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R&D Tax Reliefs: consultation

Response by the Chartered Institute of Taxation

1 Executive Summary

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 We refer to the consultation document on R&D Tax Reliefs published on 3 March 2021 and also to the discussion we had with HMT and HMRC on this proposal on 14 May 2021. Our comments below reflect our understanding of the matters under consideration in the consultation document following those discussions.

1.3 We welcome this wide review of the UK's R&D relief schemes. We agree that it is important to review these schemes to ensure that the reliefs remain 'fit-for purpose' and consider the effectiveness of the reliefs. R&D relief is a long-standing form of government intervention into economic activity that is supported throughout the business world. We welcome the continued government focus on encouraging innovation and the importance of R&D tax relief in the context of the UK's international competitiveness.

1.4 We support the policy aim of ensuring that R&D tax relief delivers 'additionality', as this has obvious attractions from the perspective of getting best value for public money spent. Certainty for businesses has a large part to play in delivering additionality. Consistent, and preferably simple legislation; clear, consistent and developed guidance; and a consistent approach to auditing and enforcement all play a part in either delivering, or undermining certainty.

1.5 We welcome this review of the R&D tax relief regimes in the round, which offers an opportunity to clarify the policy intentions of the reliefs and, to the extent necessary, make legislative changes to ensure that the law clearly delivers those policy aims. We refer in particular, to ongoing discussions with HMRC about the application of the rules relating to contracted out R&D and subsidised expenditure, where there is currently disagreement around the interpretation of the rules.

1.6 We also welcome the focus on improving the quality of R&D advice. The CIOT has done a lot of work in this area, including addition of the topical guidance section on R&D in our Professional conduct in relation to taxation (PCRT) rules. Continued focus on professional conduct is the best way to address any concerns around fee arrangements, such as contingent fees, which, in our view, can in some circumstances be appropriate within a proper professional relationship.

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.

2.5 Our stated objectives are for a tax system that includes a legislative process which translates policy intentions into statute accurately and effectively, without unintended consequences, greater simplicity and clarity and greater certainty, so businesses can plan ahead with confidence.

3 Structure and administration of reliefs

3.1 **Question 1: Do you consider your company to be a research intensive firm? How does your business benefit from the R&D reliefs (e.g. cashflow, reduced tax liability)? If your company is an SME that claims under both the SME tax relief and RDEC, what is your experience of using each scheme and how do they compare?**

3.2 Our members represent businesses, or work in businesses, with varying degrees of research intensity, and deriving benefits that principally include income (or offsetting of expenditure), positive cashflow, and better reported accounting results. (Reduced tax liability being a means to those ends.) Our members' employers and clients have experience of both schemes. The key determining factor as to which scheme a business is eligible for is size. However, many SMEs also encounter the RDEC scheme because of subsidised or grant funded R&D, and where R&D is contracted to them by a large company. Generally, experience of both schemes is positive.

3.3 **Question 2: Is there a case for consolidating the two schemes into one? What do you value about the design of the current schemes that might be lost if they were unified?**

3.4 We understand that there is a strong presumption that SMEs would get a higher rate of R&D relief than large companies, because of the higher barriers they face to undertaking R&D. This seems a sensible presumption to us. We suspect on this basis that:

- A combined scheme would basically follow an RDEC approach, which may be more difficult for some SMEs to relate to (because RDEC was designed for large companies); but
- There would have to be elements of the SME scheme rules to protect the availability of a differential rate from being arbitraged and abused, , including the rules dealing with contracted out R&D and subsidised expenditure (discussed further below).

Thus, the potential for simplification from an approach of merging the two schemes would appear limited.

3.5 We are agnostic on the question of whether it would be better to have one scheme, using the RDEC framework, but with two rates and similar rules to those we have currently for determining which rate applies in certain circumstances, or maintain the current position with two separate schemes. There are pros and cons of each approach.

3.6 The RDEC scheme was specifically designed for the way large businesses operate, with the key feature being to provide a visible incentive for the specific departments that carry out R&D by giving the credit "above the line". As a result, the accounting for RDEC is more complex and while most SMEs (and their advisers) would be able to deal with this, it could present challenges for the smallest businesses and, indeed, the smallest firms of advisers who may not understand, for example, that the RDEC is actually taxable. Although, we also note that if there were only one scheme, based on RDEC, the accounting would become well-established and generally understood for all taxpayers and advisers considering R&D tax relief.

3.7 On the other hand, the existing rules means that in a variety of circumstances SMEs will end up running both schemes together (for example where some projects are grant funded or a project is in part subsidised), which can get very complex, and it can be difficult to explain a second scheme which operates quite differently to a company that is used to the other one. Having only one scheme, albeit with different rates, could alleviate some of these complexities. Although, presumably, an allocation (for example of the staff time for individuals who have a degree of involvement across the board) of expenditure between the various projects would still be required to apply the different rates.

3.8 We would also note that the way that the SME scheme operates results in different effective rates for SMEs depending on whether they have taxable profits or losses. The SME scheme works by reducing a company's corporation tax liability, with the option of receiving a cash payment if the company is loss making. R&D expenditure is enhanced by 130%, with the additional enhancement being deducted from the company's taxable profits (or added to a loss). If the company is in a loss-making position after this enhancement is deducted, it can claim a payable tax credit at 14.5%.

