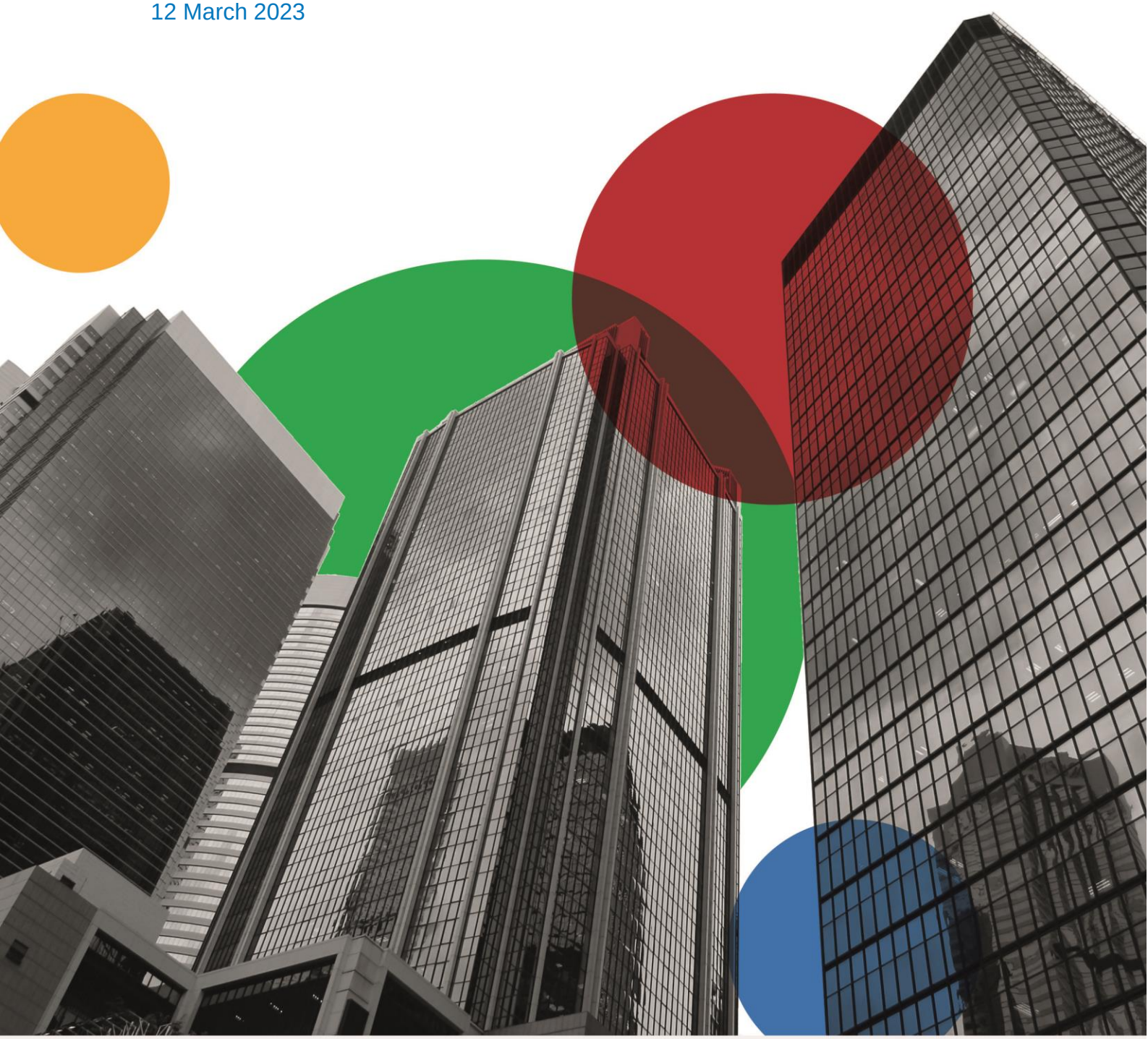
R&D Tax Reliefs Review: Consultation on a single scheme

Response from ICAS

12 March 2023



About ICAS

1. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants. We represent over 22,000 members working across the UK and internationally. Our members work in the public and not for profit sectors, business and private practice. Approximately 10,000 of our members are based in Scotland and 10,000 in England.

2. The following submission has been prepared by the ICAS Tax Board. The Tax Board, with its five technical Committees, is responsible for putting forward the views of the ICAS tax community; it does this with the active input and support of over 60 committee members.

3. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members into the many complex issues and decisions involved in tax and regulatory system design, and to point out operational practicalities.

General comments

4. ICAS welcomes the opportunity to contribute to the consultation R&D Tax Reliefs Review: Consultation on a single scheme, published on 13 January 2023.

5. We support the government's aim to introduce a simplified, single relief based on the current R&D expenditure credit (RDEC) scheme. The complexity of the current schemes can cause difficulties for claimants and HMRC.

