



## Corporation tax: research and development tax credits: consumables

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### Who is likely to be affected?

Companies carrying out research and development (R&D) activities.

### General description of the measure

The measure restricts the expenditure in respect of consumable items that qualifies for R&D tax credits where the company sells the products of its R&D activity as part of its normal business. The revised definition of qualifying consumable items makes it clear that the cost of materials incorporated in such products that are then sold will not be eligible for the relief. The measure increases the focus of the tax credit regime on the real costs of carrying out R&D activity.

### Policy objective

R&D tax credits are a key element in the government's commitment to an internationally competitive tax system and in its objective for strong and sustainable private sector-led growth. This measure ensures that they remain well targeted in incentivising R&D investment and that there is a level playing field between companies benefiting from R&D tax credits.

### Background to the measure

The measure was announced at Autumn Statement 2014.

It affects only those entities within the charge to corporation tax (CT) as R&D tax credits are not available to unincorporated businesses liable to income tax.

The UK R&D regimes provide relief for expenditure on R&D, including the cost of materials and other items, such as water, fuel and power used up or transformed in the R&D activity. The definition of consumable items is common across each of the regimes; that is the tax credit schemes for large companies and Small and Medium Enterprises (SMEs), and the R&D Expenditure Credit scheme.

## Detailed proposal

### Operative date

This measure will have effect in relation to expenditure incurred on or after 1 April 2015.

### Current law

The R&D relief regime is an incentive for R&D activity and investment in innovation. The legislation is in Part 13 Corporation Tax Act (CTA) 2009 and Chapter 6A of Part 3, CTA 2009. These provisions allow an enhanced tax deduction for relevant costs ("qualifying expenditure"), or in certain circumstances a payable tax credit instead of the deduction. Included in these costs is expenditure on software and consumable items. Consumable items is defined by section 1125 as including consumable or transformable materials.

Consumable or transformable materials are not further defined, however the guidelines produced by the Department for Business, Innovation and Skills state that the production of goods and services is not R&D activity. It is however recognised that in practice R&D activity can happen in conjunction with production, and in a way that makes the attribution of costs to one activity or the other debatable.

## Proposed revisions

Legislation will be introduced in Finance Bill 2015 to amend the R&D provisions in CTA 2009 in order to restrict the extent to which costs of materials and other consumable items are eligible for relief. In the circumstances where the R&D activity results in goods or services sold in the normal course of a company's business, the cost of consumable items reflected in those goods or services will not attract tax credits. Qualifying expenditure on consumable items will be limited to the cost of only those items fully used up or expended by the R&D activity itself and do not go on to be sold as part of a commercial product.

## Summary of impacts

Exchequer impact (£m)	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	-	+20	-	-	-	-
	These figures are set out in Table 2.1 of Autumn Statement 2014 and have been certified by the Office for Budget Responsibility. More details can be found in the policy costings document published alongside the Autumn Statement 2014.					
<b>Economic impact</b>	The measure is not expected to have any significant economic impacts.					
<b>Impact on individuals, households and families</b>	The measure will apply only to corporate entities within the charge to CT and so is not expected to have an impact on individuals, households or family formation, stability or breakdown.					
<b>Equalities impacts</b>	The measure will apply only to corporate entities within the charge to CT and so is not expected to have any equality impacts.					
<b>Impact on business including civil society organisations</b>	<p>This measure is expected to have a negligible impact on businesses.</p> <p>The measure will affect companies carrying out qualifying R&amp;D activities. These are particularly prevalent in refineries, manufacturing, aeronautical, shipping and pharmaceutical sectors.</p> <p>There will be some negligible one-off costs for businesses, associated with familiarisation with the changes to the legislation and negligible ongoing costs will be from assessing the criteria for qualifying expenditure on consumable items.</p> <p>This measure is expected to have no impact on civil society organisations.</p>					
<b>Operational impact (£m) (HMRC or other)</b>	There will be no significant impact on HM Revenue & Customs.					
<b>Other impacts</b>	<p><u>Small and micro business assessment:</u> small and micro businesses are not disproportionately represented in the small group of entities in which R&amp;D takes place in conjunction with normal production processes. This measure is expected to have a negligible impact.</p> <p>Other impacts have been considered and none have been identified.</p>					

**Monitoring and evaluation**

The measure will be monitored through information collected from tax returns and the R&D specialist units.

**Further advice**

If you have any questions about this change, please contact Martin Trott on 03000 585619 (email: [martin.trott@hmrc.gsi.gov.uk](mailto:martin.trott@hmrc.gsi.gov.uk)).

