



HM Treasury

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

Summary of Responses

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Chapter 1

Introduction

1.1 The Government recognises the important role that research and development (R&D) plays in driving innovation and economic growth as well as the benefits it can bring for society. Even in extremely challenging fiscal circumstances the Government remains committed to supporting R&D.

1.2 At Autumn Statement 2022 the Chancellor announced that, as part of the ongoing review of the R&D reliefs, the government is reforming the reliefs to ensure taxpayers' money is spent as effectively as possible. The Government also committed to consulting on the design of a potential merged scheme, with the possibility of this coming into effect from 1 April 2024.

1.3 The government published a consultation which ran from 13 January 2023 to 13 March 2023. This consultation invited views on the design of a potential merged, simplified research and development tax relief scheme, merging the existing Research and Development Expenditure Credit (RDEC) and the small and medium enterprise (SME) relief.

1.4 The Government committed to publishing a summary of responses, as well as draft legislation on a potential merged scheme for technical consultation, alongside the publication of the draft Finance Bill in the summer. This is intended to keep open the option of merging schemes from April 2024, should the Government decide to do so.

1.5 At Spring Budget 2023 the Government announced a new permanent rate of relief for the most R&D intensive loss-making SMEs. It is worth noting that as the consultation closed prior to the Spring Budget, this additional support is not reflected in views given in response to the consultation.

1.6 The Government received 149 responses to the consultation. Those responding included individuals, industry groups, businesses across several sectors, individual accountants and agents and accountancy professional bodies. A summary of these responses is set out in Chapter 2.

1.7 A decision on whether to merge schemes has not yet been made. However, in order to keep open the option of implementing a merged scheme from April 2024 with a decision at the next fiscal event, the Government has today published draft legislation on the proposed design of a merged scheme for technical consultation. This has been developed following consideration of the responses received to this consultation.

1.8 As set out in the HMRC Annual Report and Accounts published on 17 July 2023, HMRC has recently completed new analysis to better understand the size and scope of non-compliance in the R&D reliefs. The results of HMRC's random enquiry programme estimated the level of error and fraud present within R&D schemes as £1.13 billion or 16.7% of related expenditure in 2020-2021. Of the £1.13 billion of error and fraud reported in 2020-21, £1.04 billion relates to the SME scheme (24.4% of SME expenditure). This is an unacceptable level. HMRC published a document on 17 July setting out the latest HMRC analysis on the scale and shape of non-compliance in R&D tax relief schemes from claims relating to 2020-21. It also sets out the department's compliance approach to R&D. HMRC will share a further update on this approach to improving compliance with R&D tax reliefs in winter 2023, as part of their formal response to the Public Accounts Committee on this issue. Any further changes would be announced at a future fiscal event.

1.9 The Government will continue to work to reduce error and fraud, including through further consideration of the consultation responses on the potential introduction of a Minimum Expenditure Threshold.

Chapter 2

Consultation responses

Question 1

Do you agree a new scheme should be an above the line RDEC like credit? If not, what alternative would you propose?

2.1 The idea of moving the scheme to a general above the line RDEC like credit was broadly accepted among respondents. This is because in addition to the overall simplification benefits it gives claimants the ability to know the value of their R&D claim regardless of if they are loss making or in profit.

2.2 Many large companies were supportive of the transition towards a unified RDEC scheme. However, they did note that the proposed changes would not have a significant impact on the way they conduct R&D.

2.3 Of the SMEs who supported the proposal, some expressed reservations about a reduction in generosity, assuming that the current RDEC rate is adopted. They voiced concerns that many SMEs spend their early years loss-making, so the greater support gained through the SME scheme is important. The possibility of different rates of relief within a merged scheme for SMEs and large companies was raised by some respondents, although they noted that this would go against the aims of moving to a simpler design.

2.4 Furthermore, some SMEs argued that having to understand a new system would not benefit them as they believe they have a good understanding of the current scheme and so any changes to this will disproportionately affect them. Some of those opposed to the RDEC design argued that a transition away from a specific SME scheme would signal a lack of confidence in UK SMEs.

Question 2

Does the taxability and subsequent different post tax net benefits impact your decision making when allocating R&D budgets?

2.5 Most respondents concluded that taxability and post-tax net benefits were a significant factor in the allocation of their R&D budgets as it allowed for greater clarity in long term decision making and investment decisions are largely made on a pre-tax basis. However, this varied between large firms and SMEs, with some small businesses saying they allocate budgets where cashflow allows and the tax relief is sometimes considered in hindsight.