6. We have received extensive feedback from members about the problems caused by some agents offering R&D claims services – generally, these agents are not members of professional bodies. In many cases, the claims do not appear to have any sound basis. Due to the complexity of the rules, it can be difficult for companies to understand that a legitimate claim cannot be made, which gives rise to issues for members of professional bodies, whose clients are approached by such agents. It can often also cause problems for the businesses making the claims, where the agent has disappeared by the time HMRC challenges them.

7. More generally, we support simplification because complexity increases costs for both taxpayers and HMRC. Complex tax reliefs tend to generate uncertainty and disputes, diverting both HMRC and business resources.

8. On subcontracting, we agree that the same treatment should apply to all claimants in the merged scheme. This is an important opportunity to remove a major source of the complexity from the existing R&D reliefs. Broadly, we consider that the objectives of simplicity and certainty would be best served if the default position was that the subcontractor is permitted to claim, but with provision for a joint election for the contractor to claim instead. We discuss this in more detail in paragraphs 20 to 23 below.

9. We support attempts by the government and HMRC to reduce fraud and abuse arising from R&D relief. We therefore favour the inclusion of a PAYE/NICS cap and a minimum expenditure threshold in the new merged scheme.

10. Rather than answering the specific questions in the consultation, some of which are clearly aimed at companies incurring R&D expenditure, we have grouped our comments in line with the chapters of the consultation.

Main Features

11. We agree that the new scheme should be an above the line RDEC-like credit. RDEC has provided more momentum to companies considering R&D because it is above the line. This makes it easier to articulate and quantify the benefits, and to generate internal support.

12. However, in some areas it would be useful to adopt aspects of the SME scheme, for example the SME approach to the PAYE/NICs cap. This is discussed in more detail below.

Detailed design – sub-contracting

13. We agree that the same treatment of sub-contracting should apply to all claimants in the merged scheme. If the treatment differs, it will undermine the important objective of simplifying the relief available for R&D.

14. The consultation proposes (in paragraphs 3.11 to 3.13) that the RDEC approach to subcontracting would be adopted. However, as the consultation notes, the current schemes are designed to ensure that relief cannot be claimed on the same expenditure more than once; this is achieved through the interaction of the two schemes.

15. Broadly, under the current rules where a large (or overseas) company subcontracts to an SME, the large company cannot claim (under RDEC) but the SME may be able to claim under RDEC for contract R&D. Similarly, an SME subcontracting to another party can claim for that expenditure under the SME rules and the other party cannot claim for contract R&D under RDEC because it was contracted by an SME.

16. We understand the objective is to simplify the new scheme and remove boundaries, with the intention being to take forward one rule for all claimants. We support applying the same treatment to all claimants in the merged scheme; this is an important opportunity to remove a major source of the complexity from the existing R&D reliefs.

17. Under the current rules, there is an inconsistency in interpretation between some agents, the professional bodies and HMRC over what constitutes contract R&D. The challenges in this area are highlighted by the recent First-Tier Tribunal cases of *Hadee Engineering* and *Quinn*. There is no legislative definition of a “subcontractor” and HMRC’s current guidance refers to a multifactorial approach, considering commercial factors such as the assumption of economic risk, ownership of the IP generated, and the level of autonomy enjoyed.

18. There is a wide spectrum of possible commercial arrangements where one party might engage with another and where R&D activity is, or has been, undertaken. For example, in ‘scenario one’, party A may simply subcontract R&D activities to party B on terms that it will pay for party B’s time and materials. At the other end of the spectrum, in ‘scenario two’, party A may contract with party B to supply it with a finished product, on terms that it will only be required to pay if that product meets certain technical milestones. In scenario two, party B may have to undertake R&D at its own risk in order to develop the product, and party A may have no interest in the details of that R&D work, or the IP generated by it.

19. Considering the possible default positions for which company should be permitted to claim R&D relief, the first alternative would be for the subcontractor to claim. In this case, it should be a requirement that the activities undertaken by the subcontractor represent an R&D project in their own right. It would make no sense for the subcontractor to obtain relief for routine work. The benefits of the subcontractor claiming are that the subcontractor will understand the nature of the activities that it undertakes and will be better placed to define the boundaries of the R&D activities within them. It will also have the information about the expenditure that it incurs (for example, the time spent by staff and the materials consumed).

20. In the context of scenario two above, this approach would clearly appear to be the most appropriate. However, in the context of scenario one, where the subcontractor is not bearing any economic risk, it may not seem so appropriate for the subcontractor to be the company that benefits from the R&D tax relief. For this reason, we consider that the parties should be able to make a joint election to permit the “other company” to claim. In the context of scenario one above, this may well be the appropriate solution. For more on this joint election, see paragraph 23 below.

21. One disadvantage of adopting a default position where the subcontractor can claim, is that it could potentially increase the number of small claims, exacerbating the problems with error and fraud outlined in the consultation. In addition, where this default position is adopted, there will be

circumstances where activities are contracted out, that do not represent an R&D project in their own right, but that form an essential part of a wider R&D project undertaken by the contracting company. In those circumstances, where the subcontractor cannot claim, there should be provision for the contracting company to obtain relief.

