

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

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 agree that having one scheme for Research and Development (R&D) tax relief rather than two, would be a simplification to the UK tax code, and that, if there is to be one scheme for all companies, it should be an above the line Research and Development Expenditure Credit (RDEC) like credit.
- 1.3 However, a single scheme with a single rate will not necessarily be simple or fair for all smaller companies. In particular, complications will arise as a result of the two rates of corporation tax that will come into effect from 1 April 2023. This will mean that companies which have profits that are subject to marginal relief will receive a lower level of effective support for R&D activities.
- 1.4 We are not persuaded that the reasons for historically giving a higher rate of relief to small to medium sized enterprises (SMEs) no longer apply. Consequently, whilst we recognise that it would involve additional complexity within the scheme, consideration should be given to having a higher rate of R&D relief for smaller companies within a single scheme, especially during a transitional period.
- 1.5 In any event, the government should recognise the shock caused by the reduction in rate to the relief available to SMEs already announced and the disproportionate impact on smaller companies of the recent compliance measures. In determining its support for SME R&D, and in particular for that undertaken by smaller companies and start-ups, the government should consider whether additional support such as grants would help to deliver the policy aims.
- 1.6 It will be necessary to have some rules within the scheme to prevent double claims in respect of R&D in circumstances such as subcontracting of R&D activities. On balance, for simplicity and ease of enforcement, we suggest that the R&D relief is given to the company that undertakes the R&D activities in all cases, even

though this may be somewhat counterintuitive to designing a scheme that maximises additionality of the tax relief.

- 1.7 With regard to timing, implementing a new scheme from April 2024 is too soon. The current pace of change in the R&D relief regime is already challenging for businesses and their advisers. The timetable 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 to avoid a repeat of the unsatisfactory position that companies are currently in with regard to the changes due to come into effect from 1 April 2023. This will minimise uncertainty, which is one of the biggest blockers to investment. It is important that changes are managed in an efficient manner and well communicated in conjunction with transitional rules which minimise commercial disruption.
- 1.8 More generally, we note the Report published in January 2023 by the House of Lords Finance Bill Sub-Committee¹ (the Lords' sub-committee Report) that considers the measures intended to tackle error and fraud announced in Autumn 2021 and due to come into effect from 1 April 2023. The recommendations made by this report will remain relevant in relation to any new, single scheme.

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 We welcome this consultation as part of the wide review of the UK's R&D relief schemes that began in Spring 2021. 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 generally, and the continued government commitment to supporting SME R&D that is highlighted in the foreword to the consultation document. We also note the reference to the importance of R&D tax relief in the context of the UK's international competitiveness; in this

¹ [House of Lords Report: Research and development tax relief and expenditure credit](#)

regard, we suggest that the UK is looking increasingly less competitive in light of recent international developments².

- 3.2 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. It is also important that there is a fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented) and a responsive and competent tax administration, with a minimum of bureaucracy.
- 3.3 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. It also provides an opportunity to consider the current challenges of the operational aspects of the tax relief that are discussed in the Lords' sub-committee Report. These are discussed further in response to some of the questions below. We urge the government to take into account the recommendations made by the Lords' in their report, as these will remain relevant in relation to any new, single scheme. In particular, the perceived issues around HMRC's compliance activities noted in the Lords' sub-committee Report will not be solved by a single scheme.
- 3.4 It also must be recognised that the reduction in rate to the relief available to SMEs announced in the Autumn Statement 2022 came as a shock. It will cause many SMEs to have to re-evaluate the economic viability of their businesses and R&D projects. This may be an intentional policy outcome, with the aim being to focus more on R&D being undertaken by larger companies. If this is the case, the government should be more open and transparent about its policy aims. We hope, however, that the government's commitment to supporting SME R&D, includes an aim to continue to incentivise R&D by smaller companies, down to and including the smallest start-ups. If so, the disproportionate impact on smaller companies of the recent compliance measures must be recognised as detrimental to this policy aim. 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&D³. Also as discussed below, without additional support, a single scheme will not necessarily be simpler for SMEs and will, in some cases, result in SMEs receiving a lower effective rate of relief as a result of the two rates of corporation tax that are coming into effect from 1 April 2023.
- 3.5 In addition, the way the UK is currently implementing changes in relation to R&D is making things worse for investment that is happening in the short to medium term. Currently companies are facing changes to the rules that come into effect from 1 April 2023 (less than four weeks), with no sight of the detail of all of those rules. This unsatisfactory position is made worse by the fact that it is suggested that the rules may change again in 12 months' time (see question 14 below). While we do think that it is most important to get the structural regime right for the long term (and so support the ongoing review), the intermediate, piecemeal

