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R&D Merged Scheme

The R&D expenditure credit and ERIS schemes were merged for accounting periods starting on or after 1 April 2024.

The New Merged Scheme

For accounting periods beginning on or after 1 April 2024, the new merged scheme will bring together both the SME scheme and the R&D expenditure credit (RDEC) for SME subcontractors and larger businesses. For every company that claims R&D tax relief, there will be some impact due to the introduction of the merged scheme.

Alongside the new merged scheme, there is also the Enhanced R&D Intensive Support (ERIS) which allows for loss making R&D intensive SMEs (*R&D Intensity Condition explained below*) to deduct an extra 86% of their qualifying costs in calculating their adjusted trading loss to make a total of 186% deduction. The Company can then surrender the lower of the enhance deduction, or the tax adjusted losses in the period for a tax credit totalling 14.5%. This gives an overall benefit of up to 27% when considering the full calculation.

Or to put it another way – the Company can receive up to £27k as a tax credit for every £100k of qualifying R&D expenditure incurred.

Merged Scheme Accounting periods beginning on (or after) 01/04/2024	
Profit Making SME	An after-tax rate of up to 16.2%. Relative to 16.2p to the £
Loss Making SME	An after-tax rate of up to 16.2%. Relative to 16.2p to the £
Large Company/RDEC	An after-tax rate of up to 16.2%. Relative to 16.2p to the £
R&D Intensive SME	A new benefit of up to 27%. Relative to 27p to the £

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Eligible Costs

The merged scheme allows claims on the following expenditure categories:

Staffing Costs: Salaries, wages, NICs, pensions, and other benefits for employees directly involved in R&D activities.

Externally Provided Workers (EPWs): Costs for contractors or agency staff engaged in R&D, provided they are subject to UK PAYE and Class 1 NICs.

Contracted-Out R&D: Payments to third parties for R&D activities, where the claimant company can demonstrate that it initiated and directed the R&D work.

Consumable Items: Materials and utilities consumed during R&D, such as water, power, and fuel.

Software Licences: Costs for software used directly in R&D activities.

Data and Cloud Computing: Expenditure on data licences and cloud services essential for R&D.

Clinical Trial Payments: Remuneration to participants in clinical trials.

Notably, the merged scheme removes the previous restriction on claiming for subsidised R&D expenditure, which was applicable under the SME scheme.

Overseas Restrictions

As part of the merged scheme, there is also a focus on only allowing R&D costs that have been incurred in the UK, with a restriction in place for costs incurred overseas. However, there are specific exclusions to the rule provided. This is in the form of a three-step test, if the claimant can satisfy each of the three steps, the overseas costs in question may be eligible to be claimed:

- Conditions necessary for R&D are not present in the UK.
- Conditions necessary are present in the location of undertaken R&D; **and**
- It would be wholly unreasonable for the company to replicate conditions in the UK

Looking further into the three-step test, HMRC label out two categories which may allow for the overseas expenditure eligible to be claimed. First, the legal or regulatory requirements behind the overseas work. This may be guidance from regulatory bodies or potentially a contract which obligates this work to be undertaken. Second, HMRC focus on the geographical, social and environmental circumstances. This focuses on ideas such as the sustainability of the work being conducted alongside the IP ownership surrounding. For subcontractors based in a foreign country, those costs will still be excluded even when connected.

Subcontracted R&D Changes

HMRC have looked to refresh and simplify the rules surrounding subcontracted R&D. To ensure consistency across the regime, for accounting periods beginning on or after 1 April 2024 these rules will also apply to all schemes.

A person "contracts out" research and development if—

- the person enters a contract under which activities are to be undertaken for it (whether by another party to the contract or by a sub-contractor),
- the activities undertaken to meet the obligations owed to the person under the contract include research and development, and
- 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 the contract that research and development of that sort would be undertaken in order to meet those obligations.

In HMRC's consideration the meaning of 'intended' or 'contemplated' is more than the belief or knowledge that R&D will be required or realised. HMRC expect that a specific action regarding R&D was considered, planned, and acknowledged as needed. There is a need to provide to specify the work that's needing to be done in the period, not just to speculate the potential actions or potential application this work may have.

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. 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
- decision-making process (for example whether the motivation to undertake the R&D flow from the customer's wider strategy or an immediate tactical challenge recognised by the contractor),
- the experience and seniority of decision-takers, and
- 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).

There needs to be a deliberate push by either party in starting the R&D. Mere speculation or acceptance that R&D may be needed will not be sufficient. Specifically, HMRC are attempting to ensure that the Company who made the decision to undertake the R&D during the period gets the relief for the relative expenditure. This new interpretation of subcontracted R&D means that it is increasingly important to consider who has the ownership of the R&D in relation to the above as this will determine where the ability to claim lies.

Updates to Subsidised Funding

Previously, if you were happy that the “contracted out” rules didn’t apply, you may still fall into the subsidised rules which restricted R&D tax relief to the less beneficial RDEC scheme. Thankfully to help simplify the process, HMRC have removed this restriction. For periods beginning on or after 1 April 2024, subsidised costs from grants or through research agreements will not be restricted.

PAYE/NIC Cap

The PAYE/NIC has also now been applied to the new merged scheme. This means that the cap is set at (£20,000 + (3 x (PAYE + Class 1 NIC Liabilities)).   It is important to note that a company that is preparing, or currently creating/managing intellectual property would be exempt from the cap if it doesn’t spend more than 15% of its qualifying R&D expenditure on connected parties.

If you plan to claim under the merged scheme and the amount exceeds the cap, any excess is carried forward as a Research and Development expenditure credit that you can claim in the next accounting period.

If the accounting period is of less than 12 months duration, the amount of £20,000 is proportionately reduced and split amongst the months that are being claimed appropriately.

Intensity Condition

As mentioned above, replacing the current standing ‘SME Intensive scheme’ is ERIS, which essentially mimics the existing SME scheme. To meet the intensity condition, the Company’s relevant R&D expenditure must be **at least** 30% of its total expenditure for the accounting periods beginning on or after 1 April 2024.

The R&D intensity is broadly the amount of expenditure incurred on R&D as a percentage of total expenditure, taking into account the R&D expenditure and total expenditure of any connected companies.

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