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Research and Development – Draft legislation for a single scheme and Additional tax relief for Research and Development intensive small and medium-sized enterprises

Comments 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 On 'L-day' in July, the government published policy papers and draft legislation for technical consultation on a single scheme for Research and Development (R&D) and additional tax relief for R&D intensive small and medium-sized enterprises (SMEs). These were published in order to keep open the option of implementing a merged scheme from April 2024, although a final decision on whether or not to merge the R&D schemes will be made a future fiscal event.

1.3 In making its decision whether or not to merge the R&D schemes and introduce a new scheme, we strongly urge the government to slow down the timetable. An implementation date of April 2024 is over ambitious; it will present practical difficulties for HMRC and taxpayers, and will result in unintended consequences. The current uncertainty and rushed implementation is undermining the policy intention of supporting and encouraging R&D in the UK. There has been insufficient opportunity to consider and consult on many important aspects of the new merged scheme.

1.4 In addition, an important opportunity to simplify the UK tax system is being missed because the time is not being taken to incorporate the additional relief for R&D intensive SMEs into the new scheme. As the new rules are proposed, the UK will continue to have two R&D schemes, and not a single scheme as had been envisaged and previously consulted on. This outcome flies in the face of overall policy objectives to embed tax simplification within the tax policy making process and the tax system.

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 Introduction

3.1 At Spring Budget 2021 the government launched a review of the two R&D tax relief schemes - the Research and Development Expenditure Credit (RDEC) and the SME R&D relief. Following an initial wide-ranging consultation in Spring 2021, there have been further consultations on specific proposals around changes to the scope of what qualified for R&D and compliance measures intended to tackle error and fraud. At Autumn Statement 2022, the Chancellor announced that, as part of the ongoing R&D tax reliefs review, the government would move towards a simplified, single relief based on the RDEC scheme. A high-level consultation on a single scheme was conducted between January and March 2023. Following the closure of this consultation on 13 March 2023, the Chancellor said at the Spring Budget that while a decision on implementing a merged scheme had not yet been taken, the government would publish draft legislation in summer 2023. The Chancellor also announced additional relief for R&D intensive SMEs. The draft legislation and policy papers for both of these reliefs were published on L-day on 18 July 2023. We have had the opportunity to discuss the approach proposed in the draft legislation and policy paper with HM Treasury (HMT) and HMRC since they were published and our comments below reflect our understanding of the measures following those discussions, and build on the comments we made during those meetings.

3.2 We have considered the draft legislation and policy papers in the light of the CIOT's objectives for the tax system. These objectives are that a tax system should comprise rules that translate policy intentions into law accurately and effectively, without unintended consequences. The tax system should aim to provide simplicity (so far as possible) and clarity, so businesses can understand how much tax they should be paying and why, and also to provide certainty so that businesses can plan ahead with confidence. It is also important that there is responsive and competent tax administration, with a minimum of bureaucracy.

3.3 These objectives are not being met in relation to R&D tax relief. There has been insufficient consideration of detail of a single scheme, which is still being developed, to be confident of the policy implications of a single scheme. There are likely to be unexpected and/or unintended consequences unless further time is taken to assess the detail of the new rules before it is implemented. The many intermediate and piecemeal changes of recent years have undermined the overall perception of the relief in terms of stability and certainty for

business. In addition, the disproportionate impact on smaller companies of the recent compliance measures must be recognised as detrimental to the policy aim of supporting SMEs and encouraging them to invest in R&D. Our fear is that the new compliance requirements make the administration too complicated and too costly for SME companies, deterring them from claiming and, ultimately, the overall impact is to discourage R&D. These changes are also taking place at a time when there are significant problems with HMRC's approach to compliance with the SME scheme. In July, CIOT shared with HMRC our members' concerns around how HMRC are conducting R&D enquiries into claims by small and medium sized enterprises (SMEs), in a letter to the Director of Wealthy and Mid-Sized Business at HMRC[1]. HMRC recognises that improvements are needed, which we welcome, but whilst we agree that error and fraud within the system needs to be tackled, the current adverse impact on genuine claimants from the 'volume approach' is unsatisfactory[2].