² In February 2023 South Africa announced an effective 125% tax deduction for R&D, and there are similar measures being introduced in other countries, for example Singapore and Chile. Also the Inflation Reduction Act of 2022 in the US, and the response to it from the EU, will have an impact in terms of international competition.

³ For example, there was no consultation on the new Additional Information Form, nor was it announced pursuant to a Finance Bill and as such no regulatory impact assessment has been published. It is not clear that the government has considered the costs and consequences for enforcing this, which will be significant for SMEs and micro businesses in particular that do not routinely capture the specific project and company costs that will be required to produce the information, giving rise to a significant additional administrative burden.

changes that have been made in recent years since the review of R&D reliefs started are not helpful to the overall perception of the relief in terms of stability and certainty for business.

- 3.6 We recognise that several of the changes have been focussed on tackling error and fraud, and thus the government has decided that immediate action should be taken. As noted below, we are supportive of the government taking action to tackle error and fraud, but are doubtful that all of the measures will be successful in this regard. In any event, it must also be recognised that this approach is harmful to the additionality of R&D relief, as constant changes will discourage marginal investment; making it more likely that relief will be given to investment that would be happening anyway, rather than encourage the UK as a location during the decision making process on whether and where to invest, which always takes place ahead of the investment actually being made.
- 3.7 There will also be unnecessary compliance costs as a result of the changes that have been announced if things change again in the short to medium term, but businesses generally view these as a mere nuisance compared to the uncertainty. As we said in response the Tax Plan in Spring 2022, that invited comments on potential reforms to the UK's capital allowances regime⁴, businesses require consistent levels of relief to help them plan and grow. The overwhelming feedback that we received is that stability and certainty is more important to businesses than any particular rate of relief, and we believe the same to be true in respect of R&D relief.

4 Main Features

- 4.1 Currently, 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. In our response to the consultation in Summer 2021, we said that generally, we understood that experience of both schemes was positive. However, since that time we have seen more negativity arise in relation to the SME scheme. This negativity is mostly focussed on HMRC's administration of the scheme (we refer to the Lords' sub-committee Report discussed above), but the fluctuating benefit of the SME scheme is also a factor. It is difficult for SMEs to forecast the funding that will be available through the SME scheme, as the benefit (based on current rates) arising from a fixed amount of R&D expenditure can vary from 18.8% to 33.3%, depending on whether the company makes a profit or a loss (which may not be known at the time of the R&D spend). This will be complicated further when there are two rates of corporation tax after 1 April 2023 and these complexities will not be resolved for SMEs by a single scheme (see paragraphs 4.11 and 4.12 below).
- 4.2 With regard to the overall design of a single scheme, we had understood that there was a 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 (for example, access to finance for this type of high risk investment). This seemed a sensible presumption to us. In our response to the previous consultation in Summer 2021, we said that, if this presumption is respected, it would mean 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 arbitrated and abused, including the rules dealing with contracted out R&D [and subsidised expenditure] (discussed further below).