2.6 Additionally, stakeholders felt that the RDEC scheme provides more certainty on the cash value of the tax credit on an annual basis,

which is important when preparing financial budgets and forecasting. Respondents believe a stable and tax efficient regime for R&D spend, particularly over the long term, will encourage greater investment in UK R&D including from internationally mobile investors.

Question 3

If you use RDEC now, is there anything in your view that should be changed?

2.7 Responses to this question were varied. The most common view was that capital expenditure should be included as an eligible cost, as stakeholders felt it would further attract and anchor innovative research and development in the UK and support UK businesses to invest and scale up. Respondents also felt the inclusion of payments for subcontracted R&D is essential, especially for smaller businesses who lack the capabilities to carry out all their R&D in house.

2.8 Some other views raised were that the UK definition of R&D should be broadened to include social sciences and humanities, eligibility for the relief should be extended to include unincorporated businesses, and the group rules should be amended to allow losses to be surrendered to discharge other group members' tax liabilities.

2.9 Many respondents called for simplification of claiming under the RDEC scheme, with many firms citing the seven-step process as overly complex, especially for SMEs moving into the RDEC scheme. In addition to this, many asked for clearer and more user-friendly guidance from HMRC, specifically for Qualifying Indirect Activities (QIAs), Externally Provided Workers (EPWs) and software.

2.10 Some stakeholders raised the issue of US foreign tax credit rules meaning that US parented group companies do not always retain the full benefit of the RDEC at group level. This issue arises when there is an automatic offset of a credit against the company's tax liability, causing businesses affected to suffer additional US tax liabilities. Respondents who raised this claimed it could result in a significant reduction in the attraction of the UK as a location for carrying out R&D, and that greater consideration should be given to the interaction between the UK and other countries' tax systems.

Question 4

Do you agree the same treatment of subcontracting should apply to all claimants in the merged scheme?

2.11 Around half of respondents were in favour of all companies having to operate under the same subcontracting rules in the proposed merged scheme, and only 10% supported the idea of having differentiated subcontracting rules. Many respondents chose not to comment on this issue or provided ambiguous answers, with 39% of respondents falling into this category.

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?

2.12 Most respondents who expressed a view on this question thought that the entitlement should sit with the customer, as in the SME scheme. This was because they felt that the company carrying the financial risk should claim the benefit.

2.13 Those that proposed following the RDEC style believe it aligns with the intent of R&D regimes in the UK to reward and incentivise the performer of the R&D, not the stakeholder who subcontracted the R&D out to another firm.

Question 6

Can you see any positive or negative impacts on your business or sector from the Government adopting either approach?

2.14 Supporters of the SME approach believe it will ensure that businesses are encouraged to take the necessary risks associated with R&D because it will reward the firm taking the financial burden of the project. Additionally, many small firms cannot perform all aspects of R&D in-house so outsourcing is critical for them, and respondents believed they should be entitled to the relief because the financial risk is theirs and SMEs need as much support as possible.

2.15 Those in favour of the RDEC approach see the rules as being more straightforward if the performer of the R&D is rewarded, as supply chains can be long and complex creating the potential risk of double counting. Respondents in favour of the RDEC approach also suggested that if only the company carrying out the R&D could claim it would help reduce error and fraud, and bring clarity to who 'owns' the R&D.

2.16 Complexity in determining where the R&D activity takes place was noted regardless of which scheme was preferred, but there was support for having a coherent set of rules which clarified how subcontracting would work, and how contract research organisations fit within the new model.

Question 7

Do you have an alternative model you think could apply to all claimants in the new scheme? Please provide qualitative and quantitative evidence with your proposal.

2.17 An alternative model for subcontracting is joint election, which was recommended by 10% of respondents. This is where the subcontractor and the customer would state that for the purposes of determining whether work was R&D they would be treated as part of the same group. Some respondents cited the subcontracting model in the Republic of Ireland as an example of joint election, through which the customer is allowed to claim for a certain proportion of the R&D activity it subcontracts out, in addition to the standard requirement for the claiming company to have carried out the qualifying R&D activity.

Under these rules, the customer would need to notify the subcontractor in advance of commissioning the R&D in order to claim themselves.

2.18 Respondents suggested several potential advantages of a joint election model, primarily that there could be more flexibility for claiming in different commercial circumstances and the potential for more dispersed R&D to be eligible.

