SSRO

Single Source Regulations Office

Determination made on 25 May 2022

The treatment of Research and Development Expenditure Credit when determining the extent to which research and development costs are allowable costs under a qualifying defence contract

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The Single Source Regulations Office (SSRO) is an executive non-departmental public body, sponsored by the Ministry of Defence (MOD). It plays a key role in supporting the regulatory framework for single source defence contracts established by Part 2 of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations).

The regulatory framework specifies how contracts that meet the requirements for being qualifying defence contracts (QDCs) or qualifying sub-contracts (QSCs) must be priced and requires transparency over those contracts and from the contractors who hold them. The SSRO may be asked to give an opinion or make a determination on matters related to the regulatory framework in circumstances set out in the Act and Regulations.

Executive summary

1. The Secretary of State for Defence referred a question to the SSRO for determination under section 20(5) of the Defence Reform Act 2014 (the Act). The referral concerned the extent to which research and development (R&D) costs were allowable costs under a qualifying defence contract (QDC). Specifically, the SSRO was asked to determine whether the amount of the R&D costs applied indirectly to the contract through cost recovery rates for a particular year should be offset by research and development expenditure credit (RDEC), a tax credit received by the contractor in respect of those costs. The contract to which the referral relates is for the provision of equipment support.

2. In making its determination on the matter referred, the SSRO reviewed evidence submitted by the MOD at the time of referral and by both parties in response to requests for information concerning the referred contract; the calculation of the contractor's contested cost recovery rates; the R&D costs applied indirectly to the contract; and the contractor's RDEC claim in respect of those costs. We held an oral hearing to allow both parties to present their cases to the Referral Committee and for the Committee to seek clarifications on evidence submitted. We held bilateral meetings with each party to clarify our understanding of the facts of the case. We met representatives of HM Revenue and Customs and HM Treasury to discuss the policy intent and operation of the RDEC scheme and considered government publications related to the scheme. Additionally, we sought and considered evidence from other regulators on the treatment of RDEC in other regulatory frameworks and engaged a specialist R&D tax credit consultancy to assist with understanding the RDEC scheme and its interaction with the requirements of allowable costs.

3. Having considered the evidence available and the SSRO's statutory guidance on the requirements of allowable costs, the SSRO's determination is that there is no need for RDEC received by the contractor in respect of its R&D costs for the particular year to be taken into account when determining the amount of those R&D costs that are allowable costs applied indirectly to the referred contract through cost recovery rates. The basis of the determination is summarised in this document. We are satisfied that the SSRO's guidance on allowable costs does not require RDEC to be offset from the referred R&D costs in order to ensure that:

    a) good value for money is obtained in government expenditure on qualifying defence contracts, and

    b) persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts.

4. We found no compelling evidence to suggest that applying the referred R&D costs to the contract at their full amount would result in an outcome that was not comparable to what occurs in contracts under competition. The determination reflects our understanding of the Government's intention under the RDEC scheme to make R&D activity more profitable for companies, through the payment of RDEC, to encourage greater levels of R&D activity and bring consequential benefits to the UK economy and society.

1. Introduction

1.1 The Secretary of State for Defence referred a question to the SSRO for determination under section 20(5) of the Defence Reform Act 2014 (the Act). The referral concerned the extent to which research and development (R&D) costs were allowable costs under a qualifying defence contract (QDC). Specifically, the SSRO was asked to determine whether the amount of the R&D costs applied indirectly to the contract through cost recovery rates for a particular year should be offset by research and development expenditure credit (RDEC) received by the contractor in respect of those costs.

1.2 The approach taken by the SSRO to investigate and make a determination on the matter referred was consistent with the SSRO's published procedures.[1]

1.3 This document contains an anonymised summary of the SSRO's determination on the referral. The sections of this document explain:

a) the circumstances giving rise to the referral;

b) the matter referred and the costs whose allowability the SSRO was asked to determine;

c) the RDEC scheme enacted under the Corporation Tax Act 2009;

d) the relevant legislation and guidance on the determination of allowable costs which has guided the SSRO's determination on the matter referred;

e) the matters we have considered; and

f) the SSRO's determination on the matter referred.

1.4 The SSRO is grateful to the parties to the referral for their cooperation during the course of the SSRO's investigation of the matter referred.

1 SSRO (2021) *Guidance on the SSRO's Referrals Procedures for Determinations Under the Defence Reform Act 2014.*

2. Background to the referral

2.1 This section sets out the circumstances giving rise to the referral.

Ministry of Defence spending on R&D

2.2 The Ministry of Defence (MOD) spends a significant amount on R&D each year. Its total gross expenditure on R&D in 2020/21 was £1.128 billion.[2] More than two-thirds of this expenditure (£768 million) was with UK businesses.[3] The MOD's R&D spending is set to increase. Through its Defence and Security Industrial Strategy, the Government has committed £6.6 billion of new funding for defence R&D in the period to 2025.[4] This is intended to encourage innovation and enable the development and exploitation of new technologies. The Strategy notes that 'R&D projects and programmes will play an important role in creating, generating, and sustaining the necessary skills, knowledge and capability to maintain a thriving and innovative industrial base'.

Government support for R&D

2.3 The UK Government has for many years been committed to promoting R&D as a driver of economic growth. It seeks to ensure that 'the UK provides an internationally competitive environment for companies to innovate'.[5] To this end, it provides corporation tax reliefs for companies that work on innovative projects in science and technology.

2.4 Since 2013, large companies, or those who have been sub-contracted by them, have been able to claim RDEC (a tax credit[6]) in respect of their qualifying R&D expenditure. In September 2021, the Government estimated that it would receive 9,675 RDEC claims in respect of 2019/20 accounting periods (4,370 claims from large companies and 5,305 claims from small and medium-sized companies (SMEs) that claim RDEC as sub-contractors). These claims were estimated to total £3.1 billion (£2.7 billion claimed by large companies and £375 million claimed by SMEs).[7] HMRC's most recent evaluation of RDEC estimated that for every pound spent on RDEC, between £2.4 and £2.7 is additionally invested in R&D by UK companies.[8]

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2 Ministry of Defence (2021) *MOD Department Resources: 2021 (***link***)*.

3 Office for National Statistics (2022) *Research and Development Expenditure by the UK Government: 2020, Table 14: Analysis of UK government purchased or funding provided for research and development (R&D) by funding and receiving organisations: 2020.*

4 HM Government (2021) *Defence and Security Industrial Strategy: A Strategic Approach to the UK's Defence and Security Industrial Sectors.*

5 HM Treasury (2012) *Consultation on an 'Above the Line' Credit for Research and Development.*

6 HM Revenue & Customs (2020) *Claiming Research and Development Tax Reliefs* (**link**) **(Accessed 4 March 2022).**

7 HM Revenue & Customs (2021) *Research and Development Tax Credits Statistics: September 2021* (**link**).

8 HM Revenue & Customs (2020) *Evaluation of the Research and Development Expenditure Credit (RDEC): HMRC Working Paper 20.*

The treatment of RDEC paid in respect of expenditure under government contracts

2.5 The treatment of RDEC received by companies in respect of qualifying expenditure on R&D performed under single source defence contracts, has been a long-standing issue. Industry raised concerns about this with HM Treasury in 2012, in response to the Government's consultation on the introduction of RDEC as an 'above the line' credit to replace the pre-existing R&D tax relief for large companies.[9] Respondents believed that the MOD would look to 'claw back' an above the line credit in the pricing of its non-competitive R&D contracts, effectively removing the benefit that had, until then, been provided as a deduction in calculating the taxable profits of the claimant. Some also believed that foreign governments would take a similar approach.

2.6 In response, the Government said that the treatment of R&D tax relief in the pricing of MOD single source contracts was a matter of procurement policy. It proposed that the matter be reviewed as part of the MOD's response to the review of its single source pricing regulations undertaken by Lord Currie of Marylebone in 2011.[10] It also noted that the SSRO was due to be set up in 2014/15 and would, following consultation with the MOD and industry, 'make a recommendation on the "fair and reasonable" treatment of R&D relief in the pricing of MOD single-source contracts' considering 'the implications for levels of R&D investment in the UK defence sector'.

2.7 In 2014, prior to the SSRO's establishment, the Review Board for Government Contracts[11] (RBGC), at the request of the MOD and the Joint Review Board Advisory Committee,[12] reviewed the treatment of RDEC in the Government Accounting Conventions[13] (GAC). The aim was 'to enable MOD to make recommendations in preparation for the transition to the baseline Single Source Costs Standards (SSCS) on the formation of the SSRO'.[14] The RBGC's analysis of HMRC R&D Tax Credit Statistics released in Aug 2013 suggested that the impact of RDEC on the profitability of the Reference Group[15] whose average rate of return was used to determine the target rate of return in the Government Profit Formula (GPF) would be small. This was accepted by both parties. No adjustment to the Reference Group

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9 HM Treasury (2012) *Consultation on an 'Above the Line' Credit for Research and Development.*

10 Lord Currie of Marylebone (2011) *Review of Single Source Pricing Regulations. In 2011, Lord Currie's review had recommended that the Government Accounting Conventions be updated into 'Accounting Regulations… a comprehensive statement of costs allowable in both contract pricing and in overhead recovery (eg, through rates)' (E.122). It said that the SSRO should be responsible for developing and issuing the appropriate regulations and that adherence to the regulations would be a matter for the MOD and contractors (E.123). Research and development was noted by Lord Currie as one of a number of 'significant issues' to which attention should be given, with the regulations giving 'a clear statement of what costs are not to be included in contract pricing' (E.125).*

11 The body responsible for reviewing and maintaining the Government Profit Formula used by the MOD when pricing single source work prior to the introduction of the Single Source Contract Regulations 2014 and establishment of the SSRO.

12 A body comprising representatives of the Confederation of British Industry (CBI) and those trade associations and companies that had particular interest in non-competitive government contracts.

13 Accounting conventions, agreed from time to time between the MOD acting on behalf of the Government and the CBI acting on behalf of industry, used to determine costs and capital employed attributable to non-competitive government contracts.

14 Review Board for Government Contracts (2014) *2014 Annual Review of the Profit Formula for Non-competitive Government Contracts,* paragraphs 504 to 514.

15 The group of UK companies, representative of British industry, whose average rate of return was used by the RBGC to determine the target rate of return in the GPF

data was recommended. The RBGC considered it fair and reasonable that a GPF contract should be priced on the cost of carrying out MOD-funded R&D that is net of any above the line RDEC.

The SSRO's initial guidance on costs

2.8 The SSRO published its first statutory guidance on allowable costs on 26 January 2015, following a public consultation.[16] In many respects this reflected the approach to costs taken by the RBGC, pending further review. It contained the following guidance on R&D tax credits.

12.20 Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure must be offset against Allowable Costs. This can include tax reductions or cash offsets that reduce the tax liability. The costs associated with making such claims would generally be Allowable.

12.21 The matching principle needs to be applied so that tax rebates that relate to research and development are accounted for and offset against the relevant expenditure.

