These notes refer to the Corporation Tax Act 2009 (c.4) which received Royal Assent on 26 March 2009

CORPORATION TAX ACT 2009

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 13: Additional relief for expenditure on research and development

Overview

Chapter 2: Relief for SMEs: cost of R&D incurred by SME

Overview

2706. This Chapter sets out some rules that apply to a "small or medium sized enterprise" ("SME"). An SME is defined in section 1119.

Section 1043: Overview of Chapter

2707. This section summarises the contents of this Chapter. It is new.

2708. This Chapter rewrites the reliefs given by Schedule 20 to FA 2000 if a small or medium-sized enterprise incurs expenditure on in-house direct research and development or research and development that is sub-contracted out by it.

Section 1044: Additional deduction in calculating profits of trade

2709. This section allows the company to claim the relief, gives the conditions that have to be met and the amount of the relief. It is based on paragraphs 1 and 13 of Schedule 20 to FA 2000.

2710. Relief under this Chapter is given as an additional deduction for expenditure that is already deductible in calculating trade profits (see *subsections (5)* and *(7)*). The amount of the deduction is increased by 75% (see *subsection (8)*).

2711. The relief has to be claimed (see *subsection (6)*). The procedure for making the claim is in Part 9A of Schedule 18 to FA 1998.

2712. This section makes clear that relief is given only to companies liable to corporation tax. See *Change 77* in Annex 1 and the commentary on section 1039 (overview of Part).

Section 1045: Alternative treatment for pre-trading expenditure: deemed trading loss

2713. This section allows a small or medium-sized enterprise to claim immediate relief for qualifying research and development expenditure incurred in a pre-trading period. It is based on paragraphs 1 and 14 of Schedule 20 to FA 2000.

2714. The usual treatment of expenditure incurred before a company starts trading is given by section 61 in Part 3 (trading income). Expenditure incurred up to seven years before the day the company starts to trade is treated as incurred on that day if it would have been deductible had the company been trading when the expenditure was incurred.

2715. This section allows the company to elect for pre-trading expenditure to create a deemed trade loss for the accounting period in which it was actually incurred. Subject to the restrictions in sections 1048 and 1049 the loss can be used in the same way as other trade losses. It can be set off against other profits under section 393A of ICTA or surrendered as group relief. Any part of the loss not used is carried forward. See the commentary on section 1048.

2716. If the company is entitled to relief because it has made an election under this section, *subsection (8)* provides that the expenditure is not allowed again under the ordinary rules in section 61 for dealing with pre-trading expenditure.

2717. The company has to meet the other qualifying conditions for the relief. In particular the pre-trading expenditure must exceed the threshold for relief (see *subsection (3)*) See the commentary on section 1050(5)(b) for more details on the treatment of pre-trading expenditure for the purposes of the threshold test.

2718. This section makes clear that relief is given only to companies liable to corporation tax. See *Change 77* in Annex 1 and the commentary on section 1039 (overview of Part).

Section 1046: Relief only available where company is going concern

2719. This section sets out a precondition for relief under sections 1044 and 1045. It is based on paragraph 18A of Schedule 20 to FA 2000.

Section 1047: Elections under section 1045

2720. This section sets out the procedure for making an election under section 1045. It is based on paragraph 14 of Schedule 20 to FA 2000.

Section 1048: Treatment of deemed trading loss under section 1045

2721. This section imposes a restriction on the use of a deemed trade loss and explains how any unused loss is to be dealt with. It is based on paragraph 23 of Schedule 20 to FA 2000.

2722. It is not a condition of section 1045 that the pre-trading research and development leads to the establishment of a trade. But if it does any of the loss created by the section 1045 election that is unused when the trade starts is treated as a trade loss brought forward (see *subsections (3)* and *(4)*).

Section 1049: Restriction on consortium relief

2723. This section prevents a loss created by relief given under this Chapter being surrendered as consortium relief unless the claimant company is also a small or medium-sized enterprise. It is based on paragraph 22 of Schedule 20 to FA 2000.

Section 1050: R&D threshold

2724. This section gives the minimum amount of qualifying expenditure the company must incur in an accounting period to claim relief under this Chapter. It is based on paragraph 1 of Schedule 20 to FA 2000.

2725. *Subsection (2)* reduces this limit proportionately if the accounting period is less than 12 months. The source legislation does not explicitly state how the reduction is done. Subsection (2) eliminates uncertainty by prescribing the arithmetic formula to be used where an accounting period is less than 12 months. The formula adopted has been widely used in the rewrite Acts. It incorporates a denominator of 365 days, regardless of the length of the calendar year. In this case, it makes a small change adverse to the taxpayer. See *Change 78* in Annex 1. This Change also affects sections 1064, 1075, 1097 (see paragraphs 27672767, 28042804 and 28492849).

