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R&D tax relief: new contracting out rules and overseas restrictions - draft guidance

Comments by the Chartered Institute of Taxation

1 Introduction

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.

1.2 Finance Act 2024 introduces the new merged scheme for R&D relief. This is expected to come into effect for accounting periods beginning on or after 1 April 2024, subject to confirmation of the 'appointed day' by regulations. HMRC have published draft guidance published ahead of the implementation of the reforms on:

- contracted out R&D activities; and
- the overseas rules.

1.3 We welcome the opportunity to comment on this draft guidance on these two potentially difficult areas of R&D tax relief. However, we urge an acceleration of the timetable for the full guidance on the rest of the changes, which we understand will only be available later in 2024, that is to say after the new rules have come into effect. This is much needed for certainty, consistency and to enable people to get the application of the new rules right.

1.4 Paragraph numbering would have been helpful with reviewing and commenting on this draft. It is not clear whether this guidance, once finalised, will be included within the CIRD manual, in which case we would expect the usual manual paragraph numbering, or published as a standalone document. However, even in the latter case, paragraph numbering would be helpful, as it would make it easier to reference in correspondence and discussions (including with HMRC) going forward.

2 About us

2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it –

taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

3 Overseas Expenditure

3.1 Overall, the legislation introducing the restrictions for R&D tax relief to R&D activity in the UK, subject to certain conditions applying is sensible. The 'circumstances' in which overseas expenditure on contracted out R&D and on payments for EPWs, set out in section 1138A(2), are helpful on balance. Words like 'wholly unreasonable' are always more helpful than not for taxpayers focused on doing the right thing rather than worrying about if they are pushing the envelope.

3.2 The sections in the draft guidance on contractor payments and externally provided workers are clear, with good examples. We recognise that this will always be an area of judgement, and the discussion in the guidance is helpful in recognising that many factors may be taken into account.

3.3 Section 3.2 of the guidance discusses '**Evidence to support a claim**'. It is disappointing that HMRC have not been able to provide any detail or clarity around what documentation needs to be maintained to justify the claim. But, we understand the reasons given for not doing so. Any list of documentation provided in guidance could not be exhaustive, and we agree that it will depend on the industry and company, and that circumstances will vary widely. It will be important that HMRC caseworkers also understand the industries and businesses they are considering, and what would be reasonable in terms of what they ask for when conducting compliance checks. If HMRC are taking an approach that deciding on what documentation is required to evidence the claim is a matter of judgement for the company and for the company's tax team, HMRC must ensure that their approach in the future is not prescriptive as to the evidence that is required. After adopting this approach in the guidance, it would be inappropriate for a caseworker to write to a company along the lines of 'we/HMRC would expect you to be able to provide [x, y or z] documents to support your position'.

3.4 However, notwithstanding our understanding of HMRC's points here, we suggest that there is more that HMRC could say in the guidance around this point to help taxpayers. For example, the guidance at section 3.2, in relation to the overseas restriction, suggests it would be prudent to obtain PAYE or NIC reference numbers, but this may give rise to data protection considerations and the contractor/EPW would be under no obligation to share information. Similarly, there are very limited examples regarding the contemporaneous evidence it would be reasonable to retain to support the contention that it would be wholly unreasonable for R&D to be undertaken in the UK. In **Example 4**, how would the taxpayer demonstrate to HMRC's satisfaction that there is time pressure and UK facilities are unavailable in the required timescale, and in **Example 5**, how

would the taxpayer demonstrate that a contract research organisation does not have personnel in the UK who could undertake the project management and data analysis? Similarly, as regards subcontracting chains (discussed in section 7.3), what evidence would a UK contractor be expected to obtain to demonstrate that an overseas engager is not itself working on behalf of a UK company?

3.5 In section **6.1 The conditions** we query the inclusion of the following bullet under the heading 'Geographical, environmental and social conditions':

'• *centres of human expertise such as university or other research groups (but see section 6.2 for the distinction between this and availability of workers).*'

As noted in the guidance, this potential condition overlaps with the excluded conditions in section 6.2 around availability of workers. It is not clear from the relevant examples in section 6.2 how 'centres of human expertise such as university or other research groups) could be a valid condition. In particular, we refer to **Example 14**, which says that the related EPW costs will not qualify where AI scientists from a 'well known university outside the UK' are engaged. Please could HMRC include an example to show where the condition in the bullet point above might be valid, and not 'knocked out' by the exclusions in section 1138A()3)(b)?

3.6 Is the point intended to be explained by the sentence immediately following Example 15? This reads:

'*The exclusion in CTA09/1138A(3)(b)(ii) does not extend to other 'people related' factors such as location close to key investors or to a leading university research group which might provide advice or guidance, unless these individuals are workers carrying out R&D.*'

Does this mean that the presence in that overseas place of the people doing the R&D is excluded, but the presence of people who may support (indirectly) those people doing the R&D is possibly a valid condition? If so, perhaps this could be stated more explicitly.

3.7 Please could HMRC consider the sentence in the paragraph immediately before Example 13 (in section **6.2 Excluded conditions**) that reads:

'*For example, the cost of constructing or adapting the facility referred to above may or may not be a cost of the R&D, depending on whether it is a cost of the R&D.*'

This is rather confused and could be better expressed.

3.8 The cross referencing has gone awry in **Example 17**, this refers back to '*Example 2.4*' which does not exist.

3.9 **Example 17** is qualified in so far as the 'training of [staff] would take too long'. Earlier in the guidance (near the start of section 6.2) we are told that: 'Where cost is a factor however it will often not be the only one. For example, if time pressures mean that R&D cannot wait until a new facility is developed in the UK, the fact that the staff to operate the facility are in short supply, and therefore expensive to employ, does not mean that CTA09/1138(3)(b)(i) and (ii) prevent the conditions in 1138A(2) being met.' Might that not be a relevant argument here: the R&D needs to be done now and there is no time to train new staff?

