

Consultation response

R&D TAX RELIEFS REVIEW: CONSULTATION ON A SINGLE SCHEME

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INTRODUCTION

Background

The consultation seeks views on the design of a single RDEC style incentive to encourage business investment in R&D. The proposal is to move from the existing separate schemes for SMEs and large businesses, to one incentive which aligns both the rule base and rates of relief. The proposed commencement date for the newly designed scheme is 1 April 2024.

In addition, proposed changes to qualifying expenditure and activities, as well as new rules governing the administration of the incentive are due to come into force for businesses during 2023. The Chancellor's proposed rebalancing of the rates of relief – increasing the generosity of RDEC and decreasing the rate for the SME scheme – was announced in the Autumn Statement 2022 and new rates will apply for expenditure incurred on or after 1 April 2023.

ForrestBrown – about us

ForrestBrown is a specialist R&D tax consultancy. Formed in 2013 and a member firm of the Chartered Institute of Taxation since inception, professional standards have always been at the heart of our culture. We are passionate about the transformative power of R&D tax reliefs and our role in providing clear and accurate professional advice to our clients.

Our multidisciplinary team comprises a combination of chartered tax advisers, chartered accountants, lawyers, and industry specialists from R&D-intensive sectors, working from our offices in Bristol, London and Glasgow.

Our focus on technical excellence and professional standards led us to help form the CIOT/ATT professional standards working group, which drafted the topical guidance on the application of PCRT to R&D tax advice (published in 2020). We believe that reputable advisers, alongside professional bodies and HMRC, have an active role to play in raising awareness of professional standards and protecting more businesses from poor advice.

We support measures which create or improve simplicity, certainty and value for money for genuine UK innovative businesses.

ForrestBrown – summary conclusions and recommendations

Single scheme

We support the proposal for a single scheme to simplify access to and administration of the incentive (but not at the expense of reduced generosity for R&D-intensive SMEs).

Rates of relief

We recommend that the proposed reduction in rates of relief for the SME scheme be delayed, with the commencement date aligning with the introduction of the single scheme.

There is strong evidence to support a higher rate of generosity for SMEs due to the higher barriers smaller businesses face in undertaking R&D and accessing other forms of finance to support this investment. We recommend prioritising retaining a higher rate of relief for SMEs, with consideration of specific rates for different types of project included in a longer term policy roadmap.

R&D tax policy roadmap

The latest consultation is part of the broader review of R&D tax reliefs launched in March 2021. While the consultation offered the opportunity to undertake a wide-ranging review of the way in which we incentivise R&D in the UK through the tax system, the changes proposed to date have fallen short of this.

We agree with the recommendation made by the House of Lords Economic Affairs Committee that the Government should publish a roadmap through to the end of the wider consultation process. The roadmap should set out the remaining areas that it is considering as part of the ongoing review, with an indicative timeline for consultation with stakeholders. We also agree that this consultation should seek ideas rather than limit input to aspects of the detailed design of proposals.

Definition of R&D

We strongly recommend that the newly formed Department for Science, Innovation and Technology carries out an urgent review of the definition of R&D for tax purposes, including the published guidance, examples and case studies which support the interpretation and application of the definition.

We believe this would be a far more practical and effective solution to ensure that government funding is targeted to genuine R&D, rather than the proposals to redefine “R&D-intensive SMEs” and introduce higher rates of relief for specific types of R&D project.

Errors and fraud

Concerns of abuse in the system underpin many of the changes which have formed part of the wider review of R&D tax reliefs. Improving the regulatory framework for professional tax advisers would be the most effective way to protect businesses from poor advice which leads to errors and abuse. We support compulsory professional body membership for any firm offering paid-for tax advice.

We support the various recommendations and conclusions of the House of Lords Economic Affairs Committee regarding the need for HMRC to be adequately resourced in terms of both numbers of caseworkers and expertise within its R&D compliance team. Better training for compliance case workers would enable HMRC to target and tackle abusive claims much more successfully.

Recognising R&D decision-makers in commercial supply chains

We do not accept that a single scheme could simply follow the current SME or RDEC rules on subcontracted R&D. Notwithstanding a period of uncertainty regarding HMRC’s interpretation of these rules which adds complexity, picking one or the other accepts the introduction of both deadweight in the system and allowing genuine R&D projects to miss out on valuable incentives.

Instead, rules should be defined which require the identification of an R&D decision-maker, being the entity, which can control whether or not R&D takes place and whether or not to invest in further R&D.

PAYE/NIC caps and overseas R&D

A combined PAYE/NIC cap on the amount of payable tax credit available should be incorporated into the combined single incentive. It makes sense for this to be based upon the current SME scheme cap, since

this was recently the subject of detailed consultation. The SME cap includes scope to vary the multiplier (currently 300%): this should be kept under review.

The PAYE/NIC cap serves to limit the amount of cash credit available to companies where UK based payroll costs do not make up a sufficient proportion of their overall R&D cost base. This protects the exchequer by preventing companies with little substance within the UK from benefitting from the scheme. Such companies contribute less in terms of spillover benefits from R&D, which are a critical element of the economic policy behind the incentive.

Similarly, the proposed restrictions on overseas R&D activities are targeted towards businesses that choose to base R&D activity offshore primarily for reasons of cost. However, the proposed rules create a cliff edge, introduce only very limited exceptions and increase the administrative burden on most businesses accessing relief. These rules are overly onerous within a scheme which already incorporates the protection of the PAYE/NIC cap.

