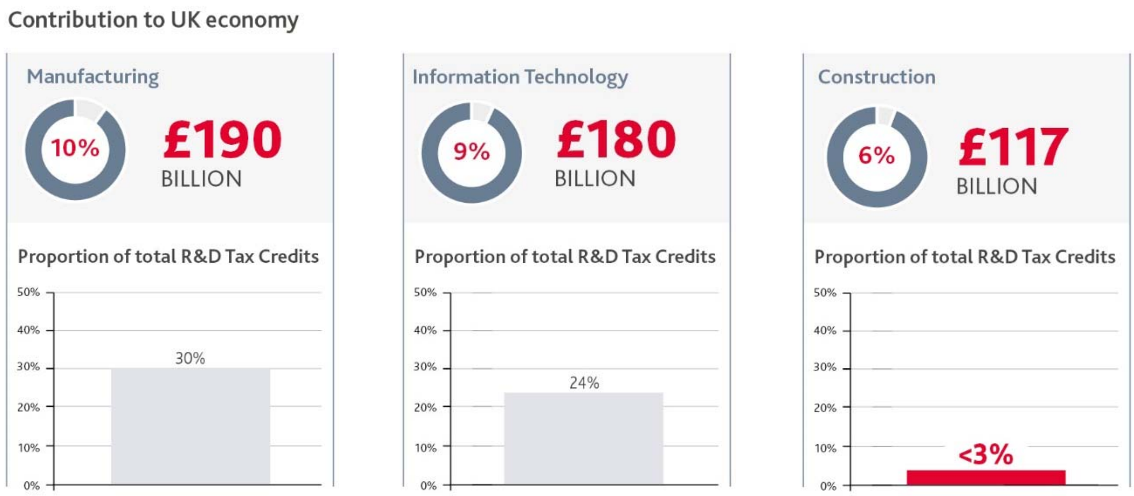
Learning from R&D claim trends in construction

BDO's R&D team highlights current trends and what to learn from them.

Looking ahead in 2021 is challenging for all businesses, so it is vital to make the most of the support mechanisms offered by the government. Tax reliefs for research and development are familiar, but in many cases it appears that construction businesses don't always make the most them. Learning from major trends that we have identified will help businesses improve their cash flow and forecasting in the year ahead.

Under claiming

Analysing the government's own statistics for R&D claims shows that businesses in the construction sectors consistently claim less R&D relief than businesses in other sectors. For example, in 2018, the construction sector represented 6% of the UK economy (a total of £117bn turnover), but less than 3% of the total R&D credits given by the government went to construction businesses.



We believe that low figure is not down to the fact that construction businesses do markedly less R&D than those in other sectors: new techniques, designs and materials are constantly coming through to the market to meet evolving safety and environmental standards.

So why do construction sector businesses claim less? In our experience, this is more to do with the way that businesses in the sector manage claims – chiefly the fact that the process is not given sufficient attention. This is perhaps understandable when your business is focusing on delivering excellent infrastructure on time and on budget, but it does mean that there is scope for construction and infrastructure businesses to improve their bottom line in this area.

Commonly, R&D claims work is outsourced once the project is underway, and often in a rush at the year end. As any good project manager will know, outsourcing a task does not guarantee it will be done well, and outsourcing work that is outside your comfort zone can meet with mixed results. The key to managing the process well is to involve an R&D adviser from the earliest project stage so that they can help you identify qualifying work and set up robust monitoring and data collection processes to make the annual claim process easier and as accurate as possible.

Clear records of who is doing the R&D

A recent tax case has highlighted several key lessons about how HMRC interprets some of the key qualifying rules for claiming R&D relief under the SME scheme. Businesses who learn these lessons are much more likely to succeed with their claims for R&D tax credits.

The case concerned a number of projects carried out by an engineering company in delivering specialised and bespoke products to its customers. The disputed claims related to projects carried out ten years ago and finally came to court after HMRC issued a closure notice on an ongoing enquiry as the company (in its view) had failed to provide sufficient evidence to resolve the enquiry.