4 Contracting out R&D: new rules

4.1 The guidance is helpful in so far as it clarifies HMRC's interpretation of new section 1133 CTA 2009 (contracted out R&D), but it is disappointing that the legislation has been drafted very broadly and guidance is relied on to reduce its scope. In particular the emphasis the guidance places on allowing the decision-maker to claim

contrasts sharply with the legislation, which does not introduce this concept. Similarly the guidance indicates that in order to claim R&D tax relief, the company doing the contracting out must be able to understand and articulate the R&D, which will require it to have some technical expertise. Whilst this approach is the right one to ensure that the regime works as intended, the legislation does not necessarily require this, so there may be scope for taxpayers to challenge HMRC's approach. Furthermore, whilst the guidance indicates that the word 'contemplate' should be read to require significant, focussed attention, it appears to selectively quote definitions of the word in order to support this. Another possible meaning of 'contemplate', which is not mentioned in the guidance, is 'to view as likely or probable', and this appears to us to be the more natural meaning in the context in which the word appears in s1133.

4.2 We remain of the view that the legislation should be amended in a subsequent Finance Bill to provide clarity. More specifically, we would like to see the amendments suggested in our briefing to the Finance Bill 2023-24 Committee of the Whole House[1]. This included the suggestion that the legislation should have something around that the company doing the contracting out – the customer (Company A) in the guidance - must itself be seeking to resolve a scientific or technological uncertainty (that is to say, have a valid R&D project) in order to claim relief. The current position, whereby a company's ability to claim R&D tax relief could change in the event that HMRC changes its interpretation, or a court finds HMRC's interpretation to be incorrect, creates uncertainty.

4.3 There is a reference missing at the end of this sentence in the third paragraph under the heading **7.1 Basic Principle**: '…which is important for the reasons set out in section.' There is also some repetition in this section of the draft guidance. In the text following Example 18, the first and last paragraphs are identical.

4.4 In section **7.2 CTA09/1133**, the first paragraph dealing with **CTA09/1133(2)** could be clearer. The draft guidance says: 'If all three parts of the definition in subsection (2) are not satisfied then the customer cannot claim for any payments it makes to the contractor – but the contractor may be able to claim, if it carries out R&D.' (emphasis added).

This sentence is potentially confusing in relation to the possibility of the contractor (Company B) being able to claim. It is necessary for all three conditions in section 1133(2) to be satisfied in order for Company A to have the right to claim; but it is not correct to say that all three must be failed in order for Company B to have the right, which it is possible to read the sentence as currently saying (see added emphasis above). The sentence may be clearer if phrased such that all three parts must be satisfied for the customer (Company A) to be able to claim (along the lines of the first sentence of the next paragraph), and that if any of conditions are failed, Company A cannot claim, but Company B may be able to.

4.5 The paragraphs following Example 20, from the fifth paragraph, discuss the involvement of competent professionals. The fifth paragraph is sensible, and we note that the guidance recognises that there could be third party advisers providing the competent professional. We suggest that the guidance should also specifically recognise that a less sophisticated customer might rely on the contractor's competent professionals during the contract discussion/specification phase. In such a scenario the customer could still be making a decision to contract out the R&D.

4.6 The draft guidance goes on to say in the next paragraph that the mere presence of competent professionals is not sufficient for Company A to be entitled to claim. Again, this is sensible. However, it would be helpful if the guidance could also clarify that the fact Company A does not have its own competent professionals is also

[1] Finance Bill 2023-24 briefing - Corporate Taxes – see paragraphs 2.21 to 2.30

not conclusive that it is not entitled to the R&D claim; again we are envisaging a circumstance where Company A may be using the contractor's competent professionals to advise its thinking.

4.7 This point feeds into Examples 21 and 24, where the question of Company A's competent professionals may also be relevant, but is not discussed. We agree that Example 24 works on its own terms, but suggest that it could be expanded to further consider the point around competent professionals. Example 24 seems to assume that, if Company B seeks to renegotiate the contract once it realises that R&D may be beneficial, the fact that Company A now knows R&D will be done, and, if this is reflected in the contract, then Company A has contracted out the R&D to Company B. How does this fit with Example 21 and the discussion in that example around Company A's expertise? What if in Example 24 Company A does not itself have the appropriate competent professionals, but it relies on Company B's competent professionals to advise it and arrive at the situation described, whereby the contract now specifies that R&D that Company B will carry out for Company A and Company A is paying for it? That is to say, as the Example seems to conclude, that Company A has contracted out the R&D to Company B and it entitled to claim tax relief for it. Example 24 could helpfully be expanded to consider these points.

4.8 Examples 22 and 23 cross reference to 'Example 2a': there is no Example 2a, should this be 'Example 21'?

4.9 We suggest that the language at the end of Example 24 is amended to refer to 'Company A' and 'Company B' throughout, rather than just 'A' and 'B', for consistency. This point crops up at a number of other places in the draft guidance – see, for example, the paragraphs after Example 20 that discuss wider circumstances and competent professionals.

4.10 In Example 25 and Example 26, the term 'subcontracts' is used. We suggest this is amended to 'contracts', as we agree that using this term, rather than 'subcontracting' (unless there are three or more parties) is helpful and consistent with the legislation.

4.11 In Example 27, under heading **7.3 Section 1133(3) – (6) CTA09: Subcontracting chains** there is a rogue ']' in the middle of the final full paragraph before the bullet points.

5 Acknowledgement of submission

5.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation
1 March 2024