2726. S*ubsection (5)(b)* deals with pre-trading expenditure by deeming the company to be carrying on a trade for the purpose of deciding whether the expenditure would be deductible. In the absence of any special tax rule to the contrary pre-trading expenditure is allocated to periods of account in accordance with generally accepted accounting practice.

2727. Subsection (5)(b) is needed for the purposes of section 1045. That section allows a company to elect to create a trade loss out of its pre-trading expenditure on qualifying research and development. Section 1045(3) requires the company to meet the threshold test in the period covered by the election.

2728. Section 1137 may also be relevant in this regard. It applies to a company that incurs qualifying Chapter 2 or 7 expenditure at a time when it does not have an accounting period. In practice this must be pre-trading expenditure. The section deems the company to have the accounting periods it would have had if it had been trading when it incurred the expenditure.

2729. *Subsections (7)* and *(8)* deal with expenditure that qualifies under Chapters 3 and 4 of this Part. The basic rule applies. The expenditure must be deductible in calculating the trade profits for the accounting period. In this case the ordinary operation of section 61 is not suspended.

2730. There is no requirement in this section that the expenditure is incurred in the same trade or pre-trading activity. So qualifying expenditure on one trade can be used to meet the threshold required to make a claim under section 1045 in respect of pre-trading expenditure on a separate activity.

2731. There have been a number of changes to the threshold since the relief was introduced by Schedule 20 to FA 2000. Most of these are not relevant to the accounting periods affected by this Act. But Schedule 2 (transitionals and savings), provides that expenditure incurred before 1 April 2002 is ignored for the purposes of subsection (3)(b) and (c), and that section 61 (which provides for up to 7 years' worth of pre-trading expenses to be treated as incurred on the start date of the trade) is ignored in applying this rule.

2732. In relation to qualifying Chapter 3 expenditure the transitional rule preserves the effect of paragraph 2(2) of Schedule 15 to FA 2002. That provision extended the threshold test to include expenditure that qualifies under Part 2 of Schedule 12 to FA 2002, rewritten in Chapter 3 of this Part.

2733. Paragraph 2(2) of Schedule 15 to FA 2002 provides that the extension does not apply to expenditure incurred before 1 April 2002 and that for this purpose no account is taken of section 401 of ICTA.

2734. In relation to qualifying Chapter 4 expenditure the transitional preserves the effect of paragraph 3(2) of Schedule 31 to FA 2003. That provision extended the threshold test to include qualifying additional SME expenditure as defined in paragraph 10B of Schedule 12 to FA 2002, rewritten in this Part in Chapter 4.

2735. Paragraph 10B(a) of Schedule 12 to FA 2002 provides that:

> "qualifying additional expenditure" is any expenditure which had the SME been a large company throughout the accounting period in question, would have been qualifying R&D expenditure of that company

2736. This brings into play the commencement provision in paragraph 20(1) of Schedule 12 to FA 2002, which provides that Schedule 12 does not apply to expenditure incurred before 1 April 2002 and that "for this purpose no account shall be taken of section 401 of ICTA".

2737. There are very limited circumstances in which the transitional applies. This Act has effect for accounting periods ending after 31 March 2009. The earliest date on which

an accounting period covered by the Act could start is 2 April 2008. For the transitional rule to apply the expenditure would have to be incurred in the period between 2 April 2001 and 31 March 2002.

Section 1051: Qualifying Chapter 2 expenditure

2738. This section identifies the expenditure that qualifies for relief under this Chapter. It is new.

Section 1052: Qualifying expenditure on in-house direct R&D

2739. The section defines "qualifying expenditure on in-house direct research and development". It is based on paragraph 3 of Schedule 20 to FA 2000.

2740. The broad aim of Schedule 20 to FA 2000 is to give relief to the company that incurs the expenditure on the research and development. Paragraph 3(3) of Schedule 20 to FA 2000 describes that as research and development directly undertaken "by the company" or "on its behalf". A common set of conditions is used to decide whether expenditure on either type of research and development qualifies for relief.

2741. This Act uses the labels "in-house direct research and development" and "contracted out research and development" to describe the two types of research and development. It also rewrites the conditions that apply to each type of research and development separately. In part this is because the two types of activity are quite distinct and in part because the rules on sub-contractor payments apply only to contracted out research and development.

2742. The term "in-house direct research and development" is merely a label. It is not a condition of the relief that the research and development is incurred "in-house". The condition that the research and development is directly undertaken by the company is rewritten in s*ubsection (3).* This requires that the research and development is undertaken "by the company itself".

