House of Lords Finance Bill Sub-Committee – call for evidence on draft Finance Bill clauses in relation to R&D
Response by the Chartered Institute of Taxation

Introduction

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.

We welcome the focus of the Sub-Committee on research and development tax relief (R&D relief), in particular on the provisions included in the draft Finance Bill in relation to proposed changes to R&D relief, and this opportunity to provide evidence to the Sub-Committee.

Answers to questions

1 Have the changes to the definition of R&D gone far enough in modernising R&D relief, and if not, what more needs to be included?

1.1 The draft Finance Bill changes will extend the scope of qualifying expenditure to include the costs of datasets and of cloud computing. We understand that there will also be a change to the definition of R&D to remove the exclusion of pure mathematics, although this is not reflected in the draft legislation published in July (as how this will be done is still under consideration by HMRC). These changes are welcome and will bring the definition of R&D up to date for technology companies. However, the changes are not the result of a wholesale review of the definition of R&D. They are a response to issues raised by claimants in a particular sector who identified that a large proportion of their costs within R&D projects fell within these categories. There is therefore scope for a wider review of the definition of R&D in order to modernise R&D relief.

1.2 In this regard, we note the recent report from the Office for National Statistics (ONS)[1] which highlights the difference between the tax definition of R&D and that which is used by the ONS for its BERD survey. Recognising the differences in measuring R&D expenditure has led to the revised conclusion that the amount spent on R&D in the UK is greater than previously thought, and may, in fact, be meeting the government's target, set in 2017, to invest 2.4% of GDP in R&D. Aligning the definitions could simplify the process for businesses and allow for more accurate reporting. Practically this could include removing the remaining exclusions around social sciences and economics from the BEIS guidelines.

1.3 Ultimately, the decision for government about which activities they would like to encourage by way of tax incentive is one of policy.

2 How effective will the changes be in countering error and fraud resulting from spurious R&D claims and is there more that can be done, or different approaches that could be adopted?

2.1 We share the government's concern over abuse of R&D tax relief and are supportive of efforts to reduce this. We discussed in our comments on the R&D Tax Report[2] the importance of the terminology that is used in order to be clear as to the problems that are arising, and that the proposed changes are intended to tackle. 'Error' and 'fraud' are two different things that need to be tackled differently, although they are often put together in a more general category of 'abuse' of the R&D relief. We understand that the government

[1] Comparison of ONS business enterprise research and development statistics with HMRC research and development tax credit statistics - Office for National Statistics
[2] https://www.tax.org.uk/ref897 - paragraph 6

perceives that much of the issue – that is to say the error and fraud – arises from R&D advisers that encourage companies to submit 'spurious' claims.

2.2 Several of the changes in the draft legislation focus on either the agent that is advising the company that is making the R&D claim, or the information that must be provided with the claim. We understand from our discussions with HMRC that the intention is to improve the quality of advice that companies receive in relation to R&D tax relief claims and make it easier to identify the agents that are minded to make spurious claims and, indeed, harder for them to make such claims.

2.3 We welcome these efforts. The UK does not regulate tax advice and, as a result, there are agents in the R&D market that do not adhere to the strict professional standards such as Professional Conduct in Relation to Taxation (PCRT) that members of the CIOT and other professional bodies do. We have always recognised that, as well as being bad for the integrity of the tax system, spurious claims can arise as a result of taxpayers being attracted by promises of R&D tax relief by agents that are not required to observe the standards within PCRT, and using these agents in preference to those that are governed by them. It is also problematic for a practitioner adhering to PCRT, 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.

2.4 We recognise that HMRC have finite resources and it is unrealistic to expect them to review all R&D claims in detail. In our view the best way to tackle the problem of spurious claims within the current compliance and regulatory framework is by developing HMRC's risk assessment mechanisms to deliver a more effective triaging system for R&D tax relief claims. Some of the changes will help with this. In particular, the requirement for claims to include details of agents who have advised the company on compiling the claim should help HMRC build a useful database of higher-risk agents so they can focus their resources better. Properly designed and utilised by HMRC, the requirement that more detail is provided with the claim could help as well.

2.5 More fundamentally, the problems surrounding behaviour by some agents in this sector are exactly those that the government's 'raising standards' agenda was intended to address. There was a consultation last year on Raising standards in the tax advice market[3]. While there is ongoing work in this area, we are concerned that the agenda appears to be stalling: the problems in the R&D market are very much a reflection of the need to pursue the raising standards agenda more vigorously. We think that in principle those providing tax services should be subject to the professional standards and disciplinary processes applying to professional body members. In relation to R&D in particular, it is also important to counter the erroneous belief that giving advice in relation to R&D is not tax advice. In our view it clearly is.

