ForrestBrown®
R&D tax credit consultancy

The scope of qualifying expenditures for R&D tax credits: consultation

13 October 2020

ForrestBrown Ltd response

Introduction

Since their introduction in 2000, R&D tax incentives have had a powerful impact on innovative UK businesses. At ForrestBrown we are passionate about the transformative power of R&D tax credits. Based on our own research and our work with our clients, we have seen the positive impact that this funding can have on a business. Many businesses use the cash received to grow their team, stimulating STEM jobs, and the majority do this in the UK.

As we face a post-Brexit and post-COVID-19 UK, it will become ever more critical to support and nurture UK based businesses; including technology start-ups through to established global businesses that recognise the R&D credentials of the UK knowledgebase. Brexit has caused significant uncertainty and challenge for businesses in the UK, and the coronavirus pandemic has put them under unprecedented strain. As we move into recession, helping innovative businesses to protect their investment in R&D makes good economic sense.

Overwhelmingly, our clients find R&D tax incentives to be an important form of funding for innovation, and we have seen first-hand the transformative effect the tax incentive can have for a business. However, we believe that there are clear opportunities to review the current R&D tax incentives to clarify the support on offer and to ensure that it is meeting its policy intent. A further review could help ensure that the system is not open to misuse either through poor-quality advice or fraudulent activity.

The time is right for the R&D tax incentive in the UK to be reviewed. It was introduced 20 years ago and has undergone a substantial number of individual amendments since that time. The result is a complex set of rules and a number of challenges to its effectiveness. These challenges include a continued lack of understanding among businesses, a vulnerability to abuse, a market which attracts poor quality advisers, a hardening of compliance efforts from HMRC and increasing costs. As the UK moves into a potentially prolonged recession, an effective tax system which protects innovation investment becomes absolutely key to recovery.

This consultation is currently running alongside the ongoing consultation covering the re-introduction of the PAYE/NIC cap. These changes together will create further complexity and uncertainty, and because of the lack of research and data into the effectiveness of the incentive, their impact is far from clear.

The PAYE/NIC cap will introduce new restrictions on relief and is designed to address abuse of the incentive. It is being introduced in response to fraudulent activity. A well-funded and well-trained HMRC compliance team would be a more effective way to combat fraudulent activity, instead of new legislative protections, which will increase the administrative burden on law-abiding companies while fraudsters will no-doubt take little notice (fraud by its very definition operates outside the law).

With respect to this consultation, it is clearly signposted that any additional qualifying expenditure introduced needs to come at the expense of reducing the scope of qualifying expenditure by some other means in order to make the change cost-neutral. A cost-neutral aim, while understandable in the current climate, is made much more challenging when only peripheral aspects of the incentive are being reviewed and such incremental changes risk damaging the effectiveness overall as the wider context of the incentive is not being considered. This 'quid pro quo' approach to the consultation adds to the problem of incidental amendments creating complexity and potentially harming the overall effectiveness of the incentive.

Notwithstanding the points above, businesses will welcome modernisation of the software costs category of R&D expenditure, to better reflect the way in which claimants interact with software today and its importance to certain types of R&D projects and activities.

At ForrestBrown, we recommend a wider consultation on the design of R&D tax incentives in the UK, as a more effective option than incremental changes which add complexity without addressing the root causes of the challenges faced. This comprehensive review should cover:

- Updating the definition of R&D so that it is accessible for businesses and society.
- Providing better, more comprehensive guidance on R&D tax incentives generally, and specifically on their interaction with other funding for innovation.
- Introduction of a different, simpler, faster mechanism for very small R&D tax credit claims.
- A temporary enhanced generosity for projects which address key economic, environmental and social problems.

Finally, it should be noted that we are professional advisers to companies which undertake R&D and make R&D tax credit claims, and our responses to questions which refer to 'your business' should therefore be read as 'our clients' businesses'. In preparing our response to this consultation, we have carried out a number of interviews with clients to understand and represent their feedback and recommendations.

Question 1 (a)

Are there uses of data that contribute to R&D but which do not currently attract relief through the RDEC and SME schemes?

Based on our research, there are data costs which are essential to R&D activities, but which do not currently attract relief through the tax incentives. This is particularly true in aerospace and scientific projects, and across high-tech/high-performance industries. These high-R&D intensity sectors are therefore missing out on relief for genuine R&D expenditure.

Our clients noted that the availability of new data for purchase is limited, but can be instrumental in encouraging and enabling innovation. Smaller businesses in particular often cannot afford to invest the substantial sums needed to develop novel data purely for their own use in R&D. Such datasets exist in much larger businesses, but there is little leverage to encourage these larger players to share or sell such assets.