⁴ [Potential Reforms to UK's Capital Allowance Regime \(tax.org.uk\)](https://www.tax.org.uk/Pages/Potential-Reforms-to-UKs-Capital-Allowance-Regime.aspx)

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

- 4.3 However, as noted in the consultation document (at paragraphs 1.16 and 1.27-1.28), following changes at Autumn Statement, the rate of relief provided by the two schemes is now broadly aligned. As mentioned above, this reduction in the rate of relief available to SMEs has already had a significant impact.
- 4.4 The reasoning for the removal of the more generous relief for the SME scheme was predicated in part on findings around higher degrees of error and fraud within the SME scheme, as well as the finding that the SME scheme is less successful in increasing the amount of R&D undertaken – additionality – see paragraph 4.8 below. While we empathise with the government’s focus on mitigating fraud within R&D tax relief, there remains a concern that tax policy (and current compliance activity) is being designed with this at the forefront, as opposed to what is the best way to achieve the overall policy objectives of supporting R&D generally, and SME R&D specifically. This is resulting in a direction of travel whereby compliant taxpayers are being penalised because of the poor behaviours of the minority within the R&D regime. In this regard we again note the recommendations of the Lords’ sub-committee Report and urge the government to pay heed to these.
- 4.5 We would also reiterate what we have previously said to government⁵ that error and fraud are two different things. We were pleased that this point was also made in the Lords’ sub-committee Report. Their Lordships concluded that *‘although the draft Finance Bill 2022-23 measures are said to be directed at helping to reduce error, they have primarily been aimed at tackling the increasing number of spurious claims.’*
- 4.6 **Question 1. Do you agree a new scheme should be an above the line RDEC like credit? If not, what alternative would you propose?**
- 4.7 We agree that having one scheme for R&D tax relief rather than two, would be a simplification to the UK tax code, although perhaps a more perceived than real simplification for the majority of taxpayers for whom it is clear which scheme applies to them, and thus they only have to consider one in reality in any case. We also broadly agree that, if there is to be one scheme for all companies, it should be an above the line RDEC like credit.
- 4.8 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. The consultation document says (at paragraph 1.11) that additionality in the SME scheme is lower than the RDEC. At paragraph 2.9 it is suggested that the structure of the RDEC, and the fact that it factors earlier in relation to investment decisions, contributes to additionality.
- 4.9 However, just because on the basis of measurement used by the government the current SME scheme does not appear to produce as much additionality, it does not follow that targeting that population with an RDEC scheme would necessarily get the best results. It is not clear to us that small businesses will be as incentivised as larger ones by the above-the-line benefit. This is discussed in response to question 2 below with regard to decision making. Thus, although, the evidence may work against the existing SME scheme, it does not necessarily prove that RDEC would be as good at driving additionality for SMEs as it is for larger companies.
- 4.10 Also, the rules in the SME scheme as to the correct interpretation of what is subsidised expenditure and ‘subcontracting’ (referred to as ‘contracted out R&D’ under the current legislation) have been the subject of an ongoing disagreement as between HMRC and the CIOT (and many other advisers and experts). The disagreement between the tax profession and HMRC as to the correct legal interpretation of the rules has

⁵ Our response to the [R&D Tax Reliefs Report](#) published in Autumn 2021 – see paragraph 6 in particular

been causing administrative difficulties for taxpayers as a result of the ongoing uncertainty; this makes outcomes appear more uncertain and reduces additionality of R&D tax relief.

- 4.11 With regard to the rate of the relief, for larger companies currently, the RDEC has the advantage of a consistent proportionality between R&D expenditure and credit amount, to be contrasted with the fluctuating relief of the SME scheme, as described in paragraph 4.1 above. However, for SMEs the return to a main corporation tax rate and a small profits rate will be an additional complexity and a single scheme for R&D tax relief with one rate would mean that some SMEs would receive less support for R&D than large companies. For example, a SME with £50,000 profits would bear 26.5% tax on the RDEC claim, which is more than the rate that would apply to a larger company or a loss making one.
- 4.12 It would be possible for a single scheme based on RDEC to retain a difference in the rate of the relief available for large companies and that for SMEs, and in our view this should be considered by the government to ensure that from a policy perspective effective encouragement and support is given to R&D activities within this sector. We recognise that the availability of a differential rate would give rise to complexity (including, potentially, in relation to the rules dealing with contracted out R&D, discussed at paragraph 5 below, where a protection against arbitrage of the rates may have to be built in along the lines of what exists now in circumstances where large companies subcontract R&D to SMEs), but the case for giving SMEs a lower effective rate of support in some cases has not been made out. However, merely giving SMEs a more generous rate of R&D relief will not eliminate the issue described above arising from the two rates of corporation tax, if there are different definitions of ‘large company’ for corporation tax and R&D relief.
- 4.13 As suggested in response to question 15 regarding the transfer of SMEs into a new scheme, we suggest that the government needs to do some further thinking around support for SMEs, and encouraging R&D to be undertaken by them.
- 4.14 **Question 2. Does the taxability and subsequent different post tax net benefits impact your decision making when allocating R&D budgets?**
- 4.15 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.
- 4.16 With regard to decision making around R&D, we suggest that 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 large 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 believe that the lesser reported additionality of the SME scheme could be more apparent than real. Also, the additionality report makes the point that what has been measured is the impact of changes in the rate of the relief and that, therefore, the SME additionality ratio is likely to be affected by the fact that it is currently on a generous rate. Thus

