Part 1: Additional relief for expenditure on research and development

Overview

1. This Part gives additional relief for expenditure by a company on research and development including research and development into certain vaccines. It is based on Schedule 20 to FA 2000 and Schedules 12 and 13 to FA 2002.

2. The relief is given in addition to any deduction allowed in calculating the company's trade profits. For example, a clause in the trading income Part (not in this print) rewrites the deduction given by section 82A of ICTA for expenditure on research and development.

3. The structure of the Part is:

- Chapters 2 to 4 allow small or medium-sized enterprises relief for expenditure incurred on research and development;

- Chapter 5 allows large companies relief for expenditure incurred on research and development;

- Chapter 6 allows all companies relief for expenditure incurred on research and development into vaccines against certain potentially fatal diseases which are especially prevalent in the developing world;

- Chapter 7 allows a small or medium-sized enterprise to surrender a loss created by the relief given under Chapters 2 and 6 in return for the payment of a tax credit;

- Chapters 8 and 9 provide for a number of miscellaneous matters such as expenditure by groups of companies and refunds of expenditure; and

- Chapter 10 contains definitions, including definitions relevant to the qualifying expenditure.

4. This Part does not rewrite any of the provisions in paragraphs 12 and 13 of Schedule 12 to FA 2002 which apply only to insurance companies. We are considering how to deal with insurance specific material on a Bill-wide basis.

5. References to research and development are abbreviated to R&D following the same convention used to abbreviate United Kingdom to UK. The words will usually be abbreviated when used in a longer phrase. See, for example, R&D threshold in clause 14.

Chapter 1: Introduction

Clause 1: Overview of Part

6. This clause gives an overview of the Part. It is new.

7. The source legislation refers to “tax relief” given to companies in calculating their trade profits. *Subsection (1)* makes clear that the relief is given only to companies liable to corporation tax. See *Change 1* in Annex 1.

Q1. We welcome comments on the proposal to make clear that Schedule 20 to FA 2000 and Schedules 12 and 13 to FA 2002 apply only to companies liable to corporation tax.

8. The reference to Part 9A of Schedule 18 to FA 1998 in *subsection (11)* is to that Part as amended by this Bill. See paragraph 2 in Schedule 1. As this Bill brings all the additional reliefs for research and development together Parts 9B and 9C of Schedule 18 to FA 1998 are repealed by this Bill.

Clause 2: Meaning of “research and development”

9. This clause applies the definition of “research and development” in section 837A of ICTA to this Part. It is based on paragraph 25 of Schedule 20 to FA 2000, paragraph 19 of Schedule 12 and paragraph 27 of Schedule 13 to FA 2002.

Clause 3: Meaning of “relevant research and development”

10. This clause defines “relevant research and development”. It is based on paragraph 4 of Schedule 20 to FA 2000, paragraph 17 of Schedule 12 and paragraph 5 of Schedule 13 to FA 2002.

11. “Relevant research and development” is a key concept. All of the reliefs given in this Part include a condition that the expenditure is incurred on relevant research and development in relation to the company.

Clause 4: Meaning of “small or medium-sized enterprise”

12. This clause defines “small or medium-sized enterprise”. It is based on paragraph 2 of Schedule 20 to FA 2000, paragraph 2 of Schedule 12 and paragraph 5 of Schedule 13 to FA 2002.

Clause 5: Section 4: qualification

13. This clause makes a qualification to the European Union definition of small or medium-sized enterprise. It is based on paragraph 2 of Schedule 20 to FA 2000, paragraph 2 of Schedule 12 and 5 of Schedule 13 to FA 2002.

14. The European Union definition requires a company to include figures from a partner or linked enterprise in determining whether it breaches the qualifying thresholds. Article 4(2) gives the company a period of grace if the inclusion of those figures means it ceases to be a small or medium-sized enterprise. The company will cease to be a small or medium-sized enterprise within the European Union definition only if the limits are exceeded in two consecutive accounting periods .

15. The effect of the qualification in this clause is to remove that period of grace. The company ceases to be a small or medium-sized enterprise for the purposes of this Part in the second accounting period.

Clause 6: Meaning of "large company"

16. This clause defines "large company". It is based on paragraph 2 of Schedule 12 to FA 2002.

Clause 7: Meaning of "sub-contractor" and "sub-contractor payment"

17. This clause defines "sub-contractor" and "sub-contractor payment". It is based on paragraph 9 of Schedule 20 to FA 2000 and paragraph 6 of Schedule 13 to FA 2002.

Chapter 2: Relief for SMEs: cost of research and development borne by SME

Clause 8: Introduction

18. This clause summarises the contents of Chapter 2 of this Part. It is new.

19. Chapter 2 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.

20. Although *subsection (1)* of clause 8 makes clear that the Chapter applies only to small or medium-sized enterprises this condition is repeated in the clauses which set out the qualifying conditions for the Chapter to apply, clauses 9 and 10.

Clause 9: Additional deduction in calculating profits of trade

21. This clause 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.

22. The relief has to be claimed, *subsection (1)*. The procedure for making the claim is in Part 9A of Schedule 18 to FA 1998.

Clause 10: Alternative treatment for pre-trading expenditure: deemed trading loss

23. This clause 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 paragraph 14 of Schedule 20 to FA 2000.

24. The usual treatment of expenditure incurred before a company starts trading is given in section 401 of ICTA. Section 401 of ICTA is rewritten by a clause in the trading income Part [not in this print]. 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.

25. Clause 10 allows the company to elect for pre-trading expenditure to create a trade loss for the accounting period in which it was actually incurred. Subject to the restrictions in clauses 12 and 13 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 clause 12.

26. If the company is entitled to relief because it has made an election under this clause *subsection (7)* provides that the expenditure is not allowed again under the ordinary rules for dealing with pre-trading expenditure.

27. The company has to meet the other qualifying conditions for the relief. In particular the pre-trading expenditure must exceed the threshold for relief, *subsection (3)*. See the commentary on clause 14(5)(b) for more details on the treatment of pre-trading expenditure for the purposes of the threshold test.

Clause 11: Elections under section 10

28. This clause sets out the procedure for making an election under clause 10. It is based on paragraph 14 of Schedule 20 to FA 2000.

Clause 12: Treatment of deemed trading loss under section 10

29. This clause imposes a restriction on the use of the 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.

30. The loss can be carried back and set against the losses of a previous accounting period only if the company was entitled to make an election under clause 10 in that earlier period, *subsection (2)*.

31. It is not a condition of clause 10 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 clause 10 election that is unused when the trade starts is treated as a trade loss brought forward, *subsections (3)* and *(4)*.

32. If the company is already carrying on another trade the commencement of the new trade may not trigger the start of a new accounting period. The loss brought forward can be set against the profits of the new trade in the accounting period it starts.

Clause 13: Restriction on consortium relief

33. This clause 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.

Clause 14: R&D threshold

34. This clause gives the minimum amount of qualifying expenditure the company must incur in an accounting period to claim relief under Chapter 2. It is based on paragraph 1 of Schedule 20 to FA 2000.

35. *Subsection (1)* sets the limit at £10,000 in a 12 month accounting period. This is proportionately reduced if the accounting period is less than 12 months, *subsection (2)*.

36. *Subsection (3)* allows the £10,000 to be made up of expenditure that qualifies for relief under any of the three Chapters of this Part under which a small or medium-sized enterprise can claim relief. The basic rule for expenditure incurred under any Chapter is that the expenditure must be deductible in calculating the company's trade profits for the accounting period. But the treatment of pre-trading expenditure is modified if the expenditure qualifies under Chapter 2.