Sharing of data encourages collaboration and fosters faster innovation. And it enables bigger problems to be solved by drawing on problem-solving talent across a number of different private sector organisations. In sectors such as aerospace, a sector populated by a mix of huge multinationals and many far smaller supporting businesses, sharing of data can help to optimise the supply chain.

Therefore, any benefit or marketplace which supports the sharing of data sets, particularly scientific, commercial or financial metrics would likely boost innovation across these sectors, in particular affording a valuable boost to smaller businesses. Some of our clients noted that the purchase of datasets can be cost-prohibitive, leading them to consider creating their own data. They were interested in a potential future market for sharing data.

This consultation considers the extension of qualifying expenditures for R&D reliefs. We note that the process of putting a dataset together would currently be considered routine and therefore associated expenditure would not qualify for relief unless considered a qualifying indirect activity. If a proposal to extend the eligible cost categories to include the purchase of datasets for R&D is taken forward, we recommend consideration is given to the eligibility of activities carried out to create data for R&D, through clarification of how paragraph 31(f) of the BIS guidelines is applied to these cases specifically. This would

ensure a balanced approach.

Overall, based on our discussions, we believe that including the cost of a dataset purchased for use in R&D, by lowering the cost of capital of the associated R&D activity, should increase demand and therefore availability of this data, which would stimulate more R&D across key R&D-intensive sectors.

Question 1 (b)

To what extent are datasets employed in the R&D process consumed? To what extent do they retain value?

In our research, it was clear that businesses using data for R&D do consider the data to be consumed by the process. However, crucially, this judgement is made on the basis that it is purchased for a specific purpose and once deployed in an R&D project, retains no or negligible value to their business. This is in contrast to HMRC guidance on the meaning of consumed or transformed at CIRD 82400, which requires a material to be no longer usable in its original form, rather than simply of no further value to the business itself. Clearly it would still be possible to use this data again, although businesses report that it would be highly unlikely to occur in practice.

Financial and commercial data are used to develop new predictive and assessment techniques using cutting edge or completely novel machine learning and AI approaches. In these cases, many datasets are used once to ingest into a platform or for training purposes and their reuse value is then exhausted as the data will be specific to the project.

For projects involving physical models, CFD simulation and experimental flow data is needed to verify the reliability of novel scientific simulation techniques. In these cases, data is currently only shared on a very specific request and need basis. Most models are tested once and then of no further value.

If data costs were to be factored into the consumables category, an update to the meaning of consumed or transformed would be required to reflect the practicalities of their use in R&D. In practice, the risk to the exchequer is low. Even if on rare occasions the data is used again, it is not purchased again, so there would be no double counting. It may be possible to include a purpose test, to demonstrate that the initial purpose of purchase was for R&D.

Question 2 (a)

Do you already claim for software costs under the current definition? If so, what was your experience of separating out the R&D specific costs for the purposes of the claim?

Our clients tell us that analysis of eligible software costs is not straightforward. This occurs for a combination of reasons.

Most notably, the definition of software has not been updated since the introduction of this category in 2004. In the intervening 16 years, the way in which consumers interact with software has changed substantially. In practice, HMRC accept annual license fees for software packages used wholly or partly in R&D. Such amounts can be packaged by software providers with other services, which makes an accurate split of expenditure challenging.

In many cases, software costs make up a small proportion of a company's overall R&D claim. The largest software cost to many businesses is often hosting, which does not currently attract relief.

Our clients cited this as an area where they deferred to us as their specialist R&D tax advisers, to determine an appropriate methodology and calculation for the claim. This, and the other points above, suggest that software costs is a category open to errors and misunderstandings on eligibility. As it is unusual for amounts to be material within an overall claim, it is also an area where discussion between companies, R&D advisers and HMRC has been limited. Guidance is also sparse.

In summary, we welcome modernisation of this category of expenditure, and would recommend more detailed guidance which reflects the way in which businesses interact with and use software to facilitate their R&D activities.

Question 2 (b)

Are there any software costs that currently qualify for R&D tax credits, that could be limited or excluded from relief without materially affecting R&D projects?

This consultation seeks change, and therefore rather than consider the existing category, we recommend that a newly modernised software costs category replaces the current category. It would therefore be important that this new category is well defined, with guidance provided to support businesses in understanding eligibility of different types of software costs. It is important that this guidance reflects the practical reality of how businesses interact with software and the different uses of software within an R&D project. This approach avoids the need to consider limitations or exclusions, as any expenditure not covered by the definition of the new category would fall away anyway.

This approach would follow the process of replacing the consumable stores category with the consumable items one in 2004.

Question 2 (c)

Are there any software costs, partially or wholly for R&D purposes, that do not currently qualify for R&D tax credits, that should be if the regime is to better reflect the nature of modern R&D?

Overwhelmingly, our clients told us that cloud hosting and service costs are intrinsic to R&D activities but currently excluded from R&D claims.