3.4 Against this background it is disappointing that the proposal to move to a new merged scheme, a concept that we support in principle, is being rushed, risking unintended consequences and failing to deliver on its simplification potential because the additional relief for R&D intensive SMEs being currently proposed as a separate scheme. Instead, what we would like to see is a single scheme that incorporates the additional relief for R&D intensive SMEs, implemented in a sensible timeframe that allows time for further consultation and for HMRC to have chance to gain insights from their newly introduced additional information requirements.

4 Policy intentions

4.1 The government's stated policy is that it remains committed to supporting R&D, recognising the important role that it plays in driving innovation and economic growth, and bringing benefits to society. It is our view that the proposals for a merged scheme require a more considered approach than is currently permitted by the proposed timetable to ensure that this policy intention is not undermined.

4.2 In our view there needs to be more open discussion about the implications of the proposed merged scheme to minimise unintended consequences. We discuss the timetable and consultation process further in paragraph 5 below. However, from a policy perspective, it is important that the implications of the new scheme for the overall R&D spend by UK companies, and which companies will be able to claim the reliefs, is fully understood. It seems likely that the effect of the merged scheme will be to reduce the number of claims overall, and that larger companies may increasingly make these, with mid-sized businesses in particular being less likely to be able to claim relief than they are under the current rules. This is particularly because of the effect of the rules on sub-contracting, which are discussed at paragraph 7 below, as these will consolidate the R&D undertaken by a company itself and the work contracted out into the larger company.

4.3 We recognised that this might be an intentional policy outcome in our response to the consultation on a single scheme earlier this year, noting that the reduction in rate to the relief available to SMEs will cause many SMEs to have to re-evaluate the economic viability of their businesses and R&D projects[3]. The rate of relief at 20% set out in new section 1042F will result in a further fall in value of the cash equivalent of the relief. It may be that the government's aim is to focus more on R&D being undertaken by larger companies. The consultation document published in January 2023, says (at paragraph 1.11) that additionality in the SME scheme is lower than the RDEC. 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. However, if the

[1] Our letter and HMRC's response can be read here.
[2] See further comment in CIOT press release
[3] https://www.tax.org.uk/ref1076 - see paragraph 3.4

government wishes to focus R&D tax relief more on larger companies, it should be more open and transparent about these policy aims.

4.4 Ensuring that there are clear and certain rules around the availability of tax relief for R&D will benefit the additionality of the scheme as a whole. Ensuring that the UK is a place where R&D tax relief is available to those undertaking R&D activities, and that the reliefs are administered fairly, will ensure that innovation is seen to be encouraged and supported. If the system makes it too difficult to claim tax relief, or introduces arbitrary rules around who is able to claim the relief, the narrative around people who are doing R&D, but are missing out on tax relief would operate as a general disincentive. Also, while additionality should drive design to an extent, an equally important consideration is that the principle of equity means that the tax system should not treat one claimant differently from another just because one is 'additional'. These points are considered again in relation to the proposed subcontractor rules in paragraph 7 below. However, they are important in the overall policy context because there has been no open discussion about the winners and losers from key design feature of the proposed merged scheme, nor of the complications arising from the changes. This should happen to ensure policy intentions are implemented into statute accurately and effectively, without unintended consequences.

5 Timetable

5.1 It is our strong view that, if a decision is made to implement a merged scheme for R&D tax relief, the start date for a merged scheme should not be fixed until it is clear that the detail of the scheme is settled and has been properly consulted on. In any event, a start date of April 2024 is too soon.

5.2 We welcomed the wide review of the UK's R&D relief schemes that started in 2021, agreeing that it is important to review these schemes to ensure that the reliefs remain 'fit-for purpose' and consider the effectiveness of the reliefs. We also said that the review of the R&D tax relief regimes in the round offered an opportunity to clarify the policy intentions of the reliefs and to ensure that the law clearly delivers those policy aims. However, although there has been a review of R&D tax reliefs ongoing on since 2021, consultations and announcements on this have either been limited in scope, focussing on particular measures and policy decisions, or, where they have considered the possibility of a single scheme, been at a high level and lacking in detail.