comparing the effectiveness of the two schemes based only on the additionality ratios will not necessarily produce a sensible policy outcome.

- 4.17 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 also seems likely to us that stability in the rules and their interpretation are important to promoting additionality.
- 4.18 Finally, with regard to designing an R&D scheme for tax relief that will deliver the government’s overall policy of encouraging R&D, it is important to consider the overall additionality benefits of the scheme for the economy 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, for example by having unreasonable and untargeted compliance measures and hurdles, or the rate of the relief is perceived to make undertaking R&D less cost effective, the narrative around people who are doing R&D, but are missing out on tax relief would operate as a general disincentive.
- 4.19 **Question 3. If you use RDEC now, is there anything in your view that should be changed?**
- 4.20 In our response to the previous consultation on R&D Tax Relief in Summer 2021 we asked whether any consideration has been given in government to extending the availability of R&D tax relief to unincorporated businesses? Historically it has been suggested that the increased susceptibility of unincorporated businesses to fraud has prevented them from being included within the scheme, but we have not seen any evidence or explanation as to why the government may consider this to be the case. Could the government revisit this and publish their thinking in this regard? It may be a good time to re-evaluate this conclusion in light of the recent measures that have been added to R&D reliefs to counter fraud generally. Is there any evidence around whether the availability of R&D relief is a factor in driving businesses to incorporate?

5 Detailed design: subcontracting

- 5.1 The consultation document discusses the complexities around the rules in relation to subcontracting (and to a lesser extent subsidised expenditure). These rules in the SME scheme have been the subject of an ongoing disagreement as between HMRC and the CIOT (and many other advisers and experts) as to the correct interpretation of what is subsidised expenditure and ‘subcontracting’ (referred to as ‘contracted out R&D’ under the current legislation)⁶. Whilst the issues with regard to subsidised expenditure may fall away as a result of a single scheme, whether or not a single scheme would solve the issues around subcontracting is less clear, and depends upon what the rules in the new scheme would say. The most important thing in this regard is that this review of the R&D tax relief regimes in the round, takes the opportunity to clarify the policy

⁶ [R&D Tax Reliefs](#) – see the Appendix in particular.

intentions of the reliefs and the desired outcomes, and then ensure that these are translated into statute accurately and effectively, without unintended consequences.