We recommend retaining and reviewing the PAYE/NIC cap (noting that a review is necessary for the single scheme anyway), instead of introducing the proposed restrictions on overseas R&D. We note that the House of Lords Economic Affairs Committee has recommended that the overseas R&D rules are delayed, or new transitional provisions designed to soften their impact.

Notification of R&D claims to HMRC

We support the recommendation made by the House of Lords not to proceed with this proposal, based on a lack of evidence to support its introduction, the additional administrative burden for companies and the additional resource requirement it introduces for HMRC.

Minimum threshold

There have been minimum thresholds for accessing R&D tax relief previously, and while re-introducing one may result in a reduction in the volume of R&D claims, we do not believe it is an effective method of reducing error and fraud.

Qualifying indirect activities (QIA)

We note that HMRC appears to have a long-standing discomfort with the eligibility of such activities. It is not clear what data is available to quantify the impact of such a change, however, care should be taken to consult with those sectors most affected by their exclusion before making a policy decision based on cost saving and ease of administration. Any decision to remove QIAs from the scope of R&D tax relief should instead be based on their effectiveness (or otherwise) in incentivising additionality.

Capital expenditure on R&D

The current capital allowances regime does not effectively incentivise capital expenditure on R&D, nor does it include any specific relief for energy-efficient capital projects and purchases. The ending of the super deduction for plant and machinery expenditure offers an opportunity to design a successor targeted towards providing facilities for R&D and investing in green technologies to help the UK achieve its ambitious goals in these areas.

We recommend that capital expenditure on R&D receives tax relief at a more generous rate than the current full expensing approach, differentiating it from other forms of capital allowance on general plant and machinery.

MAIN FEATURES

1. Do you agree a new scheme should be an above the line RDEC like credit? If not, what alternative would you propose?

Superior mechanism

We have consistently advocated for the benefits of the RDEC and championed it as a preferred mechanism. We agree that a single scheme should be modelled on the more recently designed RDEC structure as we believe it provides greater benefits than the current structure for SME relief, for several reasons:

Certainty

RDEC distances the calculation of tax relief as far as possible from the company's taxable profit or loss position, meaning the benefit of an RDEC claim remains consistently proportional to the qualifying R&D expenditure incurred. This helps companies to factor their benefit into future investment decisions.

In contrast, the mechanism for giving SME R&D tax relief is directly linked to a company's profit or loss position. This results in an effective benefit rate for an SME of anywhere from 18.85% to 33.35% of their R&D expenditure (set to reduce to between 8.60% and 21.50% from 1 April 2023). Such variance does little to help SMEs factor their R&D benefit into future budgets and investment decisions.

Visibility

The credit can be recognised above the line in the company's accounts. Visibility in the accounts strengthens a company's financial statements and ensures that R&D tax relief, and the activities generating it, sit firmly on the boardroom agenda discussed by investment decision makers.

This visibility and management information is equally important to many R&D-intensive SMEs (particularly those with specified investment enterprise backing or other external stakeholders) and could be critical to decisions ranging from access to wider financing to shareholder queries.

Access and administration

Under current legislation, an SME first considers the criteria for eligibility for SME R&D tax relief. If a criterion is failed, the SME company then reverts to a separate rule base governing RDEC. Over half of all RDEC claims by volume are actually made by SMEs. Many of these SME RDEC claims will be made by companies also accessing SME R&D relief (e.g. on different projects), requiring them to negotiate two very different relief mechanisms.

A simplification of the tax mechanism should benefit both companies and HMRC, as there is an administrative burden placed on HMRC in maintaining two separate schemes.

Dual rates of relief

Whilst we agree with unifying the reliefs under a single RDEC-like mechanism, we share the concerns raised by respondents to the 2021 consultation regarding the equalisation of the rates of relief. There is a strong case for maintaining dual rates of relief, with a higher rate of relief continuing to be afforded to SMEs.

Smaller businesses and start-ups are in many cases pre-revenue, typically have a greater risk of failure and often undertake a higher proportion of R&D activity than their larger counterparts. As a result, SMEs are more reliant on funding to innovate, but generally will have fewer avenues available to them to access funding. The generosity of the SME incentive is therefore a vital pillar in facilitating this innovation.

HMRC's research on additionality ratios suggests that the SME scheme offers a lower pound for pound return on taxpayers' money, although this way of thinking may be influenced by large businesses being more likely to track and report on their product development more diligently. This - combined with the likelihood that large companies are probably planning future R&D projects over a longer strategic time frame compared to SMEs in which R&D is more embedded culturally, in a day-to-day way - means comparison of the two schemes based purely on additionality ratios may be imprudent.

HMRC's research is also clear in its recognition of the spillover benefits of incentivising R&D in SMEs, both in technologically linked and geographically proximal businesses. These benefits include knowledge diffusion, enhanced competition and higher average turnover than non-claiming firms.

A major reduction in the rate paid to SMEs at this time would put substantial strain on R&D-intensive businesses, undermining confidence in the incentive and, in turn, restricting its success.

2. Does the taxability and subsequent different post tax net benefits impact your decision making when allocating R&D budgets?

We assume this question alludes to the fluctuation in effective benefit under the current SME incentive.