3.9 Say a company makes £100 of profit and has spent £100 on R&D, so before R&D tax relief, it breaks even (no profit or loss). Its R&D relief enhancement will be £130 (£100 @ 130%), which when deducted leaves it with a loss of £130, that it can surrender at 14.5%, for a payable tax credit of £18.85 (£130 @ 14.5%). This SME has spent £100 on R&D and received an effective benefit of £18.85 (or 18.85%). If the same SME had made a loss of £100 before taking into account the R&D expenditure of £100, the resulting payable tax credit is calculated by reference to the loss of £100 plus the R&D relief enhanced amount of £130, so would be £33.35 (£230 @ 14.5%), giving an effective benefit rate of 33.35%.

3.10 So, under the existing system, the same level of R&D investment can generate quite different effective benefit rates for SMEs, hampering its effectiveness. This uncertainty would be resolved by adopting the RDEC model for SMEs.

3.11 **Question 3: What do you think explains the difference in additionality between the two schemes? How could the schemes be improved to incentivise the R&D a business does or might consider doing? Can you give evidence to support your suggestions?**

3.12 'Additionality' has obvious attractions from the perspective of getting best value for public money spent (in the form, in this case, of taxes forgone or credits cashed). The key difficulty with it is that the true comparison that has to be made is between the R&D that occurred in reality and the hypothetical and counterfactual amount of it that would have occurred without the relief/intervention/policy. It is inevitable if the relief is to be focussed in an attempt to reflect that concern, some kind of proxy will have to be used for the hypothetical and counterfactual figure. Some tax regimes look at prior historic levels of R&D within the business: this may capture cases where businesses increase R&D expenditure in response to the policy (though it may still be that some such increases would have occurred without it), but it fails to address cases where businesses contemplate reducing levels of R&D and might be dissuaded from that by intervention. Other proxy measures might have other disadvantages.

3.13 There is a difference in the way large and smaller businesses operate. Large businesses who use the RDEC are much more likely to track their product and technology development as a department, meaning it is much easier to report on. The introduction of RDEC has given more momentum to R&D within businesses because it is above the line. It is easier to articulate and quantify the benefits. Those working in business have noted that RDEC helps them internally – because they can highlight the benefits of the R&D. These larger businesses are also much more likely to be planning and preparing budgets for future R&D projects, making it much easier to measure the additionality of the relief. SMEs generally handle R&D in a completely different way. The R&D becomes embedded as a culture within the day to day operation of the business as a whole. It is therefore much more difficult to track additionality in the same way, because the R&D is inherent in the day to day operations, as opposed to the business having a specific R&D team or department. For these reasons we suspect that the lesser reported additionality of the SME scheme could be more apparent than real.

3.14 If it is hard to design rules to require 'additionality', it is unfortunately easy to discourage it: the more uncertainty there is about what types of activity and in which contexts qualify for relief, the less likelihood there will be of the relief actually stimulating such expenditure. Such uncertainty can arise for a number of reasons: from changing and uncertain interpretations of statutory terms, to difficulties in interpreting the facts on the ground even against clear statutory criteria. To what extent do decision-makers understand the interactions between the technological uncertainties, the business plan to remove these, the financial and expenditure implications, and the resulting application of the conditions for relief? Even in the smallest companies, these interactions involve different skillsets and require communication. Consistent, and preferably simple legislation; clear, consistent and developed guidance; and a consistent approach to auditing and enforcement all play a part in either delivering, or undermining certainty.

3.15 The discussion with regard to the differences between the two schemes, and the extent to which these should be retained, is relevant to ongoing discussions with HMRC about the application of the rules relating to contracted out R&D and subsidised expenditure. We disagree with aspects of HMRC's interpretation of these rules and consider that HMRC's interpretation will lead to undesirable policy outcomes. However, regardless of which interpretation is correct, this review of the R&D tax relief regimes in the round, offers an opportunity to clarify the policy intentions of the reliefs and, to the extent necessary, make legislative changes to ensure that the law clearly delivers those policy aims, including ensuring additionality. Legislative change could avoid what may otherwise turn out to be a long period of market adaptation to a less favourable regime that arises from HMRC's interpretation, and considerable uncertainty (and perhaps litigation) over what will qualify for SME relief, that will be particularly damaging from an 'additionality' perspective.

3.16 We set out further thoughts around the policy with regard to contracted out R&D and subsidised expenditure in the Appendix.

3.17 **Question 4: To what extent do the rates of relief available to you impact your investment decisions and/or your choice of location? Is the balance of relief between the two schemes appropriate? Is there any evidence of significant deadweight where investment decisions would proceed without relief?**

3.18 Our members report that, while R&D incentives are not the most important factor in investment decisions, they do play a significant and increasing role in such decisions for larger businesses, including international businesses in relation to decisions about location, particularly where other factors may be broadly equal. They envisage that this will continue in the coming years.

3.19 For smaller companies the role of R&D tax reliefs in the decision making process reflects that R&D is very much part of how these companies 'do business', in the sense that a growing business will always be striving to improve its products and services to continue to grow and to be competitive. At the point these businesses first hear about R&D relief, they are usually surprised to find that the things they are doing qualify, so at that stage, they would have been making those decisions anyway. However, once the company is aware of the R&D tax relief, and the company has a greater understanding of the relief and the kind of activities it rewards, the availability of the relief does influence decision-making going forward. While some of the same decisions would have been made anyway, the prospect of obtaining R&D relief is now a significant factor in that decision making process, meaning that more positive decisions to invest in R&D are taken than previously may have been. It seems likely to us on this basis that stability in the rules and their interpretation are important to promoting additionality.