## 1 Relief for expenditure on research and development: expenditure on consumable items

- (1) CTA 2009 is amended as follows.
- (2) In Part 13 (additional relief for expenditure on research and development), in section 1126 (software or consumable items: attributable expenditure), after subsection (6) insert –

“(7) This section is subject to sections 1126A and 1126B.”

- (3) After section 1126 insert –

### “1126A Attributable expenditure: special rules

- (1) Expenditure on consumable items is not to be treated as attributable to relevant research and development if –
  - (a) the relevant research and development relates to an item that is produced in the course of the research and development,
  - (b) the consumable items form part of the item produced, and
  - (c) that item is transferred by a relevant person in the ordinary course of the relevant person’s business.
- (2) Expenditure on consumable items is not to be treated as attributable to relevant research and development if –
  - (a) the relevant research and development relates to a process of producing an item,
  - (b) the consumable items form part of an item produced in the course of that research and development, and
  - (c) that item is transferred by a relevant person in the ordinary course of the relevant person’s business.
- (3) If –
  - (a) the item produced as described in subsection (1) or (2) may be divided, and
  - (b) only a proportion (“the appropriate proportion”) of that item is transferred by a relevant person in the ordinary course of the relevant person’s business,

the appropriate proportion of the expenditure on the consumable items is not to be treated as attributable to the relevant research and development.
- (4) If –
  - (a) a number of items are produced in the course of the relevant research and development described in subsection (2), and
  - (b) only a proportion (“the appropriate proportion”) of those items is transferred by a relevant person in the ordinary course of the relevant person’s business,

the appropriate proportion of the expenditure on the consumable items is not to be treated as attributable to the relevant research and development.
- (5) A reference in this section to producing an item includes a reference to preparing an item for transfer.
- (6) For the purposes of this section a consumable item forms part of an item produced if –

- (a) it is incorporated into the item produced, or
  - (b) it is turned into, or it and other materials are turned into, the item produced or a part of the item produced.
- (7) A reference in this section to the transfer of an item is a reference to—
- (a) the transfer of ownership of an item to another person (whether by sale or otherwise), or
  - (b) the transfer of possession of an item to another person (whether by letting on hire or otherwise),
- and a reference to the transfer of an item includes, where the item is incorporated into another item, the transfer of that other item.
- (8) In this section—
- “item” includes any substance;
  - “relevant person”, in relation to relevant research and development, means—
- (a) the company that incurs the cost of the research and development, whether it is undertaken by itself or contracted out,
  - (b) the company to which the research and development is contracted out, whether it is undertaken by itself or contracted out,
  - (c) the person (other than a company) who contracts out the research and development to a company and incurs the cost of the research and development,
  - (d) the person (other than a company) to which the research and development is contracted out, or
  - (e) a person who is connected to a company or person described in paragraph (a), (b), (c) or (d).

#### **1126B Attributable expenditure: further provision**

- (1) The Treasury may by regulations make provision for the purpose of identifying when expenditure on consumable items is attributable to relevant research and development, including provision modifying the effect of section 1126 or 1126A.
  - (2) Regulations under this section may include provision about—
- (a) the circumstances in which expenditure on consumable items employed directly in relevant research and development is, or is not, to be treated as attributable to that relevant research and development;
  - (b) the circumstances in which consumable items are, or are not, to be treated as employed directly in relevant research and development.
- (3) Regulations under this section may—
- (a) make different provision for different purposes;
  - (b) make incidental, consequential, supplementary or transitional provision or savings.
- (4) Regulations under this section may amend—
- (a) section 1126;
  - (b) section 1126A;

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- (c) any other provision of this Act, if that is appropriate in consequence of provision made under paragraph (a) or (b).
- (5) Regulations under this section may make provision that has effect in relation to expenditure incurred before the making of the regulations, provided that it does not increase any person's liability to tax."
- (4) In each of the following, after "1126" insert "to 1126B" –
- (a) section 104D(5);
  - (b) section 104E(5);
  - (c) section 104G(6);
  - (d) section 104H(7);
  - (e) section 104J(6);
  - (f) section 104K(7);
  - (g) section 1052(7);
  - (h) section 1053(6);
  - (i) section 1066(5);
  - (j) section 1067(5);
  - (k) section 1071(7);
  - (l) section 1072(8);
  - (m) section 1077(6);
  - (n) section 1078(7);
  - (o) section 1101(7);
  - (p) section 1102(6).
- (5) In section 104Y(2), for "and 1126" substitute "to 1126B".
- (6) In section 1310(4) (orders and regulations subject to affirmative procedure), after paragraph (za) insert –
- “(zb) section 1126B (provision about when expenditure on consumable items is attributable to relevant research and development),”.
- (7) The amendments made by this section have effect in relation to expenditure incurred on or after 1 April 2015.