The SSRO's 2018 guidance consultation

2.9 As part of a programme of work to review and update its allowable costs guidance, the SSRO engaged with stakeholders during summer 2018 on its guidance on R&D costs. A consultation on changes to the guidance ran from October to December 2018.[17] The SSRO's proposals were informed by the following considerations:

a) There were many tax credits and other reliefs in place globally.

b) Guidance should be principles-based rather than written with a specific credit in mind so that it can be generally applied.

c) It would be preferable for guidance on offsets against costs to be dealt with in a single section rather than in two places (part D.1.6 dealing with credit gained through the taxation system as a result of R&D and part E.4.1 dealing with reimbursements, credits, grants or refunds received that cannot be identified to a particular contract).

d) A particular allowable cost should reflect the net cost to the contractor, so any cost claimed should take account of any amounts received by the contractor that directly reimburse a part of all of that cost.

e) It is unnecessary to offset benefits received by the contractor that are not intended to reimburse a particular cost. We considered that generic grants and tax credits (including RDEC) were not given with a view to reimburse particular costs and, therefore, were not relevant to the determination of allowable costs.

f) Generic grants and tax credits (including RDEC) were given as a matter of government policy and our guidance should not alter those policy objectives.

g) The costs of making claims should be allowable if the claimed credit is offset against allowable costs, although specific guidance on this was not required.

16 SSRO (2015) *Single Source Cost Standards: Statutory Guidance on Allowable Costs.*
17 SSRO (2018) *Pricing Guidance Review 2018: Consultation on Changes for 2019/20.*

2.10 Following consideration of the consultation responses, the SSRO published updated guidance in February 2019 for application from 1 April 2019.[18] The updated guidance:

a) removed the explicit requirement when determining allowable R&D costs to offset any benefits or credits gained by contractors through the taxation system as a result of those costs; and

b) introduced principles-based guidance to assist the parties to contracts to determine an appropriate treatment for credits in general.

2.11 The SSRO published a response to consultation feedback alongside the updated guidance. The SSRO's consultation response[19] identified the following factors that had informed the final guidance.

a) The MOD and contractors had differing views on whether it was the policy intent of RDEC to reimburse a particular cost. The SSRO had been unable to identify any particular aspect of the rules on RDEC claims which directed how the ultimate benefits should be distributed between customers and shareholders. In the absence of clarity regarding the intent of the policy we did not consider it appropriate for the SSRO's guidance to provide unequivocal direction on the matter.

b) Allowable costs should reflect the net costs incurred by the contractor and costs should only be recovered once. Where the cost the contractor incurred was lower than it otherwise might have been, for example because a discount had been applied or it had been recouped from another source, then that reduction should be reflected in the costs claimed from the MOD as Allowable Costs.

c) Given the many sources of income, tax credits and other reliefs which may (or may not) act to reimburse a particular cost, and the need for the guidance to be broadly applicable, we included guidance (paragraph E.4.3) to assist the parties to agree an appropriate treatment for credits taking account of the specificities of the case.

2.12 There have been no subsequent changes to the SSRO's guidance on credits.

Impact of the change in guidance

2.13 Under the guidance in force to April 2019, RDEC was treated as an allowable credit against the contractor's expenditure and apportioned among all direct hours of the business when calculating its actual cost recovery rates. This had the impact of reducing the rates of the business that were applied in the pricing of QDCs.

2.14 The change in the SSRO's guidance in 2019 has given rise to differing views between the MOD and the contractor as to the appropriate treatment of RDEC when determining allowable costs. The positions of the parties to this referral are summarised below:

a) The MOD believes that RDEC should be offset from R&D costs. It considers that if RDEC received by a contractor is not offset from R&D costs when determining whether those costs are allowable costs under a QDC:

i) the contractor recovers some amount of its R&D costs more than once,

18 SSRO (2019) *Pricing Guidance Review 2018: Changes for 2019/20.*
19 SSRO (2019) *Pricing Guidance Review 2018: Summary of Consultation Responses.*

contravening the SSRO's allowable costs guidance;

ii) the Government effectively pays twice for the same costs, which would reduce the value for money it receives on contract expenditure; and

iii) the contractor earns an inappropriate level of return on a regulated contract.

b) The contractor considers that the removal from the SSRO's guidance of an explicit reference to RDEC means it should no longer be included in the calculation of allowable costs. It argues that RDEC is not a credit that reduces its R&D costs but, rather, one that discharges its tax liability. As tax costs are not allowable costs, it considers RDEC is not relevant to the determination of allowable costs.

2.15 We consider the more detailed points put forward by each party to the referral in section 6 of this determination.

3. The matter referred

3.1 We describe below the matter the SSRO has been asked to determine.

The referral

3.2 On 28 October 2021, the MOD on behalf of the Secretary of State for Defence asked the SSRO to make a determination under section 20(5) of the Defence Reform Act 2014. The referral concerned the extent to which R&D costs (applied indirectly to a contract through cost recovery rates) were allowable under a QDC. Specifically, the SSRO was asked to determine whether the amount of the R&D costs that the contractor had included in calculating its actual cost recovery rates for a particular year should be offset by an amount of RDEC received by the contractor through the UK corporation tax system in respect of those costs. Through the determination, the MOD sought to establish the principles guiding the treatment of RDEC that would also inform:

a) the agreement of forward rates to be used in determining a firm price for the referred contract; and

b) the approach to take with regard to RDEC in other qualifying contracts.

The referred contract

3.3 The contract to which the referral relates is the for the provision of equipment support (hereafter, ‘the referred contract’ or ‘the contract’). Under the referred contract, the contractor is required to provide a range of support related to systems and equipment over a five-year period. This includes technical support, provision of capital spares and equipment repairs, and the provision of consumable spares. The statement of work details the scope of the support to be provided and the associated expectations on the contractor to undertake project, risk, quality, obsolescence and safety management activities. The contract requires the contractor to develop solutions to address obsolescence and safety issues and to improve equipment availability.

Pricing of the contract

3.4 The price of a QDC is subject to controls imposed by the Act and the Single Source Contract Regulations 2014 (the Regulations). Regulation 10(1) requires the price payable under a QDC to be determined in accordance with the pricing formula:

Price = (CPR x AC) + AC

3.5 In the pricing formula, ‘CPR’ is the contract profit rate for the contract, determined in accordance with regulation 11. ‘AC’ is the primary contractor’s allowable costs determined in accordance with one of the six regulated pricing methods described in paragraphs (4) to (11) of regulation 10.

3.6 The contract was agreed with a provisional price as the labour rates that would be used to price the contract remained subject to agreement. The treatment of RDEC in determining the amount of R&D costs to include in the rates was one of the matters requiring agreement. The rates used to determine the provisional price excluded any offset for RDEC received in respect of R&D costs which were included in the rates calculation.

3.7 The contract provides that:

a) the price is provisional in respect of the labour rates used to calculate costs;

b) once forward pricing rates are agreed, the parties will meet to consider whether it is necessary to re-price the contract; and

c) the price on redetermination by the parties will be a firm price.

3.8 The MOD reported that the timeline for agreeing the forward pricing rates and any consequent redetermination of the contract price was yet to be established with the contractor.

3.9 The estimated allowable costs are comprised of bid costs, labour, material, and risk and expenses. Labour costs account for 67 per cent of the total estimated costs.

3.10 The bid and labour costs are calculated by applying hourly labour rates to an amount of hours for which staff are expected to be engaged in performing the requirements of the contract. The labour rates are for groups of staff undertaking different roles, for example, engineers, project managers, technicians, projects support and graduates.

3.11 The contractor provided a contract price breakdown which details the hours required by each staff group to develop the proposal and to perform the contract. The bid costs relate to work by staff in ten cost centres. The labour costs for years 1 to 5 of the contract are based on an annual estimate of work by staff in 17 cost centres. Engineering staff (two cost centres) account for almost half (49 per cent) of the total labour hours in these years.

RDEC received by the contractor

3.12 The contractor reported that it received RDEC in respect of qualifying R&D expenditure in the particular year. The amount of qualifying R&D expenditure is established each year, with support from specialist advisors, by reviewing the company's prior year expenditure. The RDEC claim is submitted as part of the company's tax return and is subject to HMRC agreement.

3.13 The contractor provided a breakdown of the qualifying R&D expenditure in the particular year and its associated RDEC. The majority (97.5 per cent) of the qualifying R&D expenditure was labour costs incurred in the performance of R&D under contracts. The remainder was the result of non-contract (self-directed) R&D. The contractor provided the names of seven projects which accounted for 86 per cent of the self-directed R&D labour costs. The MOD indicated that this information had not been supplied to it prior to the referral investigation.

The contractor's approach to accounting for RDEC

3.14 The contractor said that the treatment of RDEC in its statutory accounts is informed by consideration of two international accounting standards, IAS12 Income Taxes and IAS20 Accounting for Government Grants and Disclosure of Government Assistance. While recognising that RDEC is not a government grant, it said it uses IAS20 when preparing its statutory accounts. IAS20.29 states that 'Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense'.

3.15 The contractor's statutory accounts for the particular year indicate that RDEC was included in cost of sales in the calculation of its operating profit. The contractor stated that the amount of RDEC it reported in its statutory accounts each year was an estimate as the actual amount of credit was unknown at the time the statutory accounts were prepared. Any adjustment required due to variance between the estimated and actual amounts was reflected in subsequent statutory accounts. The contractor provided a breakdown of the RDEC reported in its statutory accounts for the particular year which included adjustments relating to RDEC reported in prior years' accounts.

3.16 The contractor stated that the difference between the estimated RDEC at the time of accounts preparation for the particular year and the actual amount received is due to the final agreed figure for qualifying R&D spend in the particular year being lower than estimated when the accounts were prepared. It advised that an associated true-down adjustment was reported in the statutory accounts for the subsequent year.

3.17 The contractor reported that the RDEC received in respect of qualifying R&D expenditure for the particular year was applied in line with the HMRC's guidance to settle the company's corporation tax liability. No residual payment was received by the contractor from HMRC in relation to RDEC for that year.

The contested costs

3.18 The contractor's approach to calculating labour rates for the particular year is described in its Questionnaire on the Method of Allocation of Costs (QMAC). The contractor provided clarification on its approach. Employees are assigned to cost centres depending on their function. The charge-out rate for each cost centre is calculated by summing all the salary and payroll costs for staff within the cost centre with any overhead costs allocated to the cost centre (the numerator) and dividing this by the total number of utilised hours for staff within the cost centre (the denominator). Only hours performed on direct contract work are included within the calculation of the denominator. Using this method, the costs associated with time spent on non-contract activities, including non-contract R&D, are recovered through an uplift to the hourly charge-out rate for the cost centres undertaking those activities.

3.19 The contractor provided information about the costs and hours which had been used to calculate the actual rates for the particular year for its different cost centres. This included the ten cost centres used in calculating the bid price, and the additional seven cost centres which (in subsequent years) would also be used to calculate the labour costs under the contract.

3.20 The total amount of costs included in the calculation of labour rates for the particular year included qualifying R&D expenditure on which RDEC was claimed. In accordance with the methodology described above, the hours associated with the R&D labour costs under contracts were included in the rates calculation, but the hours associated with the non-contract R&D costs were excluded.

