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HMRC internal manual

Corporate Intangibles Research and Development Manual

From: **HM Revenue & Customs (/government/organisations/hm-revenue-customs)**

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CIRD274400 - Patent Box: Terms of the R&D fraction : R&D subcontractor expenditure CTA10/s357BLC and BLD

CTA10/S357BLC and CTA10/BLD

There is no definition of 'subcontracted' within the legislation for R&D as each case is determined on its particular facts, with reference to the relevant guidance on categories of subcontracted activities. However, guidance to the meaning of subcontracted activities is covered at CIRD84250 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird84250) and CTA10/S1133 defines “sub-contractor payment”. It covers a variety of contractual arrangements.

S1 is the company’s qualifying expenditure on relevant R&D sub-contracted to unconnected persons

S2 is the company’s qualifying expenditure on relevant R&D sub-contracted to connected persons

CTA10/S1122 defines “connected persons” for the purposes of qualifying sub-contracted expenditure. This applies regardless of whether the connected person is resident overseas or within the UK. More detailed guidance is at CIRD82150 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird82150)

Qualifying expenditure on relevant R&D is defined at CIRD274200 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird274200). Where the expenditure to the subcontractor contains elements relating to work that is not relevant R&D, a reasonable apportionment should be made.

There is no restriction to 65% of subcontractor expenditure as with the SME R&D tax credit scheme.

Further information

1. **Foreign Permanent Establishments**

Where a company has elected under S18A CTA2009 to exempt profits and losses arising in its foreign permanent establishments, any R&D expenditure undertaken in-house or subcontracted to unconnected persons by that branch, will be treated as expenditure subcontracted to connected persons i.e. “S2” in the R&D fraction, rather than “D” or “S1” respectively.

2. **Externally Provided Workers**

When a company only has the role as the provider of individual services, such as staff, that company may not be classed as undertaking subcontracted R&D. It will depend on the wording of the contract and actual substantive activities of the company, but if staff costs fall within the definition of an Externally Provided Worker they could be counted in the fraction as in-house expenditure under D. They would need to substantively and contractually meet the qualifying conditions under the relevant heading CIRD83000 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird83000) but if they do, external workers provided by a 'connected' company would be classed as direct qualifying expenditure rather than connected subcontractor payments.

Please note Patent Box has not followed the Overseas Expenditure Provisions and Contracted Out R&D rules that apply to R&D Tax Relief Schemes and are coming into force as from 1 April 2024. For Patent Box purposes the pre-April 1 2024 rules continue to apply.

3. **'Pass Through' Costs**

For details regarding the interaction between cost share arrangements and 'pass through' costs please refer to CIRD276100 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird276100).

'Pass-through' costs are where a contractor makes payments via a connected company to a third party subcontractor (or where a contractor makes payments via a third party to a connected party subcontractor). Provided the intermediary company only performs minimal administrative functions in relation to the contract or subcontract, these payments are regarded as 'passing through' the intermediar(ies) directly to the ultimate payee.

For example, where a pharmaceutical company (contractor) contracts via a subsidiary (intermediary) to conduct clinical trials, and the subsidiary performs administrative functions in respect of the contract (e.g. holding or entering into the contract, making payments to research sites and other vendors), these would be classed as directly subcontracted third party R&D expenditure of the pharmaceutical company, and therefore S1 in the hands of the pharmaceutical company

However, where the connected party intermediary controls the project or manages the R&D work on behalf of the pharmaceutical company, then the pass-through principles would not apply, and the payment would be treated as connected party subcontracted R&D (i.e. S2) in the hands of the Pharmaceutical company.

Commercial fact patterns are not always so clear cut and it is expected that arrangements may include examples where the intermediary has a dual role. These roles could include having own R&D projects (i.e. that the intermediary ‘controls’), and also acting for another member of the group and arranging R&D with a third party, either on a different project or sometimes within the same project. In each case the company should identify who is in control of (e.g. managing) the project or part of project and what the different types of expenditure relate to. It is possible to have both S1 and S2 expenditure within the same project and care should be taken when tracking and tracing to identify the purpose of the expenditure and link it to the correct classification.

Example A:

- Company A owns IP and enters into arrangements with a connected party. Company B.
- Company B outsources to Contract Research Organisations (“CROs”) on behalf of Company A.

- Company B also undertakes R&D itself through a significant in-house team.
- In some cases the R&D undertaken by Company B will be on the same products as the R&D which is outsourced to CROs.

The fact that Company B has a significant number of staff engaged in R&D does not in itself mean that pass through is denied – it is instead important to look at the circumstances around each of Company B's activities.

Taking for example the scenario where Company B's staff, in association with undertaking R&D on a product, also manage and control the outsourcing work with CROs on that product, taking on both day to day management and overall control of the CRO's work. This level of control is demonstrated through Company B's staff designing clinical trials/R&D work and dealing with significant decisions and issues as they arise.

In this case, it would be clear that Company B controls the work outsourced to CROs, and Company A has subcontracted the whole R&D activity to Company B. In this scenario pass through treatment should be denied.

Taking then the example where Company B's staff, in addition to undertaking R&D on a product, also undertake day to day management of the relationship with the CRO for R&D on that product. However, beyond the day to day management, control of the outsourced work does not rest with Company B. This is evidenced by the fact that serious issues or concerns need to be escalated by Company B's team, and Company B's team do not design the studies/R&D work or take key decisions.

This is indicative that Company B does not own or control the outsourcing to the CRO and hence pass through would be allowed.

4. Integrated payments made to connected party

Where a service fee, profit element or other additional charge is included in the payment made to the subcontractor it is only necessary to include in the fraction term those costs which specifically relate to qualifying R&D expenditure.

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