HMRC internal manual

Corporate Intangibles Research and Development Manual

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CIRD162100 - R&D Tax Reliefs: reformed reliefs: contracted out R&D: more detailed examples

Example 1

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 2

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.

Example 3
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, i.e. 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 CTA09/S1133(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 4
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.

Example 5
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).

Example 6
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).

Example 7

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 CTA09/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 8

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.

Example 9

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 CTA09/S1133(2)(c), Company B is entitled to claim.
- Company B has contracted out R&D to Company C as it the conditions at CTA09/S1113(2) are met, Company C is not entitled to claim because Company B is the customer.

Example 10
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 CTA09/S1042F or CTA09/S1053A, if they constitute R&D (see CIRD81920 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-

development-manual/cird81920)), 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 CTA09/S1133 – see CIRD161000 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird161000)).

Example 11
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.

Example 12
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 CTA09/S1042F or CTA09/S1053A (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.

CTA09/S1133(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 CTA09/S1042F(3) is met and Company B can claim.

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