37. *Subsection (5)(a)* gives the basic rule that Chapter 2 expenditure must be deductible in calculating the trade profits for the accounting period. But *subsection (6)* suspends the normal operation of section 401 of ICTA for this purpose. This means that pre-trading expenditure is not bunched into the accounting period in which the trade starts when determining if the threshold is met in that accounting period.

38. 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 accounting periods in accordance with generally accepted accounting practice.

39. Subsection (5)(b) is needed for the purposes of clause 10. That clause allows a company to elect to create a trade loss out of its pre-trading expenditure on qualifying research and development. Clause 10(3) requires the company to meet the threshold test in the period covered by the election.

40. Clause 80 may also be relevant to this point. It applies to a company that incurs qualifying Chapter 2 or 6 expenditure at a time when it does not have an accounting period. In practice this must be pre-trading expenditure. The clause deems the company to have the accounting periods it would have had if it had been trading when it incurred the expenditure.

Example 1

A small or medium-sized enterprise incurs qualifying Chapter 2 expenditure of £3000 a year on research and development in each of the four calendar years 2009, 2010, 2011 and 2012. The company does not start to trade until the beginning of 2012. Section 401 of ICTA treats the £9,000 pre-trading expenditure incurred in the first three years as incurred in 2012. But clause 14(6) suspends this

rule for the purposes of the threshold test in clause 14. The company does not meet the £10,000 test in any of the four years.

Example 2

The facts are as in Example 1 except that in the year 2011 the company incurs qualifying Chapter 2 expenditure of £12,000. The threshold test is met in that year and the company can make an election under clause 10 for the £12,000.

41. *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 401 of ICTA is not suspended.

42. There is no requirement in clause 14 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 clause 10 in respect of pre-trading expenditure on a separate activity.

43. 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 Bill. But paragraph 1 in the transitionals and savings Schedule provides that expenditure incurred before 1 April 2002 is ignored for the purposes of clause 14(3)(b) and that section 401 of ICTA is ignored in applying this rule.

44. 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 this Part in Chapter 3.

45. 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.

46. 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.

47. 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

48. This applies 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".

49. There are very limited circumstances in which the transitional will apply. Subject to parliamentary approval this Bill will take effect for accounting periods ending after 31 March 2009. The earliest date on which an accounting period covered by the Bill could start is 2 April 2008. For the transitional rule to apply the expenditure would have to be incurred in the period 2 April 2001 to 31 March 2002.

Clause 15: Qualifying Chapter 2 expenditure

50. This clause identifies the expenditure that qualifies for relief under Chapter 2. It is new.

Clause 16: Qualifying expenditure on in-house direct research and development

51. The clause defines "in-house direct research and development". It is based on paragraph 3 of Schedule 20 to FA 2000.

52. 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.

53. This Bill 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.

54. 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".

55. The clause refers to "in-house *direct* research and development" to be consistent with clauses 31 and 46. Those clauses are the equivalents to this clause in the Chapters which give relief to large companies and for expenditure on vaccine research. The respective paragraphs 3(1) of Schedules 12 and 13 to FA 2002 both require that the expenditure is on "direct research and development".

56. We want to preserve that phrase because it has a specific meaning in the Department of Trade and Industry guidelines on the meaning of research and development for tax purposes. 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 clause 16 does not introduce a new condition into the rewrite of paragraph 3 of Schedule 20.

57. The clause 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 a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Clause 17: Qualifying expenditure on contracted out research and development

58. This clause defines what is meant by "contracted out research and development". It is based on paragraphs 3 and 9 of Schedule 20 to FA 2000.

59. Condition B prevents the sub-contractor further sub-contracting the research and development. This condition is based on paragraphs 3(3) and 9(2) of Schedule 20 to FA 2000.

60. Paragraph 3(3) of Schedule 20 to FA 2000 requires that the research and development is "directly undertaken by the company or on its behalf". The "directly undertaken" requirement applies both to research and development that the company does itself and research and development that it contracts out. In other words the research and development must be directly undertaken on behalf of the company.

61. Paragraph 9(2) of Schedule 20 to FA 2000 provides that a sub-contractor payment is a payment by the company to another person "in respect of relevant research and development contracted out by the company to that person". There is no provision for "that person" to further sub-contract the work.

62. The clause 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 a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Chapter 3: Relief for SMEs: Research and development sub-contracted to SME

Overview

63. This Chapter rewrites the relief given to small or medium-sized enterprises by Part 2 of Schedule 12 to FA 2002. That Part allows small or medium-sized enterprises to claim relief for research and development sub-contracted to them on the same basis as that on which Part 1 of Schedule 12 to FA 2002 allows relief to large companies. In effect it overrides Condition D in clause 16 in Chapter 2 of this Part.

64. The Chapter applies only to expenditure incurred on or after 1 April 2002. See paragraph 20 in Schedule 12 to FA 2002. Paragraph 2 in the transitionals Schedule preserves this commencement rule. For the purposes of this Bill it is relevant only for to the treatment of pre-trading expenditure.

Clause 18: Additional deduction in calculating profits of trade

65. This clause allows a small or medium-sized enterprise to claim relief for expenditure on research and development contracted out to it. It is based on paragraph 11 of Schedule 12 to FA 2002.

66. As with relief under Chapter 2, relief under Chapter 3 is given as an additional deduction for expenditure that is already deductible in calculating trade profits, *subsections (4)* and *(5)*. The amount of the deduction is increased by 25%, *subsection (6)*.

Clause 19: R&D threshold

67. This clause 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 7 of Schedule 12 to FA 2002.

68. The rules are very similar to those in clause 14. The minimum amount of expenditure is £10,000, reduced proportionately if the accounting period is less than 12 months long. The £10,000 can be made up of expenditure qualifying under any of the three Chapters of this Part under which a small or medium-sized enterprise can claim relief. There is no requirement that the expenditure is incurred in the same trade or pre-trading activity.

69. A significant difference to clause 14 is the treatment of pre-trading expenditure.

70. Unlike clause 14 the normal rules in section 401 of ICTA for dealing with pre-trading expenditure are not suspended, *subsection (5)*. Pre-trading expenditure is bunched into the accounting period in which the trade starts and counts towards the threshold for that period. This includes expenditure that qualifies under Chapter 2 of this Part. For the purposes of claiming relief under Chapter 2 itself section 401 of ICTA is suspended, clause 14(6).

Example

In the accounting period ended 31 December 2010 a company incurs £6,000 pre-trading expenditure on in-house research and development which qualifies under Chapter 2. The company starts trading in the accounting period ended 31 December 2011 when it incurs further expenditure of £3,000 which qualifies under Chapter 2 and £2,000 on work sub-contracted to it which qualifies under Chapter 3.

For the purposes of the threshold in clause 14 the company's qualifying expenditure in the accounting period ended 31 December 2011 is £5,000. It cannot claim relief under Chapter 2 for that period. For the purposes of the threshold in clause 19 the company's qualifying expenditure in the accounting period ended 31 December 2011 is £11,000; ie the £5,000 actually incurred plus the £6,000 bunched into that accounting period by section 401 of ICTA. The company can claim relief under Chapter 3 on £2,000 qualifying expenditure.

Clause 20: Qualifying Chapter 3 expenditure

71. This clause identifies the expenditure that qualifies for relief under Chapter 3. It is based on paragraph 8 of Schedule 12 to FA 2002.

72. Relief is given to companies that do the research and development themselves (clause 21), and to companies that commission the research and development from certain other persons (clause 22). Clause 20 prevents more than one company claiming the relief and the relief leaking out into the income tax sector.