2.19 However, respondents also recognised possible drawbacks, such as the need for clear guidance on definitions of subcontracted R&D to avoid duplication of claims, and to mitigate against error and fraud. It was acknowledged that while the administrative process for joint election could be relatively simple, it could also create complexity by introducing different understandings of R&D eligibility criteria across the claiming customer and subcontractor, and inconsistency between old and new contracts during transition between regimes.

2.20 Another model respondents proposed was to allow all companies to claim for subcontracted or funded R&D, except in cases where the customer is a UK SME, to prevent duplication of claims. However, it was acknowledged that this would maintain the requirement to distinguish SMEs and large companies, and would not provide a mechanism for claiming dispersed R&D.

Question 8

What are your experiences of the PAYE / NICs cap?

2.21 Overall, most respondents didn't express any concerns or challenges with either cap as currently operated, with 38% of respondents choosing not to answer the question.

2.22 For RDEC, UK staff costs generally form most of the qualifying expenditure for most claims and therefore there is usually sufficient PAYE/NICs. However, some large companies noted that the increase in the RDEC rate from April 2023 could mean the cap becomes more of a binding constraint on the amount of relief claimed in future, limiting the effectiveness in driving UK investment.

2.23 SME respondents explained that it is possible for non-staff expenditure, such as subcontracted R&D, to form a high proportion of qualifying costs for some businesses, particularly in the life sciences sector. This does not generate PAYE/NICs and so could potentially limit the payable credit. Therefore the exemption within the current SME cap is helpful for such businesses.

2.24 Respondents to the consultation found it complex to calculate the level of PAYE/NICs, especially for large companies who have many employees. They said this was because it was often a labour-intensive process to gather the necessary payroll data to accurately calculate the level of PAYE/NICs for R&D employees.

Question 9

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

2.25 Some respondents proposed a complete removal of the cap, while others suggested that all companies could use the same cap to reduce the complexity of having two sets of rules and helping companies gain a greater understanding of the system. In addition, these respondents felt this approach would help reduce the workload of HMRC due to only having to ensure compliance with one scheme.

2.26 Respondents noted that a whole company's PAYE/NICs is easier to identify and calculate than the PAYE/NICs for solely R&D employees. Therefore, a cap calculated on whole company PAYE/NICs would be simpler for taxpayers than a cap based only on R&D employees.

Question 10

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

2.27 Overall, most respondents supported the simplification achieved through a merged scheme with a single PAYE/NICs cap. Among those who answered the question, the SME cap was the preferred option.

2.28 This was due to a view that SMEs could be negatively impacted if the RDEC cap was implemented. The reasons for this are twofold, with both the overall decrease in generosity if the current RDEC cap is favoured, and specific effect on start-ups with few employees if the base level of £20,000 in the SME scheme is removed. Also, many SMEs understand the current system and felt that changing it would create unnecessary complexity for them in having to learn a new system and could potentially create a greater reliance on tax consultants which is unpopular among many of the respondents.

2.29 In contrast, a small number of respondents thought that the RDEC cap should apply as they felt the RDEC cap is simpler to calculate.

2.30 Many respondents questioned whether a cap is necessary at all, and thought consideration should be given to removing it entirely. They particularly felt this was the case as the rule to exclude overseas subcontracting as a qualifying expense is due to come into effect from April 2024 and this would achieve a similar outcome, meaning the cap is no longer required.

Question 11

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

2.31 Many respondents felt that if a cap was taken forwards then it should be simplified as the calculations are overly complex. The most common suggestion for how to simplify this was for the cap to include the full amount of the PAYE/NICs liability of the entire company, not just those working on R&D, as this would demonstrate that the company has a real presence in the UK.

2.32 Another suggestion to simplify the cap was that the SME Intellectual Property management criteria could be made more objective, for example by aligning the criteria with the definition of

“qualifying company” in the Patent Box rules (i.e. that the company holds a qualifying Intellectual Property right, as defined, or an exclusive licence in respect of any qualifying Intellectual Property rights).

2.33 Should the RDEC cap be taken forward, some suggested that the cap should be increased to avoid businesses being constrained by this now that the RDEC rate has increased.

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?

2.34 Around 60% of respondents who answered this question were supportive of some kind of targeted R&D support. Of those, two-thirds saw the case for providing targeted support to R&D intensive businesses and around 70% thought there was a case for targeting specific types of R&D.

