



What would you do with another 10% on your R&D budget?

By Derek Henderson, senior tax partner at Deloitte

It was very encouraging to note that in the last Chamber of Commerce oil and gas survey, sponsored by Deloitte, the UK came top as a centre for research and development. The development of the next wave of new technologies is critical to the long-term future of this industry and the more new technology developed in the UK, the better for UK PLC.

Even more encouraging was that 25% of smaller firms, employing less than 100 people, and 36% of firms with more than 100 employees reported an increase in R&D. It was however concerning that over a quarter of the contractors surveyed said that they did not undertake any R&D.

Of the operators surveyed, their R&D focused on developing new processes, improving extraction and developing related software. Contractors' R&D centred around the development of new equipment and processes, developing new services and new software.

However, if we are to recover the remaining reserves around the world in more complex fields with greater challenges, then we need new approaches in terms of technology, equipment and skills.

In many areas, particularly subsea, the industry is working with technologies developed in the eighties. Only a greater focus on R&D will yield the game-changing technologies that will allow the industry to exploit those reserves.

Excuses for not carrying out R&D vary from shortage of time and people, cost and "we don't do R&D in a real production environment, we just get the job done".

When it comes to the cost issue, many companies are unaware of or shy away from the Government's incentives for R&D activities. But from Deloitte's own research it is becoming increasingly clear that too many companies are not taking advantages of the available relief.

The main reason for this is that many are not aware of what qualifies as R&D and companies are not claiming at all or are under claiming.

If they did claim correctly, large companies could benefit from up to an additional 10% on their R&D budget whilst SMEs (broadly companies/groups with fewer than 250 employees) can enjoy a benefit of up to 15% with a cash credit of up to 24% available to loss making SMEs.

If every company had an additional 10% towards their R&D budget, we might start to see some startling new, UK sourced, technologies coming to market.

There are currently two different relief schemes available for revenue expenditure, one applicable to SMEs and another to large companies. In both cases the relief provides for additional tax deductions that reduce the overall tax burden suffered by the claimant companies. There is also a further relief available to all companies for capital spend

In practice, most costs associated with exploratory and appraisal work will be capital. Once a field is determined to be commercially viable however there are large amounts of revenue spend on activities associated with extraction and further processing which will meet the criteria for qualifying R&D expenditure and therefore the enhanced relief.

The old assumption that R&D is only undertaken by men in white coats is not true for the purposes of this relief. The official guidance states that R&D for tax relief purposes takes place when "a project seeks to achieve an advance in science and technology through the resolution of scientific or technological uncertainty." Essentially R&D may occur when a piece of work sets technology challenges that cannot be overcome by standard procedures and using the pool of knowledge that is readily available to experienced engineers working in the field. If those engineers attempt to overcome these technological uncertainties and in so doing enhance the company's knowledge or capabilities, create new or appreciably improved existing products or replicate existing products in a technologically different way, there is a good possibility that they are undertaking eligible R&D activities – whether or not they are successful. For large companies, it does not matter that they are being paid by a customer to overcome the challenges, the important point is that they are the ones making the attempt.

The main types of costs that can be claimed are those associated with employing people to carry out the work and those associated with software or consumable items utilised in the work.

Changes announced in the 2006 budget will result in a reduction of the time limits for making claims from six years to two with transitional rules

that mean the ability to claim for up to four years will expire on 31 March 2008.

For the avoidance of doubt, the claim for the cash tax credit by SMEs is currently, and will remain, one year from the filing deadline for the tax return.

This means that 2007 and early 2008 are going to be a busy time for the tax inspectors responsible for reviewing these claims so it would be wise to start thinking about this early and avoid filing claims at a time when there may well be a rush.

It is also very important not to underestimate the time taken to compile the necessary information to support a claim. It can take an experienced team several months from starting the claim to filing and that will already take most companies into the anticipated "busy time".

In our experience financial people do not always understand the intricacies of the R&D process in sufficient detail to determine whether or not there is technological uncertainty. Confusion as to what types of activities qualify, often results in eligible activities being overlooked. The more eligible activities overlooked, the less the potential benefit, and at the end of the day, this could have an impact on the future R&D budget available to you. The regime has suffered from widely held misconceptions about the extent of its availability and time is running short to overcome these misconceptions and ensure you are getting your full entitlement.

So think about it and see if an additional 10% on R&D spend could revolutionise our industry. ■

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He is a member of the Institute of Chartered Accountants of Scotland (1986), the Chartered Institute of Taxation (1988) and holds a joint honours degree in Law and Accountancy from the University of Edinburgh.

Derek serves a range of multinational and institutionally backed oil service companies and specialises in cross border structuring, merger and acquisitions, reorganisations and expatriate tax issues. He also acts for a number of significant owner managed businesses and high net worth individuals across a range of industries.