3.20 The balance between the two schemes is also relevant in the discussions around the meaning of contracted out R&D and subsidised expenditure because, as explained in the appendix, the interpretation of these rules will have a large impact on the availability of the SME scheme. As discussed above, we envisage that a differential between the relief available for large businesses and SMEs will remain, even if the decision is made to have one scheme based on RDEC with different rates and some rules for deciding which rate should apply.

3.21 As explained in the appendix. HMRC's current approach will have the effect of greatly reducing the circumstances in which SME R&D relief is available. In addition, the approach will lead to considerable deadweight as it results in a denial of relief to a company making decisions about incurring expenditure on R&D activities undertaken to deliver a commercial contract.

3.22 We think that from a policy perspective, if there is a chain of two or more contractors in a supply chain, the focus of relief should be at the company which decides whether to undertake R&D or not (and if so, how to go about it and so what expenditure is incurred). If HMRC's interpretation of the current legislation as to what constitutes contracted out R&D is correct, it seems likely that changes in the law would be needed to secure this outcome.

3.23 More generally, is any consideration being given in government to extending the availability of R&D tax relief to unincorporated businesses? Is there any evidence around whether the availability of R&D relief is a factor in driving businesses to incorporate?

3.24 **Question 5: Would a departure from the ordinary CTSA system be justified? Should more information and assurance be required from companies at the point of claiming? Should a company providing more information upfront be treated differently?**

3.25 We understand that there is no intention on the part of government for R&D tax relief to be taken out of the tax system altogether (for example, by introducing a grant system to encourage R&D instead of giving tax relief). We agree that there are no obvious benefits from such a significant change, which would be a major upheaval. We also agree that there are aspects of the CTSA system that constrain the way in which HMRC is able to administrate the relief, for example, around time limits and the rules around enquiries etc. As

mentioned above (at paragraph 3.14), a consistent approach to auditing and enforcement all play a part in either delivering, or undermining certainty in a tax system, which in turns feeds into whether the tax relief delivers additionality.

3.26 HMRC face challenges as a result of the current legislative framework of R&D relief which sets out very little with regard to what is required to make an R&D claim: the only requirement in the legislation being the figures in the CT600 form (and new CT600L). This lack of legislation around what is required is in part a result of the policy intention to encourage take up of R&D by making it easily accessible to all taxpayers. HMRC cannot 'reject' an R&D claim that provides very little (or no) supporting information on the basis that it does not comply with the legislation. The route to challenging claims is the opening of a formal enquiry. It is recognised that enquiries would appear very threatening to smaller taxpayers and also are resource intensive for HMRC and are not, therefore, always an effective route for tackling low level errors in R&D claims (the revised guidance at CIRD81800 regarding submitting returns other than via the Gateway (COTAX) was noted).

3.27 The challenge, therefore, is to consider ways in which the legislation could be tightened up to make combatting error and fraud easier, while ensuring it remains easy and straightforward for companies to claim. While the claims process is not overly bureaucratic, the rules are complex and require specialist tax input or advice in order to be confident in claims. We would welcome initiatives that improve the tax administration of the reliefs for taxpayers. For example, extending the advance assurance regime and making it more effective by ensuring that it provides the taxpayer with education around how it should approach an R&D claim, rather than simply focussing on speed in terms of providing the assurance. The impact on the resources required within HMRC from changes could be significant and should be taken into account at an early stage. In addition, these initiatives need to be supported by keeping 'tinkering' and unnecessary changes to a minimum.

3.28 A result of taking R&D tax reliefs out of the CTSA system might be to increase the number of non-tax specialists completing claims for companies. Where these undertake work that they are competent to perform, and perhaps can do more cheaply, this should be welcomed, but the implications for ongoing requirements to conform to tax law, and for professional standards where these non-tax specialists are not members of professional bodies, need to be considered.

3.29 The rules should require companies to provide sufficient information to HMRC to enable HMRC to assess the claim and ensure that the necessary conditions for tax relief have been satisfied before the tax relief is given. Although it is already requested in guidance that details of costs claimed and a summary of R&D activities be submitted with a claim, there is a perception that it is also possible for companies to submit no supporting evidence, but have their claims routinely approved "on the nod". This may in part be due to lack of HMRC resource. If a greater degree of information was required with the claim, it would make it easier for HMRC to identify the quality and quantity of supporting information at the point of submission, such that the HMRC system can flag returns containing claims but, for example, no attachments to the return. Currently there is no suggestion that claims submitted without supporting evidence are more routinely targeted by HMRC in terms of opening enquiries into them. Formalising the requirement to provide reasonable information could ensure that those that do not comply could be targeted for review prior to the tax relief being awarded.

3.30 Despite the legislation only providing HMRC with the formal enquiry route to question R&D tax relief claims, our members' experience is that it is quite common for HMRC inspectors to ask questions with regard to claims outside of the framework of a formal enquiry and this seems to us to be a sensible approach. This approach could be developed into the possibility of a legislative process for a 'mini enquiry' into the R&D tax relief claim only. The benefits of submitting information in advance on a voluntary basis for taxpayers would be to reduce the scope for any such enquiry and ensure that the cash is received more quickly.

