Analysis

R&D relief: importance of payment

Speed read

Most of the categories of eligible expenditure require that the expenditure is not only incurred but also paid before being eligible for inclusion in a claim for research and development (R&D) tax relief. The First-tier Tribunal recently had to consider the question of whether an anticipatory R&D claim could be made before payment had actually been made. The decision in the appeal was (in my opinion) entirely predictable, but it seems HMRC's guidance may actually be too generous. Revenue expenditure included in intangible fixed assets can be treated as deductible in the year incurred.

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In the recent case of *Gas Recovery And Recycle Ltd v HMRC* [2016] UKFTT 746 (TC), the First-tier Tribunal had to consider when the deadline was for payment of research and development (R&D) expenditure in order for it to be included in a valid R&D relief claim.

Requirement for 'payment'

Any company undertaking qualifying R&D and making an R&D tax relief claim will have incurred expenditure on one or more eligible cost category. Advisers not familiar with the R&D tax relief legislation may be surprised to know that, for some of these cost categories, there is also a requirement that the amount has actually been paid (rather than simply incurred) before relief can be claimed. This is the case for the following categories:

- staffing costs;
- externally provided workers;
- subcontracted R&D (SME scheme);
- payments to clinical trial subjects; and
- contributions to independent R&D (large companies).

The case before the tribunal concerned subcontracting payments, so I will refer to that legislation. The principles apply equally, however, to all of the areas listed.

CTA 2009 s 1051 provides that an SME's 'qualifying Chapter 2 expenditure', on which it is going to claim R&D tax relief, includes 'its qualifying expenditure on contracted out research and development (see s 1053)'. The pertinent part of s 1053 provides that:

'(1) A company's "qualifying expenditure on contracted out research and development" means expenditure:

'(a) which is incurred by it in making the qualifying element of a subcontractor payment (see sections 1134 to 1136); and ...'

Section 1134 deals with situations where the subcontractor is a connected person and the pertinent provisions are at sub-s 2.

'(2) the qualifying element of a subcontractor payment is:

'(a) the entire payment; or

'(b) if less, an amount equal to the subcontractor's relevant expenditure.'

Section 1135 deals with electing for connected persons treatment; and s 1136 deals with other cases, i.e. non-connected persons, where no election has been made under s 1135. The pertinent part of s 1136 states that:

'(2) The qualifying element of the subcontractor payment is 65% of the subcontractor payment.'

As can be seen, there is a clear requirement that not only must there be expenditure, but there must also have been an actual payment (in this case to the subcontractor).

The question for the tribunal was whether it matters when this expenditure is actually paid. HMRC has always been clear that it does matter, providing guidance on this requirement in its *Corporate Intangibles Research and Development Manual*. CIRD82100 includes the following paragraph:

'Where the underlying legislation requires not only that there be expenditure, but also payment, this means that the amount must actually be paid. While the payment in these circumstances need not have been made by the end of the accounting period in which the expenditure is shown, it must have been made before the claim to R&D tax relief can be valid. This approach does not alter the time limits for making a claim, but it does mean that the claim cannot be accepted before payment is made.'

The tribunal case

The pertinent facts from the tribunal decision are as follows.

In 2009, Gas Recovery and Recycle Ltd (GRRL) entered into a contract with an unconnected third party, Microgas Systems Ltd (MSL), for MSL to undertake certain R&D activities on behalf of GRRL. It was accepted that GRRL was an SME; and therefore, provided all of the other conditions were satisfied, GRRL would be eligible to claim R&D relief in respect of the qualifying element of the payments to MSL under that subcontract.

In the year in dispute, ending 31 March 2013, a total of £1,112,434 of GRRL's subcontractor costs were included in intangible fixed asset additions on the company's balance sheet. Importantly, however, it seems that, as a result of cash flow difficulties, none of this expenditure was actually paid to MSL until a part payment was made on 9 February 2015. A further instalment was paid on 30 March 2016 and final payment made in June 2016.

GRRL had treated the expenditure of £1,112,434 as a 'subcontractor payment'; and, in accordance with s 1136(2), included 65% of that amount – i.e. £723,082 – in its R&D tax relief claim. HMRC had rejected that element of the claim, on the basis that payment had not been made before the claim was made (see the final sentence in HMRC's guidance above). Although some of the expenditure – the first instalment of £20,833 – was actually paid before time ran out to amend the claim, no amended claim was made in time.

GRRL argued that it was not necessary for the payment to have actually been made at the time the claim was made. It was, in effect, arguing that the submitted claim was a 'placeholder or contingent claim' (words used by HMRC at the tribunal), which could be validated by subsequent events, even where those events took place after the time limit had passed. It argued that the wording of the guidance at CIRD82100 supported its argument.

The company's argument appears to have been that the claim could not be *accepted* before payment had actually been made (see the final sentence in HMRC's guidance above); however, the claim could be made within the time limit and then subsequently *accepted* by HMRC when payment was actually made.

