ForrestBrown®
R&D tax credit consultancy

Consultation response

POTENTIAL REFORMS TO THE UK'S CAPITAL ALLOWANCES REGIME

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INTRODUCTION

About ForrestBrown

ForrestBrown is a specialist research and development (R&D) tax consultancy, founded in 2013 and a member of the Chartered Institute of Taxation. Our multidisciplinary team includes chartered tax advisers, chartered accountants, lawyers, and industry specialists from R&D-intensive sectors. We are passionate about the transformative power of R&D tax credits and about our role in providing clear and accurate professional advice to our clients.

We welcome this opportunity to share our views on potential reforms to capital allowances and have focused on how current and future approaches could interact with existing R&D tax incentives. Our response draws on recommendations put forward in our response to the government's consultation on R&D tax reform, submitted in June 2021, in which we urged the government to prioritise:

- Creating a *coherent, long-term platform* for the relief with greater *flexibility* to adapt as government priorities change.
- More *effective* and *precise* targeting to maximise additionality and reduce wastage.
- Providing *certainty* to businesses and simplifying the administration of the relief.

Capital allowances and R&D

Sitting alongside R&D tax incentives, which provide relief on revenue expenditure, Research and Development Capital Allowances (RDAs) provide a valuable deduction for capital expenditure on R&D, on assets used for R&D purposes, or on providing facilities for carrying out R&D. RDAs rely on the same definition of R&D as R&D tax credits, so are available to innovative businesses seeking to achieve an advance in science or technology through the resolution of technological uncertainty.

The case for enhanced tax relief on capital R&D

Capital expenditure on R&D is currently excluded from R&D tax relief but does attract capital allowances at 100%. However, the introduction of the Annual Investment Allowance (AIA) and the capital allowances super-deduction have eroded the benefit of R&D capital allowances (although the RDA is available on a broader cost base and without a cap).

To achieve the government's objectives to increase R&D expenditure to 2.4 % of GDP by 2027 and establish the UK as 'a science and technology superpower', it is essential that the tax treatment of R&D expenditure is coherent and provides a compelling incentive for companies to invest in innovation.

R&D tax relief stimulates investment, with every £1 of tax forgone through R&D tax relief resulting in up to £2.70 of additional investment in R&D by UK companies. In a survey of clients carried out to inform our response to the government's consultation on R&D tax reform, 61% of respondents said more tax relief for capital expenditure on R&D would incentivise their business to carry out more R&D. Nearly a quarter (23%) said they used the funds they received (or saved) through making an R&D claim to reinvest in capital, equipment or property.

In addition, more effective recognition of capital expenditure within R&D tax relief would make the UK more attractive to inward investment. The government recognises that the UK has a lower proportion of innovating firms overall than other advanced economies. The UK R&D tax system is particularly let down by its lack of effective relief for capital expenditure when compared with jurisdictions such as Spain, Ireland, France and Japan. As a result, leading global innovators have not chosen the UK when making key R&D investment decisions. Capital investments could more effectively anchor R&D activity in the UK, driving further investment as well as creating high-value jobs.

Recommendations to improve capital allowances for R&D

The UK already provides relief for certain capital expenditure on R&D through RDAs. However, this relief is hugely underutilised in its current form. In our survey, when asked if their business had claimed RDAs, 35% responded 'No' and 46% responded 'I don't know', highlighting a chronic lack of awareness which impedes the uptake of the current mechanism. We have summarised the issues contributing to this below.

RDAs are not generous enough

RDAs offer a 100% tax deduction for qualifying expenditure. In principle, capital expenditure qualifying for RDAs will also potentially attract other types of allowance. It is for the company to allocate expenditure to the relevant capital allowance and naturally this would typically be done to the most generous allowance available first.

The introduction of the 130% capital allowance super-deduction (although temporary) has compromised the relative generosity of RDAs for overlapping expenditure, as it is more generous than RDAs at 100%. The AIA offers a 100% deduction for plant and machinery up to a cap (currently £1m), so there is no additional incentive effect for expenditure which attracts both types of allowance (e.g., plant and machinery used for R&D).

Other allowances available attract relief at lower rates but the existence of both the AIA and the super-deduction mean that RDAs lack sufficient generosity to present a meaningful incentive effect.

There is no reward for loss-making companies

The effective benefit rates of RDAs are inconsistent for loss-making and profit-making companies. Profitable companies receive an immediate cash benefit of 19% (to rise to 25%) on qualifying R&D capital expenditure, while loss-making companies often receive no immediate cash benefit. This is significant given that a large proportion of R&D tax relief claims are submitted by companies in a post-R&D loss-making position. This disparity largely exists because, unlike for other types of qualifying R&D expenditure, RDAs do not generate a cash credit.

There is a lack of clear guidance

When making an RDA claim, the R&D usage of the asset for its entire useful life needs to be assessed upfront. There is limited published guidance available for businesses to aid them in making this assessment, leading to inconsistencies and errors, as there is also no ability to reassess the R&D usage year on year if plans change. Nor are there any requirements for companies to provide any support for the R&D usage assessment made. This leaves the system open to abuse, as a change of use is not considered a disposal event and therefore would not trigger a balancing charge.

There is a lack of permanence

Capital allowances in general dictate the period over which capital expenditure can be written off for tax purposes but, where assets appreciate in value, a sale typically results in a claw back of allowances. Notwithstanding the complexities in the current RDA guidance, it should be recognised that there is an extra layer of complexity for businesses considering whether to pursue an RDA claim on capital investment.