2.35 Those in favour of providing targeted support believe it can help to ensure the greatest return on public investment, address the greater barriers or challenges faced by certain groups, and reduce the number of claims made in error.

2.36 Among those in favour of targeted support for specific sectors, it was noted that these could be targeted at areas that generate the most significant societal benefits, are of strategic importance to the UK’s economy, or are aligned with broader government priorities. The most common suggestions for types of R&D that require further support were net zero or green tech initiatives, followed by life sciences.

2.37 Those opposed to the idea of targeted support argued that this would add additional complexity to the scheme, undermining tax simplification and potentially leading to higher rates of error and fraud. Respondents also highlighted the issues surrounding how a firm may be defined as R&D intensive or which sectors may be eligible for the more generous support. Some felt that the tax system was not the most appropriate way of providing targeted support, and that alternatives such as grants should be considered.

Question 13

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

2.38 There were few responses to the question of how more generous support might be provided within an overall cost envelope. Of those that did respond, the most common suggestions were for a minimum expenditure threshold to be implemented or for tax incentives to be restricted for ‘soft innovation’. Some argued that the higher cost is justified due to the increased spillover effects the investment would bring, so the R&D envelope should be expanded.

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'?

2.39 Views on the proposed implementation date were mixed, with a third in favour, almost 30% neutral and almost 40% opposed to merging schemes from 1 April 2024. Many felt the timeline was too ambitious with the significant changes being proposed and businesses, especially SMEs, should be given more time to adjust. Furthermore, the consultation found delay of implementation should help improve compliance as it provides an opportunity to understand the new regulations in greater detail.

2.40 Those in favour of the proposed implementation date called for clarity in the new scheme to allow them to make the required adjustments to their programmes. Many of the supporters wanted all the proposed legislation, additional guidance and final policy position in place and agreed before the end of 2023.

Question 15

How can Government ensure SMEs are supported in the transfer into a new scheme?

2.41 Respondents felt that SMEs will need reliable and timely guidance ahead of the merger date, particularly for SMEs with fewer resources. Many asked for education surrounding the new system to try to enable SMEs to shift away from reliance on tax advisors/agents. Some suggested support could be provided through a designated HMRC helpline for those affected by the merger.

Question 16

Does claiming for expenditure on qualifying indirect activities influence your decision to undertake R&D?

2.42 Almost 55% of respondents that answered this question felt that qualifying indirect activities (QIAs) were important when carrying out R&D. The types of QIAs many firms use to support their R&D include dedicated R&D finance, human resources, real estate and facilities teams. These respondents were concerned that limiting or excluding these costs would adversely impact the UK's competitiveness, with many citing the attractiveness of QIAs as a supplementary reason for undertaking R&D within the UK.

2.43 In contrast, a quarter of respondents argued that QIAs do not have a material impact on R&D investment decisions, viewing them as a 'nice to have' addition to their claim and saying it was uncommon for QIAs to represent a significant proportion of a company's claim. Some felt this is an area lacking in clarity and very prone to error and boundary pushing.

2.44 A number of ideas were suggested as an alternative to QIAs, including replacing them with an uplift in staff costs or all direct activities, or placing a cap on the value of QIA expenditure that can be claimed as a proportion of total expenditure. Some took the view that

removing the ability to claim relief for QIAs entirely would be a simplification of the R&D relief scheme and reduce the overall cost of relief to the Exchequer, whilst having minimal impact on R&D activity in the UK.

Question 17

Do you think a minimum threshold should be implemented? If one was implemented what at what level should it be introduced?

2.45 There was a mixed response regarding the implementation of a minimum threshold, with 21% of respondents in favour of a threshold, 33% opposed to this, 30% who did not comment and 12% who were indifferent.

2.46 Those against the threshold believe it will act as a barrier for small innovative firms to carry out R&D. Furthermore, some argued the issue of fraud would not be solved by a threshold as it could incentivise claim inflation among firms trying to reach the threshold to be eligible for the support.

2.47 The respondents in favour of a threshold see it as necessary to cut down on the error and fraud. They also stated that it's difficult to believe that R&D is being carried out for an amount below c. £25,000 as activity being done under this expenditure threshold is unlikely to be pushing the boundaries of science and technology, and therefore unlikely to meet the definition of R&D. However, some of those in favour of a threshold still see a need to help support businesses that will not be eligible if a threshold is introduced, and they propose the possibility of grants to help firms that fall into this category.