Cloud hosting and service costs provided by suppliers such as AWS, Google, Azure, are routinely used in prototyping and other R&D activities in projects that seek to take advantage of the scalability and types of compute resources these technologies offer.

The clients we spoke to identified R&D benefits not just from the use of these services themselves but for their clients through the use of their platforms, indicating a return to the exchequer through greater business opportunities.

Question 3 (a)

What experience do you have of claiming R&D tax credits in other jurisdictions, where expenditures pertain to data or cloud computing?

We have limited direct experience of R&D tax regimes in other jurisdictions.

Question 3 (b)

What evidence can you provide that a scope expansion in these areas would drive additional investments in research and development.

As explained above, our clients were optimistic that these changes in particular could help to create more transparent sharing of data, which they strongly feel would foster greater investment in R&D overall.

In response to this question, our clients spoke in general about the impact of R&D tax relief on their businesses. One cited that access to R&D tax credits influences project risk assessments and feeds into the business decision making processes. While access to R&D tax relief will not typically be the deciding factor, it is very much an influencing factor for riskier projects.

Another confirmed that sharing of datasets is a known driver of innovation, and the prohibitive cost associated with preparing data has prevented such assets being readily accessed previously.

In general, claimants felt that positive changes to the relief spoke to the long-term stability of the incentive. Increasing the scope and modernising this category shows the government's commitment to supporting private sector investment in R&D.

Question 4

Would changes to the R&D tax relief rules in the areas outlined above lead to any change in the commercial relationships between companies, insofar as expenditure is outsourced to a third-party provider?

Our clients were not clear what was meant by this question and could not say with clarity that such changes would occur. It was noted in respect of cloud services, that these services are dominated by a very small number of providers, which makes changes to their contractual terms less likely.

Question 5 (a)

Are there expenditures on indirect activities which should be limited or excluded from eligibility for relief?

The proposal to modernise the software costs category and potentially increase its scope was seen by our clients as a very welcome and positive commitment by the government to continue to protect and

encourage R&D investment. For this change to be brought in alongside a corresponding restriction on relief counteracts this effect and would come at a time when UK businesses are facing unprecedented short, medium and longer terms challenges.

Qualifying indirect activities do not typically contribute a significant proportion of an R&D claim. Prior to 2009 HMRC did not accept that such activities could form part of an R&D tax relief claim, despite being specifically included in the definition of R&D by the BIS guidelines. It should be borne in mind that reintroducing this previous mismatch between the official government definition of R&D for tax purposes and the activities eligible for R&D relief will reintroduce confusion. If there is concern that the inclusion of these activities is leading to errors or abuse, we would recommend that this is resolved through guidance, or a more comprehensive review and update of the definition itself.

Question 5 (b)

Are there other expenditures on routine work which should be limited or excluded from eligibility for relief?

The use of the term "routine work" is interesting here. The BIS guidelines say the following about routine work:

- Paragraph 12 (advance): "**routine** analysis, copying or adaptation of an existing product, process, service or material, will not be an advance in science or technology".
- Paragraph 22 (overall knowledge or capability): "the **routine** analysis, copying or adaptation of an existing process, material, device, product or service will not advance overall knowledge or capability, even though it may be completely new to the company or the company's trade".
- Paragraph 23 (appreciable improvement): "The improvement should be more than a minor or **routine** upgrading, and should represent something that would generally be acknowledged by a competent professional working in the field as a genuine and non-trivial improvement".
- Paragraph 24 (appreciable improvement): "Improvements that arise from taking existing science or technology and deploying it in a new context (e.g. a different trade) with only minor or **routine** changes are not appreciable improvements".
- Paragraph 29 (system uncertainty): "assembling a number of components (or software sub-programs) to an established pattern, or following **routine** methods for doing so, involves little or no scientific or technological uncertainty".
- Paragraph 35 (end of R&D): "there is a distinction to be drawn between such problems and **routine** fault fixing".
- Example A4 (prototypes): "Additional work is done to resolve this problem. If this involves a **routine** adjustment of the existing prototype (i.e. no scientific or technological uncertainty) then it will not be R&D (paragraph 14)".
- Example D1 (advance): "if the method used to search for those molecular structures (e.g. running a computer program on a particular set of data) is itself entirely **routine**; the activity directly contributes to the resolution of scientific or technological uncertainty (paragraph 27(c)) and so would be R&D (paragraph 4)".

What is clear from the guidelines is that routine work can fall within the boundaries of an R&D project, but routine activities alone cannot themselves constitute an R&D project. Given the prevalence of the term 'routine' within the guidelines, any changes to the eligibility of routine work or activities should be enacted through an update to the definition itself, rather that in supplementary provisions, to avoid confusion.

For further information, please contact:

Jenny Tragner
Director
0117 926 9022
j.tragner@forrestbrown.co.uk