2.6 We continue to encourage HMRC in their efforts, alongside CIOT and other professional bodies, to improve standards in the R&D advice sector, to ensure that only legitimate claims are made. These efforts are supported by ensuring that advisers are observing high standards. In this regard we welcome the publication by HMRC of guidance on 'How to choose a tax agent', published on 22 September 2022[4]. The CIOT published similar advice in relation to choosing an adviser in relation to R&D in 2020. This can be found on our website[5].

2.7 With regard to the other measures in the draft Finance Bill legislation, we agree with the government 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.

2.8 However, 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. 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. (NB. HMRC has confirmed that they do not envisage this change leading to a personal liability for the senior officer – the

[3] https://www.gov.uk/government/consultations/raising-standards-in-the-tax-advice-market
[4] How to choose a tax agent - GOV.UK (www.gov.uk)
[5] 201006 Choosing an RD Adviser (Final).pdf (kc-usercontent.com)

measure is intended to be an awareness and behavioural prompt, rather than a mechanism to impose an additional penalty or liability.)

2.9 We also note the introduction, in Finance Act 2021, of a new cap on the payable element of the R&D tax credit for small and medium sized companies, based upon the Pay-As-You-Earn (PAYE) and National Insurance Contributions (NIC) that the company is required to pay for its own employees, as well as some PAYE and NIC of connected companies. This change has effect for accounting periods beginning on or after 1 April 2021 so is only just beginning to take effect. We believe this cap will assist in deterring abuse.

2.10 In addition, errors that may arise from ignorance rather than intentional abuse will be reduced by focussing on assistance from HMRC to businesses (question 4) and improving HMRC guidance (question 5).

2.11 We are concerned, however, that the proposed measure that will require companies to give advance notification of R&D claims will prevent genuine claimants from accessing the relief to which they are entitled, while not necessarily leading to a significant reduction in abuse. We do not support this measure. This measure is discussed in response to question 6 below.

3 How successful is the refocusing of the relief in encouraging activity in the UK without adverse consequences?

3.1 The draft Finance Bill clauses seek to ensure that R&D relief is focussed on innovation in the UK. We understand the policy aims of ensuring, so far as possible, that the R&D activities that are supported by the UK's tax relief schemes are conducted in the UK. This should ensure that the broader benefits that arise for society because of R&D activity are focussed and encouraged within the UK. However, it is not clear the extent to which the change will encourage R&D to be brought 'onshore' to the UK and companies may face practical difficulties around applying the rules and the narrow exemptions.

3.2 A lot of work is currently carried out overseas because of the availability of skilled resource that may not be available (or not at a similar cost) in the UK. It is reasonable for the government to want companies to develop that resource in the UK. If there is a cliff edge cut off, however, it is possible that R&D activity will simply move offshore (to the detriment of the UK economy) rather than the expertise being developed in the UK. It would be sensible if companies were to be allowed time to develop the equivalent expertise and resource in the UK.

4 How aware are smaller businesses of R&D relief? Is there more that HMRC could be doing in practice to help smaller businesses access relief to which they are entitled?

4.1 We note that the first of HMRC's five strategic objectives[6] is to "collect the right tax and pay out the right financial support", recognising the role of HMRC in ensuring that R&D relief is given where it is due. Although it has improved, there remains a low level of awareness of R&D relief amongst some smaller businesses. In particular there is a lack of awareness of the complexities of the R&D relief rules and of the compliance burden in claiming the relief.

4.2 We recognise the challenges placed on HMRC's service levels by an organised crime attack on the R&D relief system in April. However, there are practical difficulties that are often encountered by taxpayers and their advisers as a result of the lack of joined up processes within HMRC – for example, reports emailed to the R&D unit not being linked to the company's CT return. This can lead to HMRC asking for information that has already been provided – wasting time and resource for both the taxpayer and HMRC. It is also frustrating for businesses and their advisers to be unable to speak to anyone at HMRC to understand what is happening to their R&D relief claim.

[6] HM Revenue and Customs Outcome Delivery Plan: 2021 to 2022 - GOV.UK (www.gov.uk)

4.3 Beyond these general systemic issues, there is also one particular area where HMRC's current stance is creating uncertainty and may be harming R&D relief's effectiveness for smaller companies. The rule in question is the one denying access to the more generous SME R&D relief if the R&D expenditure is 'subcontracted' or 'subsidised'[7]. The issue is that HMRC are now extending their interpretation of these terms in what seems to advisers to be a potentially catch-all way, so that R&D can be seen as 'subsidised' by being pursuant to the delivery of a profitable contract on arms' length terms, and 'subcontracted' by a customer even if the customer was unaware that R&D might be needed to deliver it. Under these broad definitions it is difficult to see why 'subsidised' expenditure would not always in any case be 'subcontracted', and consequently it would only seem possible to claim the relief for R&D without successful commercial application, which runs counter to the purposes of the relief.