2.48 The proposed level for a potential threshold to be set at ranged between £5,000 - £200,000 among respondents. The most common suggested threshold ranged between £10,000 - £25,000.

Chapter 3

Next steps

3.1 The Government has published draft legislation setting out the proposed design of a potential merged scheme, taking into consideration the responses to the consultation. It has also published draft legislation on the support for R&D intensive loss-making SMEs, announced at Spring Budget 2023, which would continue to operate alongside a merged scheme if the Government decides to implement one.

3.2 The Government has not yet taken a decision on whether to merge schemes, but intends to keep open the option of doing so from April 2024 with a decision being made at the next fiscal event. If the Government did decide to merge schemes, this would present significant opportunities for tax simplification. These include having a single set of qualifying rules and being able to remove the exceptions for subcontracting to certain types of entity, known as 'qualifying bodies'.

3.3 The Government considers that an above the line RDEC type scheme would be the best approach if the schemes are merged. This recognises respondents' views that this will make the benefit more visible for firms and easier to factor into R&D investment decisions. The increase in the RDEC rate from 13% to 20% at Autumn Statement 2022 means the UK now has the joint highest uncapped headline rate of tax relief in the G7 for large companies.

3.4 Other benefits of moving to a potential merged scheme based on this proposed design would be the ability for SMEs to benefit from carried forward losses, and the greater spillovers expected by allowing customers to claim for subcontracting.

3.5 If the Government chooses to implement a merged scheme it would result in a change in the timing of relief for some companies, with a small decrease in the immediate cash benefit for SME loss makers, but a greater total benefit due to the ability to carry forward the loss deduction to use in the future if they return to profit.

3.6 The evidence suggests an approach to subcontracting where the customer is able to claim for qualifying payments to a subcontractor would have higher spillover benefits. This is also the preferred approach among the majority of respondents to the consultation. While there could be merit to some alternative approaches, these could bring unnecessary complexity to a scheme where a key purpose of merging is simplification. Under these rules, subcontractors performing R&D for a customer would not be able to claim R&D relief as this would be claimed by the customer instead. However, the government intends for

a merged scheme to have an exception for R&D done by subcontractors who are working for non-UK corporation tax payers to ensure this R&D expenditure continues to qualify for relief.

3.7 The Government would like further discussions to understand how a potential merged scheme could distinguish between 'normal' contracts and 'contracted out R&D' so that those undertaking qualifying R&D are enabled to claim relief, whilst avoiding double claims. The Government will work with industry to further develop its approach to this issue, ahead of making a decision on whether to merge schemes.

3.8 The PAYE/NICs caps exist to stop abuse from overseas companies setting up structures to claim payable tax credit in the UK. However, many respondents raised the point that this would no longer be necessary once the restrictions on overseas subcontracting come into effect. In light of the recently published statistics on error and fraud, the Government's view is that now is not the right time to remove the cap. Therefore, in line with respondents' asks, the Government intends for a merged scheme to have the more generous SME scheme cap if implemented. However, the Government recognises that the cap adds some complexity to the reliefs and will consider in future whether there is a case to remove this once it can be determined that this won't open the system up to abuse.

3.9 The Government recognises the challenges presented to businesses in understanding and adapting to new sets of rules, in particular for SMEs, if a merged scheme is pursued. HMRC are committed to improving the guidance offer for all customers. As well as the commitment to review the Corporate Intangibles Research and Development manual (CIRD), HMRC's technical guidance on the reliefs, HMRC has work in train to consult on new draft guidelines to assist R&D claimants with understanding their obligations (the "Guidelines for Compliance" project).

3.10 The consultation also sought views on the potential introduction of a Minimum Expenditure Threshold and on reforming the rules on Qualifying Indirect Activities (QIAs). The results of the Mandatory Random Enquiry Programme show that in the smallest claims where expenditure was less than £10,000, over 75% of the claim value was non-compliant. It is also accepted that the lack of clarity on the definition of QIAs makes them prone to boundary pushing. In light of the publication of the HMRC Annual Report and Accounts on 17 July, which showed that error and fraud rates have reached the unacceptably high level of 24.4% for the SME scheme in 2020-21, the Government intends to keep these options for reform under consideration.

3.11 The Government now invites views through a technical consultation on the proposed merged scheme design to ensure that the draft legislation captures the policy as intended. A decision on whether to merge schemes will be made at the next fiscal event.

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This document can be downloaded from www.gov.uk

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