ICAEW
REPRESENTATION 94/22

HOUSE OF LORDS ECONOMIC AFFAIRS COMMITTEE FINANCE BILL SUB COMMITTEE ENQUIRY: DRAFT FINANCE BILL 2022-23

Issued 31 October2022

ICAEW welcomes the opportunity to provide written evidence to the House of Lords Economic Affairs Committee Finance Bill Subcommittee inquiry into the proposed changes to the R&D tax relief regime, a copy of which is available from this link.

This response of 31 October 2022 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

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GENERAL COMMENTS AND SUMMARY

1. HMRC could do more to simplify and promote its guidance on R&D tax relief, as well as engage more pro-actively with companies, agents and representative bodies. This would help to raise awareness of the reliefs and understanding of which types of projects and expenditure qualify, thereby increasing the accuracy of claims.
2. R&D activity has moved on since the BEIS guidelines and much of HMRC's guidance were published. Both should be updated on a regular basis to keep pace with technological developments. HMRC could also expand its guidance on the application of the R&D definition to a wider variety of specific industry sectors and activities.
3. HMRC could also do more to highlight those agents that are making fraudulent and spurious claims. If its powers do not currently allow them to name these agents then these could be extended to do so.
4. We believe that the pre-notification requirement would have just as much impact on genuine claimants as fraudulent ones and is therefore not especially well-targeted. If the government wishes to introduce this requirement, we have suggested some amendments that would reduce the impact on genuine claimants. We also recommend that more effort is put into investigating claims made by agents which HMRC suspects are fraudulent or spurious.
5. At present, the UK is seen by many multinational businesses as a favourable territory in which to locate their global R&D hubs. If relief is restricted for overseas expenditure, this could reduce the UK's attractiveness as an R&D centre, which is contrary to the government's stated aims.
6. If the government wishes to encourage more R&D activity in the UK, we believe that it should provide incentives that make it cheaper overall for that activity to be carried out in the UK compared to overseas.
7. The biggest difference that the government and HMRC could make in encouraging R&D activity is in providing more certainty regarding the availability of the relief. Introducing subjective tests limiting the availability of relief for overseas costs only adds to uncertainty. Greater certainty could be achieved by HMRC adopting a more consistent approach to its handling of claims across individual case workers and R&D units.
8. We have noted that other countries provide this level of certainty through clearance procedures and by making the analysis of qualifying expenditure more straightforward.

RESPONSES TO SPECIFIC QUESTIONS

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

9. We welcome the inclusion of pure mathematics and cloud computing costs to the list of qualifying expenditure. However, we believe that more types of expenditure could be included to reflect the overall cost of carrying out R&D activity.
    - Certain third-party costs continue to be ineligible for R&D relief because of the mechanics of the two schemes. Some R&D projects require extensive testing (for example, drug discovery) or other routine work which forms part of a wider R&D project but is not eligible for relief.

      Where this is carried out 'in house' or in a group of companies it can qualify for R&D relief. However, if it is contracted-out to a third party by a large company then neither the R&D contractor nor the company undertaking the work can qualify. This creates an unnecessary difference in treatment which should be rectified to ensure all relevant R&D costs can be included.
    - Regulatory costs associated with undertaking R&D in particular sectors – eg drug discovery – are also a key cost of doing R&D which are often non-qualifying.

- Rent/leasing costs – These are a key part of R&D work which we believe should be supported by the regime.

10. The government should also take this opportunity to carry out a wider review of the definition of R&D to ensure that it reflects modern practices. Piecemeal additions to the definition are helpful but a more comprehensive approach is required.
11. In addition, HMRC guidance on how the definition of R&D applies across sectors should be updated regularly and HMRC's assessment of what constitutes qualifying expenditure should be applied more consistently in line with that guidance.

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

12. We believe that the measures proposed are too broad and could have just as much impact on genuine claimants as they do on claims made fraudulently or spuriously.
13. We believe that HMRC should instead focus on improving its guidance to minimise errors in claims and tackling specific boutique firms that it is aware are making spurious claims by examining claims submitted by them more closely.
14. In recent months, HMRC has been carrying out additional checks on R&D tax relief claims, which has resulted in delays in the processing of genuine claims. While we accept that genuine claimants must bear some of the inconvenience, now that HMRC has more information about the agents that are submitting fraudulent claims, we recommend that HMRC focuses its resources on monitoring and investigating the claims made by those agents.

