

Tax credit cash helped start-up to profitable growth

WOLFSON MICROELECTRONICS PLC

Microelectronics
Edinburgh
300 Staff
2005 Turnover £91m
2005 R&D £12m
www.wolfsonmicro.com

KEY ISSUES IN THIS CASE STUDY

- ▶ Involve ... staff from the technical departments early
- ▶ Produce a short report for HMRC to highlight the advance in technology aspects of R&D projects, to accompany corporation tax return
- ▶ Qualifying R&D activity may not be obvious or recognised as such, particularly in some sectors

The company

Wolfson Microelectronics plc designs, develops and sells a range of proprietary high performance integrated circuits combining analogue and digital technology, known as mixed-signal integrated circuits. They outsource the manufacturing process which allows them to focus their resources on product development and marketing activities.

Their analogue-intensive mixed-signal integrated circuits provide the user interface to digital information, by converting between real world analogue signals such as sound and light to the digital format used in electronic equipment. The features and performance characteristics of their mixed-signal integrated circuits play a crucial part in determining the functionality and usability of a wide range of digital electronic products such as MP3 players, games consoles, mobile phones, scanners and printing equipment, DVD players and flat screen TVs and other applications.

“Substantial investment in R&Dcritical to future success”



The markets for their products are characterised by rapid technological changes and advances and the company believes that a continuing substantial investment in R&D is therefore critical to their future success. Their R&D activities focus on the definition, design and development of innovative proprietary products; this involves the exploitation of existing intellectual property and the generation of new intellectual property in circuit design, algorithm development and system architectures.

This Edinburgh-based company employs 300 people. The company report ending December 2005 showed a turnover of £91m with an R&D expenditure of £12m. The R&D expenditure as % of sales was 13%.

Awareness

Jill Goldsmith, Corporate Compliance Manager said: "We originally became aware of the R&D tax credits through reading commentary on the Budget and the financial press." The company's eligibility for R&D tax credits was identified from a review of the legislation and related guidance and from discussions with their tax advisers regarding their understanding of the rules and their application in practice.

Identifying which costs are eligible

Establish procedures to collect and analyse expenditure by project

Jill said: "The total R&D costs incurred by our company are reported separately on the profit and loss account in the financial statements. We focussed on identifying, from an analysis of these total costs, which categories of expenditure contained costs that could be eligible for inclusion in the R&D tax credit claim.

As a significant proportion of the company's R&D expenditure relates to staff costs, we firstly identified the R&D activities on which the employees spent their time. The project time and cost records were used for this purpose.



Review, Review, Review

The specific objectives, activities and status of each project were reviewed, with the technical project managers, and then assessed for eligibility for R&D tax credits by reference to the relevant sections of the DTI's "Guidelines on the Meaning of Research and Development for Tax Purposes".

Those members of staff not formally assigned but still directly contributing, to the R&D activities were then considered firstly by gaining an understanding, from the employees themselves or their managers, of the nature of their involvement in those eligible R&D projects.

Other costs (such as materials and consumables) incurred for the purposes of the eligible projects were then reviewed and considered in terms of the R&D tax credit criteria.

The analyses of total R&D costs incurred for the financial year were then reviewed again to assess whether any other remaining items of expenditure would be eligible to include in the R&D tax credit claim in view of the rules and guidelines."

Making a tax credits claim

Straightforward aspects of claiming

Jill said: "The aspects of the claiming process which we found straightforward were:

- ▶ identifying those R&D projects which met the criteria for being eligible for R&D tax credits;
- ▶ collecting the details and analyses of the costs associated with those projects (staff costs, consumables, etc); and
- ▶ specific items of capital expenditure used for R&D purposes which met qualifying criteria for 100% capital allowances.

More difficult aspects of claiming

The aspects of the claiming process which we found more difficult were:

- ▶ identifying any eligible "qualifying indirect activity" and the costs associated with this which could be included in the claim for R&D tax credits; (See Technical Note)
- ▶ interpreting the qualifying criteria for the "consumable stores" category of expenditure;
- ▶ considering the eligibility of those costs which are not directly incurred on R&D projects but were included in the R&D costs category in the profit and loss account."

Our R&D tax credit claims are successful

Profitable

Jill said: "Wolfson Microelectronics started claiming the R&D tax credits in respect of the year ended 31 December 2000 when the company's operations and sales were much smaller (annual sales £8.7m) and the company was loss-making. The availability of the R&D tax credits at that time helped to support the funding of some of the R&D activities which otherwise might have been delayed. The investment in R&D was extremely important to the future growth and development of the company."

"In the years since then, our company has grown its sales revenue by over 900% and the investment on R&D in total has remained at around 12 to 15% of sales over those years."

Technical Note: Treatment of qualifying indirect activities

Although the 2004 DTI guidelines say that some qualifying indirect activities may be R&D for general tax purposes, this does not necessarily mean they will qualify for relief under the R&D tax credits scheme. For example, in the case of staff costs, the directors or employees must be directly and actively involved in relevant R&D. 'Directly and actively engaged' refers to hands on work. Staffing costs in respect of clerical or administrative staff engaged in those activities are not qualifying expenditure. In the case of managers, time they spend directing the technical course of, or providing direct technical input into, the ongoing R&D activities can be considered as direct engagement in R&D."

“The availability of R&D tax credits in more recent years has reduced the company’s total tax charge and, as a result, has reduced the net (after tax) costs of qualifying R&D projects.”