5.3 As a result, in our view it is too early to have moved to draft legislation, presented for 'technical' consultation. There has been no consultation on, or discussion of, the issues that have become apparent following the publication of draft legislation and policy papers. These issues include the interaction of a new merged scheme and the remaining scheme for R&D intensive SMEs (discussed in paragraph 6 below), or the difficulties around the proposal to follow the SME rules for subcontracted R&D (discussed in paragraph 7 below). This latter aspect of the rules, in particular, is a massive change for large companies. These issues (and others) deserve a much more detailed discussion of the principles underpinning them, and their implications than is possible with the proposed timetable of a start date of April 2024. This discussion would help determine the best way to achieve the policy aims, and to deliver a coherent and workable set of rules. Without it, the outcome is highly likely to be far from satisfactory.

5.4 In addition to the lack of consultation on the detail of the proposed single scheme, the proposed timetable is too short to allow businesses to react to it before the start date. April 2024 is too soon for businesses to organise their contracts and businesses arrangements to reflect the new rules, particularly when much of the

detail remains outstanding. Thus, any perceived additionality that might otherwise result from the new rules will be lost for some time.

5.5 It is unfortunate that the government is continuing to put businesses in a position of great uncertainty around the provision of R&D tax relief in the UK. The current situation is the antithesis of additionality. Businesses are unable to have any certainty about what R&D tax relief may be available to them in respect of investment decisions currently being taken due to the uncertainty about whether or not a new scheme will be introduced, at all, or in April 2024. In addition, a lot of important detail for a new scheme is still missing. Certainty for businesses has a large part to play in delivering additionality.

5.6 We recognise that the changes to the R&D tax relief that have already been announced, namely the additional tax relief for R&D intensive SMEs and the delay to the restrictions on overseas expenditure in R&D tax reliefs need to be dealt with. Indeed, the current unsatisfactory situation arises largely because of the decisions around the reform of R&D tax reliefs that have been taken in a somewhat 'knee-jerk' manner ahead of the completion of a coherent review of these reliefs. Decisions such as reducing the rate for SMEs generally, followed by the introduction of an additional relief for R&D intensive SMEs shortly afterwards, as well as the recent compliance measures (additional information form and claims notification) have resulted in a general perception of uncertainty and incoherent change. To rectify matters and introduce some certainty, the government should announce that the timetable for a new single scheme should ensure that the new rules are fully published, and the detail of what will be required from companies is fully available, in good time before the commencement of a new regime.

5.7 The changes already announced will have to be dealt with in a different way if the introduction of a merged scheme is delayed from April 2024. The restriction for overseas expenditure in R&D tax reliefs was delayed in order to allow the government to consider the interaction between this restriction and the design of a potential merged scheme (paragraph 4.53 of the Spring Budget 2023). This restriction is reflected in the draft legislation published for the merged scheme and these aspects would have either to be separated out and included in the existing legislation, or delayed again.

5.8 We discuss the additional relief for R&D intensive SMEs in more detail in paragraph 6 below in the context of simplicity. As this additional relief has effect from 1 April 2023, legislation will have to be included in the next Finance Act. We suggest this additional relief could be built into the existing SME scheme for the time being, until proper consideration can be given to including it in a fully merged scheme.

5.9 The government has emphasised that a decision has not yet been taken whether or not to implement a merged scheme. Both the additional relief for R&D intensive SMEs and the restriction on overseas expenditure would have to be dealt with in a different way to that proposed by the draft legislation if the decision is made not to go ahead. Therefore, despite the fact that the draft legislation has been presented as one package incorporating the changes that have already been announced as well as the new single scheme, we assume that some thought has been given as to how these aspects might be delivered separately.

5.10 In conclusion, we strongly urge the government to pause its current rushed progress towards a merged scheme for R&D tax reliefs, and to take sufficient time to consult fully on and properly consider the areas of complexity and difficulty. Less haste and more speed will better ensure a set of rules that are 'fit-for purpose' and deliver on the policy aims of supporting and encouraging R&D in the UK.

6 A single scheme - simplification

6.1 In our response to the consultation on a single scheme earlier this year, we said that having one scheme for R&D tax relief rather than two, would be a simplification to the UK tax code. However, although the single scheme outlined in the draft legislation would provide some opportunities for simplification, the clear fact is that, because of the way it is currently proposed that the additional relief for R&D intensive SMEs will be provided, there will still be two R&D tax relief schemes in the UK. The two existing schemes are not being merged; rather most SMEs are being incorporated into the new single scheme based on an 'RDEC' approach, and the SME scheme is remaining for a smaller group of R&D intensive SMEs. The result is that most of the benefits of a simplification that would come from having a single scheme in the UK will not be realised. This is a huge missed opportunity.