Unsurprisingly, the tribunal had little difficulty in agreeing with HMRC (with one exception, discussed below, which didn't actually affect the outcome) and dismissed the appeal. The claim in respect of the subcontract costs could not validly be made because no actual payment had been made in time.

Intangible fixed asset treatment

As mentioned above, GRRL included the expenditure on the subcontracted R&D in fixed assets on its balance sheet. It was accepted by all parties that this was in accordance with accounting practice.

In accordance with basic principles in CTA 2009 ss 46 and 87, the company would have been able to take a deduction for the amount of £1,112,434 included in fixed assets, as it was amortised to the P&L account. Where expenditure on R&D is included in intangible fixed assets, however, CTA 2009 s 1308 allows the company to ignore that accounting treatment (amortisation policy) and treat that expenditure as deductible in computing the company's profits for corporation tax purposes in that period. This section does not change the fact that the expenditure must be revenue in nature, but it does change the basic timing rule in allowing the expenditure to be treated as deductible before it has been amortised through the P&L account.

This did not make any difference to the outcome of this appeal, as s 1308 does not alter the requirement that the amount actually be paid before it can be included in the R&D tax relief claim. However, this provision is very valuable in many cases. Eligible expenditure included in intangible fixed assets can be included in the R&D claim of the period in which it was incurred, rather than in instalments as amortised. This is provided, of course, that it has been paid in time.

Disagreement with HMRC's interpretation

The tribunal was quite clear in its view that payment was important, and that GRRL could not submit a claim and then expect it to be held open pending such payment being made. It felt HMRC was incorrect, however, in asserting that the payment need only be made before the claim is made (within the time limit). Notwithstanding that disagreement, the tribunal found – in comments that are *obiter* to its decision – that the outcome of the appeal would have been the same even if HMRC's view on this point were correct.

The rationale for the tribunal's view on timing is summarised as follows (para 49):

'The additional deduction is given "*for an accounting period* if it meets each of conditions A to D": s 1044(1) (emphasis added). Condition D requires qualifying Chapter 2 expenditure deductible "in computing for corporation tax purposes the profits of the trade *for the period*". That leads on to the requirement in s 1133 for "*a payment made* by the company to another person".'

The tribunal concludes (para 49) that: 'those provisions taken together and in the context of the rest of Part 13, give a legislative requirement for a payment to be made in the accounting period for which relief is claimed.'

Although there is quite a legislative leap from the second to the third of the points above, I think I can see why the tribunal has reached its conclusion on this point – although I think it was the wrong decision.

In order for a claim for R&D relief to be made, there needs to be qualifying Chapter 2 expenditure (in this case) that is deductible in the period. Considering only the subcontracted activity, there can only be qualifying Chapter 2 expenditure if there is 'qualifying expenditure on contracted out research and development'. Looking at s 1053, this means that the company needs expenditure 'incurred by it in making the qualifying element of a subcontractor payment'. Clearly, until the payment is made, there is no subcontractor payment and therefore no qualifying Chapter 2 expenditure (in relation to the subcontract activity).

Whilst I concede that this may be correct as a strict interpretation of the legislation, I cannot see that it was what Parliament intended as, apart from anything else, it produces a slightly odd result.

Example

Eagle Ltd has subcontracted all of its R&D to Hawk Ltd. In the year ended 31 December 2015, the total billed by Hawk for this work was £1m (assume it was 100% relevant R&D). The invoice was raised on 31 December 2015 and paid by Eagle on 31 January 2016.

HMRC intends to continue to apply its (correct, in my view) interpretation of the law that payment only needs to have been made before the claim is made

On the tribunal's analysis above, Eagle has no qualifying Chapter 2 expenditure for 2015, as the payment was made after the year end. Ignoring R&D relief, however, Eagle will have been able to deduct the full £1m in computing its profits for corporation tax purposes for 2015 (assuming it had charged it all to its P&L account or included it in an intangible fixed asset).

The problem comes when Eagle looks to claim R&D relief on the subcontracted expenditure in 2016. Although the payment was made in that year, there can't be any qualifying Chapter 2 expenditure because the expenditure isn't deductible in computing for corporation tax purposes the profits of the trade for that year. Eagle already had a deduction for that expenditure in 2015, even though it wasn't called 'qualifying Chapter 2 expenditure' at that point. On the tribunal's analysis, Eagle would either have to adjust its corporation tax computation so as not to take a deduction for the costs in 2015 or forego the R&D relief on that expenditure.

Conclusions

This was an odd case to end up before the tribunal, as the legislation and practice in this area have always been quite clear. It does, however, highlight the importance of a good understanding of legislation in a specialist area of taxation. HMRC has confirmed that it intends to continue to apply its (correct, in my view) interpretation of the law that payment only needs to have been made before the claim is made. This is a First-tier Tribunal decision – which may still be appealed, although I really would be surprised – which doesn't create any precedent beyond the actual case. Nothing will change in practice as a result of this decision. ■