73. If a large company commissions the research and development that company will not be able to claim relief under Chapter 5 of this Part. This is because that Part requires the company to carry out the research and development itself. If the research and development is contracted out to a small or medium-sized enterprise the effect of s*ubsection (2)* is to allow that company to claim relief under Chapter 3 of this Part.

74. If the research and development is contracted out by another small or medium-sized enterprise that company will be able to claim relief itself under Chapter 2. Subsection (2) prevents relief being given to the sub-contractor company under Chapter 3 of this Part.

75. The relief given by this Part is restricted to corporation tax payers. Subsection (2) prevents a sub-contractor company getting relief if the work has been contracted out by a person, other than a large company, who could get a deduction for the payment in calculating their trade profits. This prevents the sub-contractor passing on some of the benefit of the relief to an income tax payer by charging lower prices.

Clause 21: Expenditure on sub-contracted research and development undertaken in-house

76. This clause identifies the expenditure which qualifies for relief if the company undertakes the research and development itself. It is based on paragraph 9 of Schedule 12 to FA 2002.

77. As in clause 16, this clause uses the label "in-house" to describe research and development that the source legislation describes as being "directly undertaken" by the company.

78. The clause does not reproduce the condition in paragraph 9(4) of Schedule 12 to FA 2002 that the expenditure is not of a capital nature. This condition is unnecessary because a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Clause 22: Expenditure on sub-contracted research and development not undertaken in-house

79. This clause identifies the expenditure which qualifies for relief if the company commissions another person to do the research and development. It is based on paragraph 10 to Schedule 12 to FA 2002.

80. The clause does not reproduce the condition in paragraph 10(4) of Schedule 12 to FA 2002 that the expenditure is not of a capital nature. This condition is unnecessary because a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Chapter 4: Relief for SMEs: subsidised expenditure on research and development

Overview

81. This Chapter rewrites the relief given to small or medium-sized enterprises by Part 2A of Schedule 12 to FA 2002. That Part allows small or medium-sized enterprises to claim relief for expenditure on research and development that is subsidised on the same basis as that on which Part 1 of Schedule 12 to FA 2002 allows relief to large companies. In effect it overrides Condition E in clause 16 in Chapter 2 of this Part.

82. The Chapter applies only to expenditure incurred on or after 1 April 2002. See paragraph 20 in Schedule 12 to FA 2002. Paragraph 3 in the transitionals Schedule preserves this commencement rule. For the purposes of this Bill it is relevant only to the treatment of pre-trading expenditure.

Clause 23: Additional deduction in calculating profits of trade

83. This clause allows a small or medium-sized enterprise to claim relief for expenditure on research and development that is subsidised. It is based on paragraph 11 of Schedule 12 to FA 2002.

84. As with relief under Chapter 2, relief under Chapter 4 is given as an additional deduction for expenditure that is already deductible in calculating trade profits, *subsections (4)* and *(5)*. The amount of the deduction is increased by 25%, *subsection (6)*.

Clause 24: R&D threshold

85. This clause 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 10A of Schedule 12 to FA 2002.

86. The threshold is the same as that which applies to Chapter 3 of this Part and the clause invokes the conditions in clause 19.

Clause 25: Qualifying Chapter 4 expenditure

87. This clause identifies the two categories of expenditure that qualify for relief under this Chapter. It is based on paragraph 10B of Schedule 12 to FA 2002.

88. This Bill takes a different approach to identifying the qualifying conditions from that taken in the source legislation. Paragraph 10B of Schedule 12 to FA 2002 defines what it calls “qualifying additional SME expenditure” by providing first that the expenditure would qualify for relief under Part 1 of Schedule 12 to FA 2002. It

then superimposes the qualifying conditions in Schedule 20 to FA 2000. But it removes the condition that the expenditure must not be subsidised.

89. In this Chapter the qualifying conditions are set out in full to avoid the reader having to make these modifications.

Clause 26: Subsidised qualifying expenditure on in-house direct research and development

90. This clause defines what is meant by "subsidised qualifying expenditure on in-house direct research and development". It is based on paragraph 10B of Schedule 12 to FA 2002.

91. *Subsection (2)* contains the condition that the expenditure must be subsidised. The other conditions are the same as those in clause 16.

92. The clause does not rewrite the condition in paragraph 10B(c) of Schedule 12 to FA 2002 that the expenditure "is not qualifying sub-contracted R&D expenditure for the purposes of this Schedule". It is unnecessary.

93. To qualify under Part 2A of Schedule 12 to FA 2002 the expenditure must qualify for relief under Schedule 20 to FA 2000 but for the fact it is subsidised. Expenditure would not qualify under Schedule 20 to FA 2000 if it is paid in respect of activities sub-contracted to the company. Condition E in subsection (6), which reproduces condition D in clause 16, is all that is required.

94. This clause does not reproduce the condition that the expenditure must not be capital in nature. This condition is unnecessary because a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Clause 27: Subsidised qualifying expenditure on contracted out research and development

95. This clause defines what is meant by "subsidised qualifying expenditure on contracted out research and development". It is based on paragraph 10B of Schedule 12 to FA 2002.

96. The clause does not allow a small or medium-sized enterprise to claim relief for a subsidised contribution to independent research and development. A large company can claim relief for such expenditure, clause 33, but a small or medium-sized enterprise cannot and therefore the condition in paragraph 10B(b) of Schedule 12 to FA 2002 would not be satisfied.

97. This clause does not reproduce the condition that the expenditure must not be capital in nature. This condition is unnecessary because a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Chapter 5: Relief for large companies

Overview

98. This Chapter rewrites the relief given to large companies by Part 1 of Schedule 12 to FA 2002. That Part gives relief for expenditure on direct research and development undertaken by the company itself and for research and development that is contracted out to it. There is no restriction for expenditure that is subsidised but relief for expenditure which it sub-contracts is limited.

99. The Chapter applies only to expenditure incurred on or after 1 April 2002. See paragraph 20 in Schedule 12 to FA 2002. Paragraph 2 in the transitionals Schedule preserves this commencement rule. For the purposes of this Bill it is relevant only to the treatment of pre-trading expenditure.

100. A "large company" is any company which is not a small or medium-sized enterprise, clause 6.

Clause 28: Additional deduction in calculating profits of trade

101. This clause allows a large company to claim an additional deduction for qualifying expenditure on research and development. It is based on paragraph 11 of Schedule 12 to FA 2002.

102. As with the reliefs given to small or medium-sized enterprises the relief increases any deduction already given in calculating trade profits, *subsection (5)*. The amount of the increase is 25%, *subsection (6)*.

Clause 29: R&D threshold

103. This clause gives the minimum amount of expenditure that a company must incur in an accounting period to claim relief under Chapter 5. It is based on paragraph 1 of Schedule 12 to FA 2002.

104. The threshold of £10,000, *subsection (1)*, is reduced proportionately if the accounting period is less than 12 months long, *subsection (2)*. The normal operation of section 401 of ICTA is not suspended. So pre-trading expenditure that is bunched into the accounting period in which the trade starts counts towards the threshold, *subsection (4)*.

Clause 30: Qualifying Chapter 5 expenditure

105. This clause identifies the three categories of expenditure that qualify for relief under Chapter 5. It is based on paragraph 3 of Schedule 12 to FA 2002.

Clause 31: Qualifying expenditure on in-house direct research and development

106. This clause defines "qualifying expenditure on in-house direct research and development". It is based on paragraph 4 of Schedule 12 to FA 2002.

107. "In-house direct research and development" is the term this Bill uses to describe research and development that is undertaken directly by the company.