- 5.2 In our discussions with HMRC, focussing on the current SME scheme, we have said that, from a policy perspective, if there is a chain of two or more businesses in a supply chain, 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 seemed to us to best deliver the policy aims around the additionality of the SME R&D relief. However, maintaining this approach in the context of a single scheme would require resolution of the difference in interpretation as to what is contracted out R&D, and clarity going forward as to precisely what contractual arrangements amount to subcontracting (or contracting out) R&D. Consequently, as discussed below, the best overall policy outcome may be to give the R&D relief to the company that undertakes the R&D activities in all cases.
- 5.3 We can also see that, if the rules are clear and consistently applied in this regard, so that companies are aware of the availability of the relief and where it will be given, it will be taken into account in the decision making and thus contribute from an additionality perspective: a company considering contracting out R&D will be aware of the fact that it is ceding the right to claim the tax relief and this will be reflected in the contract price.
- 5.4 **Question 4. Do you agree the same treatment of subcontracting should apply to all claimants in the merged scheme?**
- 5.5 Yes; in order to provide the simplest and most straightforward set of rules, we agree that the same treatment of subcontracting should apply to all claimants in a merged scheme.
- 5.6 **Question 5. If so, where R&D activity is subcontracted, do you think that the customer should claim the tax relief, as in the SME scheme, or the subcontractor, the person carrying on the R&D, as in the RDEC?**
- 5.7 As mentioned above, we have a different interpretation of the current legislation to HMRC and do not accept that a ‘customer’ has always contracted out any R&D that is undertaken by the person who is providing the service/product to it. Thus the service/product provider is not always a ‘subcontractor’ in the event that it is carrying on the R&D. However, if, as a policy matter, it is decided that the focus of relief follows the current RDEC rules – which means that, broadly, R&D relief is claimed by the company that is carrying on the R&D – the question of whether or not R&D has been subcontracted falls away.
- 5.8 For this reason, and also in order to advocate a new single scheme that is as simple and straightforward as possible, in our view, it is preferable that a single scheme should follow the RDEC rules.
- 5.9 As noted, in the consultation document, this approach does not address the issue within the current RDEC scheme described at paragraph 3.4 of the consultation document around ‘routine’ activities that have been subcontracted, but are not R&D for the company that is carrying them out. To deal with this issue, we suggest that the new single scheme should contain a provision to allow an election whereby a company can make an election saying that they will not be claiming R&D relief for the costs of specified activities – and this election can be given to the other company with whom they have contracted to undertake the activities, who must have it to support a claim for R&D relief in respect of the cost of those activities – if they would be R&D for them. This is a variation to the joint election suggested at paragraph 3.5, which suggests extending a fictional group situation to all subcontracting relationships. The reason for rejecting the joint election approach is that it would require a flow of information between unconnected companies that may be unwelcome and also the cooperation of a joint election. Instead, we suggest that the election made by the company undertaking the activities simply confirms that they are not claiming R&D. It is envisaged that this would only be entered

into in circumstances where that company cannot claim R&D, because the activities are ‘routine’ for them, but that should not be a requirement.

- 5.10 We accept that this is adding complexity into the scheme, and that it would give rise to new commercial considerations and also the cost of an administrative burden on mostly SMEs who rely on being able to outsource specific activities within an R&D project. However, it would ensure that R&D relief is given for all activities that are contributing to the R&D project.
- 5.11 **Question 6. Can you see any positive or negative impacts on your business or sector from the Government adopting either approach?**
- 5.12 The group of businesses that would be most negatively affected by adopting the RDEC rules in a new single scheme are the SMEs that contract out R&D – currently they are able to claim R&D relief under the SME scheme. This group may include newer SMEs who will rely on subcontracting because, initially at least, they do not have the capacity to undertake the work themselves. Under the RDEC rules, the R&D relief would fall to the company that is carrying out the R&D. This group may be partially protected from the negative impact by an election along the lines described above, to the extent that the activities being subcontracted are not R&D in the company that is undertaking them. However, this is unlikely to apply to the smallest start-up companies that are subcontracting a genuine R&D project because it is unable to carry out all of the work itself due to lack of staff.
- 5.13 We assume that the rules within the RDEC scheme that permit the subcontractor to claim relief in respect of qualifying expenditure incurred in subcontracting R&D activities to persons who cannot claim R&D (individuals, partnerships or qualifying bodies) would be replicated in a new single scheme. If so, they could also mitigate the detrimental effects of a change to the subcontractor rules for those SMEs who are subcontracting and will no longer be entitled to R&D tax relief under the new scheme.
- 5.14 Finally, it may be that on a careful analysis, many of these relationships give rise to externally provided workers (EPWs), which may also mean that R&D relief continues to be available. It is often not clear whether the relationship between two companies results in subcontracted R&D or EPWs. The position could be usefully clarified going forward if the identification of EPWs is going to become more important as a result of a change for SMEs to the RDEC rules for subcontracting.
- 5.15 The complexities and potential loss of R&D tax relief for this category of company is another reason why the government may wish to consider further its approach to incentivising R&D by smaller companies and start-ups and whether additional support is required.
- 5.16 **Question 7. Do you have an alternative model you think could apply all claimants in the new scheme? Please provide qualitative and quantitative evidence with your proposal.**
- 5.17 We do not have any comments.