3.31 From a taxpayer's perspective, providing certainty on the approach and process undertaken by the company in respect of the R&D to HMRC should limit the need for detailed review on every claim. More opportunities for the taxpayer to do this (either through a formal mechanism, or a change in approach from HMRC) would be welcome and should allow HMRC to more tightly focus its resources. Leveraging of the documentation already produced by technical teams would help in pulling together the detailed documents needed and HMRC should be able to rely on that – flexibility from HMRC in this regard would be welcome.

3.32 **Question 6: When did you first claim, and what prompted you to do so? Do you use an agent? If so, why? What is your experience of how agents' fees are structured? How could the expertise and specialist knowledge of agents assisting with R&D claims be improved?**

3.33 We are surprised that any claims for R&D tax relief are submitted without the assistance of an agent, other than those by companies large enough to have in house tax departments. We would be interested to know the split in terms of numbers and value of claims submitted with and without agents (or appropriate in house tax expertise), and would also be interested to know about HMRC's comparative experience of these claims.

3.34 We are aware that HMRC's experience is that a business model based on contingent fees is a risk factor in reviewing claims. However, our view is that there are circumstances where contingent fees are appropriate within a proper professional relationship. We appreciate that contingent or success based fees can pose threats to the independence of advisers and the professional judgements they must make: these concerns need to be addressed and we suggest that this is best done through initiatives such as the R&D content of the PCRT rules (mentioned further at paragraph 3.39 below) and focus on the standards of tax advisers generally. If a particular adviser is likely to be swayed to 'push the boundaries' just because of a contingent fee arrangement then their obvious lack of professionalism is unlikely to stop them submitting a poor claim just because a different fee structure is used.

3.35 Approaches along these lines are preferable to the government introducing rules in relation to what are otherwise commercial relationships because contingent fees are also a market response to the fact that advisers and taxpaying businesses will have different levels of experience of claims and confidence in the broad likely outcome. This is partly because advisers have more knowledge of the legislation and how uncertainties are likely to be resolved, and partly because advisers handle a portfolio of claims. Contingent fees are valued by clients for good commercial reasons – for example in respect of a client who is new to R&D and does not have the funds to invest in professional advice to make an R&D claim, as well as an education piece for companies who are unconvinced that they qualify for relief and therefore value this "safety net".

3.36 Undoubtedly if contingent fee arrangements were banned or curtailed in some way, there would be fewer claims, but the risk is that the 'lost' claims would be valid claims where the policy is to encourage the underlying expenditure on R&D activities. We would also note that the more change, complexity and uncertainty there is in applying the legislation to a particular fact pattern, the greater the market pressure for contingent or success based fees will be, and the more claims, and perhaps 'additional' underlying expenditure, will be 'lost' if such fees are banned or curtailed.

3.37 We note the consultation being undertaken in relation to *Raising standards in the tax advice market*[1]. In relation to R&D in particular, it is important to counter the eroneous belief that giving advice in relation to R&D is not tax advice. In our view it clearly is. We suggest that due consideration should be given to a requirement for compulsory professional indemenity insurance for all tax advice, including agents giving R&D advice, as well as a professional obligation to do CPD.

[1] Raising standards in the tax advice market - GOV.UK (www.gov.uk)

3.38 **Question 7: How can the responsibilities of HMRC, agents and the company be better reflected in the claims process? Question 8: What other changes might help claims to be dealt with more smoothly, while ensuring better compliance? Is there a way HMRC and advisers can work more effectively to improve the quality of external advice available to companies? If you claim R&D tax reliefs in other countries, how does the claim process differ and what are your views on this?**

3.39 We welcome the focus on improving the quality of R&D advice, and have done a lot of work in this area, resulting in the R&D content of the PCRT rules and, as mentioned above, we welcome the initiative to raise standards in the tax advice market generally. We have always recognised that, as well as being bad for the integrity of the tax system, poor claims are unhelpful for 'good' agents, because taxpayers are attracted by promises of R&D tax relief by 'bad' agents. It is also problematic for a 'good' practitioner who advises a client that R&D relief is not available – when the client reports that a business competitor has had a similar claim accepted without challenge.

3.40 CIOT has previously suggested that HMRC should consider some or all of the following in relation to combatting poor claims:

- Reporting agents for false advertising to the ASA where appropriate
- Consider how the system operates between different agents of a taxpayer, which currently does not require any linkage between an R&D agent and a 'main' CT agent. Should there be a link through the main agent, and some further controls over filing in relation to a taxpayer's CT600
- Consider whether the Form 64-8 system can be improved – although this works the majority of the time where a paper 64-8 is submitted with "R&D ONLY" in big letters, there are instances of HMRC processing these incorrectly and transferring the whole CT authority away from the main agent. This needs a uniform system to be introduced.
- HMRC could make more use of the memorandum of understanding between professional bodies and HMRC with a view to reporting more 'bad' agents where these are members of a professional body.
- Require professional indemnity insurance as is currently being proposed and noted above, although we would note that this in itself would not solve the problem of poor advice, as it is not the insurer's responsibility to regulate the market.

In our view HMRC should proceed further down the path of 'Option E' under the previous Call for evidence on raising standards in the tax profession[2].

3.41 There is a sense that, to some degree, HMRC's systems, possibly due more to resource constraints than design, result in a lack of compliance focus on the smallest claims, that these are allowed without due focus or enquiry. We suspect that this encourages abusive claims at lower levels. This is important to tackle to ensure the integrity of the system and encourage confidence and certainty and, therefore, the additionality of the relief. Our suggestion for 'mini enquiries' at paragraph 3.30 above would help in this regard.