As noted above, the SME incentive currently offers an effective benefit rate for an SME of anywhere from 18.85% to 33.35% of their R&D expenditure, depending on the company's profit or loss position, set to reduce from 1 April 2023. The variation in effective benefit is reflected below:

SME tax position	Effective benefit (current rates)	Effective benefit (post 1 April 2023)
Profitable	Up to 24.70%	Up to 21.50%*
Breaking even	18.85%	8.60%
Loss making	Up to 33.35%	Up to 18.60%

*For SMEs taxable at the main rate of Corporation Tax

This volatility encourages companies to think of the relief as a 'bonus' as they are not able to forecast it accurately and therefore cannot effectively factor it into budgets or investment decisions.

This issue will be exacerbated by the new rates introduced for expenditure incurred on or after 1 April 2023. As shown in the table above, for some SMEs, the effective benefit will drop as low as 8.60% - well below the current and proposed RDEC, which currently offers an effective benefit of 10.53%, increasing to 15% from 1 April 2023.

If the intention is ultimately to merge the two schemes, there would be merit in delaying the rate changes and coordinating them with the unification of the incentives.

3. If you use RDEC now, is there anything in your view that should be changed?

In our experience, where there is uncertainty regarding the benefit of the RDEC mechanism, this tends to arise from businesses assuming it is more complex due to the seven-step calculation. There are some simplifications that could be made to reduce this perceived complexity.

There is currently a difference in treatment of any amounts carried forward under step 2 and step 3 of the payable credit calculation. This is complex and prone to error. As it stands, any amounts deducted and carried forward at step 2 (reduction to net of tax amount) can be offset against any Corporation Tax liability in future periods. Conversely, any amounts deducted at step 3 (PAYE/NIC cap) are added to the company's RDEC for the next accounting period. Uniting the treatment of these amounts would aid simplicity and reduce errors.

It should be possible to remove step 4 (discharge Corporation Tax liability for any other accounting periods) and step 6 (discharge any other outstanding HMRC liability of the company) altogether. Under the SME incentive, these steps are typically carried out by HMRC automatically without any action needed by the taxpayer. In many cases, these steps will already be (or could be) double checked by HMRC for RDEC claimants too, with any outstanding liabilities being offset before the credit is paid. Removing these steps would reduce the calculation from a seven-step to a five-step process (four in the case of independent companies who don't need to consider group relief), providing great simplicity.

Clarification would be required in relation to the rate of tax applicable in step 2 following the return of a small profits rate and main rate of Corporation Tax. If this operates as it did historically, the main rate would be used. This would be likely to have a disproportionate impact on SMEs, who are more likely to have marginal profits (between £50,000 and £250,000. The effective rate of tax in this band is set to increase to 26.5%.

SUBCONTRACTING

4. Do you agree the same treatment of subcontracting should apply to all claimants in the merged scheme?

It makes sense in the interests of simplicity for the single scheme to incorporate one set of rules for subcontracted R&D. These rules should seek to identify the entity which controls the decision whether or not to carry out R&D, as this is where the relief will have the most effect on additionality.

There is currently substantial uncertainty regarding the meaning of 'contracted out' for the purposes of R&D tax relief, with HMRC's interpretation differing from that of the Chartered Institute of Taxation and many accountants and tax advisers.

This disagreement creates significant uncertainty for the decision-makers in businesses about their access to R&D tax relief, leads to administrative inefficiencies in compliance checks, and most of all results in relief not being consistently awarded where it would be most effective.

A contributor to this is the focus on combating fraud and error as a policy objective which has in recent years overshadowed the more positive policy objective of encouraging businesses to invest in R&D. This imbalance in policy priorities has resulted in narrowed interpretations and a desire to reduce the scope of the incentive. If the government is seeking to increase innovation, which it says it aims to do, then any form of merged relief should focus on enabling more R&D projects to take place, not fewer.

This aspect of the consultation offers the opportunity to design a set of rules which provide certainty to businesses, while recognising that simplification must be balanced alongside protecting the incentive from abuse and ensuring that relief is effectively targeted.

We recommend that the government takes enough time to consult businesses and other stakeholders on this point, which is a complex one.

5. If so, where R&D activity is subcontracted, do you think that the customer should claim the tax relief, as in the SME scheme, or the subcontractor, the person carrying on the R&D, as in the RDEC?

We do not believe that the terms "customer" and "subcontractor" are useful in this question. HMRC's current broad interpretation of the meaning of contracted out R&D leads to fewer R&D projects taking place because it squeezes the ownership of R&D projects disproportionately towards a customer rather than the R&D decision-maker.

As an incentive for businesses, all R&D on which R&D tax relief is claimed will be carried out in a commercial context (eg with a view to commercialise the results of the R&D). Within many sectors, this results in a complex ecosystem of supply chains, where R&D may be being carried out at multiple levels within the supply chain.

In this context, it is an over-simplification to refer to a customer and subcontractor. Not all customers will have contracted out R&D; in fact many will have purchased a product or service which may or may not be the result of an R&D project. The existence of an R&D project to develop that product or service does not turn that customer into the owner of the R&D project (regardless of the date on which it contracted to purchase the product).

The critical distinction between a customer and an initiator of R&D is where the decision to carry out R&D lies. If the customer contracts out specific R&D activities, it has clearly controlled the decision to carry out R&D. Conversely, if it has commissioned a product, the decision of whether R&D is carried out to deliver that product sits with the subcontractor, who should benefit from R&D tax relief.

R&D tax relief is designed to encourage businesses to increase investment in R&D. Applying relief in the way described above ensures that the relief can meet its policy aim, through identifying the R&D decision maker and lowering their cost of investment.