22. The second alternative would be for the default position to be that the contractor is permitted to claim. This would appear to give a "fairer" result in some circumstances (e.g. in scenario one above). However, it presents obvious challenges around access to the relevant information to define the boundaries of the R&D activity undertaken and to identify the eligible costs.

23. On balance, we consider that the objectives of simplicity and certainty would be better served if the default position was that the subcontractor is permitted to claim, but with provision for a joint election for the contractor to claim instead. Where that joint election is made, it could include the ability to elect to claim for the relevant underlying costs, where the parties are willing to share that information (similar to the current connected parties election that can be made for subcontractor costs in the SME regime). Where the parties don't agree to this, the default could be a set restriction (such as the 65% restriction that currently applies by default to unconnected subcontractor costs in the SME regime), to account for a nominal profit margin on the contract price.

24. Another consequence of moving to a simpler regime for subcontracting, is that the certainty over the application of the rules would permit contracting parties to take account of the R&D tax relief in their contractual terms, for example, negotiating a price that reflects the benefit that one party will receive from R&D tax relief.

25. With the objective of achieving simplicity and certainty, we would also recommend that the concept of "customer subsidisation" is removed from the new regime. We recognise that this would result in circumstances where a company can claim R&D tax relief where it is not bearing any economic risk (e.g. as in scenario one above, because another party is meeting its R&D costs in full). However, as noted above, in these circumstances we would expect the parties to jointly elect for the contracting party (which is bearing the economic risk) to claim the R&D tax relief, or for the benefit of R&D tax relief to be factored into the price paid under the commercial terms.

Detailed design – PAYE/NICs cap

26. Whilst the introduction of the new restrictions on claiming R&D relief for some overseas activities for accounting periods from 1 April 2023 should prevent the abuse outlined in paragraph 3.21 of the consultation, the absence of a cap would still leave scope for abusive claims.

27. We support the inclusion of a cap in the merged scheme. However, it is important that genuine UK-based R&D intensive companies are not adversely affected. This could be achieved by adopting the SME approach to the cap, ie £20,000 plus 300% of total PAYE/NICs liability for the period, with the exemptions set out in paragraph 3.26 of the consultation.

Detailed design – Additional support for different types of R&D or R&D intensive companies

28. We do not support the inclusion of additional support for different types of R&D or R&D intensive companies in the merged scheme. This would undermine the simplification benefits arising from having only one scheme.

29. It would also cause confusion and potentially disputes with HMRC around whether something fell into one of the 'special' categories. We have been given the following examples where boundary issues could easily arise:

    a. A company that could be described as an agritech company, software development company or green technology company.
    b. A company that could be seen as a software development company or life science/medtech company.

30. If additional support is required in some areas, it would make sense to provide this through other non-tax mechanisms, for example, grants.

Guidance and transition

31. The consultation proposes that if the schemes are merged, the new scheme should be implemented for accounting periods starting on or after 1 April 2024. This could have an adverse impact on the financing of projects already in progress, where the planning was based on the current rules (particularly given that the SME rate of relief is already being reduced from April 2023). A longer implementation timeframe might be preferable – or some form of transitional provisions.

Other design features

Pre-trading periods

32. The consultation makes no reference to the treatment of R&D expenditure in a pre-trading period. The current SME scheme permits an election to be made for the R&D expenditure, plus the additional deduction, to be treated as a deemed loss in the pre-trading period. If the proposal for a single scheme based on RDEC is adopted, this would no longer be relevant. However, given the intention to support innovation, it would be helpful for the new scheme to make some relief available in pre-trading periods, when support could be critical.

Qualifying Indirect Activities

33. We support the retention of relief for Qualifying Indirect Activities (QIAs). QIAs are well understood by legitimate agents and should be no more liable to boundary pushing than any of the other elements of the R&D definition. Removing relief for QIAs would present considerable difficulties in cases where they can be a significant and essential cost. For example, the cost of calibrating equipment or maintaining Good Manufacturing Practice (GMP) compliant clean rooms for medical research.

Minimum expenditure threshold

34. As set out in the consultation, the removal of minimum expenditure thresholds has contributed to the proliferation of low value claims and exacerbated the problems with error and fraud. It is not realistic to expect HMRC to be able to tackle abuse successfully with the current volume of small claims. Attempts to crack down by stopping and checking far more claims also cause delays to the processing of legitimate claims.

35. We therefore support the inclusion of a minimum expenditure level per year to qualify for relief, in a merged scheme. Paragraph 3.42 of the consultation notes that in 2019/20 over 50% of claims were worth £25,000 or under. A threshold of at least £25,000 would make sense. However, this should be combined with the ability to make a joint election (discussed in paragraphs 20 to 23 above) and some provision for pre-trading periods (paragraph 32 above). To avoid disadvantaging start-ups, consideration could also be given to allowing businesses to claim relief once cumulative expenditure in the pre-trading period/first three years of the business had reached the threshold – although this would add a degree of complexity.

##

Contact us

CA House, 21 Haymarket Yards, Edinburgh, UK, EH12 5BH

+44 (0) 131 347 0100

connect@icas.com | icas.com

@ICASaccounting ICAS – The Professional Body of CAs