3.42 From an international perspective, the UK R&D credits regime is generally considered to be well structured. It compares favourably with many other regimes that can be overly bureaucratic (for example the South African requirement to get pre-approval) and some have even been scaled back in recent years (for example Australia). In contrast, the UK regime is generally easy to apply for and well administered, so there is greater certainty of the benefits available earlier in the process. However, while the claims process is not overly bureaucratic, the rules are complex and require specialist tax input or advice in order to be confident in claims. We understand that there is a perception internationally that the regime is more arcane, complex, and narrow than it actually is. We suggest that the government should promote the regime more to encourage more

[2] Our response to this Call for evidence can be found at: 200825 Raising standards in the tax advice market - CIOT response.pdf

small and medium enterprises and international businesses to consider the regime as beneficial as it actually is (and, therefore, give it greater weight in making investment decisions).

4 Qualifying expenditures and R&D definition

4.1 **Question 9: Is there evidence to suggest areas of activity other than those covered by the R&D definition drive positive externalities which should be recognised by the tax system?**

4.2 We think any evidence of this sort would be primarily economic in nature. The R&D definition is based on the BIS guidelines which are now over 20 years old, and may, therefore, be somewhat outdated due to the progress of time and continued technological developments. There have been updates (for example in relation to software), that are useful and much more understandable to a taxpayer than the original guidelines. It may be an appropriate time to consider a rewrite of the BIS guidelines. However, even if this is not undertaken, consideration could be given to some more supplementary sections, in particular around some of the newer areas in the rules like the expenditure categories of cloud computing and data and also around digital and technology sectors, and the modern economy more generally.

4.3 There are however mixed views as to whether or not more detailed guidelines or HMRC guidance would be helpful. More tightly drawn definitions and scope could provide a greater degree of clarity to the rules. A black and white line of what is in and what is out could be more useful in some areas than what seems to be quite grey (and potentially open to manipulation) at the moment. It may also be possible to include some examples which would be 'easy wins' and could make it clear that some of the more spurious types of claims that HMRC sees are not permitted. However, on the other hand, because R&D is so fact and circumstances specific, in many cases, the more general guidelines setting out the concept and parameters of R&D are preferable, and examples could be misused. Finally, the case for any changes has to be weighed against the need to improve the perceived stability of the basic entitlement to reliefs, which is vital to building up an awareness in the national and international business communities of broadly what will qualify, which is almost a necessary condition of ensuring additionality. Genuine and uncontroversial clarifications should not be a problem in this regard, and some other changes have to be made or will bring greater benefits, but a balance needs to be struck.

4.4 Ultimately, the decision for government about which activities which they would like to encourage by way of tax incentive is one of policy. However, if there are other areas, there is a further question, as to whether including them as an extension to the R&D system would be the best way to do this, rather than designing some completely new scheme. For example, should work in relation to social sciences and advanced maths be incentivised and if so how?

4.5 **Question 10**: **Do you think R&D tax reliefs could better incentivise R&D with specific social value, e.g. green tech? Could R&D tax reliefs be used to disincentivise R&D in certain fields?**

4.6 It would, of course, be possible to have differing rates of relief for different sectors, industry or types of R&D; some other countries do vary their reliefs by sector and industry. In particular, the government has committed to ambitious environmental targets, and increased R&D reliefs in relation to green tech could be one way to incentivise investment in this area and ensure that the tax system is aligned with the environmental policy aim where appropriate. If the government wishes to encourage particular activities, for example around digitalisation and sustainable technologies, one way of doing this would be to provide a larger tax credit for activities in these areas.

4.7 Similarly, as the second question envisages, it would be possible to seek to affect investment activity by excluding specifically excluding from the relief activities that would otherwise be R&D but is undertaken in

relation to technology that is likely to lead to higher carbon emissions. Considering that the basis of R&D relief rests on 'externalities' and contributing to the rescue or alternatively the destruction of the planet is a big and clear externality, we agree that this is an option that should be considered.

4.8 However, either of these approaches would also be ripe for confusion and complexity, as well as potentially presenting opportunities for abuse. Defining green tech (and other specific areas of activity) could be challenging, and there will be R&D that transcends more than one sector and thus any differential between rates or activities that are included or excluded would inevitably lead to complex methodology to apportion claim costs to the right sectors in many cases. In addition, we repeat our note of caution (as per paragraph 4.3 above) that the case for any changes has to be weighed against the need to improve the perceived stability of the basic entitlement to reliefs. If an effective way was found, of factoring into economic decisions generally a realistic 'carbon price' that properly reflected global warming externalities, the operation of the market should ensure that R&D effort would be directed in a 'green' direction: without such a change, it is unclear to us that tinkering with the R&D rules is likely to be effective in this regard, and could have other disadvantages as we have noted.

4.9 As we discussed, good developmental activity takes many years to build up. The recent example of the success of the development of a vaccine for COVID-19 in the UK is, in fact, the result of decades of development within the pharma sector. It is difficult to try to guess today what will be the key areas from which the UK would benefit in the medium to long term. Thus on balance it is probably preferable to maintain the current system which is sector agnostic.