If (A) identifies the need to carry out R&D in developing a product/service but outsources some of the work needed to complete the R&D project to (B) then this R&D has been subcontracted to (B). (A) is the decision-maker of the R&D and is instructing the carrying out of the R&D.

If (A) requests a product/service to be delivered by (B) and does not specify how this is to be achieved in the contractual arrangement, then it cannot have subcontracted R&D. If R&D is subsequently required to be undertaken to deliver the product/service it will be (B) who is the decision-maker of whether a separate R&D project is required.

In the first scenario, the R&D project is naturally embedded within the delivery of the contract by the decision-maker (A) and so (A) should be entitled to R&D tax relief. In the second scenario, the R&D project is separate to the delivery of the contract and is the result of a decision made by (B), so (B) should be entitled to R&D tax relief.

Prior to the recent disagreement with HMRC on this subject, the principle set out above was well established and understood by businesses claiming relief. We recommend that a similar approach be adopted into the new single scheme, supported by clearer guidance to prevent errors.

Once it is established where the principle right to claim should sit, currently it is necessary to determine which scheme the relevant expenditure should be claimed under, since there are differences in the rate of relief, eligible cost base and treatment of subsidised expenditure. Taking each of these in turn:

Rate of relief

We understand that the government's intention is to remove the rate differential between SMEs and large companies. We do not agree that this is the right approach.

As noted above, there is a strong case for a higher rate of generosity for SMEs due to their more limited access to finance for high-risk endeavours such as R&D.

If the future single scheme uses the recommendation above to identify the R&D decision-maker within a commercial relationship, it would be possible to continue to offer a higher rate of relief to SMEs with the inclusion of some anti-avoidance provisions to protect against arbitrage of the rates.

Eligible cost base

Most notably, SMEs can generally claim for R&D activities contracted out to third parties, whereas large companies can only do so in very limited circumstances (generally where there is no prospect of the subcontractor making an R&D claim).

The subcontracted R&D category within the SME scheme introduces the risk of two companies claiming relief for the same work, where the principal includes the amount paid to a subcontractor as part of its claim, and the subcontractor separately decides that it has carried out an R&D project and makes a claim for the costs it has incurred on the work. This should not occur, since the subcontractor should identify that the R&D it has carried out has been contracted to it by another SME. However, under self-assessment and since commercial arrangements are rarely documented with an R&D claim in mind, there is scope for ambiguity and therefore error.

The simplest approach to address this risk would be to remove the subcontracted R&D category from the scope of relief under the new scheme. This would, however, have a detrimental impact on SMEs in particular. The category is itself a recognition that SMEs often do not have all of the R&D capability they need in-house, or the capacity to employ those skills quickly enough to contribute to a project, and therefore often rely on outsourcing specific aspects of an R&D project. An example would be laboratory testing, where a large company is far more likely to have in-house testing capability than an SME. On top of the reduction in the rate of relief for SMEs, removal of this category of expenditure would have a further detrimental impact specifically on this subset of innovative businesses.

The consultation discusses the previously proposed certification or joint election approaches to allow subcontracted activities to attract relief while guarding against a double claim in both entities. Both of these options, as was noted in the 2011 consultation responses, introduce significant complexity to the system.

A clearer set of legislative provisions and supporting guidance on what constitutes subcontracted R&D would be preferable. This would place more emphasis on the party contracting out activities to ensure that it can evidence that those activities were R&D in order to include related expenditure in an R&D claim. Where this evidence is available, it should also prevent the subcontractor from erroneously seeking to claim for the same activities, since the evidence will quite clearly point to the fact that the principal was the R&D decision-maker.

Under this system, it would be possible to introduce subcontracted R&D into scope for large businesses, with minimal impact on the overall cost envelope. This would resolve the issue of dispersed R&D noted in the consultation document at 3.4.

Subsidised R&D

This is another area where HMRC's change in approach to interpreting the law has resulted in a great deal of uncertainty. We highlight the comments made by the House of Lords committee regarding HMRC's response to the Quinn tribunal case¹.

¹ Paragraph 157: "We are concerned about the uncertainty that has arisen as to the meaning of "subsidised expenditure" following the decision in the Quinn (London) Limited tribunal case. HMRC should consider what steps it can take to help resolve this uncertainty and address the concerns raised with us in evidence."

The consultation document suggests that adopting the SME or RDEC rules for contracted out R&D would in some way also automatically affect how subsidised expenditure is treated. These are two separate provisions in the current legislation and should therefore be considered separately.

The current system applies restrictions for subsidised expenditure on SME R&D tax relief only. For subsidised R&D expenditure (or R&D project expenditure where a notified state aid has been received), an SME can still access relief under RDEC.

It is not yet clear what amendments would be made to the SME scheme as a result of the Subsidy Control Act. Equally, with the reduction in the SME rate and proposal to equalise the rates, whether any specific provisions would be needed in future for notified state aid specifically.

Notwithstanding that the two topics should be considered separately, it is not clear what evidence there is to support a move to introduce restrictions for large businesses for subsidies received, since no restriction has previously been considered necessary. In which case, in a future scheme where rates are equalised, why would restrictions on SMEs be carried over?

Summary

It is fundamental to establish a common legislative consensus on what contracted out R&D means. The test as to whether R&D has been contracted out should seek to identify the R&D decision-maker.

Once the R&D decision-maker has been identified, there should be scope for that party to include expenditure on R&D contracted out to other parties, provided the decision-maker can clearly evidence that specific R&D activities have been contracted out.