In court, the director representing the company was unable to provide conclusive evidence that it had carried out R&D work, and that this was done in its own right. For some of the projects, HMRC had argued that the work to create bespoke products for their customers had involved no research and development to resolve a technical uncertainty through an advance in technology. HMRC also maintained, that for some of the projects, even if there was qualifying R&D, the company was merely providing an outsourcing service for its customer as it had been engaged to design and manufacture a bespoke product (so any R&D relief would accrue to the customer).

Another important line of attack from HMRC was that even if there was genuine R&D work carried out by the company in its own right (rather than as a subcontractor) the claims failed because the work was 'subsidised' by their customers. It argued that the fact that the company received payment for a 'bespoke' product involving R&D amounted to a subsidy for any R&D expenditure, ie the uncertainty over the project was factored into the price. This would mean that no claim for R&D under the SME scheme would be possible (although a claim under the RDEC scheme may have been possible if the other conditions had been met).

The clearest learning point is that all R&D claims should be supported with a clear audit trail of evidence. The most important evidence will relate to the technical issue that the R&D work was carried out to resolve: can you demonstrate what the technological uncertainty was and why R&D work was needed to resolve it? Selling a bespoke product does not automatically mean that qualify R&D has taken place. Then a claim must also include specific records relating to the costs of that work (ie those costs relating solely to the project).

For all contracts that are not a sale of an off-the-shelf product, the contract should include a clear delineation of any project responsibilities and costs to adapt or enhance the product for the customer. Where it is clear that the customer is bearing all the costs (and risks) of such work, it is highly unlikely that the supplier will also be able to make an R&D claim.

However, where it is not possible to pass on such costs to the customer and there is a chance that a technical uncertainty needs to be resolved to deliver the project, the contract should make clear that the supplier is taking on the financial risk of unknown costs. It should also make clear who owns any intellectual property/design right that arises from the project: where the supplier retains the IP, this helps to demonstrate that it has undertaken R&D work in its own right.

Poorly compiled R&D claims

In a highly price-competitive sector, it is no surprise that construction businesses used to getting a good price from suppliers will often apply the same selection criteria to advice on R&D claims. As small firms of R&D advisers often pitch their services as a commodity, competing on price and speed (rather than quality), this is understandably attractive to construction businesses – especially if R&D is not a significant part of their business.

Unfortunately, the 'production line' approach to compiling R&D claims that many smaller providers take is not well suited to preparing accurate, complete and robust claims. In our experience, forensic analysis of the business, project and research work is needed, along with meticulous attention to detail.

For example, staffing costs are a major component of R&D claims and need to be thoroughly analysed to demonstrate what is claimed directly relates to R&D work. During the last year, businesses may have placed some workers on furlough or seen increased sick leave due to Covid-19 and this clearly has an impact on costs that can be claimed.

Employees that are placed on furlough are not permitted to 'work' during any furlough period (under the initial scheme to 30 June 2020) or on days for which furlough payments are claimed under the 'flexi-furlough' scheme since 1 July 2020. Therefore, HMRC's guidance states that they cannot be taking part in qualifying R&D activity and so furlough payments will not be qualifying staff costs. For the same reason, employer costs to 'top up' a furloughed employee's wages would also not qualify. HMRC points out that even if an employee was put on furlough but the employer did not claim for the individual's pay through the CJRS, that individual will still be expected to have ‘ceased work’ so the related staff costs are unlikely to qualify as R&D costs as the individual cannot be taking part in qualifying R&D activity.

Where an employer has described an employee as ‘furloughed’ but not claimed for his or her salary under the CRJS, if qualifying R&D work was actually carried out by that individual, then the appropriate proportion of the individual’s staff cost could be claimed. Note that where a furloughed employee has worked during a furlough period and the employer did claim for their wages under the CJRS, that part of the CJRS claim would be invalid and the employer must report this to HMRC by 20 October (or within 90 days of the payment if later).

The position is complicated by the fact that individuals can undertake training while on days of furlough. Similarly, individuals can take holiday and sick leave while on furlough (although employers must not put individuals on furlough simply for their holiday absences). HMRC has long accepted that qualifying staff costs relating to R&D can include the relevant individuals’ holiday pay and sick pay and this must be apportioned the same way, for example, 63% qualifying R&D work, 37% non-qualifying based on a time apportionment. HMRC’s new guidance sets out that:

> *“Any period during furlough which is taken as annual leave or is recorded as sick leave can be included in the staffing cost calculation.”*

i.e. periods of sick or holiday pay during furlough can be apportioned in the same way for employees engaged in R&D work before/after furlough.