## EXPLANATORY NOTE

### RELIEF FOR EXPENDITURE ON RESEARCH AND DEVELOPMENT: EXPENDITURE ON CONSUMABLE ITEMS

#### SUMMARY

1. Clause [X] restricts the expenditure in respect of consumable items that qualifies for research and development ('R&D') tax credits. In the circumstances where a company sells or otherwise transfers ownership of the products of its R&D activity as part of its ordinary business then the cost of materials that go to make up those products is excluded from expenditure qualifying for relief. This restriction will apply to expenditure incurred on or after 1 April 2015.

#### DETAILS OF THE CLAUSE

2. Sections (1) and (2) amend section 1126 Corporation Tax Act 2009 (CTA 2009) so that the expenditure defined by that section as attributable to relevant research and development is further qualified by new sections 1126A and 1126B.

3. Section (3) sets out the additional rules that define attributable expenditure.

#### *New section 1126A*

4. The new section 1126A adds to the attribution rules in section 1126.

5. Subsection (1) excludes certain expenditure on items such as materials, components or machine parts making up a finished product. Where such items are both used in the development of a product and are part of the product that is then transferred the cost of the items included in the transferred product will not be qualifying expenditure.

6. Subsection (2) excludes expenditure on certain items which are used in a production process that itself involves some element of research and development. Where this process results in those items being available for transfer then the cost of those items transferred will not be qualifying expenditure.

7. Subsections (3) and (4) require an apportionment to be made between non-qualifying and qualifying expenditure on consumable item where not all of the product referred to in subsections (1) and (2) is sold or transferred. The effect is that if some of the product is retained for additional trials, or discarded as sub-standard, the costs of the consumable items in the retained or discarded products will remain qualifying expenditure and will not be excluded by subsections (1) or (2). This applies whether the product is a single item measured in terms of volume or weight (subsection (3)), or is made as discrete units (subsection (4))

8. Subsection (5) ensures that reference to producing an item refers to the entire process, including the use of ancillaries, such as packaging, that might be required before it is transferred.
9. Subsection (6) ensures that reference to a consumable item forming part of a product includes situations where that item has been physically or chemically changed in some way during the production process.
10. Subsection (7) defines 'transfer of an item'.
11. Subsection (8) defines 'item' and 'relevant person'.

***New section 1126B***

12. The new section 1126B confers powers on the Treasury to amend the attribution rules by regulation.
13. Subsection (1) allows the rules attributing expenditure on consumable items to relevant research and development to be amended by regulations. This enables the Treasury to take into account various ways in which R&D might be undertaken and consequently the manner in which relevant expenditure on consumable items may be incurred
14. Subsections (2), (3), (4) and (5) set out what the regulations may amend and how.
15. Sections (4) and (5) make consequential amendments to other sections in CTA 09 that refer to the definition of consumable items in sections 1126 and now sections 1126A and B.
16. Section (6) makes a consequential amendment to section 1310(4) to reference the regulatory powers described in paragraph 13 above.
17. Section (7) applies these provisions to expenditure incurred on or after 1 April 2015

**BACKGROUND NOTE**

18. Additional relief for R&D costs is an incentive for R&D activity and investment in innovation. R&D tax credits provide an enhanced deduction for expenditure on R&D, including the cost of materials and other items, such as water, fuel and power transformed or consumed in the R&D activity.
19. As laid out in guidelines issued by the Department for Business, Innovation and Skills ('BIS'), production costs are not expenditure on R&D. In practice, where R&D activity takes place in conjunction with commercial production the attribution of the cost of consumable items, as previously defined, can be uncertain. This has led to claims for relief for costs in respect of materials and other items used in the production of goods effectively indistinguishable from normal commercial products.



20. This measure makes the relief more targeted on innovative research and development activities, rather than activities related to production. This makes it fairer for those companies that already adhere closely to the BIS guidelines.

21. If you have any questions about this change, or comments on the legislation, please contact Martin Trott on 03000 585619 (email: [martin.trott@hmrc.gsi.gov.uk](mailto:martin.trott@hmrc.gsi.gov.uk)).