6. Can you see any positive or negative impacts on your business or sector from the Government adopting either approach?

As noted above, removing the subcontracted R&D cost category from the scope of relief would adversely impact SMEs in particular.

Similarly, introducing restrictions for large businesses on subsidised expenditure would be an unnecessary additional administrative burden and reduction in generosity for those businesses.

Inevitably, a change is likely to result in some winners and losers, since new rules may result in a company losing its right to claim relief to either a supplier or a customer. For this reason, we recommend that more time is taken to properly consult with businesses across a range of sectors, seeking to understand how R&D supply chains work and how rules can be constructed most effectively. Proper consultation, planning and transparency will be key, both in aiding businesses to prepare for change and in reducing errors when new rules are enacted.

7. Do you have an alternative model you think could apply all claimants in the new scheme? Please provide qualitative and quantitative evidence with your proposal.

Please refer to our response at question 5 above.

CAP ON PAYABLE CREDITS

8. What are your experiences of the PAYE/ NICs cap?

As R&D tax advisers, we have experience in working with clients to support R&D claims where the current RDEC cap and the more recently designed SME cap have applied, as well as the original SME PAYE/NIC cap that restricted the payable tax credit to the PAYE and NIC liabilities of the claiming company.

9. Are there any ways the Government could simplify the PAYE/NICs cap whilst ensuring there is protection against abuse?

Having one cap (rather than separate ones for SME and RDEC claims) is reasonable and fits with the wider objective of tax simplification.

PAYE/NIC caps and overseas R&D activities

The current and previous PAYE/NIC caps provide a mechanism to limit the cash benefit paid out to companies who make little to no contribution to the exchequer via income tax and national insurance contributions on employee remuneration. The SME cap in particular was re-introduced (in an amended form) in response to abusive structures which sought to funnel costs through a UK shell company. This protective measure also aligns the incentive with the current policy objective of refocusing R&D activity to the UK.

However, unlike the forthcoming restrictions on overseas R&D, the PAYE/NIC caps target businesses with little UK-based substance to their activities, while still allowing relief on non-employee expenditure provided there is also a UK employment base. In this way, the PAYE/NIC caps target similar structures to the proposed new restrictions on overseas R&D, but without the cliff edge which those new regulations pose.

The function of the PAYE/NIC caps and the intended new restrictions on overseas activity, therefore, appear to target a similar concern, and the two measures overlap substantially. Applying both of these measures is unnecessary and excessive and has the potential to add an unnecessarily complex burden onto businesses.

The PAYE/NIC caps already provide a good level of protection against claims being paid to companies with little substance and activity in the UK, without being overly restrictive where there are legitimate reasons to carry out some R&D activity overseas.

We recommend that the case for both measures is reconsidered to allow for further consultation with business and industry groups before the overseas R&D provisions are implemented. The introduction of further restrictions on overseas R&D expenditure should be delayed until this further consultation is completed.

10. Which of the SME and RDEC PAYE & NICs cap should the Government implement in the new scheme?

It is important to balance simplicity with the need to target the caps effectively and protect legitimate R&D claims. Both caps can be relatively complex in some circumstances. However, each was designed relatively recently following detailed consultation and protections built in to ensure that relief would not be restricted unnecessarily.

The SME cap in particular includes important exclusions for companies who actively manage IP generated from R&D activity within the UK, provided external R&D expenditure contributes only a modest proportion of total spend.

Such protections should be incorporated into a new single scheme.

11. Should the Government change the way either cap is calculated if it is taken forwards? And if so, how?

We have considered below the key differences between the operation of the SME and RDEC caps.

De minimis amount

The SME cap incorporates a de minimis level of £20,000, which is the amount of credit that can be claimed regardless of the company's PAYE/NIC liabilities. This de minimis was introduced to protect the smallest businesses from being impacted by the cap, as such businesses would likely be in the very early stages of development where cash flow is important to support R&D investment.

The de minimis also simplifies the calculation of the cap for the smallest businesses. For this reason, we recommend retaining this in a combined scheme, although consideration could be given to simplifying its operation so that it doesn't add complexity for larger businesses.

Hallmarks test

The hallmarks test in the SME cap excludes a company from having to apply the PAYE/NIC cap where it can demonstrate that it actively manages IP generated through its R&D activities, and that its connected party EPW/subcontractor costs contribute only a modest proportion of its overall R&D expenditure.

The hallmarks test is a good example of introducing a reasonable amount of additional complexity in order to protect against unintended consequences. It should therefore be retained.

300% multiplier

The 300% multiplier applies to the SME cap and makes it more generous than the RDEC version. The incorporation of a multiplier provides a useful mechanism for government to keep the impact of the cap under review.

Although the SME PAYE/NIC cap has been fairly recently re-introduced, in our experience it does not impact a high proportion of businesses, therefore there may be scope to review the level of the multiplier.

Calculation of total expenditure on workers

The current SME cap allows a company to include its total PAYE/NIC for employees/directors, regardless of involvement in R&D. RDEC by contrast includes PAYE/NIC on all employees/directors involved in R&D (regardless of their level of involvement).

Based on the policy intention to provide support for R&D-intensive businesses, a cap which incorporates only employees/directors who are engaged in R&D may be preferable.

Both caps allow for connected party EPWs (and subcontracted R&D for SMEs) to be taken into account, restricted to any R&D apportionment applied to those costs.