3.21 The contractor did not offset the RDEC received from the R&D costs included in the rates calculation for the particular year. The contractor has not made any allowance for RDEC in the forward rates used to determine the provisional price of the contract. As noted previously, the approach taken by the contractor prior to April 2019 was to make an adjustment for RDEC in the calculation of actual rates.

4. Research and Development Expenditure Credit

4.1 We summarise below key features of the RDEC scheme, which provides corporation tax relief related to a company's qualifying R&D costs.

Background

4.2 RDEC is a form of corporation tax relief that supports companies that work on innovative projects in science and technology. RDEC can be claimed by large companies seeking to research or develop an advance in their field (including when contracted to do so by another person) or small to medium-sized companies that have been sub-contracted to do R&D work by a large company.[20]

4.3 Chapter 6A of the Corporation Tax Act 2009 (CTA 2009) establishes a legislative scheme for RDEC. HM Revenue and Customs (HMRC) provides guidance within the Corporate Intangibles Research and Development (CIRD) Manual for companies wishing to make a claim for RDEC.

4.4 The CTA 2009 makes detailed provision for the circumstances in which a company is entitled to RDEC, the amount of any entitlement and payment of the credit. Where a company is entitled to RDEC for an accounting period, it is taken into account as a receipt of the company in calculating its profit for that period.[21] A seven-step process must be followed during which the credit is applied to discharge the company's or its group members' tax and other liabilities to HMRC before any payment is made to the claimant.[22]

4.5 The SSRO's attention was drawn to the fact that an R&D tax relief was first introduced for large companies in 2002 to complement the support already available to smaller companies. The Government indicated that it wished to encourage enterprise and innovation by helping businesses 'to overcome some of the barriers to longer-term investment created by the market, especially where there are wider benefits above and beyond those going to the firm making the investment'.[23]

4.6 RDEC was introduced into the CTA 2009 by the Finance Act 2013. It applies to R&D expenditure incurred on or after 1 April 2013. The RDEC scheme ran concurrently with the large company scheme for R&D expenditure until 31 March 2016. From April 2016, it replaced the support previously provided to large companies.[24] The RDEC scheme did not alter the way qualifying activity was identified or how qualifying expenditure was calculated, but it did change the method by which relief was given.[25]

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20 HM Revenue & Customs (2021) *Claim Research and Development (R&D) Expenditure Credit* (link).
21 Section 104A(1) of CTA 2009.
22 Section 104N of CTA 2009.
23 HM Treasury (2001) *Budget 2001: Investing for the Long Term: Building Opportunity and Prosperity for All.*
24 HM Revenue & Customs (2016, updated 2022) *Corporate Intangibles Research and Development Manual*, CIRD89710.
25 HM Revenue & Customs (2016, updated 2022) *Corporate Intangibles Research and Development Manual*, CIRD89705.

4.7 The large company scheme support was accounted for ‘below the line’ as a super-deduction in calculating the taxable profit of the claimant, thereby reducing the company’s tax liability or increasing tax losses. RDEC is accounted for ‘above the line’, increasing the claimant’s operating profit, as illustrated below.

Illustration of different treatments of R&D tax relief

		Below the line Large company R&D tax relief (£000)		Above the line (ATL) RDEC (£000)
Turnover		2,400		2,400
R&D expenditure	(1,000)		(1,000)	
ATL credit 10%	-	(1,000)	100	(900)
Other expenditure		(1,000)		(1,000)
Profit/ (loss)		400		500
Superdeduction 30%		(300)		-
Taxable profit/loss		100		500
Tax @25%		25		125
ATL credit		-		(100)
Tax payable		25		25
Tax saved		75		75

4.8 As an above the line credit, RDEC was designed to increase visibility of the tax relief to corporate stakeholders and improve certainty of relief for companies by separating the calculation of the credit from the company’s wider tax position. It also provided greater financial and cash flow support to companies with no corporation tax liability.[26] Profit-making and loss-making companies can both claim credits under the RDEC scheme, whereas only profit-making companies could benefit from the large-company scheme. The amount of the credit received is not contingent on whether the claimant makes a profit or a loss. The above the line, taxable treatment of the relief also enabled the Government to provide a more generous headline rate of support at no additional cost.[27] It was considered that these changes would make the UK a more attractive location for large company R&D investment, leading to an increase in the level of R&D activity in the UK.[28]

Qualifying R&D

4.9 The work that qualifies for relief under the RDEC scheme must be part of a specific project to make an advance in science or technology. The project must relate to the claiming company’s trade, whether existing or one that it intends to start up based on the results of the R&D. Qualifying projects may research or develop a new process, product or service or improve on an existing one. To claim RDEC a company must explain how its projects:

a) looked for an advance in science and technology;

b) had to overcome uncertainty;

c) tried to overcome this uncertainty; and

26 HM Treasury (2012) *‘Above the Line’ Credit for Research and Development: Response to Consultation.*
27 HM Treasury (2012) *Consultation on an ‘Above the Line’ Credit for Research and Development.*
28 HM Treasury (2012) *‘Above the Line’ Credit for Research and Development: Response to Consultation.*

d) could not be easily worked out by a professional in the field.

Qualifying expenditure

4.10 A company can claim costs on a project from the date it starts working on the uncertainty until it develops or discovers the advance, or the project is stopped. A claim can be made up to two years after the end of the accounting period to which it relates. Claims can be made for:

a) staff costs – being:

- a proportion of the salaries, wages, Class 1 National Insurance contributions and pension fund contributions of staff working directly on the project, including administrative or support staff who work directly to support a project but not for staff doing clerical or maintenance work that would have been done anyway; and
- 65% of relevant payments made to an external agency that provides staff for the project;

b) sub-contracted expenditure undertaken by:

- a charity;
- a higher education institute;
- a scientific research organisation;
- a health service body; or
- an individual or partnership of individuals; and

c) consumable items used up in the R&D including materials and utilities.

Amount of credit

4.11 The amount of credit is calculated as a percentage of the claiming company's qualifying R&D expenditure. The rate of credit as a percentage of qualifying R&D expenditure has increased over time:

- 11 per cent up to 31 December 2017;
- 12 per cent from 1 January 2018 to 31 March 2020; and
- 13 per cent from 1 April 2020.

4.12 The credit is taxable at the main rate of corporation tax; presently, 19 per cent.

Claiming RDEC

4.13 RDEC, along with other R&D reliefs, is administered by HMRC as part of the corporation tax system. A company will claim RDEC by entering its qualifying expenditure into its company tax return form. A separate claim should be made for each accounting period. Companies have a period of one year to submit returns after the end of the accounting period and another year to amend or withdraw a claim. Companies are required to keep records in support of their claims. HMRC can request these records if enquiring into a claim. The Government has indicated that this system for claiming RDEC makes it easy for companies to claim and take full advantage of the relief.[29]

29 HM Treasury and HM Revenue & Customs (2021) *R&D Tax Reliefs: Consultation*

How the credit is to be applied

4.14 The payable credit is subject to certain restrictions. Section 104N(2) of the CTA 2009 and HMRC guidance (CIRD 89780) sets out the steps that a company must take to apply RDEC in the settlement of liabilities to HMRC before any payment can be made. These steps are shown below.

> **Section 104N(2) of CTA 2009**
>
> The amount to which the company is entitled in respect of the R&D expenditure credit (the set-off amount) is to be treated in the following way—
>
> Step 1 The set-off amount is to be applied in discharging any liability of the company to pay corporation tax for the accounting period. If any of the set-off amount is remaining, go to step 2.
>
> Step 2 If the amount remaining after step 1 is greater than the net value of the set-off amount (see subsection (3)), that amount is to be reduced to the net value of the set-off amount. For provision about the treatment of the amount deducted under this step from the amount remaining after step 1, see section 104O.
>
> Step 3 If the amount remaining after step 2 is greater than the company's total expenditure on workers for the accounting period (see section 104P)—
>
> a) that amount is to be reduced to the amount of that expenditure (which may be nil), and
>
> b) the amount deducted under paragraph (a) from the amount remaining after step 2 is to be treated for the purposes of this section as an amount of R&D expenditure credit to which the company is entitled for its next accounting period.
>
> If any of the set-off amount is remaining, go to step 4.
>
> Step 4 The amount remaining after step 3 is to be applied in discharging any liability of the company to pay corporation tax for any other accounting period. If any of the set-off amount is remaining, go to step 5.
>
> Step 5 If the company is a member of a group, it may surrender the whole or any part of the amount remaining after step 4 to any other member of the group (see section 104R). If no such surrender is made, or any of the set-off amount is otherwise remaining, go to step 6.
>
> Step 6 The amount remaining after step 5 is to be applied in discharging any other liability of the company to pay a sum to the Commissioners under or by virtue of an enactment or under a contract settlement. If any of the set-off amount is remaining, go to step 7.
>
> Step 7 The amount remaining after step 6 is payable to the company by an officer of Revenue and Customs. But this is subject to section 104S (restrictions on payment of R&D expenditure credit).

Accounting treatment

4.15 Section 46 of the CTA 2009 requires that the profits of a trade must be calculated in accordance with generally accepted accounting practice (GAAP), subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes. Section 104A(1) provides that RDEC is to be brought into account as a receipt in calculating the profits of the trade for an accounting period.

4.16 Accounting standards guide the treatment that is applied to expenditure and income in the preparation of statutory accounts. We were advised that following the Government's consultation on the implementation of an above the line credit, it was broadly accepted that companies may rely on either IAS12 Income Taxes or IAS20 Accounting for Government Grants and Disclosure of Government Assistance when deciding the appropriate treatment of RDEC in statutory accounts. These standards can only be applied by analogy, as neither was written with RDEC in mind.

4.17 Under IAS20, RDEC may be accounted for above the line within profit and loss as other income. Under IAS12 it may be accounted for by making an adjustment to the tax line in the accounts. The ability to choose the presentational treatment of RDEC in statutory accounts does not alter the substance of the credit.

5. Relevant legislation and guidance

5.1 We indicate below the relevant legislation and guidance on the determination of allowable costs which has guided the SSRO's determination on the matter referred.

The requirements of allowable costs

5.2 Section 20(2) of the Act requires that in determining whether a particular cost is an allowable cost under a qualifying defence contract, the Secretary of State or an authorised person, and the primary contractor, must be satisfied that the cost is:

a) appropriate;

b) attributable to the contract; and

c) reasonable in the circumstances.

5.3 In determining whether the requirements of allowable costs ('the AAR test') are met in relation to a particular cost, the Secretary of State or an authorised person, and the primary contractor, must have regard to guidance issued by the SSRO under section 20(1) of the Act. The SSRO has issued relevant guidance, which is extracted in Appendix 1 and outlined below.