What we learned from the experience

“Involve ... staff from the technical departments early”

Jill said: “It is important to involve members of staff from the technical departments early in the financial period to review the profile, objectives and activities involved in R&D projects which are in progress or planned for the rest of the year.”

“We have found, in the last few years, that the availability of a greater amount of guidance and commentary regarding R&D tax credits has assisted with the process.”

prepare short report for HMRC to highlight technology advances

“In recent years we have compiled a short report which summarises the R&D activities conducted by the company, the identification of qualifying costs and an outline of the qualifying R&D projects to highlight the ‘advance in technology’ aspects of these projects. This report has then been appended to our corporation tax computation and submitted with the corporation tax return to HMRC.”

Level and amount of tax credit received

As reported in the Company’s Annual Report and Accounts 2005 and 2004, the amount of R&D tax credit received was approximately £230k (2004: £185k). The company applied for the SME scheme in earlier years. As a result of the growth in the company’s

operations, they now apply for the Large Company scheme.

The benefits

In the earlier years in which Wolfson claimed R&D tax credits, when the company was loss-making, Jill said: “We were able to undertake some R&D projects which otherwise might have been delayed. It should be noted that, at that time, the company was also eligible for “SPUR” grant funding which assisted with the costs of a particular R&D project. As a result of the grant funding all of the costs of that project were, however, not eligible for R&D tax credits.”

“In the more recent years as Wolfson has grown and is profitable, R&D tax credits have benefited our company by reducing the net (after tax) cost of some of its R&D activities. Since the company’s shares are now listed on the London Stock Exchange its financial results are more regularly and more closely monitored by external stakeholders and the financial results (after tax) are an important measure for many of these stakeholders.”

Technical Note: Grant for Research and Development

Grant for Research and Development was introduced on 1 June 2003 as a replacement for the former Smart scheme. It is a DTI product delivered by the RDAs. The grant encourages small and medium-sized businesses to research and develop technologically innovative products and processes by sharing some of the costs and risks associated with R&D projects and fostering recognition of the importance of undertaking R&D. The grant is only available in England, Scotland, Wales and Northern Ireland run their own (SMART and SPUR) schemes.

Advice to newcomers

Jill said that "our advice to newcomers would be:

- ▶ Read the guidance available on HMRC and DTI websites regarding R&D tax credits and any relevant publications and commentary issued by business advisers on the subject. All of these sources of information may help to indicate aspects of the organisation's activities which may be eligible for R&D tax credits

"Ensure that the technical manager(s) in your organisation who co-ordinate R&D activities are familiar with at least the main points of the rules and the guidance regarding R&D tax credits"

- ▶ Consult your tax advisers regarding any questions or clarifications arising from your interpretation of the legislation and the Guidelines relating to R&D tax credits.
- ▶ It may be beneficial to ask Trade Associations your company belongs to for advice or practical guidance or experience of identifying qualifying R&D expenditure (particularly if eligibility for R&D tax credits is not immediately obvious from the company's operations);
- ▶ Ensure that you have established procedures to collect and analyse expenditure on R&D that can be identified by project. This level of expenditure analysis is extremely helpful in the process of compiling, reviewing and supporting the R&D tax credit claim

- ▶ Document the process used to identify eligible costs for R&D tax credits and ensure there are copies of supporting documentation and analyses retained in one place as a point of reference. This will assist during the review of the claim before it is submitted to HMRC and in case there are any subsequent questions regarding the claim
- ▶ Prepare a summary of: the process used to identify qualifying R&D expenditure; the types of expenditure included; and the features of the R&D activities which meet the qualifying criteria for R&D tax credits. Ensure that this summary is reviewed by both technical manager(s) within the company and also by the company's tax manager or tax adviser. This summary may then be appended to the corporation tax computation to be filed with HMRC along with the corporation tax return
- ▶ Review afresh each financial year the R&D activities conducted by the company as the nature, extent and expenditure profile of the activities may have changed which could result in more or less expenditure being eligible for R&D tax credits compared to the prior year".

Technical Note: most grants and other cases when SME R&D tax credit relief cannot be claimed

The SME scheme for R&D tax relief is sufficiently generous that it is considered by the European Union to be a notifiable State Aid. Where an R&D project has received funding which is another notified State aid then no expenditure by the company on that project can qualify for the R&D SME relief. Notified state aids are usually government-funded grants such as the Grant for Research and Development (which replaced the SMART award in June 2003). But not all government grants are notified State aids - for example, some funding under the SMART label (e.g. grants for feasibility studies and micro-enterprise awards was not). If clarification of the status of a grant is needed, the body that has provided or arranged the funds should be able to help. Where the company has benefited from a state aid for a project which disbars it from claiming the R&D relief under the SME scheme it can, for expenditure incurred in accounting periods beginning on or after 9 April 2003, claim under the large company scheme for that project.

Recommend others to claim

Qualifying R&D activity may not be obvious or recognised as such, particularly in some sectors

“Whilst a significant element of our company’s activities relates to R&D it may not be obvious to companies in other sectors that they may conduct some activities which qualify for R&D tax credits. It is worth considering this each year and at least ensuring that those personnel responsible for tax compliance and those personnel involved in technical activities within the company are aware of the relevant criteria for R&D tax credits.”

Jill said: “We would recommend that companies do claim, where eligible, R&D tax credits as this can be beneficial while a company is in its phase of establishing products and / or services and a customer base. It is also beneficial through the time a company is expanding its product portfolio, and later by reducing the effective total tax charge when a company is generating taxable profits but at the same time continuing to invest in innovative work to sustain or grow its product and / or service portfolio.”