6 Detailed design: Cap on payable credits

- 6.1 **Question 8. What are your experiences of the PAYE / NICs cap?**
- 6.2 When the re-introduction of a PAYE/NIC cap into the SME scheme was consulted on in 2019 we noted that there was an underlying issue around simplicity v fairness with a cap. Introducing a cap immediately increased the complexity of the SME R&D relief, as it requires claimants to compare the credit to a multiple of PAYE and

NIC liabilities. It also creates unfairness as genuine businesses are disadvantaged. This led to the inclusion of a threshold which significantly increased the complexity level (but which was considered necessary to reduce the unfairness). At the time we noted our support for HMRC in their efforts to prevent, so far as possible, fraudulent and abusive claims, and continue to do so. However, we suggest that the cost/benefit of a cap on payable credits in relation to any new scheme is looked at again in terms of the increased complexity (and unfairness) v the perceived benefit of a cap (in stopping fraudulent and abusive claims). Do the benefits outweigh the costs arising from the loss of R&D relief to smaller, genuine claimants?

6.3 Question 9. Are there any ways the Government could simplify the PAYE / NICs cap whilst ensuring there is protection against abuse?

6.4 In the event of the introduction of the PAYE/NIC cap in the SME scheme in April 2021, we recognised the efforts by HMRC to minimise the impact of the cap on genuine businesses as much as possible. We continue to encourage HMRC to counter fraudulent and abusive claims in other ways. In this regard, we have said that we agree that some of the measures that are to come into effect on 1 April 2023 will assist HMRC with this. We agree that it is reasonable to require all claims to the R&D reliefs to be made digitally, with the important exception of those companies exempt from the requirement to deliver a Company Tax Return online (these companies must continue to be able to submit claims on paper). However, we have also said that we do not see what HMRC is gaining from the measure requiring each claim for R&D tax relief to be endorsed by a named senior officer of the company, and there is already a requirement for a declaration as to the completeness and correctness of the claim by a director of the company before it is submitted. We do not support the measure that will require companies to give advance notification of R&D claims, as this will prevent genuine claimants from accessing the relief to which they are entitled, while not necessarily leading to a significant reduction in abuse. We agree with the Lords' sub-committee Report that this *'is uniquely onerous and its benefits in countering abuse are questionable'* (paragraph 13 of the summary of conclusions and recommendations).

6.5 It remains important that, in seeking to prevent abuse of the relief the government does not inadvertently discourage genuine claims by making claiming the relief unreasonably and unnecessarily difficult. In addition, unreasonable compliance measures will always impact the smaller claimants disproportionately.

6.6 Question 10. Which of the SME and RDEC PAYE & NICs cap should the Government implement in the new scheme?

6.7 We suggest that the SME cap, with its base level of £20,000 is more helpful, as it will apply to start-ups with no employees as yet. See also the comments above around the cost benefit analysis.

6.8 Question 11. Should the Government change the way either cap is calculated if it is taken forwards? And if so, how?

6.9 We suggest that the cap could be simplified if it was determined by reference to all the company or group's employees, rather than only relevant employees. The aim of using evidence of a UK PAYE scheme to demonstrate that there is a real business in the UK, and not an artificial presence, would still be satisfied if a broader class of employees was used. Thus a reasonable compromise proposal might be the SME cap, with its de minimis level, but also capped at 100% of all employees PAYE/NIC liabilities for simplicity.

7 Detailed design: Additional support for specific companies

7.1 Question 12: Do you consider the government should provide more generous support for different types of R&D or more R&D intensive companies relative to less R&D intensive companies?