In the absence of the forthcoming overseas R&D restrictions, a version of the SME PAYE/NIC cap which incorporated the RDEC method for calculating total expenditure on workers, and kept under review the level of multiplier could be an effective mechanism.

Alongside the overseas R&D provisions, we recommend that a combined PAYE/NIC cap follows the SME model, which is the more generous of the two existing caps.

ADDITIONAL SUPPORT FOR SPECIFIC COMPANIES

12. Do you think the government should provide more generous support for different types of R&D or more R&D-intensive companies relative to less R&D-intensive companies?

Potentially, yes. However, an effective R&D tax relief system starts with a clear statement of intent from the government on the purpose and focus of R&D tax reliefs and this remains a priority.

A clear statement of intent would include target sectors, as well as examples of the types of commercial R&D projects which should benefit from the incentive, and what measures of success will be applied in reviewing the incentive.

Businesses across a diverse range of sectors access the incentive, but there is little formal guidance on the application of the definition of R&D to different sectors, leading to uncertainty, errors, disputes and abuse. Updated, clear and well publicised examples and case studies would not only improve awareness of R&D tax relief in less traditional R&D sectors, but also help to reduce errors and disputes in the application of the definition.

Gravity Industries – a client of ForrestBrown - is a pioneering aeronautical innovation company re-imagining the future of human flight. Richard Browning (Gravity Founder and Chief Test Pilot) supports greater clarity, stating that "a simplified scheme would increase additionality for innovative companies and government alike."

Clear examples and case studies should be produced in collaboration with other relevant government bodies. BEIS had responsibility for the UK's innovation strategy and public funding for R&D. The definition of R&D which governs tax credits was drafted by its predecessor the DTI (Department for Trade and Industry), and ownership now moves to the newly formed Department for Science Innovation and Technology. A joined-up approach between DSIT, HM Treasury and HMRC is essential to safeguard the policy intent of the relief.

Even with a modernised definition in place, designing a mechanism for more targeted R&D tax relief would present challenges. Richard Browning of Gravity points out that, because SMEs are more agile, and test orientated in comparison to larger companies, targeting specific sectors for additional support could have the unintended consequence of excluding those which do not fit neatly into an existing category.

SMEs are often able to pivot to market demands in a way that bigger businesses are not. According to Richard Browning of Gravity, "we often find that larger, more complex organisations can't keep up with our pace of testing and prototyping." Introducing more complexity to the scheme without providing a revised definition of R&D may add to the administrative burden of these smaller companies, limiting their commercial agility in the process, and disincentivising them to explore new applications for their products and services. It would also exacerbate current concerns regarding the misapplication of the definition of R&D and poor behaviour in the market for R&D advice.

Cost categories common to specific target sectors could potentially provide a proxy to enable enhanced rates of relief to be offered. For example, companies in the life science sector typically make comparatively greater use of Qualifying Indirect Activities (QIA's) due to lab running and maintenance costs. It could therefore be theoretically possible to use QIAs as a means to increase the rate of relief for the life sciences sector. But challenges would still remain, as life science companies increasingly use digital technology which does not require lab equipment.

Another alternative approach would be to target the field of science or technology that an advance is sought in. However, this would require a detailed assessment of each of the projects undertaken, creating more complexity for businesses and requiring even greater compliance resources within HMRC.

Whether targeting tax relief by sector or by field of science or technology, there would be a requirement to keep guidance up to date, with the likelihood that target sectors would change frequently. While targeting certain sectors and types of innovation to improve the UK's global competitiveness has some merits, modernising the definition of R&D and providing clearer guidance on the existing scope of the incentive to businesses should be the priority.

Targeting particular types of company or R&D project can more realistically be contemplated once a clear statement of intent and modernised definition is in place. Even then, it is worth acknowledging the difficulty of categorising highly innovative SMEs, many of which may be in the process of redefining the sector in which they operate, or even creating a new one. Picking winners and losers by sector or field of science or technology risks duplicating aspects of direct grant funding and closing the door to funding for many of our most innovative SMEs.

13. In the event this were to be done, how might this best be achieved within an overall cost envelope?

Our response to this question takes a step back to examine the data underpinning the cost envelope calculation.

For the past five years, the government's sights have been set on investing 2.4% of gross domestic product (GDP) in R&D by 2027. The target has been cast in a new light by the recent admission that the methodology underpinning key data used to measure progress towards it was flawed. In a paper released alongside HMRC's publication of its annual statistics on R&D tax credits², the Office for National Statistics (ONS) issued new guidance on the interpretation of its survey of business expenditure on research and development (BERD). Based on the updated methodology, the UK may already have surpassed its R&D investment goal.

²<https://www.gov.uk/government/statistics/corporate-tax-research-and-development-tax-credit>

This suggests that the available data on R&D may have limitations as a guide to policymaking when viewed in isolation and without considering real world impacts as reported by businesses. For example, when considering the overall cost envelope of SME R&D tax relief, it is important to note that HMRC's evaluation of the additionality ratio of the SME scheme does not take spillover benefits into account. As a result, the full value of R&D tax relief to the UK economy and society may not be captured within the current cost envelope.

HMRC's evaluation considered the direct impacts of the scheme through analysis of the additionality effect on R&D expenditure, identifying R&D expenditure that would not have happened in the absence of the scheme. The lower additionality of R&D tax relief for SMEs has been cited as a reason for rebalancing R&D tax relief in favour of the RDEC scheme.