While this seems a relatively sympathetic approach, HMRC’s guidance does go on to make clear that redundancy payments or pay in lieu of notice (PILON) are not regarded as relating directly or indirectly to qualifying R&D activities so such costs must be excluded.

Time spent on training related to R&D project would normally be treated as a qualifying and included in staff costs calculation and, as training does not breach the furlough rules, we would expect cost relating to relevant furlough period training to qualify (although HMRC’s new guidance is currently silent on this specific point).

One final complexity is that the CJRS payments, while not treated as EU state aid (soon to be replaced by new UK rules), they are regarded as a government subsidy. Therefore, should an apportioned part of furlough period staff costs be claimed (ie for holiday or sick pay) a qualifying SME could not claim relief for that element of staff costs under the SME scheme: relief on that small element of costs would have to be claimed under the RDEC.

However, claims under the Coronavirus Statutory Sick Pay Rebate Scheme are classed as EU state aid. Therefore, you cannot include the staff costs for a worker in an R&D claim if you have previously claimed under the CSSP rebate scheme for that worker’s period of sickness. So it is important to check sickness records for R&D staff when compiling R&D claims – although this must, of course, be handled carefully with your HR team to protect their privacy.

Sadly, our experience suggests that a ‘production line’ approach to R&D claims is not sufficiently detailed to deal with such complexities and the end result is too often that the R&D claim submitted is substandard.

BDO is frequently called in to help out when R&D claims have gone wrong, to resolve the dispute and agree the correct claim with HMRC. Across our 75 strong national team we have also seen numerous cases where hastily compiled claims have overlooked many qualifying costs, and amending a claim can improve tax recovery significantly.

The struggle to manage multiple claims well

Many businesses that undertake a large number of R&D projects could benefit from a sampling methodology to calculate their R&D tax relief and streamline the claim process.

Prime examples in the construction sector include construction materials manufacturers and design consultancies, because they must solve technological challenges on a regular basis to deliver solutions to clients that cover a range of developments and projects. So it is not surprising that a sizeable portion of such companies’ activities can meet the R&D tax credit eligibility criteria.

However, keeping track of the eligible work and related costs is a major task for companies that undertake hundreds of projects a year. One solution to providing robust and sustainable process to assess and track projects is to adopt a standard methodology for every project.

In our experience, while this can give a clear framework for the business, it often leads to overly-rigid methodologies being adopted, which can mean larger businesses do not access their full entitlement to the R&D tax scheme. This issue is particularly acute where a standard method has not been updated for many years as the business has grown and in some cases evolved.

Staying up to date and making the right claims
As your business expands, and new teams form and your systems change, the methodology you use to identify R&D projects and track costs should be reviewed and updated to ensure that you are capturing and claiming relevant costs for your Research and Development Expenditure Credit (RDEC) claims.

For example, BDO was engaged by a large multinational engineering consultancy to support their RDEC claims that had previously been supported by the same adviser for over 10 years. The business employs around 30,000 people globally, of which over 2,000 individuals are based in the UK. As they are specialists in infrastructure, and operate within the Oil & Gas and Defence sectors, maintaining a low risk tax profile was essential to their organisation.

We were able to leverage industry expertise from within our team and use our intimate understanding of large and complex company structures to navigate and map the business's operations and financial systems. This analysis enabled us to develop a new sampling methodology for R&D claims and agree it with HMRC - superseding an existing methodology agreed with HMRC over 10 years previously.

Applying the new and holistic methodology allowed the business to identify a 500% increase in R&D qualifying spend. As BDO had worked in close collaboration with HMRC to agree the methodology, the business had the reassurance that using it to build its RDEC claims would not trigger challenges from HMRC – protecting its low risk tax profile.

Once you have agreed a robust and sustainable R&D claims methodology, it may be applicable for several years, but it is always wise to review it annually to ensure it remains relevant and accurate for your current operations, new acquisitions and joint ventures.

Staying ahead of the trends
With each of these trends, the prudent FD will quickly identify that to stay ahead of them they need to ensure their business recognises the value that R&D tax credits can add to their bottom line, and invest time with the right adviser to make sure that value is realised.

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