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

15. The new rules requiring qualifying activity to be carried out in the UK only apply to activity sub-contracted to third parties or payments made to externally provided workers (EPWs). Hence, work would still qualify if, for example, it was carried out by an overseas branch of a UK company. However, in some cases, companies do not wish to set up a branch to carry out their overseas R&D activities or would prefer to carry this out via an overseas company, which would be caught by the sub-contractor rules.
16. Under the proposed rules, expenditure on work carried out by sub-contractors and EPWs would still qualify if the conditions necessary for the R&D:
    a) are not present in the UK;
    b) are present in the location where the R&D is undertaken; and
    c) it would be 'wholly unreasonable' for the company to replicate them in the UK.
17. We believe that these rules do not encourage activity in the UK. They merely restrict relief in situations where there is some reasonableness to those conditions being replicated in the UK.
18. They also create uncertainty in the tax system by introducing a subjective test as to whether it is "wholly unreasonable" for the company to replicate conditions in the UK. This potentially increases costs for businesses and HMRC should they need to argue this point in the courts or through the enquiry process. At the very least, clear guidance would be required on how to apply these rules in specific situations.
19. For example, take a Contract Research Organisation (CRO) for a pharmaceutical company. If it carries out clinical trials which require specific populations to be tested, due to the disease only being prevalent in certain areas of the world, the costs of doing this would clearly be allowable. However, it is less clear whether this is the case where the reason the

CRO carries out testing overseas is to ensure the clinical trial has a diverse population (without this being a regulatory requirement).

20. An alternative to HMRC writing detailed guidance would be to provide a clearance process which would give companies certainty on whether their fact patterns fall within the exemption prior to submitting their claims. Australia has a similar process, and it could be an extension of the existing advance assurance procedure in place for small and medium sized (SME) companies making their first claims.
21. These new restrictions are likely to lead to **less** R&D being done in the UK, rather than more, if they deter multinational businesses from using the UK as the location for their global R&D hub. The eligibility of certain external and overseas costs makes the UK an attractive place to locate hubs compared to other countries, but this would be reduced by placing restrictions on the eligibility of these costs.
22. We also believe that the new rules as drafted would be difficult to apply, especially where the third party carries out R&D work partly in the UK and partly overseas. How will the claimant company be able to identify whether those activities are in fact undertaken in the UK or overseas?
23. It is important that guidance is provided on how this requirement is to be evidenced, and who bears the burden of proof ie, claimant or staff provider / subcontractor. This will be important as some third parties may not be willing to provide this information unless there is a legal obligation to do so. Claimant companies will not have a contractual right to force the supplier to disclose this information, and many are likely to assume that holding a contract with a UK supplier is likely to be sufficient for the costs to qualify. The same point applies to both EPW and contracted out R&D.
24. We have considered what alternative changes could be made to encourage more R&D activity in the UK. Ideally, any change should ensure that the cost of carrying out the R&D in the UK is lower overall than carrying it out overseas. This could be achieved by removing test c) from the conditions above or providing a higher rate of relief for UK expenditure compared to overseas.
25. Alternatively, the government could limit the amount of relief available with reference to the UK PAYE & NIC liability arising on staff working on the R&D project concerned. This would give the government a more focussed tool in determining the level of UK presence that an R&D project needs to have to qualify for relief.

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

26. There remains a lack of awareness among small businesses about both the existence of R&D reliefs and the complexities involved in claiming them. These include HMRC's expectations when filing a claim, how to work with an agent and the lack of regulation in the tax advice market.
27. The impact of this is that a lot of smaller businesses become exposed to rogue agents. As fees for compiling and filing accurate R&D tax relief claims can be quite high (due to the amount of work involved), smaller companies might be tempted to work with agents that charge lower fees but work on a high-volume basis and, ultimately, do a poor-quality job.
28. HMRC could certainly do more to explain the complexities of making a claim and what to watch out for where an agent seems too cheap to be true. Some of the ways in which it might do that include:
    - continued dialogue with professional bodies to raise awareness among businesses of the regulatory framework and how to choose an advisor;
    - more direct contact between HMRC and agents, recognising that reputable advisers help promote better compliance; and
    - clearer guidance on gov.uk and other written outlets that HMRC uses to promote the reliefs.