4.4 In practice HMRC do not consistently apply the rules in this very broad way, but the current arbitrary application of these rules makes outcomes appear more uncertain and reduces 'additionality' of R&D tax relief (ie the point where the credits are stimulating more R&D activity rather than simply rewarding those who would have done it anyway). In addition, the current situation is unhelpful in relation to the overall aim of tackling abuse. Unclear boundaries encourage 'boundary-pushing'. It is possible that the cost of R&D relief to the Exchequer will fall as a result of HMRC's current interpretation of the rules, but what relief is given will be less effective in stimulating more R&D activity, the purpose of the relief, as relief will be more uncertain and more remote from the decision to undertake it.

4.5 We raise this here not because of the disagreement between the tax profession and HMRC as to the correct legal interpretation of the rules, but because 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 any of the steps available to government to resolve the uncertainty: by either pursuing the issue through the Courts to achieve a binding judicial precedent[8] or amending the legislation to ensure the legislation itself clearly accords with HMRC's interpretation.

5 How helpful is HMRC and BEIS guidance in interpreting and applying the R&D relief rules?

5.1 Overall the BEIS Guidelines are good and are the primary source of guidance on the definition of R&D for tax purposes. They are, however, now over 20 years old, and are, therefore, somewhat outdated due to the progress of time and continued technological developments. It is expected that they will be updated at some point to reflect the change to include pure mathematics within the definition of R&D. There have been updates (for example in relation to software), that are useful and much more understandable to a taxpayer than the original guidelines. 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. This work should take place alongside any wider review of the definition of R&D, if one is considered appropriate, as discussed in response to question 1 above.

5.2 HMRC's guidance (the Corporate Intangibles Research and Development (CIRD) manual) is less consistently good and is, in places, ambiguous and unclear. In addition, it must also be recognised that the CIRD manual sets out HMRC's view and interpretation of the law, which is not necessarily always correct (see above with

[7] For completeness, we note that HMRC maintain that their current interpretation is how they have always interpreted the law, and that the policy outcomes are not inconsistent with what was intended when the R&D tax reliefs were introduced. The CIOT disagrees with this contention. Our view (shared by many experienced advisers and experts that we have spoken to) is that from the outset of R&D reliefs until around 2019 HMRC applied the rules around subsidised expenditure and contracted out R&D in accordance with the CIOT's (and others) interpretation of the legislation. HMRC's current interpretation is a change by HMRC.

[8] 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.

regard to subsidised expenditure and subcontracted R&D). Conversely, shorter, brief publications (for example *Making R&D easier for small companies*) do not provide sufficient detail to give companies information as to the reality of what is expected of them by HMRC in terms of compliance, which only becomes clear if there is an enquiry into a claim.

5.3 Both types of guidance could be improved and, more generally, it may be possible for HMRC's overall guidance offering to be updated to include some examples which clearly identify some of the more spurious types of claims that HMRC sees that are not permitted.

6 What view do you take of the requirement to give advance notification of R&D claims? What effect would you expect it to have on genuine and spurious R&D claims respectively?

6.1 The requirement to give advance notification of R&D claims will mean that companies will have to inform HMRC of their intention to make an R&D claim within six months of the end of the period to which the claim relates (in addition to the current two years that they have to actually make a claim).

6.2 This measure is poorly targeted because, although it will prevent some spurious claims, it will also mean that many genuine claims will not be able to be made because the company was not aware of the relief until after the six month advance notification period, even though it is still within the two year time limit for actually making claims. It will exacerbate an existing unfairness that can arise between taxpayer companies that undertake R&D activities, based on whether or not they have an awareness of the tax relief rules at the appropriate time. It will disproportionately hurt smaller and newer companies – the kinds of companies that may only get tax advice during the year end compliance process (and often after the six-month window for pre-notification), rather than all year round.

6.3 In addition, while reducing the number of eventual claims, advance notification could in some ways increase HMRC's workload, by encouraging taxpayers to make 'protective' advance notifications before the position is clear in order to ensure that they are not prevented from making a claim as a result of a failure to comply with this new obligation. This will depend on the information that is required in the advance notification, details of which have not yet been made available by HMRC. In any event, HMRC will need to think about how it will deal with a potentially large number of advance notifications that may or may not be followed up by claims, and the compatibility of their systems to ensure the advance notifications can be matched efficiently to subsequent claims without error.