The SSRO's guidance on allowable costs

5.4 The SSRO publishes guidance to assist the Secretary of State and contractors to determine whether costs are allowable costs under QDCs. The SSRO updates its allowable costs guidance from time to time, in consultation with stakeholders, to reflect changes in legislation, good practice and learning from experience. The guidance we have considered in this determination is version 5 which was published on 16 March 2020 and applies to contracts, including the referred contract, which became QDCs on or after 1 April 2020. In all respects material to this determination, version 5 of the guidance was unchanged from the preceding version.

The AAR principles

5.5 The SSRO's guidance (see Appendix 1) sets out the typical characteristics of costs that meet the requirements of Allowable Costs (the AAR principles). The guidance makes clear that the requirements of allowable costs apply whether the contractor's costs are estimated or actual, and whether they are applied to the contract as a direct cost or as an indirect cost.

5.6 The guidance notes that determining whether each requirement is met for a particular cost requires judgement regarding:

a) the relative importance of the characteristics identified in the guidance to the particular cost under consideration; and

b) the type and standard of information that is required to be satisfied that the cost demonstrates the characteristics identified in the guidance.

Guidance on specific categories of cost

5.7 Section 5 of the Allowable Costs Guidance provides additional guidance to assist users in determining whether specific categories of cost are allowable costs.

5.8 Part D relates to research and development costs. As the only aspect of the costs we have been asked to determine is the treatment of RDEC we have not had need to consider the guidance in part D.

5.9 Part E.4 relates to credits. This guidance is intended to assist the relevant parties to determine the appropriate treatment of a credit when determining allowable costs. It is of particular relevance to the determination of this case.

Matters to which the SSRO has had regard in making the determination

5.10 In carrying out its functions under Part 2 of the Act, the SSRO must aim to ensure:

a) that good value for money is obtained in government expenditure on QDCs; and

b) that persons (other than the Secretary of State) who are parties to QDCs are paid a fair and reasonable price under those contracts.

5.11 The SSRO has sought to achieve these aims when making its determination on the matter referred by:

a) applying its guidance on the requirements of allowable costs to the R&D costs incurred by the contractor which were applied indirectly to the referred contract;

b) considering what value is being obtained by the MOD from its expenditure on the QDC in question;

c) considering the value the Government is seeking to generate through the payment of RDEC in respect of the contractor's qualifying R&D expenditure; and

d) considering the treatment of RDEC, and its effect, within the pricing of contracts outside of the single source procurement framework.

5.12 When making a determination under section 20(5) of the Act, the SSRO is required by regulations 19(3) and 54 to have regard to a number of matters. We considered each of the paragraphs in regulations 19(3) and 54 in our determination and references to the material considerations are included in this summary. These principally concern the Allowable Costs guidance which was in force at the material time and how this was considered by the parties.

6. Matters considered in making the determination

6.1 We discuss below the matters considered by the SSRO in making its determination on the question of whether RDEC received by the contractor should be offset from R&D costs when determining the extent to which those costs are allowable costs under the referred contract.

Guidance on the AAR test

6.2 We considered the matter referred with reference to the SSRO's guidance on the requirements of allowable costs.

Appropriate

6.3 The SSRO's guidance on costs which are appropriate is set out in Appendix 1. The guidance requires that costs which are included in allowable costs when determining the contract price should be those which it is reasonable to expect would be incurred by a contractor performing the requirements of the contract.

6.4 One of the characteristics of costs that are appropriate is that a reasonable person informed of the facts would consider that they enable the performance of the contract in question (paragraph 3.11(a) of the SSRO's guidance). Paragraph 3.8 of the guidance explains that costs that enable the performance of the contract include those suitably and necessarily incurred by the contractor to:

a) deliver the contract in question; or

b) deliver multiple contracts including the contract in question and equitably apportioned to those contracts.

6.5 Paragraph 3.9 indicates that delivering the contract in question may require sustaining an essential or desirable capability. The SSRO considers that, in some cases, costs arising from R&D may be regarded as necessary to sustain an essential or desirable capability.

6.6 The MOD did not ask the SSRO to determine whether the R&D costs applied indirectly to the contract through the actual labour rates for the particular year (the referred R&D costs) are appropriate. There was no argument made that the referred R&D costs would not satisfy the requirement.

6.7 The MOD said that its Cost Assurance and Analysis Service (CAAS) and Single Source Pricing Support (SSPS) team would scrutinise a contractor's R&D costs applied indirectly to QDCs. Where the MOD considered the R&D giving rise to costs was of potential benefit, the MOD may consider the costs allowable. The MOD indicated during our investigation that it considered the referred R&D costs were appropriate. It subsequently said it would reserve judgement on the allowability of these costs until the determination had concluded.

6.8 For the purposes of this referral we have assumed the referred R&D costs are appropriate.

Attributable to the contract

6.9 The SSRO's guidance on costs which are attributable to the contract is set out in Appendix 1. It requires that the costs which are included in allowable costs when determining the contract price are those incurred directly or indirectly by the contractor in performance of the contract and that the costs are not recovered from another source.

6.10 Part D in section 5 of the SSRO's guidance provides additional guidance on how the AAR test should be applied in relation to R&D costs. Paragraph D.2.1 indicates that some proportion of R&D costs applied indirectly to contracts may be attributable to a QDC if it (the R&D giving rise to costs) enables the QDC's performance. Determining whether R&D giving rise to costs applied indirectly enables a contract's performance requires consideration of whether the contract necessitated the research, either expressly or by implication (D.2.2). The guidance at D.2.2 indicates that some research may be considered necessary if it is required to maintain capability to perform the contract.

6.11 The MOD did not ask the SSRO to determine whether the referred R&D costs met the requirement of being attributable to the contract. The MOD indicated that it has annual discussions with its larger suppliers about the sorts of activities that it would accept are attributable to MOD contracts, the costs of which it would consider were allowable costs to be recovered through overheads. It said it would agree to fund R&D expenditure which contributed to building a supplier's capacity to serve the MOD and fulfil defence contracts in the future.

6.12 We have not sought to establish whether the total amount of the referred R&D costs met the requirement of being attributable to the contract. We note that the referred contract did not expressly require the performance of the R&D whose costs have been applied indirectly to it. The parties would, therefore, need to be satisfied that the R&D giving rise to the costs was necessary to maintain the contractor's capability to perform the contract.

6.13 The referral focused specifically on an amount of the referred R&D costs which the MOD believed was effectively paid for by the Government through the RDEC scheme. The MOD argued that this portion of the R&D costs was not met (incurred) by the contractor and was, therefore, not attributable to the referred contract.

6.14 We concur with the MOD that determining the extent to which the referred R&D costs are attributable to the contract requires consideration of the extent to which those costs were incurred by the contractor. We considered two ways in which the R&D costs incurred by the contractor (and attributable to the contract) could have been less than the amount claimed. Either:

a) an amount of the claimed R&D costs was not incurred by the contractor but, as the MOD suggested, incurred by the Government through the RDEC scheme; or

b) the amount of the costs incurred by the contractor was less than that claimed due to the receipt of RDEC.

6.15 In relation to a), the referred R&D costs were salaries paid by the contractor to its staff and materials purchased by the contractor from suppliers. It is our view that, in the circumstances, the R&D costs were incurred by the contractor and not by the Government. This view was supported by our expert adviser. They saw insufficient

connection between the payment of RDEC and the R&D costs in respect of which it was paid to suggest that the costs had been incurred by the Government. They noted that RDEC was a form of tax relief, which was required to be offset against tax and other liabilities before any payable credit was issued. Any payable credit had no prescribed function, could be used for any purpose and was likely to be received some time after the expenditure was incurred.

6.16 In relation to b), the SSRO's guidance on credits at part E.4 of section 5 is intended to assist in the consideration of whether a credit reduces a particular cost incurred by the contractor. If a credit does not reduce a particular cost incurred by a contractor, the cost incurred is unaffected and the credit is not relevant to the determination of allowable costs. If a credit does reduce a particular cost, it should be offset when determining the amount of the cost that is allowable. We consider the application of the guidance on credits later in this section.

Reasonable in the circumstances

6.17 The SSRO's guidance on costs which are reasonable in the circumstances is set out in Appendix 1. It requires that the costs which are included in allowable costs when determining the contract price are of an amount which it is reasonable to expect a contractor would incur in performing the contract, having regard to economy and efficiency and circumstances which may influence the amount of costs incurred.

6.18 The MOD argued that including the full amount of the contractor's R&D costs in the rates calculation would result in the amount of the referred R&D costs being higher than was reasonable given, it said, that the contractor had not incurred the full amount of those costs due to the RDEC paid. The MOD went on to argue that if the referred R&D costs were not offset by RDEC, the resulting contract price and the effective profit rate paid on the referred R&D costs would go beyond what was reasonable and beyond what was necessary to incentivise the contractor to undertake R&D activity. We consider these related points later.

6.19 The contractor argued that its R&D costs, which were principally the salaries paid to employees performing R&D activities, were unaltered by the payment of RDEC. It considered that the RDEC it had received was intended to reduce the tax it paid. It noted that it was required by law to use the RDEC it had received to settle its corporation tax and other liabilities to HMRC. It reported that in the particular year the RDEC the contractor received had been used to offset its corporation tax liability. It was, therefore, in its view, reasonable for its R&D costs to be included in the rates calculation at their full value.

6.20 We have not examined the referred R&D costs in sufficient detail to determine whether they meet the requirement of being reasonable in the circumstances in all respects. Our consideration of whether the referred R&D costs meet this requirement has been confined to the question of the whether the costs were reduced by the RDEC that the contractor received. If they were, the amount that would be considered to meet this requirement would be the net amount. As noted above, the SSRO's guidance on credits at part E.4 of section 5 is intended to assist in the consideration of whether a credit reduces a particular cost. We consider the application of the guidance on credits in the following section.

Guidance on credits

6.21 Part E.4 of section 5 of the SSRO's Allowable Costs guidance addresses credits. This is set out in Appendix 1. The guidance is intended to assist in establishing the appropriate treatment of a credit received by a contractor when determining whether the contractor's costs meet the requirements of being attributable to the contract and reasonable in the circumstances. The term 'credits' includes but is not limited to 'reimbursements, grants, discounts or refunds'; items whose effect is to alleviate the burden of meeting specific costs, typically before or around the time that the costs arise.

Only credits that reduce a particular cost are relevant

6.22 The guidance requires that allowable costs should be net of any credits that reduce a particular cost for the contractor (paragraph E.4.1). Accordingly, the amount of a particular cost included as an allowable cost in the pricing of the contract should reflect the cost incurred (or met) by the contractor. If a credit received by the contractor has the effect of reducing an amount incurred by a contractor in respect of goods or services (for example, by reducing or otherwise discharging the contractor's obligation to pay the associated cost), the amount of the cost that may be allowable under the contract is the amount paid net of the credit. For example, if a contractor pays £100 for goods or services and receives a credit of £10 which reduces the cost of that transaction, the cost incurred is £90. In this example, the contractor should not seek to recover more than the £90 as an allowable cost under qualifying contracts.

6.23 The guidance makes clear that credits that do not reduce a particular cost incurred by the contractor are not relevant to the determination of allowable costs (paragraph E.4.2). Both parties agreed that this was the appropriate test to consider.