4.10 **Question 11: What is your experience of conducting R&D in different regions across the UK? How do R&D reliefs benefit these activities, and how could the offer be improved to better support these activities?**

4.11 Our members do not report any difference of experience based on geography of where the R&D is conducted. To the extent that consideration is being given to introducing differentials to the R&D relief available to different region, our immediate concern would be one of complexity. We would be interested to see anything from the government's analysis that makes the case for this. Because currently all areas can claim to an equal extent, where the R&D is conducted is not an issue – it falls where it falls. Without any evidence as to why it is easy to dismiss it.

4.12 Whilst we are aware of the government's 'levelling up' agenda, which may suggest that trying to bring more R&D into an area would be a good thing, it is difficult to know what the 'right' level of R&D in a particular area. Evidence from MPs may be helpful in this regard: there may be very local arguments and perspectives to take into account. However, we would also note that there may be reasons why clusters of R&D activities are also beneficial, particularly with regard to additionality.

4.13 Also, on the face of it restricting where the R&D to be encouraged may take place (at least within the UK) may mean that less in aggregate additional R&D takes place within the UK, so if there is a desire to 'level up' certain regions, it may be preferable to pursue this by other policy tools that do not have that impact on R&D. After all the reason for support for R&D is the positive 'externalities' it produces and these may benefit regions other than those in which the R&D activity itself takes place.

4.14 The impact of a policy of encouraging R&D in particular regions (and, therefore, employment and activity in that area) brings into focus a more general point in relation to the subsidised expenditure rules and how those rules apply in respect of 'state aid'[3] - just because something receives some 'state aid' to encourage the employment or activity to take place in the regions, should it necessarily then be ruled out of SME support?

[3] That is to say subsidised expenditure within CTA 2009 section 1138(1)(a) and (b) – as this may be amended to reflect the UK's 'state aid' rules following the UK leaving the EU

It still delivers positive 'externalities' and as well as achieving the additional policy aims around encouraging that activity.

4.15 We also comment that we would treat the existing statitics around where R&D is undertaken with caution, as we understand that this largely relies on considering the location of the registered offices of companies claiming R&D tax relief; the location of the registered offices may or may not be indicative of where the R&D is actually taking place. Thus, there should not be a change in this regard without a clear plan to make it practical to rationally implement.

4.16 **Question 12: Are there any other areas of qualifying expenditure that should be included within the reliefs? How would this influence your investment decisions?**

4.17 We responded to the consultation published in July 2020 consulting on potential changes to the scope of qualifying expenditure for R&D tax credits in two specific areas: data and software (cloud computing) and, especially, whether expenditure on data and cloud computing should qualify for relief. We welcomed the suggested changes to qualifying expenditure in relation to data and software mooted by the consultation document, considering that these would be in accordance with the policy aims of the R&D tax relief system.

4.18 For many businesses protecting their intellectual property is a vital part of the R&D process. HMRC's approach in the past has been that intellectual property costs do not contribute to the resolution of technical uncertainties and, thus, are not R&D. Broadening the relief to include the costs relating to intellectual property arising from R&D is something the government could consider, especially if they want to incentivise businesses to both advance technology and to remain competitive in their own right.

4.19 **Question 13: What proportion of your R&D expenditure is treated as capital for the purposes of Corporation Tax? What would be the impact on your R&D activities of increased relief for capital expenditure? Question 14: Do you currently claim RDAs? If not, why not? What do you like and/or dislike about RDAs?**

4.20 R&D Allowances (RDAs) are very rarely claimed by SMEs because, generally, these companies will have all their investment on plant and machinery covered by the Annual Investment Allowance, particularly at its current level of £1million per annum. While RDAs are available for non-plant capital expenditure (for example buildings) SMEs are highly unlikely to have a specific building for pure R&D activity.

4.21 However the new super-deduction introduces a mechanism by which relief for capital expenditure can potential be extended. The government could consider extending the super-deduction beyond March 2023 in respect of R&D capital expenditure. In the manufacturing sector, in particular, this could encourage SMEs to invest more in equipment to help their product development activities.

4.22 **Question 15: How much of the activity in respect of which you claim R&D in the UK is undertaken outside of the company, and how much of that is not undertaken in the UK? What are the benefits and drawbacks of subcontracting, whether overseas or domestically? What are your commercial/other reasons for carrying out work overseas rather than in the UK? Question 16: How could the government distinguish between work that needs to take place abroad and which benefits the UK, and that which doesn't?**

4.23 Our understanding is that subcontracted activity is most common where companies who are not IT businesses need to carry out work on their bespoke IT systems. Many IT businesses have overseas development teams, this is very common and is usually because it is more cost efficient that way. In our view this does not make the R&D activities any less valuable to the UK economy as long as the intellectual property being generated is UK based. Ruling out overseas labour from R&D qualification would be very costly for business unless this happened alongside an overall enhancement in the rates of relief.

4.24 We imagine that it would be very difficult to distinguish between work that needs to take place abroad and which benefits the UK, and that which does not. Ultimately the direction the government takes in this regard

depends what the policy aims are and what the government is trying to achieve. Is the best way to achieve the externalities sought to encourage R&D activity actually undertaken in the UK or to encourage the development of intellectual property by UK companies largely operating in the UK? Or by some combination of conditions designed to maximise externalities? It is important to understand however that there could be a real adverse impact on IP available to and exploited by UK companies if the regime is restricted jurisdictionally in a simplistic way

4.25 **Question 17**: **How can we identify the supporting activities which are most valuable for R&D, while providing a clear boundary to assist companies in claiming and HMRC in administering?**

4.26 In our response to the consultation on whether expenditure on data and cloud computing should qualify for relief, we cautioned that this should not result in a scaling back of the generosity of the regime with respect to indirect costs of R&D (which were also mentioned in the consultation document), as these can form a critical part of R&D which factor into the overall investment decisions taken. This remains our view.

