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## HMRC internal manual

# Corporate Intangibles Research and Development Manual

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# CIRD84250 - R&D tax relief: categories of qualifying expenditure: subcontracted activities - meaning of subcontracted SME Scheme, Activities contracted to the SME – ss 1052(5) & 1053(4) CTA09

The guidance on this page has been amended to reflect HMRC's view following recent First-tier Tribunal decisions.

Expenditure incurred by a company in carrying out activities contracted to it by another person is not qualifying expenditure. This is intended to prevent both parties to a contract from claiming relief for the same activities.

Whether the activities were contracted to the company is a question of fact and each case should be looked at individually.

The terms of the contract between company and principal (the person which has contracted out the work, also known as the customer) are not the only factor to be considered. For example, a clause in a contract which says “Any R&D conducted to carry out the contract belongs to the principal” does not, necessarily, mean that the principal contracted out the R&D if other factors indicate otherwise. Similarly, just because a contract doesn’t refer to R&D, this does not mean that R&D has not been contracted to the claimant company. It is necessary, where possible, to look wider than that; to other correspondence or agreements, or what occurred for example.

## **Factors to Consider**

There are no “tests” which demonstrate that activities were contracted to the company, but the following are factors, listed in order of the weight likely to be attached to them, which may be taken into account when considering whether the activities were contracted to the company-.

### **If the R&D is incidental to the supply of a product or service, it is not contracted out**

Where it is clear from the contract or surrounding circumstances that the principal required R&D to be undertaken, the R&D has been contracted to the company.

Similarly, if it is clear from the contract or surrounding circumstances that the principal was aware that R&D would be necessary in order for the required product or service to be produced it is

likely that the R&D has been contracted to the company.

If it is not clear from the contract or surrounding circumstances that the principal required or was aware that R&D would be necessary in order for the required product or service to be produced, it is likely that undertaking the R&D was incidental to the supply of a product or service that the principal wanted and R&D has not been contracted to the company.

**If the company has a limited degree of autonomy, R&D is more likely to have been contracted out**

The contract or other correspondence indicate the principal exerting a degree of control over how the company carries out the work.

It might be expected that a principal who contracts out R&D would be quite specific about the nature and objectives of the work to be undertaken, otherwise the company would try to use standard techniques or ways of working. How detailed are the requirements in the contract or other correspondence?

Another indicator that the R&D was contracted to the company is where the principal is involved in the undertaking of the R&D, providing direction or guidance.

**The company has limited financial risk in undertaking the work**

It will almost always be possible for the company to argue that it has taken a financial risk. The existence of financial risk is not a strong indicator that the work was not contracted to the company.

The absence of financial risk is a stronger pointer that the work was contracted to the company. Where it is clear from the outset that what the principal requires is R&D, there may be terms in the contract which mean that the company will receive payment irrespective of the outcome. This is because R&D is by its nature speculative. Again, this might be demonstrated by the contract

or other correspondence or agreements . If this is the case, the company which is carrying out the R&D activity will be taking little or no financial risk in undertaking the work and is therefore likely to be carrying out R&D activities which have been contracted to it.

### **The company does not retain IP arising from the R&D project**

The nature of the IP in question is relevant here. IP which the principal owns and cannot be used by the company undertaking the R&D would carry more weight than “know-how”, to which the company (having undertaken the R&D) will always have access.

### **Example 1**

- Company A is a building company.
- Company B, an accountancy firm, has an office building and has engaged Company A to replace the roof.
- The contract is in a standard form and specifies only standard requirements such as style and the materials to be used.
- While the roof is being fitted, Company A decides to undertake R&D in order to try to use modern fittings in an old building.
- Company A undertakes the R&D and successfully fits the roof.

Company A's R&D activities are not contracted to it by another person.

Company B wanted a 'standard' roof and that was what Company A agreed to supply. The R&D was undertaken in the course of fitting the roof, but it was incidental to the supply.

Company A had complete autonomy in undertaking the R&D.

If Company A had been unable to complete the roof, it would have received no payment despite incurring expenditure.

Company A can argue that it retains the IP arising from the R&D. However, if this is “know-how” rather than IP it formally owns, it is likely that little if any weight would be given to this.

## Example 2

- Company C is a SME which develops and manufactures food packaging machinery, which it sells to food manufacturer customers.
- Company D manufactures cakes and has requested Company C to build and supply a new machine with increased speed and throughput for its new production line, beyond what other machines currently available are capable of performing. Company D has provided the specifications which the machine is required to meet.
- Company C enters into a contract with Company D for the design, development, manufacture and delivery of the new machine, with a single lump sum payment agreed on delivery of the machine. The contract does not specify that R&D will be carried out, however correspondence between the two indicates that Company D is aware that R&D will be required in order to meet the specifications
- Company C completes the R&D work, builds the machine and delivers it to Company D as agreed.

Company C's R&D activities are contracted to it by another person.

The R&D required to create the product is necessary in order to fulfil the terms of the agreement between Companies C & D, rather than incidental to it.

Although Company C had a high degree of autonomy with regard to how the R&D was conducted, the specifications limited the scope of the R&D to Company D's specifications.