6.24 The guidance at paragraph E.4.3 and its sub-sections sets out matters that are to be considered when establishing whether a credit should be treated as having the effect of reducing a cost incurred by the contractor. We set out below how the parties to the referral have considered these matters and the SSRO's consideration.

Method of treatment

6.25 The guidance at paragraph E.4.3 requires that the treatment of a particular credit should be consistent with the contractor's overarching cost accounting practices or use a methodology agreed with the Secretary of State. This echoes the guidance provided in paragraph 3.12(c) which requires that for a cost to be attributable to the contract it must be applied directly or indirectly to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State.

6.26 The intention of seeking consistency between the application of costs and credits to a QDC and the general application of costs and credits across the rest of the contractor's business is to avoid costs or credits being applied to a QDC in a way that is detrimental to either the Secretary of State or the contractor. An example of a detrimental application is where the QDC bears an inappropriately high or low amount of overhead costs. There may, however, be cases where it is appropriate to apply costs or credits differently to a QDC in order to meet the requirements of allowable costs. This may occur, for example, where the contractor's standard approach to recovery of overheads includes costs that are generally not allowable in pricing QDCs, such as entertainment costs.

6.27 In this case, the Secretary of State and the contractor are seeking to agree the actual rates for the particular year and use these to apply costs to determine the price under the referred contract. We understand the rates will also be used across a number of other contracts with the Secretary of State. The contractor reported that the rates exclude costs which may be applied to contracts that are not QDCs but which are determined not to be allowable under QDCs.

6.28 The contractor did not offset RDEC from R&D costs included in the rates calculation for the particular year and reported that this was the approach it had taken in relation to the pricing of other contracts. It said that its general cost accounting practice is to treat RDEC as a 'below the line' item, excluding it from the management accounts which are used to monitor the financial performance of the business. It said it makes an adjustment to take RDEC 'above the line' for reporting in its statutory accounts. Our expert adviser gave a view that the below the line treatment in management accounts is reasonable to ensure these give a true and accurate reflection of the flow of expenditure and income within the company. It noted that bringing the credit above the line in the statutory accounts achieved the intent of making the credit visible to corporate stakeholders.

6.29 The MOD argued that in determining the extent to which the referred R&D costs are allowable costs the treatment of RDEC should be consistent with the approach the contractor took to RDEC in its statutory accounts for the particular year. In preparing its accounts, the contractor applied RDEC in calculating its cost of sales. The contractor did not agree that its treatment of RDEC, or other items, in its statutory accounts should determine the treatment of these items in pricing the contract. It noted that there were other costs and income included in cost of sales in its statutory accounts which were not allowable.

6.30 We concur with the contractor that the treatment of RDEC in its statutory accounts does not determine the extent to which R&D costs are allowable under the referred contract. In coming to this view, we have considered the following:

- E.4.3 of the SSRO's guidance is concerned with consistent application of cost accounting practices so that costs are allowable, rather than what is stated in the statutory accounts.
- There is no accounting standard dealing specifically with RDEC and the applicable standards (IAS12 and IAS20) allow companies choice in how to treat the credit in statutory accounts.
- Paragraph 4.9 of the SSRO's Allowable Costs Guidance (Version 5) notes that contracting companies 'may adopt a variety of accounting policies and make judgements in the preparation of financial statements for statutory reporting purposes'. It indicates that the application of 'these policies to QDCs will not necessarily result in costs charged satisfying the AAR principles'. We consider that this guidance also applies in respect of the treatment of RDEC in statutory accounts.

6.31 The contractor's approach to RDEC in relation to the referred contract is to disregard the credit in the calculation of costs included in the rates calculation. This is consistent with its cost accounting practices, in line with the requirement set out in paragraph E.4.3 of the guidance.

Legal basis of the credit

6.32 Paragraph E.4.3(a) requires that in determining whether the treatment of a particular credit is appropriate the relevant parties should consider the legal basis of the credit and whether this indicates it reduces costs or not. The costs referred to here are the particular costs which are proposed for inclusion in the allowable costs used to determine the contract price. In this case, the particular costs are the R&D costs applied indirectly to the contract through the actual labour rates for the particular year.

6.33 The MOD noted that RDEC was founded in legislation. It considered that RDEC was not a tax credit but a payment that is made through the tax system. In support of this view, the MOD highlighted the following matters:

a) use of the term 'expenditure credit' in the name of RDEC, which the MOD considered indicates that the credit is paid to reimburse specific R&D costs;

b) the above the line treatment, and thereby taxable nature, of RDEC, which the MOD considered indicates that the credit is not intended to provide tax relief; and

c) that claimants whose RDEC exceeded their tax and other liabilities may receive a direct payment from HMRC, which again the MOD considered indicates that the credit is not intended to provide tax relief.

6.34 The contractor noted that the CTA 2009 expressly required that RDEC is used to offset corporation tax in the first instance and, subsequently, other liabilities to HMRC before any payment is made. As tax costs were not allowable costs under the referred contract (or any QDCs) it said RDEC was not relevant to the determination of allowable costs.

6.35 We consider that the legal basis of RDEC should be determined by considering the provisions of the CTA 2009. We have summarised relevant aspects of the RDEC scheme in section 4. The following material matters emerge from the CTA 2009:

a) The amount of RDEC is determined as a percentage of qualifying R&D expenditure (section 104M);

b) RDEC is to be brought into account as a receipt in calculating the profits of the trade for an accounting period (section 104A(1)); and

c) RDEC is paid in accordance with seven specified steps (section 104N), which we have summarised previously. Before any payment is made the credit must first be used to discharge any corporation tax liability for the accounting period. If any amount of the credit remains after the first step, further steps apply. Whether the credit is utilised in discharging liabilities to HMRC or is paid to the company after application of the seven-step process, profit-making and loss-making companies will receive an equivalent benefit from the credit.

6.36 As noted previously, the above the line treatment for the relief was introduced to increase visibility and certainty of the support being provided and the taxable treatment enables a higher headline rate of support. Our expert adviser gave a view that the changes to the CTA 2009 introduced by the Finance Act 2013 did not fundamentally alter the nature of RDEC as a form of tax relief. We consider that RDEC is a form of tax relief and do not accept the MOD's argument that RDEC is not a tax credit.

6.37 While the amount of RDEC is determined with reference to an amount of qualifying R&D expenditure, we find nothing in the CTA 2009 to indicate that RDEC reduces those costs. The CTA 2009 requires the credit to be used in discharging corporation tax and other liabilities to HMRC, which may be unrelated to the R&D activity giving rise to the credit, before any remaining credit can be paid to the claimant. If a cash payment is made, there is no restriction on how the company may apply that payment.

6.38 Overall, we find that the legal basis of RDEC does not indicate that the RDEC received by the contractor in respect of the particular year's R&D costs reduces the referred R&D costs.

Requirement, intent or common practice

6.39 Paragraph E.4.3(b)(i) requires that in determining whether the treatment of a particular credit is appropriate the relevant parties should consider whether there is a requirement, intent, or common practice for the credit to be used to reduce costs. If there is, this may indicate that it reduces costs. The costs referred to here are the particular costs which are proposed for inclusion in the allowable costs used to determine the contract price. In this case, the particular costs are the R&D costs applied indirectly to the contract through the actual labour rates for the particular year.

Requirement

6.40 The contractor noted that it was required to apply RDEC in payment of tax liabilities in the first instance. Consequently, it argued that its tax liability was the only 'cost' reduced by RDEC. As tax payments were not allowable costs under QDCs, there was no reason, it said, for RDEC to be taken into account in the pricing of QDCs. In further support of this point it noted that its salary costs, which were the principal basis of its qualifying R&D expenditure, were not reduced when RDEC was claimed.

6.41 Our conclusions on whether the CTA 2009 requires RDEC to be used to reduce costs are discussed above. There is no legislative requirement for RDEC to be used to reduce R&D costs.

6.42 Separately, we considered the guidance provided on RDEC by HMRC in the Corporate Intangibles Research and Development Manual. We found no requirement in the guidance for RDEC to be used to reduce R&D costs.

6.43 Our conclusion is that there is no requirement for RDEC received by the contractor in respect of the particular year's R&D costs to reduce the referred R&D costs.

Intent

6.44 The MOD considers that the purpose of RDEC is to reduce the claimant's cost of R&D and increase the amount of R&D expenditure that occurs in the UK. The contractor considers that the intent of RDEC is to encourage large businesses to employ individuals in high-value technical roles and conduct R&D in the UK.

6.45 We consider that the intent of RDEC (and other forms of R&D tax relief) indicated overwhelmingly in Government publications is to increase the amount of R&D undertaken in the UK.[30] HMRC's evaluation of the RDEC scheme indicates that it is successful in achieving that intent with additional R&D spending of between £2.40 and £2.70 for every pound spent on RDEC.[31]

6.46 HMRC's evaluation[32] and the Government's 2021 consultation on R&D tax reliefs[33] explained that companies needed additional incentives to undertake R&D activities. This was because those investing in R&D create benefits for third parties (positive externalities) in respect of which no payment is received by the company. Without incentives the level of R&D investment is sub-optimal.

6.47 The publications we have reviewed describe a variety of ways in which RDEC supports an increase in the amount of R&D undertaken in the UK. These included:

a) creating the most competitive tax system in the G20;[34]

b) ensuring the UK provides an internationally competitive environment for all companies to innovate;[35]

c) increasing the visibility and certainty of R&D relief;[36]

d) providing greater cash flow support to companies with no corporation tax liability;[37] and

e) making the UK a more attractive location for large company R&D investment.[38]

6.48 In practice, RDEC is brought into account as a receipt when calculating the operating profit of the claimant, making R&D activity more profitable than it would otherwise be.

6.49 The MOD has suggested that the intention of RDEC is to reduce the claimant's R&D costs in order to increase R&D spending. Notwithstanding that an RDEC receipt is first required to be used in offsetting liabilities to HMRC, there may be different ways in which the payment (or prospect) of RDEC could lead companies to undertake additional R&D in the UK. Companies might choose to:

a) lower the price of R&D charged to customers which drives up demand for R&D;

b) do R&D in the UK rather than elsewhere, as it is more profitable here due to the credit; or

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30 HM Treasury (2011) *Autumn Statement 2011.* HM Treasury (2012) *Consultation on an 'Above the Line' Credit for Research and Development.* HM Treasury (2012) *'Above the Line' Credit for Research and Development: Response to Consultation.* HM Revenue & Customs (2020) *Evaluation of the Research and Development Expenditure Credit (RDEC):* HMRC Working Paper 20. HM Treasury and HM Revenue & Customs (2021) *R&D Tax Reliefs: Consultation.* HM Treasury (2021) *R&D Tax Reliefs: Report.* Department for Business Energy and Industrial Strategy (2021) *UK Innovation Strategy: Leading the Future by Creating it*.