6.2 The main justifications we have been given for this is that the statements about the additional relief for R&D intensive SMEs say that this support will be along the lines of the SME scheme. However, while this may necessarily be the case for at least the tax year from 1 April 2023 to 31 March 2024, this does not seem to preclude the additional relief from being amalgamated into a single scheme when the relief being given to SMEs more generally changes, with a different (higher) rate being available to R&D intensive SMEs. Although this would add some complexity into the new scheme, in our view it would be less complicated overall than continuing to have two schemes.

6.3 As discussed in paragraph 5 above, we recognise that the additional relief has to be legislated for at the earliest possible time, as it came into effect from 1 April 2023, but, initially at least, this additional relief could be added into the existing SME scheme, before being incorporated into the overall new single scheme.

6.4 We would urge the government to consider this further because complexities arise if there continue to be two schemes. The position will be more complicated than exists under the current two schemes because of the population that will be entitled to claim relief under each of the schemes going forward. Currently, although some SMEs have to interact with RDEC to claim relief in certain circumstances and, therefore, have to deal with both schemes, more commonly a company is either large – and claims under RDEC, or is a SME – and claims under the SME scheme. A company may also move from the SME scheme to RDEC when it becomes 'large', but this is likely to be a one-time only, one-way movement. Going forward, because a SME may have to (or be eligible) to claim under one or other of the schemes depending on its activities, expenditure and/or profitability within any particular accounting period, it is likely that a large number of SMEs will bounce from one scheme to the other on a period by period basis. This will create considerable uncertainty as to what R&D relief will be available, particularly as a company will not know whether it is an R&D intensive scheme until the end of the accounting period when it is able to assess its qualifying R&D expenditure and whether this constitutes at least 40% of total expenditure.

6.5 The draft legislation does not include any detail about how the movement from one scheme to the other will be managed. For example, in Year 1 the company is a 'normal' SME and is, therefore, within the new 'RDEC' scheme. It has amounts carried forward under new sections 1042I (2) and 1042K (3). It seems that, if that company becomes an R&D intensive SME in year 2, it would obtain a super deduction at 86% and a payable credit (if applicable) at 14.5%. However, it would also still have the brought forward amounts (referred to above) to deal with. This does not feel like a simplification.

7 Contracted out and subsidised R&D

7.1 The policy paper states that the decision has been taken to follow (broadly) the approach of the SME scheme in that companies will be able to claim for payments made to subcontractors as part of an R&D project.

7.2 As we noted in our response to the consultation on a single scheme earlier this year, HMRC's interpretation of the rules in relation to subcontracting and subsidised expenditure in the SME scheme has been challenged by many taxpayers and advisers. CIOT had a number of meetings with HMRC seeking to reduce the area of uncertainty, and to arrive at a pragmatic and commercial way forward, but difficulties remain (see also paragraph 7.9 below). The decision to follow the SME scheme approach means that the issues around subcontracting will remain, and will now be relevant to all companies.

7.3 We welcome that in our discussions with them, HMRC have confirmed that the aim is that the new scheme should take the opportunity to clarify the policy intentions of R&D relief in this area, and the desired outcomes, and endeavour to ensure that these are translated into statute accurately and effectively, without unintended consequences. In this regard we welcome the clear statement of policy intent that the focus of relief should be on 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). This approach has always seemed to us the best approach to deliver the policy aims around the additionality of R&D relief. However, adopting this approach in the context of a single scheme will require clarity going forward as to precisely what contractual arrangements amount to subcontracting, and who can claim the R&D tax relief.

7.4 We have discussed with HMT and HMRC two approaches:

Option 1 – defining 'R&D subcontractor'. This approach might involve distinguishing in the legislation an R&D contract (only the customer can claim) from a non-R&D contract (the subcontractor may be able to claim).

Option 2 – notification from customer. This approach might be similar to the Irish system where by a party initiating a contract notifies the subcontractor, ahead of payment, that the subcontractor cannot claim R&D relief.