However, research on the additionality of R&D tax policy (Holt et.al, 2021)³ demonstrates that the rationale for subsidising SME R&D activity is to induce positive spillover benefits to other firms and consumers. There is evidence suggesting the wider societal benefits of knowledge creation activities such as R&D are already significant, even when the more easily measured aspects of additionality are perceived to be lower. These include increased productivity, skills and quality of life benefits.

The Chancellor has suggested that "those with more should contribute more." However, a likely outcome of the reduction in generosity for the SME scheme is that highly innovative pre-revenue start-ups will be forced to extend development timelines or spend time looking for alternative financing. This risks hampering the UK's international competitiveness in R&D-intensive sectors and cutting-edge technologies. The relief incentivises businesses of all sizes, but importantly the SME scheme helps start-up and scale-up companies to move quickly and stay ahead of global competition.

The success of SMEs also impacts the scalability and flexibility of larger, more complex companies, including multinational companies, through their supply chains. A lack of SME investment in R&D stifles competition and decelerates development, reducing broader economic spillover benefits in supply chain environments that intersect different industries.

The picture is more complex than a simple rebalancing between two categories (SME and RDEC). Costs cannot simply be shared out differently between the two without impacting complex supply chain relationships and driving different behaviours in businesses of all sizes, generating variable outcomes within what is ostensibly the same cost envelope. Focusing on value rather than cost, and by looking beyond first order effects, the redesign of R&D tax reliefs presents an opportunity to reconnect this potentially catalytic policy lever with its original policy intent.

³ <https://www.sciencedirect.com/science/article/pii/S0166497221000742>

GUIDANCE AND TRANSITION

14. If the schemes are merged do you agree the Government should implement the merged scheme on accounting periods starting on or after 1 April 2024?

The Government has reinforced its commitment to R&D, recognising that innovation is essential to driving growth and productivity in the UK. This consultation is the latest round of potential changes following the launch of the wide-ranging review into R&D tax reliefs in March 2021. Since then, we have seen changes to data and cloud costs, the introduction of mathematical advances, restrictions on overseas R&D, a suite of measures on the administration of R&D claims, changes to rates of relief and now a proposal for a major structural change to the incentive.

Such a volume of piecemeal changes over a protracted period is disruptive to businesses. It also adds unnecessary layers of complexity and scope for error which could be antithetical to HMRC's agenda to improve compliance within the scheme. The launch of the review of R&D tax relief in March 2021 promised root and branch reform of the scheme. It is clear from our client work that though some recent changes to the relief are welcome there is little to no appetite for the type of piecemeal change that makes preparation and long-term R&D investment decision-making difficult.

The changes to data and cloud costs have already been subject to a considerable lead time since the initial consultation took place in 2020. Delaying them further would be unfair to the businesses who have been waiting so long for them to be implemented. However, the remaining changes (to rates, overseas expenditure, and compliance requirements) are much newer and require more adaptation from businesses.

Putting these on hold and consolidating them into a well-designed, cohesive re-shaping of the incentive would make the changes more credible and give businesses more confidence to invest in their innovation.

This re-shaping could also then incorporate the recommendations from the recent report from the Finance Bill Sub-Committee of the Lords' Economic Affairs Committee.

While regulation of the market for tax advice was out of scope for the inquiry, the Committee has made a number of sound recommendations for tackling error and abuse of R&D tax reliefs. Importantly, the committee agree with the important distinction between error and fraud, which as we pointed out in our evidence are driven by very different behaviours. At the same time, it questioned the likely effectiveness of measures such as pre-notification of R&D claims - which it recommends should be dropped from legislation set to take effect from 1 April this year.

The committee's recommendations also include a transitional period to enable businesses to adapt to changes to the treatment of overseas expenditure on R&D. This would provide welcome

breathing space for businesses who are being asked to adapt to a raft of changes affecting the way they plan investment in R&D. The committee's calls for urgent publication of draft legislation and supporting guidance underline this point.

All the signs are pointing towards taking a step back and undertaking a careful, holistic review of the incentive, as was promised at the outset of the consultation when it was first launched in March 2021. Any resulting changes should then be introduced with sufficient notice.

Please note that the consultation document states that the new scheme is intended to apply to expenditure incurred from 1 April 2024 on page 12, but for accounting periods beginning on or after April 2024 on page 21.

We support positive reform of the R&D schemes, but this is an important transition which shouldn't be rushed. The importance of getting it right, by allowing sufficient time to consult and prepare cannot be understated.

Rather than a reactive approach to reform, a considered, diligent approach is needed.

15. How can Government ensure SMEs are supported in the transfer into a new scheme?

When RDEC was introduced in 2013, it operated in parallel to the existing large company scheme for a period of three years. We would be interested to understand if something similar has been considered here.

Regardless of whether the same is feasible in this case, it provides a useful measure of what might be deemed an appropriate transition period for such a major change.

It goes without saying that a unification of the schemes would need to be accompanied by comprehensive guidance with clear examples. As well as allowing time to design the scheme robustly. It is not clear how government intends to ensure enough time is to be built in to consult on both the draft legislation and draft guidance before legislation is enacted.

As one of its inaugural actions, DSIT should prioritise issuing a clear statement of intent for the future of the incentive to reassure R&D-intensive SMEs that they won't be overlooked. It would also be imperative for the department to work closely with HMRC in designing and implementing the scheme, and ensuring a consistent approach is applied to compliance across all claiming companies.