4.27 A survey of companies claiming R&D tax relief, and of agents, could provide some information around supporting activities. A survey could ask questions around the nature of the company's R&D, how the intellectual property they are creating is enduring and what supporting costs they consider crucial to support the activity.

4.28 As noted above, there is a difference in the way large and smaller businesses operate. Large businesses who use the RDEC are much more likely to operate R&D within specific departments, where as SMEs are more likely to have the R&D embedded within the day to day operation of the business as a whole. This will impact on the value of supporting activities between the smallest and largest business, and make identifying supporting activities a different task in each case.

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

4 June 2021

Appendix –Contracted out R&D and subsidised expenditure

1 Contracted out R&D

1.1 CTA 2009 sections 1052 and 1053 contain conditions, one of which, in each case, is that expenditure must not be 'contracted out'. Where a company carries out in-house direct R&D, condition D of section 1052 prevents the company from making a claim for SME R&D tax relief in respect of 'expenditure incurred by the company in carrying on activities which are contracted out to [it]'. Condition C of section 1053 mirrors this restriction for R&D activities that the company has contracted out itself.

1.2 In this instance, the relevant words in both sections 1052(5) and 1053(4) are that 'the expenditure is not incurred by the company in carrying on activities which are contracted out to the company by any person" (emphasis added). There is no definition within the legislation as to the meaning of these words. It is our view that the normal and natural meaning of these words implies a clear intent and understanding on the part of the principal. The terminology of 'contracting out' must involve a conscious act on the part of the principal: not only must they intend to have a third party (the sub-contractor) undertake the activity but they must know that it is R&D.

1.3 HMRC's view is that any activities carried out by a company under a contract in order to fulfil the terms of a contract should be considered to be 'contracted to the company'. Thus, HMRC considers only the outcome of a contract with regard to where the R&D activities fall, rather than the intention and knowledge of the parties as to what R&D will be undertaken.

1.4 If this view is correct, it results in very odd policy outcomes – the principal company can acquire an entitlement to R&D relief purely because of decisions taken (possibly unknown to the principal) by the 'sub-contractor' about whether or not to undertake R&D. R&D relief would be given to the person who has no control over the R&D, as it has simply entered into a contract in order to receive a specified product. The 'sub-contractor' decides how to deliver the product, which may include undertaking activities that are R&D, but would not be entitled to any R&D tax relief under the SME scheme. This result is very inimical to 'additionality'.

1.5 Further, if the position is that any R&D expenditure incurred on activities that are as a matter of fact, rather than intention, undertaken by a company in delivering a contracted result are 'contracted out', most R&D will fall out of the SME scheme.

1.6 The restrictions in relation to contracted out R&D are designed to determine which company is able to make a claim for R&D relief and under which scheme where R&D is contracted out. We understand that HMRC has concerns about the possibility of double claims and we agree that this should not be possible. We do not think that it is possible under the current law. However, while the legislation is designed to prevent double claims, we accept that there may inevitably be complex cases which may lead to differences of interpretation. These could be minimised through clear and consistent guidance for companies and agents to follow. Alternatively, to the extent that the position is considered to be unclear, this could be addressed by legislative change while maintaining the focus of the R&D relief on the companies undertaking, and choosing to undertake, the R&D activities. For example, the Irish R&D tax incentive requires parties to a contract to investigate the intentions of the other in respect of seeking relief to assist in ensuring that there are no double claims.

2 Subsidised expenditure

2.1 Corporation Tax Act s2009 section 1138(1) defines when 'company's expenditure is treated as subsidised'. We are concerned specifically with section 1138(1)(c), which says that a company's expenditure is treated as subsidised 'to the extent that it is otherwise met directly or indirectly by a person other than the company'.

2.2 In order for expenditure to be qualifying expenditure on which R&D relief can be claimed under the SME scheme, the expenditure must not be subsidised. If it is subsidised the SME would only be entitled to the RDEC, which is not as generous as relief available under the SME scheme.

2.3 In our view the meaning of subsidised expenditure within this sub-section is a payment made (or other funding made available) to a company carrying on R&D that is akin to a subsidy. That is to say money given as part of the cost of something, to help or encourage it to happen, or in this context given specifically to cover all or part of the cost of the R&D with no other expectation or benefit received by the payer. We arrive at this interpretation by giving the word 'met' its normal meaning within the context of this legislative provision.

2.4 HMRC's view is that this provision has a wider meaning, which extends what is subsidised expenditure to include, for example, payment received for undertaking a contract in respect of expenditure on R&D that has been undertaken by the company to deliver the product under that contract. We do not accept that expenditure which has been 'financed' by an arm's length but profitable contract has been 'met' by the customer: the meaning of those words is not equivalent. A supplier under a contract can make decisions as to how to honour that contract and genuinely 'meet' the expenditures flowing from those decisions.

2.5 In addition, if the wording of section 1138(1)(c) is taken to have this broader meaning, the logical conclusion of this is that subsidised expenditure would also include equity funding because that funding will in due course ('indirectly') be used to 'meet' the costs of R&D activity that is undertaken by the company. We do not consider that this is an outcome that Parliament intended. HMRC suggest that the loss element of a loss-making project could qualify for SME relief, on the basis that this element of the costs of the R&D undertaken have not been 'met' by a payment by a customer; but this carve out is not supported by the legislation. If the words are given a broad meaning, the loss will also be funded by someone as, even if the company goes into liquidation without having sold any products, the creditors will have indirectly 'met' the expenditure incurred by the company.