An update to the current RDA mechanism may therefore be required to improve its ability to incentivise capital investments in R&D. There are two main mechanisms which could deliver that additional incentive upfront: the *inclusion* of capital expenditure within qualifying expenditure for R&D tax relief, or the *enhancement* of the current RDA mechanism.

Enhancement of the current RDA mechanism

A potentially effective way to fuel investment in capital R&D expenditure would be to enhance the existing capital allowances mechanism in place – RDAs – to improve its incentive effect.

The level of generosity of a newly designed RDA should exceed the other capital allowances available on similar assets (notably the 100% deduction available under AIA and 130% super-deduction if that measure is made permanent). A sensible level of generosity could be comparable to that currently offered for revenue R&D expenditure.

It should be noted that an enhanced RDA would still effectively provide only a timing benefit to businesses in most circumstances. Where buildings or other R&D assets are sold at profit, allowances may be clawed back. Removing this aspect of RDAs would be a major departure from the existing system of tax relief for capital expenditure.

Increased generosity

Because of the way the capital allowances system operates, it is important to distinguish between different asset classes. Expenditure on structures and buildings attracts relief at 3% per annum. While the introduction of relief for these assets in 2018 was welcome, the rates mean that the cost of the building can be offset against Corporation Tax over a 33–50-year period. For plant and machinery assets, tax relief is given upfront via the AIA, or over multiple years (albeit a substantially shorter period than for structures and buildings).

Capital expenditure on R&D may fall within either class. Therefore, to provide adequate incentive the rate of generosity of RDAs should compare favourably to the AIA's at 100%. To do so, it needs to be set at greater than 100%.

If the capital allowances super-deduction is made permanent, consideration should be given to whether an enhanced RDA should be set at a higher rate to maintain its relative incentive effect.

Relief for loss-making companies

A significant disadvantage of capital allowances for loss-making companies, and companies with marginal profitability, is that they generate no immediate cash benefit from the taxable losses generated. Care has been taken within R&D tax reliefs to provide a cash credit element, recognising the risk attached to R&D activities.

A payable credit element would ensure this incentive is effectively targeted at both profit and loss-making companies, and recognises that research intensive companies may need to invest in capital equipment up front to successfully pursue their R&D. There is precedent for payable credits within the capital allowances system (payable credits existed for enhanced capital allowances up to 2020).

Improved guidance on how to calculate and evidence R&D usage

To ensure that the enhanced RDA relief is being targeted effectively, upfront calculations of the proportion of the expenditure incurred for providing facilities for carrying out research and development need to be accurate and robust.

A requirement to provide supporting documentation with the tax computation for RDA claims would encourage greater care in completing those initial calculations. Clearer guidance should be provided on how to calculate the relevant R&D apportionment with easy-to-understand numerical examples for the key different types of expenditure.

Current guidance on RDAs is limited, so any changes should be underpinned by clear, consistent guidance for taxpayers to create certainty.

Removal of the one-quarter test

Within CA60300 it is stated that expenditure on the provision of a dwelling is not expenditure on research and development. However, if it is part of a building for research and development and

represents less than 25% of the total cost, then the whole building can be considered attributable to research and development.

In effect, this creates a similar effect to the 80:20 rule within the R&D incentive, which was removed following feedback from companies that it added complexity, despite being intended as a simplifying measure. To determine whether this rule applied, companies had to calculate the actual R&D apportionment, and then apply adjustments for the 80:20 rule.

As the purpose of the enhanced RDA relief is to specifically target capital investment in R&D, removing the one-quarter test would avoid rewarding non-R&D investment and balance the cost to the Exchequer of the increased generosity.

Inclusion of capital expenditure within qualifying expenditure for R&D tax relief

This approach would create a new category of qualifying expenditure for the current SME and RDEC R&D tax incentives. This new category would be capital expenditure on either R&D items or capital expenditure to facilitate R&D activities. The total cost of capital expenditure would then be combined with the remaining qualifying expenditure categories and relief calculated via either the SME or RDEC mechanisms.

As R&D tax relief is only available on expenditure deductible in calculating the profits of a trade for Corporation Tax purposes, new legislation would be required to give effect to a tax deduction for the capital expenditure on R&D. This could operate in a similar manner to s1308 CTA 2009, which applies to revenue R&D expenditure capitalised for accounting purposes as an intangible asset. To prevent 'double dipping', such expenditure would be excluded from the capital allowances regime.

This approach would resolve the issues set out above: relief for loss-making entities and increased generosity.

However, while this would appear to be a simple solution, we note that there would be some complex challenges with this option, requiring material changes to primary legislation, the definition of R&D and other areas of the guidance. For example, the definition of R&D is set out in the BEIS guidelines, but these guidelines were not drafted with capital expenditure in mind. There may not be an advance in technology or associated technological uncertainties in building a laboratory. The capital expenditure incurred would be eligible for relief based on activities to be carried out in the premises once constructed.

The challenges then relate to the definition of the 'future R&D activities' – for which the precise details will not be known. It is not clear how this could be effectively measured or what the role of the competent professional (fundamental to the assessment of R&D activities) would be in such an assessment.

A more wide-reaching change would be to consider removing the requirement for expenditure to be revenue in nature from the R&D tax incentives legislation. This could have the additional benefit of simplifying circumstances where R&D expenditure has been capitalised for accounting purposes as an intangible asset, but a separate assessment is required to determine the correct tax treatment.

Conclusion

We welcome this opportunity to share our views on how best to support business investment to help foster a new culture of enterprise and growth in the UK. A reformed capital allowances regime which recognises the vital role of R&D can provide further incentive for UK businesses to invest in innovation.

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