31 HM Revenue & Customs (2020) *Evaluation of the Research and Development Expenditure Credit (RDEC): HMRC Working Paper 20*

32 HM Revenue & Customs (2020) *Evaluation of the Research and Development Expenditure Credit (RDEC): HMRC Working Paper 20*

33 HM Treasury and HM Revenue & Customs (2021) *R&D Tax Reliefs: Consultation*

34 HM Treasury (2012) *Consultation on an 'Above the Line' Credit for Research and Development.*

35 HM Treasury (2012) *Consultation on an 'Above the Line' Credit for Research and Development.*

36 HM Treasury (2012) *'Above the Line' Credit for Research and Development: Response to Consultation.*

37 HM Treasury (2012) *'Above the Line' Credit for Research and Development: Response to Consultation.*

38 HM Treasury (2012) *'Above the Line' Credit for Research and Development: Response to Consultation.*

c) do R&D in preference to other activities, as it is more profitable than other activities due to the credit.

6.50 The increase in R&D sought by the Government may be more likely to arise due to either b) or c) above because:

a) the benefit of RDEC does not materialise until sometime (possibly years) after the R&D costs are incurred; and

b) there may be uncertainty about the RDEC that will be received on multi-year projects.

6.51 Given the possible routes to increasing R&D activity, it is not clear that RDEC is intended to reduce the claimant's R&D costs as suggested by the MOD. Whichever mechanism leads to increased levels of R&D, care should be taken not to substitute the mechanism(s) by which the intent of RDEC is achieved for the intent (increasing the amount of R&D undertaken in the UK).

6.52 It has been said that an effect of R&D tax reliefs in the UK (including RDEC) is that they lower the cost of undertaking R&D.[39] We are satisfied that such statements do not indicate that tax reliefs are intended to reduce the costs incurred by companies in performing R&D (the costs which might be allowable costs under a QDC). The HMRC evaluation of RDEC explains that the cost which it has considered to be lowered through the application of tax relief is the gross user cost of capital for an R&D asset. This measures the cost of financing the asset, taking into account the interest foregone (if financed from equity) and the cost of depreciation as the asset ages. This is a fundamentally different type of cost to that which is anticipated for inclusion in the allowable costs of a QDC.

6.53 On the basis of the evidence available, our understanding of the Government's intent in paying RDEC to companies in respect of qualifying R&D costs is to incentivise companies to undertake more R&D in the UK. We have not identified an intention for RDEC to reduce the qualifying R&D costs in respect of which it is paid. Consequently, we do not find an intention for RDEC received by the contractor in respect of the particular year's R&D costs to reduce the referred R&D costs.

Common practice

6.54 We have noted already that recipients of RDEC are required by the CTA 2009 to apply it in a range of ways before any payment can be made. No evidence was presented by either party as to the use that is made of RDEC payments received at Step 7 of the process set out in section 104N of the CTA 2009.

6.55 The MOD indicated that, prior to the change in the SSRO's guidance on R&D tax credits in April 2019, it had arrangements with a number of its suppliers, including the contractor, to recover RDEC paid in respect of R&D costs under single source contracts. We do not consider the historic treatment of RDEC in single source contracts can be considered as common practice for the purpose of this determination. The treatment in those contracts would have been guided by the SSRO's related guidance, which explicitly required that the benefits received through the taxation system in respect of R&D were offset from costs when determining allowable costs.

39 HM Revenue & Customs (2020) *Evaluation of the Research and Development Expenditure Credit (RDEC): HMRC Working Paper* 20. HMT and HM Revenue & Custom (2021) *R&D Tax Reliefs: Consultation* (**link**).

6.56 The MOD argued that if a contract was competed, a contractor would take into account in its bid price the extent to which its costs were to be offset by government grants and credits such as RDEC. The contractor considered this to be speculation on the MOD's part. It said that basing prices on RDEC that might (or might not) be received over the life of a multi-year contract would represent a high-risk approach to contracting. It noted that the amount of RDEC paid was contingent on potential changes in the law, the status of the credit and the rate upon which it is calculated. RDEC, it said, was linked to the company's future ongoing resilience and market placement and did not influence bidding and day-to-day contract pricing.

6.57 In the absence of specific evidence concerning how RDEC has been applied in determining prices under competitive contracts, it is difficult for the SSRO to draw firm conclusions on this point. There are merits in each of the arguments presented by the parties. However, in further support of the argument presented by the contractor, we note that there may be significant timing differences between the qualifying R&D costs being incurred and the associated RDEC being paid.[40] A claim may be made up to two years after the end of the accounting period to which it relates. If the claim is subject to investigation by HMRC there may be a further delay in the credit being paid.

6.58 We considered whether there was any expectation in other regulatory frameworks that RDEC would reduce a regulated company's R&D costs. The findings of our review are included at Appendix 2. The review did not suggest that it was common practice for RDEC to be taken into account in calculating the permissible costs of regulated companies in other price control regimes.

6.59 We do not find that there is a common practice for RDEC to reduce costs.

Overall conclusion

6.60 We have not identified any requirement, intent or common practice for RDEC to reduce R&D costs. This may indicate that the RDEC received by the contractor in respect of the particular year's R&D costs does not reduce the referred R&D costs.

Calculated with direct reference to costs

6.61 Paragraph E.4.3(b)(ii) requires that in determining whether the treatment of a particular credit is appropriate the relevant parties should consider whether the credit is calculated with direct reference to costs. If it is, this may indicate that it reduces costs. The costs referred to here are the particular costs which are proposed for inclusion in the allowable costs used to determine the contract price. In this case, the particular costs are the R&D costs applied indirectly to the contract through the actual labour rates for the particular year.

6.62 The MOD and the contractor agreed that RDEC was calculated with direct reference to qualifying R&D costs which the claimant was required to identify. The MOD noted that in this case the contractor sought to apply some amount of the qualifying R&D costs indirectly to the referred contract.

6.63 We noted in in section 4 that RDEC is calculated as a percentage of qualifying R&D expenditure. We are satisfied, therefore, that RDEC is calculated with direct reference to costs. This may indicate that the RDEC received by the contractor in respect of the particular year's R&D costs reduces the referred R&D costs.

40 HM Revenue & Customs (2007, updated 2021) *Claim Research and Development (R&D) Expenditure Credit* (**link**).

From whom the credit is received

6.64 Paragraph E.4.3(b)(iii) requires that in determining whether the treatment of a particular credit is appropriate the relevant parties should consider whether the credit is received from the same entity with which the costs were incurred. If it is, this may indicate that it reduces costs. The costs referred to here are the particular costs which are proposed for inclusion in the allowable costs used to determine the contract price. In this case, the particular costs are the R&D costs applied indirectly to the contract through the actual labour rates for the particular year.

6.65 Where a credit is received in respect of goods or services whose purchase gave rise to a cost (an obligation to pay) that a contractor seeks to include in the allowable costs of the contract, it is possible that the cost incurred by the contractor in respect of those goods or services was reduced by the credit (as the obligation to pay was reduced or otherwise discharged by the credit). The guidance aims to identify cases where this may be true.

6.66 The MOD considered that the contractor received RDEC from the same entity with which it incurred costs. This was based on its understanding that when the R&D costs were applied to a QDC they were incurred by the MOD and the credit was given by HMRC, which was the same entity as the MOD (both being parts of the Government).

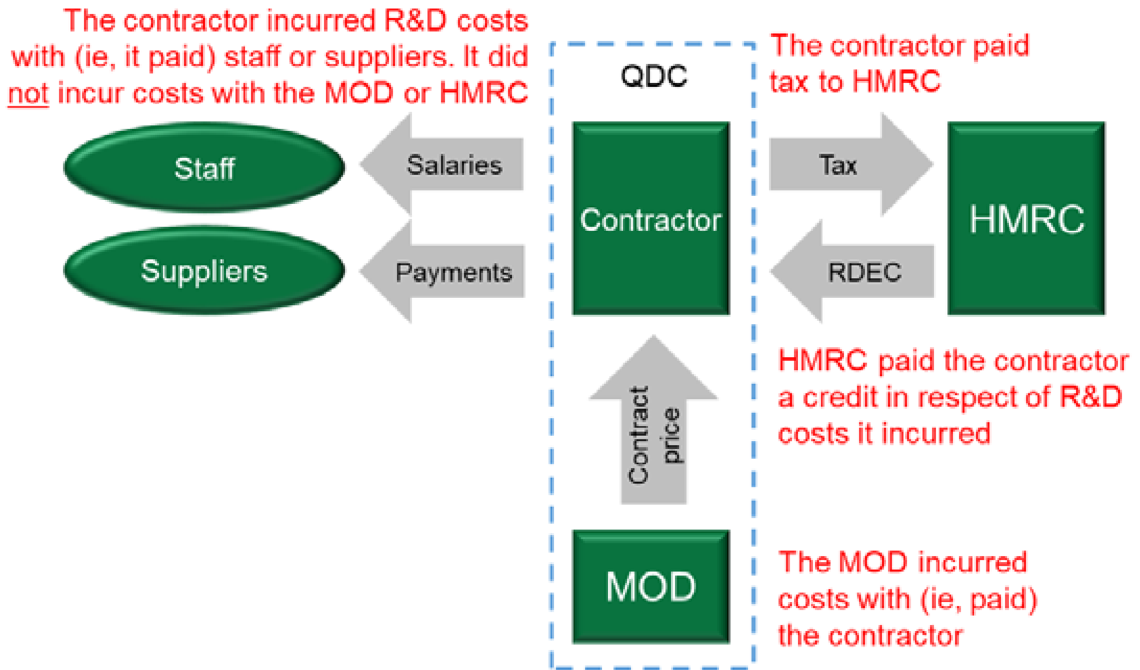
6.67 The contractor did not consider that RDEC was received from the same entity with which the R&D costs were incurred. It said that it incurred R&D costs paying salaries to staff whereas the credit was received from HMRC.

6.68 We note that the guidance requires consideration of the entity from whom the credit is received and the entity with which (not by which) the costs were incurred. In this case (see illustration below), we are satisfied that the R&D costs giving rise to RDEC are incurred by the contractor paying its staff or other suppliers. While the costs incurred by the contractor are applied through the rates calculation to establish the allowable costs of the referred contract, and in turn the contract price, we do not consider that the MOD incurred those costs. In support of the position that the contractor incurred the costs with its staff and suppliers rather than the MOD, our expert adviser suggested that:

- the contractor’s obligation to pay salaries to staff and make payments to suppliers arises under the terms of contracts that the contractor has with those persons, not the MOD; and
- the settlement of those obligations by the contractor will have occurred as they arose and was not contingent on the receipt by the contractor of the contract price to be paid by the MOD.

6.69 Our view is that RDEC was received by the contractor from HMRC. There is no suggestion that the RDEC was received from the staff or suppliers with whom the contractor incurred R&D costs.

The flow of payments between different entities in this case



6.70 Our conclusion is that the RDEC the contractor received in respect of the particular year's R&D costs was not received from the same entity with which the referred R&D costs were incurred. This may indicate that the RDEC received does not reduce the referred R&D costs.