2743. The expression "in-house direct research and development" is used because it has a specific meaning in the Department for Business, Enterprise and Regulatory Reform guidelines on the meaning of research and development for tax purposes. See paragraph 27022702. But the definition of what constitutes "direct research and development" in paragraph 3 of Schedule 12 and paragraph 3 of Schedule 13 to FA 2002 is identical in all material aspects to that in paragraph 3 of Schedule 20 to FA 2000. So referring to "in-house *direct* research and development" in this section does not introduce a new condition into the rewrite of paragraph 3 of Schedule 20.

2744. The section does not reproduce the condition in paragraph 3(2) of Schedule 20 to FA 2000 that the expenditure is not of a capital nature. This condition is unnecessary because section 53 in Part 3 (trading income) already prohibits a deduction for capital expenditure.

Section 1053: Qualifying expenditure on contracted out R&D

2745. This section defines what is meant by "qualifying expenditure on contracted out research and development". It is based on paragraph 3 of Schedule 20 to FA 2000.

2746. The section does not reproduce the condition in paragraph 3(2) of Schedule 20 to FA 2000 that the expenditure is not of a capital nature. This condition is unnecessary because section 53 in Part 3 (trading income) already prohibits a deduction for capital expenditure.

Section 1054: Entitlement to and payment of tax credit

2747. This section allows a small or medium-sized enterprise to claim an R&D tax credit. It is based on paragraphs 15 and 18 of Schedule 20 to FA 2000.

2748. Sections 1054 to 1062 rewrite the paragraphs of Schedule 20 to FA 2000 that allow a small or medium-sized enterprise to surrender a loss, created as a result of the relief, in return for a cash payment described as an "R&D tax credit".

2749. The section clarifies that a company may make part claims (*subsection (2)*).

2750. This Act does not rewrite paragraph 24 of Schedule 20 to FA 2000. This provision is no longer required, since the rule allowing the Commissioners for HMRC to deduct money for tax credits before paying their receipts into the Consolidated Fund is set out in sufficiently general terms in section 44 of CRCA (see subsections (1) and (3)(d) of that section). It is worth noting that paragraph 25 of Schedule 13 to FA 2002, which made similar provision to that made by paragraph 24 of Schedule 20 to FA 2000, was repealed by paragraph 96 of Schedule 4 to CRCA.

Section 1055: Meaning of "Chapter 2 surrenderable loss"

2751. This section defines "Chapter 2 surrenderable loss". It is based on paragraph 15 of Schedule 20 to FA 2000.

Section 1056: Amount of trading loss which is "unrelieved"

2752. This section identifies the amount of a trading loss that is "unrelieved" It is based on paragraph 15 of Schedule 20 to FA 2000.

Section 1057: Tax credit only available where company is going concern

2753. This section sets out a precondition for relief under section 1054. It is based on paragraph 18A of Schedule 20 to FA 2000.

Section 1058: Amount of tax credit

2754. This section gives the amount of the R&D tax credit. It is based on paragraph 16 of Schedule 20 to FA 2000.

Section 1059: Total amount of company's PAYE and NIC liabilities

2755. This section explains how to calculate the total amount of a company's PAYE and NIC liabilities. It is based on paragraph 17 of Schedule 20 to FA 2000.

2756. In *subsection (4)*, amount B includes both primary and secondary Class 1 NIC liabilities. But amount B does not include Class 1 contributions where under paragraph 3B of Schedule 1 to the Social Security Contributions and Benefits Act 1992, the company and the employee have jointly elected to transfer liability to the employee.

2757. "National insurance contributions" is defined in section 1319. This definition is based on paragraph 25 of Schedule 20 to FA 2000 and paragraph 27 of Schedule 13 to FA 2002.

Section 1060: Payment of tax credit

2758. This section explains the circumstances in which the payment of an R&D tax credit can be withheld or set against arrears of corporation tax. It is based on paragraph 18 of Schedule 20 to FA 2000.

2759. In *subsection (7)(a)*, the words "PAYE regulations" are to be interpreted in accordance with section 684(8) of ITEPA.

Section 1061: Tax credit payment not income of company

2760. This section makes clear that a payment of an R&D tax credit is not income of the company for tax purposes. It is based on paragraph 20 of Schedule 20 to FA 2000.

Section 1062: Restriction on losses carried forward where tax credit claimed

2761. This section provides that any losses that are surrendered in return for an R&D tax credit are not available for carry forward. It is based on paragraph 19 of Schedule 20 to FA 2000.