As the party which conducted the R&D, Company C gained "know-how" and Company D, as a manufacturer of cakes rather than machines, may not be interested in registering any legal rights. It may be argued that Company C holds the intellectual property that arises from this project. This does not mean that it can claim that the activities were not contracted to it, taking the wider circumstances into account.

### Example 3

- Company E develops and manufactures specialist high tech hair stylers for hairdressers and salons. The hair stylers are highly regarded in the industry based on performance, durability and specification. However, a key customer (Company F) has complained that the hair stylers are not very energy efficient and has requested Company E look at improving the energy efficiency of the product as part of the new version.
- Company F has confirmed that if the energy efficiency can be improved by 50% then they would order 500 units for its national salon network at an agreed price of £150 per unit.
- Company E decides to undertake R&D activities to improve the energy efficiency of the hair stylers, which would be incorporated into the product which is sold across its customer base
- Company F is only committed to purchase if the 50% reduction in energy consumption is achieved, therefore Company E will only receive revenue if it is able to achieve this and
- Company E manages to reduce the energy consumption of the hair stylers by 75% i.e. beyond that required by Company F. Company E believes that the enhanced energy efficiency

demands a higher price per unit than originally agreed, so increases the price to £175 per unit and Company F agrees to pay this.

- Company E patents a new part which resulted from the R&D.

Company E's activities are not contracted to it by another person.

Although the decision to undertake R&D has been prompted by Company F's feedback on its existing products, and there is an agreement that Company F will buy hair stylers which meet a specific benchmark, Company F was under no obligation to do so. The activities required to undertake the R&D are not contracted to Company E.

Company E retains the autonomy on how to undertake the R&D. Although Company F requires a 50% reduction in energy consumption, it has no input to how this is to be achieved and the specification is very limited.

The economic risk of the development remains with Company E as it is remunerated only if it makes a successful product (rather than reimbursement of costs).

The IP is owned by Company E.

## **SME Scheme, Activities contracted out by the SME 1053 CTA09**

A company may contract out all or just some of the R&D. 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. A contract to provide services other than a specific part of those activities is not subcontracted R&D. Nor is a contract of personal employment.

There are obviously a considerable variety of possible contractual arrangements. The following examples illustrate a range of situations, but they are not exhaustive and each case will need to be judged on its merits.

- Where a company carries out R&D on its own account and simply receives a subsidy from another entity, this is not subcontracting - it is subsidised expenditure.
- Where two companies are both carrying out R&D on the same subject they may decide to pursue the R&D jointly with each making a contribution and each free to enjoy any fruits of the R&D. This is collaborative research and each company would potentially be eligible for R&D relief on its share of the qualifying expenditure.
- Where one company carrying out R&D pays another company for the provision of workers or materials this is not subcontracting of the R&D.
- Where, for example, a consultant simply provides expert advice and charges for their time, that does not amount to subcontracting of R&D.
- Where one company engages another company to carry out R&D activity on the first company's behalf in exchange for payment then that is subcontracting of the R&D to the second company.

Where a company claims to have contracted some or all of its R&D activities to a sub-contractor it should be able to provide HMRC with an explanation of the advance sought by the project and the role played by the subcontractor.

In some instances new products are required by law to be subjected to standard tests. Such testing of products created as part of an R&D project meets the definition of activities contracted out.

With that exception, the company should be able to demonstrate that that it controlled and directed



the work undertaken by the sub-contractor to a significant degree.

## Example

- Company G is a building contractor. It has a core of regular employees whose skills cover a range of trades within construction but uses sub-contractors to carry out most of the work on its contracts.
- Company G has been contracted by a third-party to design and build a warehouse on a plot of land and, during site preparation it is discovered that the condition of the land will require that R&D is carried out to create satisfactory foundations.
- Two of Company G's staff specialise in such work and they undertake an R&D project to make the advance necessary to overcome the issue. They believe that they made the advance but, until it has been applied practically, they cannot be sure.
- When Company G prepares its claim for R&D relief it includes the payments made to Company H Ltd, a third-party groundworks specialist which undertook the on-site work, on the basis that their work formed part of the project as a test of the R&D undertaken by Company G.

HMRC would expect Company G to be able to explain how the project met the definition of R&D for tax (CIRD81300). In addition, the company should be able to demonstrate that: -

- Company H was provided with an explanation of the new techniques that had been developed and guidance on how they should be implemented. Without this, an experienced groundworks contractor would simply use established techniques.
- The subcontractor payment in respect of which relief is claimed relates solely to activities which

formed part of Company G's R&D project.

If Company G is unwilling, or unable, to provide this information caseworkers should be prepared to ask for permission to approach Company H directly. If that permission is not given, use of third-party notices should be considered.

## **Subcontracting - differences in rules for SMEs and large companies**

The rules in regard to qualifying expenditure for subcontracted R&D ([CIRD84200](https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird84200) (<https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird84200>)) differ under the SME scheme and the large company scheme. Before considering mounting any arguments you should consider the appropriate tax treatment, so as to better focus attention on those areas where tax is at risk.



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