108. The clause does not reproduce the condition in paragraph 4(5) of Schedule 12 to FA 2002 that the expenditure is not of a capital nature. This is not necessary as a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

109. Condition C in *subsection (4)* identifies the expenditure that qualifies if the research and development is contracted out to the company. It prevents more than one company claiming the relief and the benefit of the relief leaking into the income tax sector.

110. If a large company commissions the research and development that company will not be able to claim relief under Chapter 5 of this Part. This is because that Chapter requires the company to carry out the research and development itself. So subsection (4) allows a large company to which the research and development is sub-contracted to claim the relief.

111. If the research and development is contracted out by a small or medium-sized enterprise that company will be able to claim relief itself under Chapter 2 of this Part. The effect of subsection (4) is to prevent relief also being given to the sub-contractor large company.

112. The relief given by this Part is restricted to corporation tax payers. Subsection (4) prevents a sub-contractor company getting relief if the work has been contracted out by a person, other than a large company, who could get a deduction for the payment in calculating their trade profits. This prevents the sub-contractor passing on some of the benefit of the relief to an income tax payer by charging lower prices.

Clause 32: Qualifying expenditure on contracted out research and development

113. This clause defines "qualifying expenditure on contracted out research and development". It is based on paragraph 5 of Schedule 12 to FA 2002.

114. The clause does not reproduce the condition in paragraph 5(5) of Schedule 12 to FA 2002 that the expenditure is not of a capital nature. This is not necessary as a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

115. Condition D in *subsection (5)* is needed to support condition C in clause 31(4). It would be possible to by-pass the restrictions in clause 31(4) if the company contracted out research and development that had been sub-contracted to it. Without condition D the company would be able to claim relief for expenditure on the research and development it contracted out.

Clause 33: Qualifying expenditure on contributions to independent research and development

116. This clause defines "qualifying expenditure on contributions to independent research and development". It is based on paragraph 6 of Schedule 12 to FA 2002.

117. The main purpose of this clause is to support research and development carried out by universities and other non-taxpaying research institutions. Relief is given for contributions to help fund the research and development carried out by such bodies. The research and development must be related to a trade carried on by the company, *subsection (3)*, and the expenditure must be deductible in calculating the company's profits. See clause 28(6) and the deduction given by section 82B of ICTA [rewritten clause not in this print]. But the research and development is independent in the sense that it is not commissioned by or carried out on behalf of the company.

118. For example, a telecommunications company could claim relief for a contribution to a university physics department to help fund research into new methods of exploiting microwave sources. The company would not own or have exclusive rights to the results of the research.

Chapter 6: Relief for SMEs and large companies: vaccine research etc

Overview

119. This Chapter rewrites the relief given to all companies by Schedule 13 to FA 2002 for research into certain vaccines and medicines (vaccine research). The relief is given in addition to any additional relief for research and development. Most companies claiming relief for vaccine research will qualify for both reliefs.

120. The amount of the relief is an additional deduction of 50% for all types of company or exceptionally 150% if the expenditure does not qualify as trade deduction. Although the amount of the relief is the same there are minor differences in the conditions that apply to claims by large companies and claims by small or medium-sized enterprises. The treatment of pre-trading expenditure incurred by large companies and small or medium-sized enterprises is quite different.

Clause 34: Introduction

121. This clause describes the contents of the Chapter. It is new.

Clause 35: Meaning of "qualifying R&D activity"

122. This clause defines "qualifying R&D activity" for the purposes of the relief available for vaccine research. It is based on paragraph 4 of Schedule 13 to FA 2002.

123. The relief is intended to encourage research into vaccines that protect against diseases that are particularly prevalent in the developing world. This is reflected in the scope of *subsections (1)* and *(2)*. A clade is a type of genetic grouping. Subsection (2) limits relief to research into the varieties of HIV that are most common in the developing world.

Clause 36: Deduction in calculating profits of trade

124. This clause allows the company to claim relief as a trade deduction for qualifying expenditure on vaccine research. It is based on paragraphs 14 and 21 of Schedule 13 to FA 2002.

125. The clause combines the qualifying conditions that apply to small or medium-sized enterprises in paragraph 14 and to large companies in paragraph 21 of Schedule 13 to FA 2002. The amount of the relief is given separately for each type of company in the following two clauses. Also, clause 39 allows a small or medium-sized enterprise to elect to create a trade loss in respect of pre-trading expenditure.

Clause 37: SMEs: amount of deduction

126. This clause gives the amount of the deduction if a small or medium-sized enterprise claims relief as a trade deduction. It is based on paragraph 14 of Schedule 13 to FA 2002.

127. If the expenditure also qualifies for relief under Chapter 2 of this Part *subsection (2)* gives an additional deduction of 50% in calculating the trade profits.

128. If the expenditure does not qualify for relief under Chapter 2 of this Part *subsection (3)* gives a deduction of 150% in calculating the trade profits.

129. The normal operation of section 401 of ICTA is suspended when allocating qualifying expenditure to an accounting period, clause 44(3). Pre-trading expenditure is allocated to accounting periods in accordance with generally accepted accounting practice and is not treated as incurred when the company starts to trade.

130. The company may be carrying on one trade and incur pre-trading expenditure in respect of another activity. *Subsections (6)* and *(7)* make clear that relief can be claimed on the pre-trading activity and be given as a deduction in calculating the profits of the existing trade. This follows from paragraph 14(1)(b) of Schedule 13 to FA 2002, which requires only that the company be carrying on *a* trade. There is no requirement that the relief is given in calculating the profits of *the* trade for which the relief is given.

Clause 38: Large companies: amount of deduction

131. This clause gives the amount of the deduction if a large company claims relief as a trade deduction. It is based on paragraph 21 of Schedule 13 to FA 2002.

132. If the expenditure is allowable as a trade deduction the relief is an additional 50% of the expenditure, *subsection (3)*.

133. If the expenditure is not allowable as trade deduction the relief is 150% of the expenditure, *subsection (4)*.

Clause 39: SMEs: deemed trading loss for pre-trading expenditure

134. This clause allows a small or medium-sized enterprise to claim immediate relief for qualifying expenditure incurred in a pre-trading period. It is based on paragraph 15 of Schedule 13 to FA 2002.

135. The clause is very similar to clause 10. A small or medium-sized enterprise can elect to create a trading loss in respect of pre-trading expenditure that qualifies for relief under Chapter 6.

136. Clause 44(2)(b) has an important role to play in the operation of this clause. It determines how pre-trading expenditure is allocated to accounting periods. This determines whether the threshold test in *subsection (3)* is met and the amount on which relief is given.

137. Relief is not available if the company is carrying on any trade in the period, *subsection (5)*. But if the company is carrying on a trade it can claim relief for pre-trading expenditure in calculating the profits of that trade. See clause 37(7).

138. If a company makes an election under this clause no further relief is available for the expenditure. *Subsection (8)* prevents section 401 of ICTA applying. So the expenditure is not allowed as a normal deduction if the pre-trading expenditure leads to the creation of a trade.

Clause 40: Elections under section 39

139. This clause gives the procedure for making an election under clause 39. It is based on paragraph 15 of Schedule 13 to FA 2002.

Clause 41: Treatment of deemed trading loss under section 39

140. This clause imposes a restriction on the use of the trade loss and explains how any unused loss is to be dealt with. It is based on paragraph 15 of Schedule 13 to FA 2002.

141. The clause is identical in effect to clause 12.

Clause 42 R&D threshold

142. This clause gives the minimum amount of expenditure that a company must incur in an accounting period to claim relief under this Chapter. It is based on paragraph 1 of Schedule 13 to FA 2002.

Clause 43: Meaning of "qualifying Chapter 6 expenditure"

143. This clause identifies the three categories of expenditure which qualify for relief. It is based on paragraph 2 of Schedule 13 to FA 2002.

