(3) is met and Company B can claim.

The following example shows, in contrast, how the condition that s1042F(3) must be met by everyone by whom R&D is contracted out to the company prevents double claiming.

Example 31

UK Automotive company A subcontracts R&D to an unconnected US company B to develop a new gearbox. The development of the gearbox is R&D in its own right but would also form part of the Company A's R&D. The US company B then subcontracts the work on to its UK subsidiary, a connected party, Company C.

Company A can claim. It subcontracted R&D to another person, and the activity is occurring in the UK so s1138A does not apply.

The US company B can't claim (because it is not carrying on a trade chargeable to UK CT)

The UK company doing the work, company C, cannot claim because company A is able to claim.

While Company C has been subcontracted the work by a company not within the charge to tax (the US parent) and therefore apparently meet the condition in s1042F(4)(b), s1133(4)(b) applies to the activities subcontracted to company C by the ultimate customer (Company A) but neither s1042F(4)(a) nor (4)(b) applies to Company A itself so 1042F(3) prevents the UK subsidiary (Company C) from claiming.