7.5 Both of these options have their pros and cons. If option 1 could be clearly defined, this option would be preferable, as it would involve less of an administration and compliance burden and is less likely to affect how companies arrange their commercial affairs and contracts. However, we recognise the significant challenges around achieving clarity. The current draft Condition A in new section 1042C (2) largely mirrors the wording in the current legislation, the meaning of which is contentious. In addition, the wording considering the position from the perspective of the principal in new section 1042E(3), that describes R&D 'undertaken on behalf of the company' is not very clear. This approach would, therefore, require further drafting in order to provide clarity and certainty going forward.

7.6 A notification requirement (Option 2) could provide certainty. However, it will shift R&D tax relief into the commercial negotiations between parties, and the administrative burdens on companies that will have to determine whether or not a notification should be given, and monitor information flow from the subcontractor in order to have sufficient information to be able to submit an R&D claim should not be underestimated. For the larger companies with the capacity to handle the information flow and contract records etc., the impact of this change to the rules is likely to be that R&D tax relief claims will become consolidated in the largest companies that are commissioning R&D spend. For companies currently within the RDEC, the proposed approach is to move the ability to claim R&D tax relief from the companies doing the R&D to those commissioning it. The companies that will lose out from this approach are the mid-sized businesses that are

currently too large to be within the SME scheme and are claiming R&D relief under RDEC that has been subcontracted to them.

7.7 It is not clear what will happen in cases where insufficient information is provided to the company that should be entitled to give a notification and be entitled to claim the relief. A result of this requirement may be that there is no claim in respect of some R&D that is undertaken. This may be a positive outcome from an Exchequer point of view. However, we would question it as a desired policy outcome for reasons of fairness - the principle of equity means that the tax system should endeavour to treat companies that are undertaking similar activities in the same way, and not result in companies being unable to claim tax relief because of administrative burdens. This may also have a detrimental impact on additionality, with the company that might actually do some R&D, being disincentivised from doing it.

7.8 Overall, it is clear that further thinking is required to establish clearly what is contracted out R&D and how this should be treated. This is recognised in the Explanatory Notes which comment: '*The government would like further discussions to understand how a potential merged scheme could distinguish between 'normal' contracts and 'subcontracted out R&D' so that those undertaking qualifying R&D are enabled to claim relief, whilst avoiding double claims.*'. The CIOT and others have been having those discussions with HMT and HMRC over the summer. In our view, the outcome of the government's deliberation following these discussions and the proposed way forward should be the subject of further consultation.

7.9 It seems likely that the issues with regard to subsidised expenditure may fall away as a result of a single scheme. HMRC have indicated that the Condition B in new section 1042C(4) (which is in square brackets in the draft legislation) should not be required, and we agree with this. However, rules around subsidised expenditure will remain for the additional relief for R&D intensive SMEs. There has been no discussion as to how the difference in interpretation of these rules will be resolved. The current position is causing administrative difficulties for taxpayers as a result of the ongoing uncertainty. In our view, the current position is detrimental to HMRC's overall efforts to address bad behaviour in relation to the R&D regime and encourage compliance, because HMRC are permitting a situation of uncertainty to continue and are not taking the steps available to government to resolve the uncertainty: by either legislating or pursuing the issue through the Courts to achieve a binding judicial precedent[4]. The opportunity should be taken to amend the legislation to ensure the legislation itself clearly accords with HMRC's interpretation.

7.10 Currently the draft legislation does not deal with any of these issues, which is a huge omission if the intention remains that the rules should be implemented from 1 April 2024. An area as important as this should be fully considered and consulted upon before implementation. In addition, the administrative procedures necessary for Option 2 will have to be developed. There will need to be a very clear timeline and procedure for the giving of the notification, and consideration given to the implications of notifications incorrectly given etc. It is also not clear how HMRC intend to define who is entitled to claim or how they will approach compliance. In our view, there is not time to do this effectively or well in order to have legislation in place before 1 April 2024, and this is a key reason why the implementation of a single scheme should be pushed back.

[4] HMRC's technical interpretation has been comprehensively dismissed by a First Tier Tribunal decision (*Quinn (London) Ltd v HMRC* [2021] UK FTT 0437). Although not a 'binding precedent', in our view HMRC have a broader obligation and responsibility for the orderly administration of the tax system and should, therefore, accept the decision, or appeal it.

8 Acknowledgement of submission

8.1 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
12 September 2023