Clause 44: SMEs: qualifying expenditure "for" an accounting period

144. This clause explains how qualifying expenditure is allocated to the accounting periods of a small or medium-sized enterprise. It is based on paragraph 2 of Schedule 13 to FA 2002.

145. *Subsection (2)* deals with in-house direct research and development and contracted out research and development. The basic rule is that expenditure is

incurred for an accounting period if it is deductible in calculating the trade profits for that period.

146. *Subsection (3)* suspends the normal operation of section 401 of ICTA for pre-trading expenditure. Pre-trading expenditure is not treated as incurred on the first day of trading. Instead s*ubsection (2)(b)* treats the expenditure as incurred for an accounting period if it would have been deductible in calculating the trade profits for that period if the company had been trading.

147. Relief is available for pre-trading expenditure not just under clause 39 but also under the main rule in clause 37 if it can be deducted in calculating the profits of a trade.

148. *Subsection (4)* allocates contributions to independent research and development to the accounting period in which they are made. Despite the requirement in clause 48(3) that a company claiming relief for such a contribution must be carrying on a trade it is possible that the payment may not be allowed as a trade deduction. Therefore it would not be appropriate to link the timing of the payment to its deductibility in calculating trade profits.

Clause 45: Large companies: qualifying expenditure "for" an accounting period
149. This clause explains how qualifying expenditure is allocated to the accounting periods of a large company. It is based on paragraph 2 of Schedule 13 to FA 2002.

150. *Subsection (2)* deals with in-house direct research and development and contracted out research and development. Expenditure is incurred for an accounting period if it is deductible in calculating the trade profits for that period. Unlike small or medium-sized enterprises the normal rules for pre-trading expenditure in section 401 of ICTA apply, *subsection (3)*. Any pre-trading expenditure will be treated as incurred the day the company starts trading.

Clause 46: Qualifying expenditure on in-house direct research and development
151. This clause defines "qualifying expenditure on in-house direct research and development". It is based on paragraph 3 of Schedule 13 to FA 2002.

152. "In-house direct research and development" is the term this Bill uses to describe research and development that is undertaken directly by the company.

153. *Subsections (2)* and *(3)* rewrite sub-paragraphs (2) and (3) of paragraph 3 of Schedule 13 to FA 2002 which refer to the expenditure being *on* qualifying R&D activity. This clause refers to the expenditure being *attributable* to qualifying R&D activity in order to align the language with that in Chapters 2 to 5 of this Part.

154. Paragraph 3(3) of Schedule 20 to FA 2000 and paragraphs 4(4) and 9(3) of Schedule 12 to FA 2002 all require that the qualifying expenditure is attributable to relevant research and development. The provisions that define particular classes of

expenditure have rules for determining if the expenditure is attributable to relevant R&D.

155. Paragraph 3(3) of Schedule 13 to FA 2002 requires that the "qualifying R&D activity on which the expenditure is incurred is relevant research and development in relation to the company". This test is the same as requiring the expenditure to be attributable to relevant research and development and the clause adopts the language of the earlier Chapters.

156. The clause does not reproduce the condition in paragraph 3(4) of Schedule 13 to FA 2002 that the expenditure is not of a capital nature. This is not necessary as a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Clause 47: Qualifying expenditure on contracted out research and development

157. This clause defines "qualifying expenditure on contracted out research and development". It is based on paragraphs 6 and 7 of Schedule 13 to FA 2002.

158. The clause covers two distinct types of expenditure:

- a payment to a charity, university or research association. This expenditure is allowed in full provided the conditions in the clause are satisfied.

- a payment to a sub-contractor. Again the conditions in the clause have to be satisfied but it also necessary to isolate the sub-contractor element of the payment. This is described in clauses 75 to 77.

159. *Subsections (3)* and *(4)* also refer to the expenditure being attributable to qualifying R&D activity. See the commentary on clause 46.

160. The clause does not reproduce the condition in paragraph 7(5) of Schedule 13 to FA 2002 that the expenditure is not of a capital nature. This is not necessary as a clause in the trading income Part [not in this print] already prohibits a deduction for capital expenditure.

Clause 48: Qualifying expenditure on contributions to independent research and development

161. This clause defines "qualifying expenditure on contributions to independent research and development". It is based on paragraph 12 of Schedule 13 to FA 2002.

162. See the commentary on clause 33 for a description of the function of this clause.

Chapter 7: R&D tax credits

Overview

163. This Chapter rewrites the paragraphs of Schedule 20 to FA 2000 and Schedule 13 to FA 2002 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".

Clause 49: Introduction

164. This clause describes the contents of the Chapter. It is new.

165. This Bill does not rewrite paragraph 24 of Schedule 20 to FA 2000. This provision is redundant since paragraph 3 of Schedule 4 to the Commissioners for Revenue and Customs Act 2005 removed HMRC from the ambit of the Exchequer and Audit Departments Act 1866. A similar provision in paragraph 26 of Schedule 13 to FA 2002 was repealed by paragraph 96 of Schedule 4 to the CRCA 2005.

Clause 50: Entitlement to and payment of R&D tax credit

166. This clause allows a small or medium-sized enterprise to claim an R&D tax credit. It is based on paragraph 15 of Schedule 20 to FA 2000 and paragraph 16 of Schedule 13 to FA 2002.

Clause 51: Meaning of "Chapter 2 surrenderable loss"

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

168. *Subsection (1)* identifies the two sources of a surrenderable loss. Either a claim under clause 9 can create or increase a trade loss or a claim under clause 10 can create a loss out of pre-trading expenditure.

169. *Subsection (2)* gives the amount of the surrenderable loss if clause 9 applies. The loss is restricted to the amount attributable to the expenditure that qualifies for relief under Chapter 2 plus the amount of that relief. So if a company has a trade loss of £40,000 and incurred qualifying expenditure on in-house direct research and development of £10,000, the loss for the purposes of subsection (2) is £15,000. The amount of the surrenderable loss is further reduced if it is, or could be, relieved in other ways.

170. *Subsection (3)* gives the amount of the surrenderable loss if clause 10 applies. The full amount of the loss is available subject to its being reduced if it is, or could be, relieved in other ways.

171. *Subsection (4)* lists the other ways in which a company may get relief for the loss. The amount of the surrenderable loss is reduced by any claim the company could make under section 393A(1)(a) of ICTA whether or not the company actually makes the claim. In the case of losses carried back or surrendered as group relief the restriction applies only if the losses have been used in this way.

Clause 52: Meaning of "Chapter 6 surrenderable loss"

172. This clause defines "Chapter 6 surrenderable loss". It is based on paragraph 16 of Schedule 13 to FA 2002.

173. The clause follows the same pattern as clause 51 but the restriction in *subsection (2)* if the claim is made by a trading company is slightly different. Clause 51(2)(b) gives relief both for the additional deduction and for the underlying expenditure. Clause 52(2) recognises that if the company has had relief under Chapter 2 it will already have had relief for the underlying expenditure in making an R&D tax credit claim under clause 51. So clause 52(2) restricts the R&D tax credit claim to the amount of the deduction under Chapter 6.

174. *Subsection (4)* does not rewrite the reference to "any loss surrendered under paragraph 15 of Schedule 20 to FA 2000 (entitlement to R&D tax credit)" in paragraph 16(4) of Schedule 13 to FA 2002.

175. A "Chapter 6 surrenderable loss" is the loss that results from a claim to vaccine research. This will not include any amount that could have been surrendered under paragraph 15 of Schedule 20; in the language of this Bill, any "Chapter 2 surrenderable loss". So the reference to paragraph 15 of Schedule 20 is not needed.