QUALIFYING INDIRECT ACTIVITIES

16. Does claiming for expenditure on qualifying indirect activities influence your decision to undertake R&D?

Our experience as advisers suggests that, for most sectors, QIAs make up a relatively small proportion of total R&D expenditure. Where this is the case, the eligibility of expenditure on QIAs is unlikely to materially affect overall R&D investment decision-making, except perhaps for large and complex companies looking to the most competitive regime for their R&D activity.

However, there are certain industries (e.g., pharmaceutical, food science, biotechnology) where proper maintenance of laboratory equipment, for example, is often critical and requires specific resources. As such, the impact of QIAs on the value of a claim can be significant. In these cases, the ability to claim relief for expenditure on QIAs can influence internal budgeting and other management decisions, and conversely excluding indirect activities and their associated costs has the potential to adversely impact R&D undertaken within those sectors.

Indirect activities which contribute to genuine R&D are undoubtedly a legitimate cost of innovation, which in an ideal world where funds were unlimited would be rewarded in the same way as direct activities. However, within the context of a finite cost envelope, it is understandable that HM Treasury and HMRC consider whether a simplification such as removing QIAs from the scope of relief would make economic sense.

It is not currently a requirement for companies to separately identify expenditure attributable to direct and indirect R&D activities. As such, we assume that HMRC does not hold data on the cost of removing QIAs from the scope of R&D tax relief. It is proposed that this data is to be required from companies with the introduction of mandatory supporting information (part of HMRC's tackling abuse measures due to be introduced from 1 April 2023). This step in and of itself is likely to place more emphasis on the identification of expenditure on QIAs when R&D claims are prepared. It will also provide data on which a future redesign could be based. It would seem reasonable to wait until this data is available before finalising any decision in this area.

In the meantime, ensuring that HMRC's guidance on QIAs is updated and provides a range of practical examples to help companies and advisers with the identification of such costs would help protect against errors and abuse.

MINIMUM THRESHOLD

17. Do you think a threshold should be implemented? If one was implemented, at what level should it be introduced?

When the R&D incentive was first introduced, it included a minimum qualifying R&D expenditure threshold, which was subsequently amended, then removed completely in 2012. The reason for this at the time was to open the relief to all to encourage more innovation and investment in R&D by companies who otherwise may not have considered the relief or may not have qualified due to the level of threshold. However, since 2012 the R&D tax relief landscape has significantly shifted and whilst there is more that could still be done to raise awareness of R&D incentives, there are also challenges to address regarding abuse of the SME scheme in particular.

According to HMRC statistics more than 50%⁴ of claims (45,340) submitted in 2019-20 generated tax relief or a tax credit of £25,000 or less. A reintroduction of a minimum threshold would therefore be very likely to significantly reduce the overall number of R&D claims being submitted to HMRC. HMRC estimates that the error and fraud rate among SME claims is around 7%, so removing a volume of claims from the scope of the incentive would be expected to reduce the volume of erroneous or fraudulent claims. However, statistically this approach removes both valid and invalid claims without discriminating. It is untargeted and accepts that some legitimate R&D which currently receives funding will miss out on relief.

Reducing the overall volume of R&D claims should help to decrease the administrative and compliance burden on HMRC, theoretically freeing up HMRC resources to focus on targeting error and fraud in the remaining population. Going further, it could lead to new opportunities to improve guidance and engage with businesses more proactively to prevent errors.

However, a minimum threshold sets a limit on the 'runway' that companies need to kick start their innovation and investment programme by creating a cliff edge below which no relief is due and above which full relief is available. While HMRC data suggests that error and fraud is more prevalent within the SME scheme compared to RDEC, it is not clear whether there is evidence to suggest that errors and fraud are particularly problematic within the smallest R&D claims. In fact, the cases of fraud which HMRC has successfully prevented dealt with much larger sums, which one would expect given the purpose of the fraud was to (illegally) make money.

HMRC is due to provide more detail regarding its estimate of error and fraud to the Public Accounts Committee this year. It is hoped that this will include an analysis of the split between cases of error, and those where abusive or fraudulent activity has been confirmed. If this additional data suggests that errors are more prevalent within smaller claims, an education and awareness campaign would be a far more effective approach to combat this than a minimum threshold.

⁴ <https://www.gov.uk/government/statistics/corporate-tax-research-and-development-tax-credit/research-and-development-tax-credits-statistics-september-2022>

From the perspective of the administrative burden on a company, as the threshold is based on qualifying spend, a certain level of review work would still be required by the company to determine whether it would meet the threshold to make an R&D claim.

In practice, the minimum threshold could introduce a potentially damaging unintended consequence by encouraging claims to be inflated to tip just over the threshold. This would neither reduce volume nor tackle error and abuse. It seems likely that HMRC would want to carefully monitor claims near the threshold value for this reason, requiring additional compliance resource directed towards still relatively modest levels of tax.

For these reasons, we would urge caution when considering the introduction of a minimum threshold. We believe that error, fraud and abusive behaviour should be addressed through targeted measures, in particular improving the regulatory framework in the tax advisory market and ensuring HMRC has the quantity and quality of resources needed to carry out effective scrutiny of R&D claims.

18. What is the average amount of R&D expenditure per year per firm in your business or sector?

As an R&D tax adviser, we support businesses from a number of different sectors. Our clients range from start-ups to large multi-nationals. We have not provided an average figure for R&D expenditure by sector since full data on R&D claims is available via HMRC's annual statistics publication.

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