29. Given that it is mainly smaller companies that are susceptible to rogue agents, there may be a case for re-introducing the minimum expenditure requirement for R&D tax relief claims that was repealed for accounting periods ending on or after 1 April 2012. This required the company to spend more than £10,000 in a 12-month accounting period on qualifying expenditure.
30. HMRC may wish to analyse the size of the claims that are being made by rouge agents to determine whether an expenditure threshold would remove much of these agents' client base. However, such a move would risk forcing smaller companies out of qualifying for the relief and so should be seen as a last resort.

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

31. The most recent update to the BEIS guidelines was in 2004. R&D processes have developed considerably since then (for example, it includes details on R&D carried in the development of a DVD player) so we would like to see the guidelines reviewed and updated on a regular basis so that they reflect up-to-date practices. BEIS does not appear to have a role in interpreting, applying or providing guidance on its own definition which means that it does not have an incentive in keeping it updated.
32. HMRC does not follow these guidelines in some cases such as, for example, stating made during an enquiry that an activity is not R&D, without referring to these guidelines. In other cases, taxpayers have provided an explanation as to why something is R&D but HMRC has not engaged with the analysis. This is particularly the case when assessing whether something comprises an 'advance' and what the relevant advance is. For example, in the case of a piece of equipment or product which is an assemblage of different components, they all need to work together for the advance in technological capability to be achieved.
33. If the application of the rules to these situations was more fully articulated it would help build up a bank of examples which, when anonymized, could be shared widely and would help to greatly reduce the uncertainty companies face in determining whether a development is R&D.
34. One area that causes particular difficulties is software development. HMRC has done a lot of work over the years in providing guidance on the application of the rules to this form of expenditure, but it has not kept up with developments.
35. For example, there is an increasing difference of opinion between leading competent professionals, engineers and HMRC regarding the qualifying nature of technical development in data science and data modelling. While claimants understand the need for specialists from HMRC Chief Digital Information Office (CDIO) to support HMRC in validating the R&D undertaken in software claims, the approach taken requires improvement to ensure a reasoned and consistent application of the R&D definition across sectors.
36. As well as keeping up with these developments, HMRC's guidance on the BEIS guidelines could be expanded to include guidance on its application to a greater range of specific fields. At present, only pharma and software are included at CIRD81920 and CIRD81960, respectively.

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

37. We believe that the advance notification requirement would deter some non-genuine claims, because it would make it harder for rogue R&D agents to approach companies and encourage them to make historic claims. To some extent, the requirement is well-targeted because such agents would primarily approach companies that have not previously claimed R&D tax relief or have not done so in the last three years.
38. However, the requirement will impact equally on genuine claimants who will now need to consider at a much earlier point (six months, rather than two years from the end of the accounting period) whether they have a valid claim to make. This could therefore mean that

they are also prevented from making genuine claims. New claimants are less likely to be in the routine of making claims and so are most likely to miss the notification deadline.

39. What appears to be a small change could make quite a significant impact on R&D tax relief eligibility. Companies may have carried out R&D projects under the expectation that they would be entitled to relief and could therefore suffer significant cashflow and profitability issues if they are prevented from making a perfectly valid claim because they didn't submit a notification in time.
40. If the government is determined to press ahead with this notification requirement, we recommend that the six-month deadline is extended to 12 months to reduce the impact on genuine claimants. We also suggest that notifications are made on a group-wide, rather than company-by-company basis. This would mean that if any company in the group has made an R&D claim in the previous three years, notification would not be required.
41. In our response to the draft legislation, we also noted that the notification deadline is 6 months from the end of the relevant accounting period. In situations where a company has a long period of account (say, 18 months) that period of account is split into two accounting periods- the first encompassing the first 12 months and the second covering the remainder of the period of account. Where there is an 18-month period of account, the deadline for notifying a claim for the first accounting period would be the day that period of account ends. By this time, the company would not have the financial information to determine whether it has a valid claim. We therefore recommend that references to 'accounting period' are changed to 'period of account' to resolve this issue.
42. It is also concerning that the form of the notification has not yet been decided. It is important that this is agreed and publicised as soon as possible so that companies have plenty of time in which to comply.
43. The government may wish to follow the Disclosure of Tax Avoidance Schemes (DOTAS) regime as an example of how the notification regime could work. Under the DOTAS regime, taxpayers must notify HMRC within a certain timeframe if they have been involved in a notifiable tax avoidance scheme. HMRC keeps a note of the notified scheme and issues the taxpayer with a reference number which they then include in any relevant tax return.