2.6 HMRC recognise the wide scope of the legislation and then seek to limit its application by reference to a view expressed at a meeting of the RDCC in October 2013, which refers to the necessity for a 'clear and direct link between the payment received and the qualifying expenditure'. We do not disagree with this view of the legislation as set out by HMRC at the RDCC meeting in October 2013. Rather it is our view that the statement around the need for a clear and direct link is another way of describing the normal meaning of the word '**met**' in the legislation, indicating that there should be an intention for the payment made to be used to fund the expenditure on R&D. This would not, for example, include a payment by a customer of a price for a product whose development or manufacture happens to have included R&D.

2.7 More generally, however, with regard to relying on this statement made at the RDCC meeting, it cannot be correct for HMRC to assert wide interpretation of the words in the legislation, but then seek to impose an arbitrary line (for example if there is a loss from a project) rather than applying the wider interpretation to its logical conclusion. The law does not permit HMRC to restrict its interpretation of legislation at a point of its choosing if that restriction is not supported by the legislation. Instead the legislation should be amended to correctly reflect the intended outcome.

2.8 In any event, if HMRC's view is correct it will greatly restrict the circumstances in which relief under the SME scheme will be available. This should be considered in the light of the policy aims of R&D tax relief, which is

designed to encourage investment in R&D and award a higher rate of relief to SMEs, due to acknowledging the higher barriers they face to undertaking R&D.

2.9 We accept that the government will wish to put some boundaries around what activities are encouraged and when the higher rate of relief is given. Some rules in relation to grants and subsidies akin to state aid, may be appropriate (although we refer to our comments in paragraph 4.14 in the main body of the response above), however, the effect of HMRC's current view goes beyond this. The overall policy implication is that SME relief will only be available in circumstances of 'blue sky' R&D – or, oddly, in circumstances where a company is loss making. Although relief in the form of RDEC may, instead, be available, this seems to us to be contrary to the government's intention in designing the SME scheme and will reduce the amount of R&D undertaken and, therefore, the additionality that might otherwise be expected from this tax relief.

2.10 The current approach by HMRC also gives rise to a great deal of uncertainty, which of itself, will disincentivise taxpayers from utilising the relief. We are aware that HMRC is intending to publish guidance seeking to explain their view. We will be sending HMRC comments on this guidance. These will be directed at uncertainties and confusion that we think will arise from the guidance as drafted. Principally these derive from the fact that HMRC are taking what seems to us to be an extreme view of the law (which, as noted above, would have the effect that any expenditure which has been 'financed' by a profitable contract has been 'met' by the customer under that contract, and so does not qualify for SME relief). The draft guidance effectively says that HMRC do not intend to apply this interpretation to its logical conclusion; however taxpayers hoping for clarity on HMRC's views will need to know how far that interpretation will be applied and what the reason for any limits are. If HMRC are applying an approach which limits their view of the strict legal position it is essential to set out what its approach is, otherwise taxpayers will be unable to complete returns on that basis.

2.11 If the expenditure on the R&D is subsidised as a result of there being a commercial contract for the end product, the tax relief scheme would appear to encourage a company not to seek any upfront agreements, or to avoid formalising them to protect access to the relief. The policy aims of structuring the incentive with this effect are not clear. Similarly, it is not clear the extent to which a company's expenditure on R&D would be subsidised in circumstances where it begins to develop a new product which requires R&D and, following market research enters into contracts with potential customers part way through the development and R&D activity. It will be necessary for HMRC to explain how taxpayers should address the potentially complex tracing exercise that would be needed to determine which parts of the company's expenditure have been subsidised. It is also difficult to ascertain how the rule would apply where the R&D activities occur across accounting periods – with no certainty as to whether or when payment under the contract will be made, or whether the company will be loss making until the end of the project. How will a company know whether its R&D expenditure has been subsidised in earlier accounting periods in respect of which it would like to make a claim?

3 Overall policy for SME scheme

3.1 There is considerable overlap between HMRC's position in relation to contracted out R&D and subsidised expenditure. It seems to us that HMRC's interpretation would mean that both rules would apply where a company enters into a contract to provide a product, the development of which either requires or results in R&D activity by the company making the product.

3.2 While an overlap of the rules is not necessarily a problem we would reiterate that the overall policy result from HMRC's approach is that SME relief will only be available in circumstances of 'blue sky' R&D – that is to say when a company undertakes R&D completely independently and before any customer is involved. (Although HMRC's interpretation says that expenditure is not subsidised to the extent that a company is loss making, in

such circumstances where there is a customer, it would seem that relief would still not be available as a result of the R&D being contracted out.)

3.3 We would be surprised if such truly 'blue sky' R&D constitutes more than a very small proportion of the SME R&D relief claimed. However, if the government policy intention is that the SME scheme should operate on a more limited basis than we had previously understood to be the case, it is important to be clear as to the economic and Exchequer impact from this policy approach, and its impact on the expected additionality from R&D tax reliefs. In addition, consideration should be given to reformulating the rules to make clear where the boundary lies and to address the overlap and uncertainty which otherwise arises from HMRC's interpretation of the current rules.