How transactions are settled

6.71 Paragraph E.4.3(b)(iv) requires that in determining whether the treatment of a particular credit is appropriate the relevant parties should consider whether transactions are settled net of the credit. If they are, this may indicate that it reduces costs. The costs referred to here are the particular costs which are proposed for inclusion in the allowable costs used to determine the contract price. In this case, the particular costs are the R&D costs applied indirectly to the contract through the actual labour rates for the particular year. Transactions are payments made in exchange for goods or services.

6.72 The MOD said it considered all the tests in paragraph E.4.3 of the guidance were met but made no specific comment on this part of the guidance. The contractor argued that its R&D costs, principally salary costs, were not settled net of RDEC. Rather, it said it was its corporation tax liability that was settled net of the credit.

6.73 We are satisfied in this case that the R&D costs incurred by the contractor were salary costs and payments to suppliers for materials. We do not consider that these were settled net of RDEC. Indeed, as RDEC was claimed as part of the contractor's tax return, which was completed sometime after costs were incurred, we do not consider it possible for transactions to have been settled net of RDEC.

6.74 Our conclusion is that transactions related to the referred R&D costs were not settled net of the RDEC the contractor received in respect of those costs. This may indicate that the RDEC received in respect of the particular year's R&D costs does not reduce the referred R&D costs.

Requirements of the contract

6.75 Paragraph E.4.3(c) requires that in determining whether the treatment of a particular credit is appropriate the relevant parties should consider whether the credit is received as a result of a particular requirement of the contract. If it is, this may indicate that it reduces costs. The costs referred to here are the particular costs which are proposed for inclusion in the allowable costs used to determine the contract price. In this case, the particular costs are the R&D costs applied indirectly to the contract through the actual labour rates for the particular year.

6.76 The MOD considered that if the qualifying R&D costs were applied directly or indirectly in the pricing of a QDC the receipt of RDEC could be considered to be a result of a particular requirement of the contract. The MOD advised that a number of tasks had been added to the contract since it was agreed (under Item 3 in the Schedule of Requirements) and continue to be added. It provided a list of 81 numbered tasks. Of these, it considered that 14 of the included activities might, in due course, give rise to qualifying R&D expenditure in respect of which the contractor could make an RDEC claim.

6.77 The contractor submitted that the contract had not given rise to any qualifying R&D expenditure for the purpose of an RDEC claim and it did not expect it to do so. It said, the only R&D costs charged to the referred contract to date was the amount applied through the rates calculation for the particular year. It considered this amount not to be material.

6.78 We are satisfied that the R&D giving rise to RDEC in the particular year was not a requirement of the referred contract. We note that the contractor has included the qualifying R&D expenditure giving rise to RDEC in the particular year in the calculation of the labour rates which will be applied in determining the contract price. We note too that the contract does not require any particular treatment of RDEC received in respect of R&D costs applied in determining the contract price.

6.79 Our conclusion is that the RDEC the contractor received in respect of the particular year's R&D costs was not received as a particular requirement of the contract. This may indicate that the RDEC received by the contractor in respect of the particular year's R&D costs does not reduce the referred R&D costs.

6.80 We have noted the MOD's view that some of the contractor's labour costs under the contract could give rise to RDEC claims in the future and the contractor's refutation of this. This goes beyond the scope of the current determination which is focused on the treatment of RDEC in the rates calculation for the particular year. We would encourage the contractor to share details of its RDEC claims with the MOD annually in order to provide transparency about whether RDEC is claimed on costs that are applied in determining the price of QDCs.

Reaching a conclusion on the method of treatment

6.81 Having considered each of the factors identified in the guidance individually, we considered what, collectively, they indicate about the appropriate treatment of RDEC in this case.

6.82 The MOD considered that RDEC meets all the tests set out in section E.4.3 of the SSRO's guidance. Consequently, it concluded that RDEC is a credit that reduces the R&D costs in respect of which it was paid and must be offset when determining the amount of the referred R&D costs that are allowable costs under the contract. The contractor, conversely, considered that, with the exception of being calculated with reference to costs, RDEC does not meet the tests set out in the SSRO's guidance. Accordingly it did not consider RDEC reduced the referred R&D costs it seeks to recover under the contract.

6.83 The factors in E.4.3 need to be considered together. It is not the case that a single factor which may indicate that a credit reduces costs should lead to the other factors being disregarded.

6.84 The only factor of those considered under part E.4.3 of the guidance that indicates that RDEC may be a credit that reduces a particular cost is that it is calculated with direct reference to costs. We consider that the fact that the credit is calculated as a fixed percentage of qualifying R&D expenditure does not lead to the conclusion that the credit reduces the cost. All the other factors in E.4.3 point to the contrary conclusion. The legal effect of the credit does not require that it reduces the R&D cost, nor is that the effect of any other requirement, intent or common practice associated with the credit. The transactions in question were not settled net of the credit and the credit was not received as a particular requirement of the contract.

6.85 Considering the circumstances of this contract, we are satisfied that the RDEC received by the contractor in respect of the particular year's R&D costs did not reduce the referred R&D costs – those applied to the contract through the rates calculation for the particular year.

Statutory aims

6.86 In making its determination, the SSRO must aim to ensure that:

a) good value for money is obtained in government expenditure on qualifying defence contracts, and

b) persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts.

6.87 These aims are achieved when contracts are priced on the basis of allowable costs and a contract profit rate that has been determined in accordance with the requirements of the Regulations.

6.88 We considered whether applying the referred R&D costs to the contract at their full amount, without offsetting RDEC received in respect of the costs, would satisfy the requirements of allowable costs and result in a contract price that meets the statutory aims. In doing so we considered the related objections raised by the MOD:

a) that the contractor would recover an amount of its R&D costs from the payment of RDEC – making that amount of the R&D costs not allowable;

b) that the Government would effectively pay twice for R&D costs (through the contract price and through payment of RDEC), which would reduce value for money on contract expenditure; and

c) that the contractor would earn an inappropriate level of return on a regulated contract – beyond what is fair and reasonable.

Allowability of the R&D costs

6.89 Beyond the question of offsetting RDEC from the amount of the referred R&D costs, the MOD presented no specific argument concerning the allowability of the costs (principally salaries paid to the contractor's staff). During the investigation it said it would reserve judgement on allowability until the determination was concluded. The MOD's principal argument at the time of referral was that the referred R&D costs should not be included in the allowable costs as they were recovered from another source, in this case, the RDEC paid. During the investigation, the MOD said that it considered it made no difference from a government-spending point of view whether RDEC was claimed by the contractor and offset from the referred R&D costs or not claimed by the contractor and not offset. We understood from this that the MOD was satisfied that the referred R&D costs could be considered allowable provided that the contractor did not recover them from RDEC (or another source).

6.90 Our assessment of the guidance on credits indicates that although the RDEC payment is calculated with reference to the referred R&D costs, it does not reduce those costs. The Government has indicated that it pays RDEC to companies that incur qualifying R&D expenditure (including expenditure under government contracts) to address a market failure. The credit is applied in calculating the profit of the claimant which increases its profitability. The claimant is then required to apply the RDEC to discharge any tax or other liabilities with HMRC before a payment can be made. If a payment is made there are no conditions on how it is to be applied. We are satisfied, in this case, that the payment of RDEC serves a particular policy intention and the contractor's R&D costs applied to the contract are not recovered through that payment.

Value for money

6.91 The MOD's contention is that not offsetting RDEC received in respect of R&D costs that are allowable costs under a QDC undermines the achievement of value for money. However, our assessment of RDEC indicates that the credit is paid for a fundamentally different purpose to the payment made by the MOD under a QDC. The Government's stated intention in paying RDEC is to increase the amount of R&D undertaken in the UK as this is considered to be a driver of economic growth. Where the MOD allows a contractor to apply R&D costs on which RDEC is claimed directly or indirectly in determining the allowable costs and thereby price of a QDC, it expects to benefit in the short or longer term from the enhanced knowledge or capability that results from performing that R&D.

6.92 The MOD also indicated that when the Government is funding R&D under contracts (paying costs and profit on costs) there is no need for a company to be additionally incentivised by the Government to undertake R&D. The implication is that the RDEC funding does not represent good value for money in those circumstances. It is not for the SSRO to judge whether the Government secures good value for money from its expenditure on RDEC. We note that, overall, HMRC's evaluation of RDEC suggests that the scheme is successful in achieving its objective of incentivising additional R&D spending. We also note that the scheme rules for RDEC place no restriction on companies claiming RDEC in respect of qualifying R&D expenditure under government contracts. The Government's consultation on R&D tax reliefs found that the availability of R&D tax relief was a factor that influenced the investment decisions

of some, especially larger companies.[41] The contractor in this case itself reported that the reduced rate of corporation tax it was required to pay due to the RDEC scheme had led it to undertake R&D in the UK rather than in another country where it has operations.

Fair and reasonable return

6.93 The MOD expressed the view that allowing a contractor to recover its R&D costs from the MOD, earn profit on those costs and also receive an RDEC credit in respect of those costs would not be considered reasonable by the general public. The contractor considered that determining what was fair and reasonable in this context was complicated and not simply a matter to be decided by public opinion. The contractor did not think the Act and Regulations could be viewed in isolation and suggested the matter required a balanced assessment of the purposes and provisions of the Act and Regulations on one hand and the CTA 2009 on the other. It questioned the acceptability of taking a position on RDEC under the Regulations that might undermine the policy objective of encouraging investment by UK industry in R&D.

6.94 At present, the Government has determined that R&D expenditure should be incentivised, and Parliament has legislated that RDEC should be paid in respect of qualifying R&D expenditure, even if the R&D is performed under contract to the Government. As we have said previously, we do not consider that the SSRO's Allowable Costs Guidance should alter the policy objectives the Government seeks to achieve when issuing grants or tax credits, including RDEC. The Government appears content that making R&D activity more profitable for companies is an effective mechanism for encouraging greater levels of R&D activity which brings consequential benefits to the UK economy and society. The question of whether RDEC, which intentionally increases profit on R&D spending, should be paid on government-funded R&D is a matter for the Government and, ultimately, Parliament to determine taking account of the costs and benefits associated with any change in policy.

6.95 The MOD considered there should be comparability in the treatment of RDEC in QDCs with the treatment applied to contracts let under competition. We agree that what might occur within a competitive market, or in other regulatory regimes which seek to achieve market outcomes, are reasonable benchmarks against which to judge the achievement of both value for money and fair and reasonable prices. Our guidance on credits has required consideration of common practice, although evidence of this in relation to RDEC is limited. We considered the treatment of RDEC in other regulatory regimes (Appendix 2) but the available examples did not provide a clear argument for or against any particular treatment of RDEC in this case. Both parties presented arguments related to whether RDEC would be offset from costs when competed contracts were being priced. We have observed that there are practical reasons why RDEC may not influence the price of competitive contracts. Our current assessment is that there is no compelling evidence to suggest that applying the referred R&D costs to the contract at their full amount would result in an outcome that was not comparable to what occurs under competition. If the evidence on this point changes, then it can be considered in any future referral on the treatment of RDEC or in developments to the SSRO's guidance.