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

44. We have noted that individual case workers and R&D units take a variety of approaches when dealing with formal enquiries into R&D tax relief claims.
45. We would like to see a more consistent standard of checking claims across industry sectors and level of documentation and evidence being required, both in volume and quality. We would also appreciate HMRC communicating its approach in easy-to-understand terms so businesses know what to expect in advance of making claims, rather than finding out when their claims are being investigated and it is too late to do anything about it.
46. We have also noted that HMRC is increasingly using 'one-to-many' campaigns as a way of tackling non-compliance, not just in the R&D space but in many other areas of the tax system.
47. In a recent campaign, HMRC sent letters to companies operating in specific industry sectors advising them that these sectors are being targeted by rogue agents and asking them to check whether the claims those companies have made in the past are correct. While such an approach removes the need for HMRC to open formal enquiries, thereby reducing its costs, it casts doubt within companies and their agents and forces them to carry out additional work to confirm whether the claims are correct.
48. In line with our earlier comments, we believe that HMRC could do more to improve its guidance and communication of that guidance so that companies are made more aware of the rules and are able to assess more easily whether their agents are competent and genuine.

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

49. From a review of regimes in other territories, we have established that the UK regime compares favourably in terms of the light touch taken in making and handling claims. We are therefore concerned that if the UK imposes additional administrative burdens through notification and prescribed documentation requirements, this could cause it to lose its competitive edge.
50. Having said that, if the pre-notification requirement were re-focussed as a pre-clearance service, this would help to provide more certainty for companies that they had a valid claim to make.
51. The UK already has an advance assurance process available to SMEs making claims within their first three years of trading. This could be expanded in line with other countries.
52. In Austria, for example, an application must be made to the Austrian Research Promotion Agency (Forschungsförderungsgesellschaft - FFG) for approval that the R&D activities are eligible. In Belgium, companies may only apply the R&D tax credit if they request a certificate from competent regional authorities confirming that the R&D investments are not environmentally unfriendly.
53. We have noted that some territories (such as Portugal, Switzerland, Canada and France) provide an uplift on staff costs of say 40% to allow for the inclusion of overheads and possibly even qualifying indirect activities (QIA). This would simplify the reliefs as, rather than having to keep a track of and report each item of qualifying expenditure, the claim need only be based on qualifying staff costs.
54. As noted above, there are difficulties in determining whether claims involving software development cover qualifying or non-qualifying activities. To deal with this, some countries such as Spain and Italy have introduced a Technological Innovation incentive which includes a broader definition of R&D in relation to technology development, but the incentive is provided at a lower rate.

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

55. The inclusion of pure mathematics, data and cloud costs are likely to encourage more innovation and development in certain sectors. However, overall, the proposed changes are likely to reduce the amount of relief awarded, rather than increasing investment in R&D.
56. The most impactful changes that the government and HMRC could make in encouraging R&D activity are to increase certainty around the availability of the relief. R&D tax reliefs are only likely to impact R&D investment decisions where the claimant has certainty of benefit as otherwise the potential benefit is necessarily discounted.
57. We also note that with the forthcoming increase in the corporation tax rate from 19% to 25%, the net cash benefit of the RDEC will reduce from 10.53% to 9.75%. We believe that the RDEC rate may not be at a level that has a significant impact on investment decisions already and hence the rate of the relief needs to be examined and potentially increased in advance of April 2023.
58. As we have already noted above, restrictions on overseas costs are likely to have a detrimental effect in discouraging innovation where the conditions for that activity are more favourable overseas or could cause companies to move their global R&D hubs away from the UK.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).