6.4 There is also a risk that taxpayers could regard successful pre-notification as a guarantee of the eligibility of their eventual claim, leading to disquiet if the subsequent claims are rejected or enquired into. We understand that this has happened in Australia, which has a pre-registration process for R&D tax relief with some similarities to the UK's proposed pre-notification process.

6.5 In conclusion, it is our view that the advance notification requirement may not deliver on the policy intentions of preventing error and fraud, but will reduce the overall additionality of the R&D relief scheme. This is because 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, by introducing arbitrary new compliance measures and hurdles, the narrative around people who are doing R&D, but are missing out on tax relief would operate as a general disincentive. As such this measure will detract from the government's overall policy of encouraging R&D, as a result of its impact on compliant businesses. 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, and this measure will put well-advised taxpayers at a big advantage compared with those who are not professionally advised. This measure is discussed more fully in our response to the R&D Tax Report[9].

[9] https://www.tax.org.uk/ref897 - paragraph 7

7 What is your experience of HMRC's approach to dealing with claims to R&D relief which it suspects to be invalid, either through misunderstanding of the rules, or fraud?

7.1 That scrutiny and HMRC resourcing to tackle abuse of R&D reliefs is increasing is well known. There has been a high-profile prosecution for fraud and the suspension earlier this year of the payments of R&D tax claims as a result of the organised crime attack on the system was also well-publicised.

7.2 Over the summer we have seen a number of 'one-to-many' (OTM) letters in relation to R&D relief. OTM letters are standard letters sent to an identified group of taxpayers that aim to encourage or 'nudge' them into reconsidering their tax position and voluntarily correct any errors. If they are targeted at a particular group of taxpayers, they will often be based on information in HMRC's possession which has led HMRC to believe a return or claim may be incorrect. HMRC are using OTM letters more often in their compliance activity generally.

7.3 It would be helpful to understand how effective HMRC's use of OTM letters is in identifying and correcting errors in R&D relief claims, and how well they are targeted. It would also be useful to know how effective they are in educating taxpayers about the correct application of the R&D rules. We would welcome the opportunity to learn how HMRC are evaluating the responses they receive to their OTM letters and to discuss the outcome of that evaluation with them.

7.4 We support the government's efforts to tackle abuse and error, but the compliance activity should be proportionate and well-targeted. In our view the approach by HMRC in relation to compliance with R&D relief can be unnecessarily aggressive and err towards apparently assuming errors have been made. An approach by HMRC to compliance that is perceived as being aggressive and threatening will not help to generate an open and collaborative relationship between HMRC and taxpayers.

7.5 We would encourage HMRC to increase their focus on approaching compliance from the stance of seeking to ensure claims are right in the first place by raising awareness of taxpayers and the standards of agents in the R&D sector, and improving guidance, as discussed above.

8 Are there lessons the UK could learn from the tax systems of other countries about how to encourage R&D

8.1 We mention above the Australian R&D tax relief system in relation to the advance notification requirement.

8.2 The approach in Australia with regard to maximising government resources could also be considered, recognising the resourcing challenge for HMRC to check all, or even most, R&D claims in greater detail. Our understanding is that in Australia responsibility for reviewing whether the activity is R&D lies with a government agency called 'AusIndustry', which also has wider responsibility for advising and providing services to businesses. This has removed some of the burdens from the Australian Taxation Office (ATO). Giving this responsibility to an agency which specialises in supporting business has also improved compliance**.** In the UK, collaboration with BEIS, which is responsible for the definition of R&D, but currently not the application, interpretation or providing guidance in respect of it, could be considered.

9 How successful are the changes in R&D relief likely to be in encouraging innovation and development?

9.1 The changes in R&D relief are a mixture of proposals that on the one hand will broaden what will qualify for R&D relief, and on the other will make it harder to claim tax relief. As discussed above, many of the additional compliance measures around the claim itself we support as being potentially helpful to HMRC to identify and, therefore, tackle abuse.

9.2 However, it is difficult to see how the advance notification measure, which will make it harder to claim R&D tax relief, will help deliver the government's overall policy of encouraging innovation and development, or the intended additionality benefits of the R&D relief schemes. While it may reduce some spurious claims, it will also mean that many genuine claims fall out of time. There will be significant collateral damage from the measure.

The Chartered Institute of Taxation
28 October 2022

Appendix

About us

The CIOT is an educational charity (registered charity no. 1037), 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.

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.

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.

Our stated objectives for the tax system include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

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

The CIOT is a member of CFE (Tax Advisers Europe).