41 HM Treasury and HM Revenue & Customs (2021) *R&D Tax Reliefs: Consultation*

Conclusion

6.96 Having considered the matters above, we are satisfied that applying the referred R&D costs to the contract in their full amount would satisfy the statutory aims set out in paragraph 6.86. The price paid by the MOD would be lower if RDEC were offset from the R&D costs included in the contract but our guidance does not require this and we are unable to conclude that the price the MOD is paying is not value for money. This was clear from the MOD's position that it would be satisfied with the costs if the contractor had not claimed RDEC on the R&D costs. Our understanding is that it is the Government's intention that the contractor should be able to claim RDEC and that the tax relief provided should incentivise the contractor to invest in R&D in the UK.

7. The SSRO's determination

7.1 This section sets out the SSRO's determination on the question of whether RDEC received by the contractor should be offset from R&D costs when determining the extent to which those costs are allowable costs under the referred contract.

Determination on allowable costs

7.2 The SSRO's determination under section 20(5) of the Act is that there is no need for RDEC received by the contractor in respect of the particular year's R&D costs to be taken into account when determining the amount of those R&D costs that are allowable costs applied indirectly to the referred contract through cost recovery rates for the particular year. Accordingly, subject to both parties being otherwise satisfied that the contractor's R&D costs meet the requirements of allowable costs, the full amount of those costs and, where required by the rates methodology, the hours associated with them, should be included in the calculation of cost recovery rates.

Determination on the price payable under the contract

7.3 Section 20(6) of the Act provides that the SSRO may determine that the price payable under the contract is to be adjusted by an amount specified by the SSRO in consequence of a determination under section 20(5), having regard to the extent to which the cost in question was treated as an allowable cost when the price payable under the contract was determined (or last determined) in accordance with section 15.

7.4 In light of the determination described above, the SSRO determines that no adjustment is required in the price payable under the contract as a result of the determination. The provisional price was determined on the basis that the contractor's R&D costs were included at their full amount in the rates calculation, without any reduction having been made for RDEC.

Determination on costs

7.5 In making a determination, section 35(4) of the Act empowers the SSRO to require the payment of such costs as the SSRO considers appropriate by one party to the referral to the other. The SSRO has published guidance on requiring the payment of referral-related costs. This makes clear that the SSRO will only consider requiring the payment of costs by one party to the other when requested to do so by one or other party.

7.6 No claim for costs has been made by either party to this referral. Accordingly, the SSRO does not propose to require either party to make a payment of costs in this case.

Applicability of the determination to other contracts

7.7 During the SSRO's investigation, the parties expressed different views on whether the determination in this case should be applicable to other QDCs whose prices are calculated with reference to R&D costs in respect of which RDEC is also received. The MOD indicated it would like the determination to establish a precedent for the treatment of RDEC when determining allowable costs in other QDCs. The contractor, on the other hand, considered that the question of wider application of the determination to other contracts was beyond the scope of this determination and should be subject to wider debate among interested stakeholders.

7.8 The outcome of this referral will help inform the application of the regulatory framework. The SSRO expects that parties to this referral, and other contractors with qualifying contracts, will have regard to the findings of the determination when considering the treatment of RDEC in other cases, although it must be remembered that the determination is made in consideration of the specific circumstances of this case and the referred contract. The Referral Committee considers it would be beneficial for the SSRO to review its Allowable Costs Guidance in the light of the determination, to provide additional clarity on the treatment of RDEC and other tax reliefs when determining allowable costs.

Appendix 1: The SSRO's Allowable Costs Guidance

AAR principles

A1.1 Section 3 of the SSRO's Allowable Costs Guidance (version 5) sets out the typical characteristics of costs that meet the requirements of allowable costs as follows:

Appropriate

3.11 A cost is appropriate if it is of a type and arising from an activity that:

a) a reasonable person informed of the facts would consider enables the performance of the QDC or QSC in question; and

b) would withstand public scrutiny.

Attributable to the contract

3.12 A cost is attributable to the contract if it:

a) is incurred by the contractor;

b) enables the performance of the QDC or QSC in question;

c) is applied directly or indirectly to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State; and

d) has not been and is not anticipated to be recovered, directly or indirectly, from another source, as Allowable Costs must only be recovered once.

Reasonable in the circumstances

3.13 A cost is reasonable in the circumstances if it is of an amount that:

a) a reasonable person informed of the facts would consider consistent with enabling the performance of the QDC or QSC in question;

b) would withstand public scrutiny;

c) is consistent with costs incurred by the contractor in similar circumstances; and

d) demonstrates due regard for economy and efficiency in the use of resources.

3.14 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs, and which may, therefore, be considered when determining if a cost is reasonable in the circumstances, include, but are not limited to:

a) the level of competitiveness and/or market testing undertaken in the supply chain;

b) the particular specification and performance requirements of the contract;

c) the capability necessary to perform the contract;

d) uncertainty and risk affecting estimated costs;

e) the impact on actual costs of events which were not anticipated at the time of agreement;

f) the economic environment;

g) the statutory provisions in place at the time of contracting; and

h) any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'.

Research and development costs

A1.2 Part D of the SSRO's Allowable Costs Guidance (version 5) relates to research and development costs.

D.1 Research and development

D.1.1 Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

D.1.2 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

D.1.3 The costs of research and development incurred, whether applied directly or indirectly to a QDC or QSC, may be Allowable Costs.

D.2 Research applied indirectly

D.2.1 A proportion of the costs of research undertaken during the period of the contract that are applied indirectly to contracts may be attributable to the QDC or QSC in question where the research to which the costs relate enables the performance of the contract.

D.2.2 In determining whether the research enables the performance of the contract, the parties should consider the requirements of the contract and whether these necessitate the research, either expressly or by implication. Some research may be necessary if it is required to maintain capability to perform the contract.

D.3 Development

D.3.1 Accounting standards allow contractors to account for development costs in different ways. They will either recognise an intangible asset arising from development expenditure and amortise this over time or will write off the costs as they are incurred. Either approach may be used in determining the level of development costs that are Allowable Costs.

D.3.2 Development costs that are recognised as an intangible asset and amortised are dealt with in section G.1 of this guidance.

D.3.3 Development costs that are written off as they are incurred should be applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State.

D.4 Other matters

D.4.1 The costs of research or development that did not achieve its planned objectives may be Allowable Costs and should be evaluated in the same way as any other research or development costs.

Credits

A1.3 Part E.4 of the SSRO's Allowable Costs Guidance (version 5) addresses the treatment of credits as follows:

E.4.1 Allowable Costs should be net of any credits received by contractors that reduce a particular cost for the contractor. Credits may include, but are not limited to, reimbursements, grants, discounts or refunds.

E.4.2 Credits that do not reduce a particular cost are not relevant to the determination of Allowable Costs.

E.4.3 The treatment of a particular credit should be consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State. In determining whether the treatment for a particular credit is appropriate, the relevant parties should consider:

a) the legal basis of the credit and whether this indicates it reduces costs or not;

b) the economic substance of the credit, which may indicate that it reduces costs if:

i) there is a requirement, intent, or common practice for the credit to be used to reduce costs;

ii) the credit is calculated with direct reference to costs;

iii) the credit is received from the same entity with which the costs were incurred; and

iv) transactions are settled net of the credit; and

c) whether the credit is received as a result of a particular requirement of the contract, which may indicate that it reduces costs.

Appendix 2: Treatment of RDEC in other regulatory frameworks

A2.1 We sought evidence on how other regulatory frameworks take account of Research and Development Expenditure Credit (RDEC) or other tax credits received by regulated companies. The examples we found are summarised below.

Framework	Details
Department for Health and Social Care, Voluntary Scheme for Branded Medicines Pricing and Access	The Scheme provides a framework for determining reasonable limits to the profits to be made from the supply of Branded Health Service Medicines to the NHS. Any Scheme Member will, if required by the Department for Health and Social Care, provide a full, Audited Annual Financial Return (AFR), together with supporting information, which must be completed and submitted not later than three months following notification of the Department's request. Companies would be expected to report/apportion their 'net' R&D expenditure from statutory accounts. If R&D credits are recorded as income in the statutory accounts, rather than being included in the calculation of net R&D expenditure, there is no mechanism to net this off in the AFR.
Civil Aviation Authority, Heathrow Airport Ltd	The CAA's price control regime for Heathrow Airport Ltd (HAL) does not give any direction on how tax credits should be taken into account. An allowance for tax to be paid by HAL is set by grossing up the allowed cost of capital. The CAA engaged Grant Thornton UK LLP to support the design and development of a Price Control Model ('PCM') that would ultimately be used as the analytical tool to calculate the appropriate price per passenger that HAL can charge to its customers for the H7 regulatory period. GT did not propose any adjustment be made in respect of RDEC as this was expected to be an immaterial amount.
CAA, NATS En Route plc	The CAA's RP3 price control for NATS En Route plc (NERL) in 2019, set a tax uplift in the pre-tax weighted average cost of capital which aimed to reflect the effective tax rate of the company taking account of the effect of research and development tax credits and allowances for airspace design capital expenditure in reducing NERL's tax cost. This approach was considered to protect users by ensuring they shared in any gains from NERL minimising its tax costs. While the model used to estimate the tax uplift was proposed by NERL, the tax uplift that was applied in the CAA's final decision was lower than that proposed by NERL. This decision was appealed to CMA. The CMA followed a similar approach in its redetermination to setting the tax uplift.

Framework	Details
Ofwat, 2019 price review for water companies	Ofwat's final determinations under the 2019 price review (PR19) for water companies set the price (revenue allowance), service (outcomes package) and incentive package (cost sharing, other reconciliations, form of control) for the price review period. Wholesale revenue controls were based on a building block approach based on the Regulatory Capital Value (RCV) and retail revenue controls were based on the total cost to serve plus a net margin on costs to cover a return and an allowance for tax. Ofwat calculates a tax allowance reflecting the corporation tax that each company expects to pay in 2020-25. It calculates the tax allowance using a financial model based on the projected taxable profits of the appointed business and the current UK corporation tax rates and associated reliefs and allowances. The PR19 methodology introduced a tax reconciliation mechanism, which will take account of any changes to corporation tax or capital allowance rates after Ofwat makes its final determinations, as these are significant drivers of the tax allowance. The PR19 tax allowance will be subject to reconciliation at Price Review 2024.

A2.2 A review in 2020 by Grant Thornton for the Civil Aviation Authority of regulatory approaches to RDEC had similar findings:

a) Ofwat does not explicitly include any adjustments for RDEC amounts, although it does include the impact of Research and Development allowances as part of the capital allowance modelling.

b) Ofgem calculates a tax liability allowance which is modelled at the outset of the relevant Price Control Period. Based on the published model, this does not appear to give any consideration to RDEC.

c) Ofcom do not appear to calculate any tax liabilities, and merely use the relevant tax rate for the period in the calculation of their pre-tax WACC.

d) To the extent any forecast profit before tax figures include RDEC as an above the line credit, the additional tax charge arising from the credit is recognised. However, no other regulators appear to consider the potential Step 1 or Step 7 offset as part of the RDEC mechanism.[42]

42 Grant Thornton (2020) *H7 Price Control Model – Approach to Corporation Tax.*