7.2 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 specific areas that the government wishes to target, 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, or providing grants to incentivise particular sectors at particular times. For example, should work in relation to social sciences be incentivised and if so how? Direct funding for R&D can by its nature be targeted towards specific types of project.

7.3 In addition, we note that the overall definition of R&D for tax purposes has not formed part of the R&D tax reliefs review to date. We suggest that a review of the current definition of R&D is undertaken by the new Department for Science Innovation and Technology, and that there is an updating of published guidance, examples and case studies which explain what R&D is. This would be a more useful exercise than seeking to better target the scheme by trying to define different categories of companies by reference to the intensity of their R&D activity.

7.4 Question 13: In the event this were to be done, how might this best be achieved within an overall cost envelope?

7.5 As we said in response to the consultation in 2021, 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.

7.6 However, designing anything along these lines would also be ripe for confusion and complexity, as well as potentially presenting opportunities for abuse. 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 caution that the case for any changes has to be weighed against the need to improve the perceived stability of the basic entitlement to reliefs. In our view the UK's capital allowances regime has suffered in recent years due to frequent tinkering with rates and categories of expenditure that qualifies for allowances. It would be a shame if an approach to pick 'winners' and incentivise certain types of expenditure led to a similar disruptive approach in relation to R&D expenditure.

7.7 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.

8 Detailed design: Guidance and transition

8.1 Question 14. If the schemes are merged do you agree the Government should implement the merged scheme on accounting periods starting on or after 1 April 2024?

8.2 In our view implementing the rules from April 2024 would not give sufficient time given that the consultation is currently at an early stage. Uncertainty is one of the biggest blockers to investment, therefore it is important that changes are managed in an efficient manner and well communicated in conjunction with transitional rules

which minimise commercial disruption. The current pace of change in the R&D relief regime as a result of changes already announced is already challenging for businesses and their advisers.

- 8.3 We reiterate our comments in paragraph 3 above around the harmful effect on the competitiveness of the UK's R&D tax relief and overall perception of the rules as a result of the recent changes; this will be exacerbated if these are perceived to be short term measures, which could change again in a year's time as a result of the ongoing review. It is important to take the time to get the structural regime right for the long term, and sufficient time should be taken to ensure that the result is a regime that is stable. A slower, better managed transition to a new system will reduce unnecessary compliance costs.
- 8.4 The timetable 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 to avoid a repeat of the unsatisfactory position that companies are currently in with regard to the changes due to come into effect from 1 April 2023, for which the legislation has not yet been finalised.
- 8.5 We also note the discussion in the Lords' sub-committee Report around the challenges on HMRC resources that already exist in relation to the administration and compliance activities for the R&D tax relief schemes as they currently are. We are doubtful whether without significantly more resource, HMRC could manage a transition to a new scheme within a year.
- 8.6 In the immediate future, we would prefer to see the government address the recommendations in the Lords' sub-committee Report and to see an improvement in the current compliance activities before any transition to a new system.
- 8.7 **Question 15. How can Government ensure SMEs are supported in the transfer into a new scheme?**
- 8.8 As mentioned in paragraph 4 above, the reduction in rate of the SME scheme announced at Autumn Statement 2022 to take effect from 1 April 2023 has substantially reduced the generosity of the scheme for SMEs and has broadly aligned the relief with that given to large companies. Whilst this may be seen as a necessary precursor to a single scheme, we understand that it will have a significant impact on SMEs and the funding of the R&D that they will be able to undertake going forward. We also discuss in paragraph 4 that the reasons given for the reduction in the generosity for the SME scheme are not wholly persuasive, and may be viewing the impact, the additionality of R&D relief and the rate at which it is being given too simplistically. We also discuss at paragraph 5 that the companies that will lose out most significantly if a single scheme approach along the lines of the RDEC rules in relation to subcontracting is taken are SMEs that are subcontracting R&D, and, in particular, the smallest SMEs that are constrained by internal capacity.
- 8.9 For these reasons we suggest above that a higher rate of relief may be appropriate for SMEs and the case for this would be strongest during a transitional period to assist those companies that will be detrimentally affected.
- 8.10 Alongside the introduction of a single scheme for R&D relief, we suggest the government considers alternative policies to support very small R&D projects. For example a grant system should be considered to support smaller R&D initiatives. Because grant payments tend to be subject to more rigorous due diligence, this would address fraud concerns and a cash injection for the smallest projects would likely encourage investment more effectively than a tax credit scheme.
- 8.11 More generally, we agree with the conclusion in the Lords' sub-committee Report that for R&D relief to work as an incentive of R&D activity, businesses need to know not only that it exists, but what it covers. In particular, we agree that the government needs to ensure that SMEs have access to information about R&D relief and