Clause 53: Amount of R&D tax credit

176. This clause gives the amount of the R&D tax credit. It is based on paragraph 16 of Schedule 20 to FA 2000 and paragraph 17 of Schedule 13 to FA 2002.

177. The amount of the credit is limited to the total amount of the company's PAYE and NIC liabilities. This amount is defined in clause 54.

Clause 54: Total amount of company's PAYE and NIC liabilities

178. This clause 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 and paragraph 17 of Schedule 13 to FA 2002.

Clause 55: Payment of R&D tax credit: supplementary

179. This clause 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 and paragraph 18 of Schedule 13 to FA 2002.

Clause 56: Tax credit payment not income of company

180. This clause 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 and paragraph 20 of Schedule 13 to FA 2002.

Clause 57: Restriction on losses carried forward where company entitled to tax credit

181. This clause 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 and paragraph 19 of Schedule 13 to FA 2002.

Clause 58: Interpretation of Chapter

182. This clause defines various expressions used in the Chapter. It is based on paragraph 25 of Schedule 20 to FA 2000 and paragraph 27 of Schedule 13 to FA 2002.

Chapter 8: Chapters 3 to 6: further provision

Clause 59: Research and development expenditure of group companies

183. This clause deals with the case where the research and development in a group of companies is undertaken by particular members of the group on behalf of other group companies. It is based on paragraph 14 of Schedule 12 to FA 2002.

184. It is a common commercial arrangement for one or more companies in a group to undertake research and development on behalf of all the companies in the group. This means the expenditure can be separated from the trade to which the research and development relates.

Example

Company B undertakes all the testing on behalf of the group. Testing by itself is not research and development but it could be if it were done by a company as part of its own relevant research and development activity. Company A makes a payment to company B to undertake some tests on its behalf. The payment by company A does not qualify for relief because it does not satisfy condition A in clause 31. The expenditure incurred by company B on carrying out the work satisfies condition A but it does not satisfy condition B.

If the work had been carried out by company A both conditions A and B would be satisfied.

185. Clause 59 deals with this problem by treating company B as carrying out relevant research and development, *subsection (2)*.

186. *Subsection (3)* extends the fiction if company B in turn pays a third party C to undertake any of the work. It treats B as if it had contracted out research and development.

187. The clause does not apply to the relief available under Chapters 2 and 4 of this Part because it is not possible for a small or medium-sized enterprise to claim relief for research and development contracted out to it.

Clause 60: Refunds of expenditure treated as income chargeable to tax

188. This clause imposes a charge to tax if the company gets a refund of expenditure for which it has received certain of the reliefs given by this Part. It is based on paragraph 15 of Schedule 12 and paragraph 25 of Schedule 13 to FA 2002.

189. The feature most of the provisions listed in *subsection (2)* have in common is that the company has paid another person to carry out the research and development. That other person may refund some or all of the payment and the clause recovers the relief the company has had for the payment.

190. The exception to this is qualifying Chapter 4 expenditure. This is included in subsection (2) because the company has already received financial assistance for the expenditure it incurs on research and development. It is reasonable to recover any relief given if the company receives a refund of that expenditure.

Clause 61: Refunds: the appropriate amount

191. This clause gives the amount of the recovery under clause 60. It is based on paragraph 15 of Schedule 12 to FA 2002 and paragraph 25 of Schedule 13 to FA 2002.

Chapter 9: Anti-avoidance

Clause 62: Artificially inflated claims for relief or R&D tax credit

192. This clause denies relief for transactions that are intended to increase artificially the amount of relief or R&D tax credit. It is based on paragraph 21 of Schedule 20 to FA 2000, paragraph 16 of Schedule 12 and paragraph 24 of Schedule 13 to FA 2002.

193. The type of arrangement to which this clause could apply is the case where the company boosts the expenditure on which it can claim relief in circumstances where it does not have to bear the economic cost of that expenditure. For example, the company could finance the enhanced expenditure by taking out a loan it does not have to repay or for which it is guaranteed the funds to repay.

Chapter 10: Supplementary

Overview

194. This Chapter brings together the definitions of terms that apply to each of the earlier Chapters. Most of these definitions are given in Schedule 20 to FA 2000 but they are applied to Schedules 12 and 13 to FA 2002 by the respective paragraphs 17 and 5 of those Schedules. In that case the commentary shows only the Schedule 20 provision as the origin of the clause.

Clause 63: Meaning of "staffing costs"

195. This clause defines "staffing costs". It is based on paragraph 5 of Schedule 20 to FA 2000.

196. Paragraph 5(1)(a) of Schedule 20 to FA 2000 refers to "emoluments paid by the company … including all salaries, wages, perquisites and profits whatsoever other than benefits in kind". This is based on the definition of emoluments that section 131 of ICTA applied for Schedule E before that Schedule was rewritten by ITEPA.

197. ITEPA amended paragraph 5 of Schedule 20 to FA 2000 so that it referred to earnings which constitute employment income. In doing so it inadvertently expanded the definition to include benefits in kind. This change was reversed by paragraph 7 of Schedule 17 to FA 2004, which reinstated the original wording.

198. In rewriting Schedule 20 to FA 2000 we want to update the language and adapt the definition so it applies more clearly from the position of the company making the payment rather than the employee receiving it.

199. We propose to do this by referring to money earnings and reimbursed expenses. *Subsection (2)* rewrites the reference to salaries and wages by reference to money earnings. *Subsection (3)* rewrites the reference to perquisites or profits whatsoever by reference to reimbursed expenses but making clear that it does not include benefits in kind. See *Change 2* in Annex 1.

Q2. We propose to define "staffing costs" by reference to money earnings and reimbursed expenses. We welcome comments on this proposed rewrite change.

200. Paragraph 4 in the transitionals and savings Schedule preserves the wider definition inserted by ITEPA for the brief window in which it applies to accounting periods covered by this Bill. It is relevant only to expenditure incurred before 1 April 2004.

Clause 64: Staffing costs: expenditure attributable to relevant research and development

201. This clause identifies when staffing costs are attributable to relevant research and development. It is based on paragraph 5 of Schedule 20 to FA 2000.

202. The basic rule is that the director or employee must be engaged directly and actively in the research and development, *subsection (2)*. The legislation recognises that the director or employee may do this for part only of his or her time in which case the qualifying costs are apportioned, *subsection (4)*.

203. When the legislation was introduced the test was that 80% of the director or employee's working time had to be spent on relevant research and development. Paragraph 5 in the transitionals and savings Schedule preserves this for pre-trading expenditure treated as incurred in the accounting periods to which this Bill applies. It is relevant only to expenditure incurred before 9 April 2003 (Chapters 3 and 5) and 27 September 2003 (Chapters 2 and 4).

Clause 65: Meaning of "software or consumable items"

204. This clause defines "software or consumable items". It is based on paragraph 6 of Schedule 20 to FA 2000.

205. When the legislation was introduced relief under all the Chapters in this Part was given for expenditure on "consumable stores". Paragraph 6 in the transitionals and savings Schedule preserves this for pre-trading expenditure treated as incurred in the accounting periods to which this Bill applies. It is relevant only to expenditure incurred before 1 April 2004.

Clause 66: Software or consumable items: expenditure attributable to relevant research and development

206. This clause identifies when expenditure on software or consumable items is attributable to relevant research and development. It is based on paragraph 6 of Schedule 20 to FA 2000.

Clause 67: Meaning of "relevant payments to the subjects of a clinical trial"

207. This clause defines "relevant payments to the subjects of a clinical trial". It is based on paragraph 6A of Schedule 20 to FA 2000. Paragraph 7 in the transitionals and savings Schedule preserves the commencement date for this category of expenditure. That date has not yet been announced for the relief given by Chapters 2, 3 and 6 of this Part.

Clause 68: Meaning of "qualifying expenditure on externally provided workers"

208. This clause defines "qualifying expenditure on externally provided workers". It is based on paragraph 8A of Schedule 20 to FA 2000.

209. Clause 68 is the first of six clauses that deal with the relief given to expenditure on externally provided workers. Broadly it covers payments (staff provision payments) made to persons (staff providers) who supply agency workers. It applies also to payments made to other group companies for the services of individuals who are employees of those companies.

210. *Subsection (2)* calls the amount of the expenditure that qualifies "the R&D element" of the staff provision payment. Clauses 70 to 72 explain how to calculate this amount. These clauses focus on the subject matter of the expenditure. Clause 73 then identifies whether that expenditure is incurred on relevant research and development.

211. The relief applies only to expenditure incurred on or after 9 April 2003 (Chapters 3 and 5) or 27 September 2003 (Chapters 2, 4 and 6). Paragraph 8 in the transitionals and savings Schedule preserves this for pre-trading expenditure treated as incurred in the accounting periods to which this Bill applies.

Clause 69: Meaning of "externally provided worker"

212. This clause defines "externally provided worker". It is based on paragraph 8B of Schedule 20 to FA 2000.

213. *Subsection (6)* gives the condition that the payment must be made to a staff provider and not directly to the individual.

Clause 70: R&D element of staff provision payment: connected persons

214. This clause gives the amount of the R&D element of the payment if the company and the staff provider are connected. It is based on paragraph 8C of Schedule 20 to FA 2000.

215. If the company and the staff provider are connected relief is available only under this clause. The definition of connected persons in section 839 of ICTA applies, see clause 81.

216. *Subsection (1)(c)* requires that there is symmetry of treatment between the deduction of the payment in the company's accounts and the recognition of the receipt in the staff provider's accounts. This prevents the company getting relief for a payment for which there is some delay in taxing the staff provider. The accounting dates of the company and staff provider may not coincide. *Subsection (4)* gives a definition of relevant period to identify the accounts in which the receipt must be recognised.

217. *Subsection (2)* identifies the R&D element of the payment. The full amount of the payment can qualify but this is tested against the staff provider's actual expenditure which the clause calls its "relevant expenditure".

218. *Subsection (3)* defines "relevant expenditure". It includes the exclusion for expenditure of a capital nature that is omitted in the rewrite of other provisions of the source legislation for this Part. The clause in the trading income Part that denies a deduction for capital expenditure applies to determine if the expenditure would be deductible in calculating the taxable profit. It would not apply to exclude capital expenditure from the staff provider's actual relevant expenditure.

219. Subsection (3)(c) requires that the expenditure is incurred on staffing costs or agency workers' remuneration. The definition of staffing costs, as applied by *subsection (5)*, limits the relief to the expenditure that would qualify as staffing costs if it were incurred by the company itself. The definition of agency workers' remuneration in *subsection (6)* limits the relief to an amount that is actually paid to the agency worker. This excludes any amount of the payment that represents the staff provider's profit or expenditure on non-research and development related overheads.

220. Subsections (5) and (6) require the company to know how the staff provider spent the money.

221. The definition of agency workers' remuneration in subsection (6) omits the reference to section 134 of ICTA in paragraph 8C(4)(b) of Schedule 20 to FA 2000. The ICTA provision was repealed by ITEPA and the cross-reference is no longer required.

Clause 71: Election for connected persons treatment

222. This clause allows a company and a staff provider who are not connected to elect for connected persons treatment. It is based on paragraph 8D of Schedule 20 to FA 2000.

223. An election under this clause may give the company a higher amount of relief than the 65% allowed by clause 72 but it will require the company to know how the staff provider spent the money.

Clause 72: R&D element of staff provision payment: other cases

224. This clause identifies the R&D element of the staff provision payment if the company and staff provider are not connected and have not made an election under clause 71. It is based on paragraph 8E of Schedule 20 to FA 2000.

225. *Subsection (2)* sets the amount of the relief at 65% of the expenditure. This limit is intended to exclude any amount of the payment that represents the staff provider's profit or expenditure on non-research and development related overheads.

Clause 73: External workers: expenditure attributable to relevant research and development

226. This clause identifies when a staff provision payment is attributable to relevant R&D. It is based on paragraph 8A of Schedule 20 to FA 2000.

227. The clause follows the pattern of clause 64 which performs a similar function for staffing costs.

Clause 74: Sub-contractor payments: R&D element

228. This clause is the first of a group of four clauses that apply to sub-contractor payments. It is new.

229. The clauses are very similar to those that apply to qualifying expenditure on externally provided workers. As with qualifying expenditure on externally provided workers qualifying expenditure is called the "R&D element" of the sub-contractor payment.

Clause 75: R&D element of sub-contractor payment: connected persons

230. This clause identifies the R&D element if the company and the sub-contractor are connected persons. It is based on paragraph 10 of Schedule 20 to FA 2000, paragraph 10B of Schedule 12 and paragraph 8 of Schedule 13 to FA 2002.

231. If the company and the sub-contractor are connected relief is available only under this clause. The definition of connected persons in section 839 of ICTA applies. See clause 81.

232. *Subsection (1)(c)* requires that there is symmetry of treatment between the deduction of the payment in the company's accounts and the recognition of the receipt in the sub-contractor's accounts. This prevents the company getting relief for a payment for which there is some delay in taxing the sub-contractor. The accounting dates of the company and sub-contractor may not coincide. *Subsection (4)* gives a definition of relevant period to identify the accounts in which the receipt must be recognised.

233. *Subsection (2)* identifies the R&D element of the payment. The full amount of the payment can qualify but this is tested against the sub-contractor's actual expenditure which the clause calls its "relevant expenditure".

234. *Subsection (3)* defines "relevant expenditure". It includes the exclusion for expenditure of a capital nature that is omitted in the rewrite of other provisions of the source legislation for this Part. See the commentary on clause 70(3) for an explanation of this.

235. The effect of *subsections (3)(c)* and *(d)* is that expenditure is relevant expenditure of the sub-contractor if it would have qualified had the expenditure been incurred by the company.

Clause 76: Election for connected persons treatment

236. This clause allows a company and a sub-contractor which are not connected to elect to be treated as if they were connected. It is based on paragraph 11 of Schedule 20 to FA 2000, paragraph 10B of Schedule 12 and paragraph 10 of Schedule 13 to FA 2002.

237. An election under this clause may give the company a higher amount of relief than the 65% allowed by clause 77 but it will require the company to know how the sub-contractor spent the money it received.

Clause 77: R&D element of sub-contractor payment: other cases

238. This clause identifies the R&D element if the company and the sub-contractor are not connected persons. It is based on paragraph 12 of Schedule 20 to FA 2000, paragraph 10B of Schedule 12 and paragraph 11 of Schedule 13 to FA 2002.

239. *Subsection (2)* sets the amount of the relief at 65% of the expenditure. This limit is intended to exclude any amount of the payment that represents the sub-contractor's profit or expenditure on non-research and development related overheads.

Clause 78: Meaning of "intellectual property"

240. This clause defines "intellectual property". It is based on paragraph 7 of Schedule 20 to FA 2000.

Clause 79: Meaning of "subsidised expenditure"

241. This clause defines "subsidised expenditure". It is based on paragraph 8 of Schedule 20 to FA 2000.

Clause 80: Accounting periods: company not within charge to corporation tax

242. This clause treats the company as having an accounting period if it incurs qualifying expenditure at a time when it is not within the charge to corporation tax. It is based on paragraph 25 of Schedule 20 to FA 2000 and paragraph 27 of Schedule 13 to FA 2002.