that this information should be clear, accurate and simple to understand so that SMEs can easily identify whether R&D relief is relevant to what they do and, if it is, work out what steps they need to take to claim it.

- 8.12 We also note the recommendations in the Lords' sub-committee Report, that HMRC and BEIS (as the relevant business department at the time) should work together on a new awareness campaign aimed at SMEs on what is and is not R&D, and that HMRC should work with representative bodies and others to improve the accuracy and user-friendliness of its published guidance on R&D relief. This will be even more important if there is to be a change for SMEs to a new scheme. Please also see the comment above in paragraph [7.3] suggesting a review of the definition of R&D for tax purposes.
- 8.13 The new requirements of providing additional information notifications will give HMRC good visibility as to where R&D is being undertaken and by which companies and, therefore, where guidance should be targeted at appropriate times. We suggest that guidance and messaging from HMRC should be more supportive and less negative than the tone of the recent 'one to many' (or 'nudge') letters that have been sent to taxpayers.
- 8.14 In particular, 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.

9 Detailed design: Qualifying Indirect Activities (QIAs)

- 9.1 **Question 16. Does claiming for expenditure on qualifying indirect activities influence your decision to undertake R&D?**
- 9.2 In our view the framing of this question is not helpful. It is unlikely that the availability of QIAs 'influences' a decision to undertake R&D, beyond, possibly, in an international context where the decision is one about the overall competitiveness of the UK regime and where to undertake the R&D. However, the fact that the availability of QIAs may not of themselves influence the decision, does not undermine the importance of them.
- 9.3 Many support or indirect costs form a critical part of R&D (for example, ensuring that contracts are appropriate and human resources and other legal requirements are met). As such QIAs are commercially necessary expenditure in relation to an R&D project. We understand that these indirect costs, and the availability of R&D tax credits in respect of them, not only factor into the overall investment decision appraisals, but can add genuine value to the direct R&D work undertaken.

10 Detailed design: Threshold

- 10.1 **Question 17. Do you think a threshold should be implemented? If one was implemented what at what level should it be introduced?**
- 10.2 We are not averse to introducing a de minimis threshold. A threshold at a sensible level, of, at least, £50,000 may help to encourage companies seeking relief to obtain appropriate advice. We understand that taxpayers

are less likely to seek professional advice if their claims are for very small amounts, as it is not cost effective to do so.

10.3 However, the introduction of a threshold will almost certainly lead to compliance issues with claims just above the threshold in that it will, for example, encourage unscrupulous agents and companies to artificially inflate a claim up to the threshold, thereby perpetuating much of the bad behaviour that already exists. The purpose of introducing a threshold seems to be aimed at reducing error and fraud, but, like the requirement for advance notification, its impact will be indiscriminate; the effect will be an untargeted overall reduction in R&D claims, rather than being targeted at the behavioral issues that cause the error and/or fraud.

10.4 We also suggest that if a threshold is introduced, this would be another reason for the government to consider alternative policies such as grants to support very small R&D projects (as also suggested in paragraph [8.10] above. In addition, consideration could be given to permitting small companies to cumulate costs in early years, where these are lower than the de minimis, permitting a claim once the threshold is reached. This would operate in a similar way to the pre-grant relief that is available under the Patent Box, but we accept that it would add complexity to the scheme.

10.5 **Question 18. What is the average amount of R&D expenditure per year per firm in your business or sector?**

10.6 This question is not relevant to the CIOT.

11 Acknowledgement of submission

11.1 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
13 March 2023