243. This clause is needed primarily for the purposes of clauses 10 and 39. Those clauses allow a company to elect to create a loss in respect of pre-trading expenditure. A company that is not yet trading may not have an accounting period. Clauses 10 and 39 operate by reference to accounting periods. Clause 80 treats the company as having the accounting periods it would have had if it had been trading when it incurred the expenditure.

Clause 81: Connected persons

244. This clause invokes the definition of connected persons in section 839 of ICTA. It is based on paragraph 25 of Schedule 20 to FA 2000, paragraph 19 of Schedule 12 and paragraph 27 of Schedule 13 to FA 2002.

Clause 82: Meaning of "qualifying body"

245. This clause defines "qualifying body". It is based on paragraph 18 of Schedule 12 to FA 2002.

Schedule 1: Consequential amendments

246. This Schedule is work in progress. It should not be taken as a complete list of the consequential amendments that may be required or the final form those amendments may take.

Schedule 2: Transitionals and savings

247. This Schedule preserves the start dates for the various reliefs and the changes to the definitions of qualifying expenditure. Most of these are mentioned in the commentary. It is particularly relevant for pre-trading expenditure.

ANNEX 1

Change 1: Research and development: additional relief for research and development applies for corporation tax only: clause 1
This change makes clear that the additional relief for research and development, including vaccine research, applies only for corporation tax.

Schedule 20 to FA 2000 and Schedules 12 and 13 of FA 2002 apply only to companies. See the respective paragraphs 1(1) of each Schedule. The source legislation does not say that the relief given by those Schedules is restricted to a company liable to corporation tax. This leaves open the possibility that the reliefs are available to a company liable to income tax. Such a company would carry on a trade in the United Kingdom other than through a permanent establishment in the United Kingdom.

It is most unlikely that such a company would meet the qualifying conditions for relief but there are other more direct indicators that the reliefs are available only to companies liable to corporation tax.

First, the legislation is drafted in terms of accounting periods and that is a term that is defined only for corporation tax. See the respective paragraphs 1(1) of the Schedules and section 12 of ICTA.

Second, Parts 9A, 9BA and 9C of Schedule 18 to FA 1998 provide that claims to each relief must be made in the company tax return; that is, the company's return of its corporation tax liability. There is no equivalent provision for income tax.

Third, the respective paragraphs 19 of Schedule 20 to FA 2000 and Schedule 13 to FA 2002 prevent a loss that has been surrendered in return for the payment of a tax credit being carried forward. There is no equivalent provision for income tax.

The three Schedules are rewritten in Part [Additional relief for expenditure on research and development] of this Bill and repealed by Schedule 1 to this Bill. Clause 1(1), and other clauses in the Part, provide that the relief applies only for corporation tax.

This change is adverse to some taxpayers in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 2: Research and development: Meaning of "staffing costs": clause 63
This change amends the definition of "staffing costs" in the rewrite of paragraph 5(1) of Schedule 20 to FA 2000 so that it applies to money earnings and reimbursed expenses.

Schedule 20 to FA 2000 allows a small or medium-sized enterprise to claim additional relief for qualifying expenditure on research and development that is related to its

trade. “Staffing costs” as defined in paragraph 5 of Schedule 20 to FA 2000 is one of the categories of qualifying expenditure. The same definition is applied in Schedules 12 and 13 to FA 2002.

When Schedule 20 to FA 2000 was enacted paragraph 5(1)(a) defined staffing costs as:

> The emoluments paid by the company to directors or employees of the company, including all salaries, wages, perquisites and profits whatsoever other than benefits in kind

This language drew on the definition of “emoluments” in section 131 of ICTA. The only difference is that section 131 of ICTA omitted the words “other than benefits in kind”. Section 131 of ICTA identified the emoluments on which an employee was charged to income tax under Schedule E.

Schedule E was rewritten by ITEPA. The charge on emoluments became part of the charge on employment income. The word “emoluments” is quite old-fashioned and ITEPA replaced it with the word “earnings”. The charge on employment income is made up of a number of different elements and the meaning of “earnings” in ITEPA goes wider than the definition of “emoluments” in section 131 of ICTA.

ITEPA amended references to emoluments in legislation it was not rewriting to align them with the new definition of earnings. This included the definition of those staffing costs identified in paragraph 5(1)(a) of Schedule 20 to FA 2000. Paragraph 245 of Schedule 6 to ITEPA substituted the following:

> (a) The earnings paid by the company to directors or employees of the company

“Earnings” was defined in a new sub-paragraph (1ZA) which read:

> In sub-paragraph (1)(a) “earnings” means earnings or amounts treated as earnings which constitute employment income (see section 7(2)(a) or (b) of the ITEPA 2003).

There were two problems with this amendment.

First, it was unnecessary. The definition in section 131 of ICTA applied in determining the tax charge on the employee receiving the payment. It identified an amount that constituted income in the hands of the employee. Over the years it has been the subject of a significant amount of judicial comment, particularly the meaning of “perquisites and profits whatsoever”.

The definition in paragraph 5(1) of Schedule 20 to FA 2000 applies to determine the amount of an expense in the hands of the company. Although the language is the same the definition is independent of the definition in section 131 of ICTA. None of the supporting structure of Schedule E that influenced the interpretation of the definition applies to Schedule 20 to FA 2000. There was no need to change the Schedule 20 definition to mirror the rewrite of Schedule E.

Second, inadvertently it expanded the definition so that it included benefits in kind. These came in through the reference to amounts treated as earnings in section 7(2)(b) of ITEPA. The definition of those amounts in section 7(5)(b) of ITEPA includes payments under the benefits code.

This error was corrected by paragraph 7 of Schedule 17 to FA 2004. That Schedule made a number of minor amendments to, or connected with, ITEPA. The aim of the Schedule was to restore the pre-ITEPA position with minimal differences. It did this in paragraph 5(1) of Schedule 20 to FA 2000 by reinstating the original definition.

The difficulty with the original definition is partly that words such as "emoluments" and "perquisites" are out-dated and partly that aspects of the definition are not clear. In particular it is not clear what the phrase "profits whatsoever" means when looked at from the position of the employer making the payment. It is not possible to pay an amount of profit. Profit is a concept that applies to the person who receives the payment.

The definition of emoluments in paragraph 5(1)(a) of Schedule 20 to FA 2000 is rewritten in clause 63. The exclusion of benefits in kind from the definition limits the meaning to amounts paid in money. Clause 63 rewrites the definition of emoluments in two parts:

- earnings paid in money, clause 63(2); and
- reimbursed expenses, clause 63(3).

"Earnings" is not defined so it has its ordinary meaning. It will cover salaries, wages, commissions, bonuses and tips. It will also cover irregular money payments such as commissions, bonuses and tips. This covers part of the rewrite of "perquisites and profits whatsoever".

"Reimbursed expenses" covers the balance of the rewrite of "perquisites and profits whatsoever". It will apply to cash reimbursements of expenses but not to expenses reimbursed in a non-cash form such as car and fuel benefits. This follows from the exclusion for benefits in kind.

The requirement that the expenses are paid by the director or employee comes because paragraph 5(1)(a) of Schedule 20 to FA 2000 applies to "profits whatsoever". There is no profit to the director or employee unless he or she has incurred a personal liability that is then relieved by the company. So it would not apply to expenditure incurred by the employee using a company credit card because the cost would not be borne by the employee.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.