



## R&D TAX RELIEFS REVIEW: CONSULTATION ON A SINGLE SCHEME

Issued 3 March 2023

ICAEW welcomes the opportunity to comment on the R&D Tax Reliefs Review: Consultation on a single scheme published by the government in January 2023, a copy of which is available from this [link](#).

For questions on this response please contact our Tax team at [taxfac@icaew.com](mailto:taxfac@icaew.com) quoting REP 17/23.

This response of 3 March 2023 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.

ICAEW Corporate Finance Faculty has also contributed to this response. This faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policymakers and academic experts.

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### ICAEW

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## KEY POINTS

1. While many members empathised with the government's focus on mitigating fraud within Research and Development (R&D) tax relief, there was a concern that tax policy was being designed with this at the forefront as opposed to what is the best way to achieve the policy objective? This is resulting in a direction of travel whereby compliant taxpayers are being penalised because of the poor behaviours of the minority within the R&D regime.
2. Furthermore, these changes will disproportionately affect SME's who are often already significantly more disadvantaged than their larger competitors by the increased cost of living and energy crisis. There was a feeling that UK tax policy was less focused on how to ensure the UK can be a competitive jurisdiction in which to invest by supporting smaller businesses and start-ups. There was a unanimous view that targeted compliance activity would be far more effective at mitigating fraud as well as more equitable overall than the blanket shifts in policy proposed.
3. It is also important that the impact of merging the two R&D schemes is considered in light of all the other recent R&D changes. Members are already reporting that R&D businesses are scaling back investment and, in some cases, moving their headquarters overseas in response. Start-ups are particularly affected by the changes and there is concern that founders might look at the UK as a less appealing place to establish a business.
4. Most members agreed that merging the schemes could offer some simplification as SMEs would no longer need to decide which scheme they were eligible to claim under, given that some costs are only qualifying under the large scheme. However, members didn't consider that the merger would, in general, enable better quantification and certainty over the quantum of the relief. This might apply in limited circumstances where the SME had carried forward R&D credits, however this is not anticipated to apply widely.
5. There would likely be more visibility over the relief, given it will appear 'above the line' which may help investment decisions. SME's will no longer be required to shift to the RDEC scheme as the company builds turnover which was usually a point of cash-flow stress. However, members did not feel that the removal of this pinch point was likely to encourage SME's to invest.
6. Members were not opposed to an above the line scheme but stressed that companies are facing a lot of tax changes and that for many SMEs, this would be an entirely new method of claiming relief. Smaller entities are also much less likely to have significant designated tax accountant/resource to manage these changes and therefore education and guidance will be imperative to assist these businesses to manage the change and maintain compliance. Members did not think that April 2024 was a reasonable commencement period in which to ensure this could take place and felt this should be delayed.
7. In regards to subcontracting, and which party should claim the relief, the customer or the contractor, we discuss our conversations with members in more detail below. However, it was clear that there was not a consensus one way or the other, with both options offering advantages and disadvantages. It was also the area of the consultation of most concern to members. All members felt strongly that subcontracting should be included as it was important that some entity was getting the relief. Subcontracting was also viewed to be less risky in light of the movement away from allowing overseas costs to qualify under the regime.
8. While many members agreed that the ability to provide increased support to certain industries would be welcome, some believed that state intervention in this way can distort market forces and increase complexity.
9. According to HMRC research, additionality is lower within the SME scheme when compared to the RDEC, however smaller organisations may not be as incentivised by an 'above the

line' credit and therefore it does not follow that additionality will be improved by merging the schemes. It is therefore important that any redesign of the scheme takes the opportunity to iron out any areas of uncertainty around interpretation so as to support the Treasury's objective to improve additionality. This could include legislative change to reduce ambiguity and make clear HMRC's position. An example here would be the issues surrounding the *Quinn (London) Limited v HMRC* case regarding subsidised and subcontracted expenditure.

10. Our members were focused on the key areas of this consultation, therefore we have not sought to answer every question as we did not receive feedback on all questions. We have provided comments under the key topics of the consultation.

## **ADDITIONAL SUPPORT**

11. Most members agreed that a mechanism to provide extra support in certain circumstances would be welcomed, although some did suggest that this could distort market forces and fiscal policies which interfered in this way needed careful consideration.
12. Some members considered that in many industries, commercial influences would iron out changes in R&D tax relief to mitigate the impact. For example, adjustments in pricing or the quantum of investment might manage any shortfall in cash from a reduction in R&D tax relief. However, members did suggest this would be unlikely to happen in every case and there were some industries which would clearly benefit from further support. For example, life sciences tend to have an expensive funding requirement and longer maturity period which is not as attractive to private equity investment. Therefore, life sciences are much more reliant on tax incentives like the R&D tax relief and are less likely to have investors who will be willing to offer further funding to plug any gaps. There is clearly a public interest angle here too which many felt should be a consideration in allocating any further support.
13. It was also suggested that extra support could be given with some form of claw-back mechanism once a project becomes profitable. This would provide a temporary cash flow advantage at the crucial early stages of a project.
14. However, there is the issue that different rates of relief will create further complexity and it is likely that some projects will transcend more than one sector and therefore attract different rates of relief which would require some form of apportionment. This needs to be considered carefully.

## **SUBCONTRACTED EXPENDITURE**

15. As discussed above we received mixed feedback on which party to the subcontractor relationship should receive the R&D tax credit.
16. It was recognised that if the policy intent is to influence investment and drive behaviours then the customer should likely obtain the tax credit as they are the driver to instigating the project and making the investment. However, it was felt that in reality the contractor is more likely to understand whether the work they are undertaking to honour the contract is in fact R&D. It is difficult for an entity which is not actually performing the work to understand whether the project would qualify as R&D under the regime. Therefore, a regime which allowed the contractor to claim the R&D credit would be more likely to encourage compliance.
17. However, members accepted that SMEs were more likely to subcontract out R&D, particularly start-ups where it is unusual to have the resources in-house. It was therefore recognised that any move away from giving the R&D relief to the customer could negatively impact SME's even further.

18. Some members felt that there could be some form of transitional rule whereby for a finite period of time a joint election could be made to apply the old rules. This would mean that any long-term contracts, which had been negotiated on the basis of the old rules, could continue undisturbed and this would manage the commercial disruption from any changes.
19. Some members did suggest that a permanent provision like this (similar to the s198 Capital Allowances Act 2001 election) would not be welcomed as this would be likely to create unnecessary commercial tensions and complexities. However, other members considered that some flexibility regarding who could make the claim for subcontracted costs, enabling some commercial adjustment between parties would be positive with the suggestion of a 'certification' process to ensure no double counting of claims. Members views on this point confirmed that there is a great deal of subjectivity in what might be the best outcome. It is perhaps best to consider which option will result in the least complexity and mitigate the risk of double counting and fraud or error.
20. There could also be complexity around the definition of R&D where the subcontracted element is routine and in isolation would not meet the definition of qualifying R&D expenditure, while if the work was considered as part of the wider project, it would amount to R&D for tax purposes. There was appetite to consider a provision which could capture this type of situation and allow the expenditure to qualify to manage the impact of any new regime.
21. On balance, opinion tipped towards giving the customer the right to claim subcontracted expenditure should the Treasury decide to allow only one entity to qualify, although this was an area of significant debate and conflicting opinions.

## **DE MINIMIS THRESHOLD**

22. Members were not averse to introducing a de minimis threshold but did suggest that for this to have any significant impact, it would likely need to be larger than £25,000. The figure of £50,000 was suggested a number of times. Members accepted that businesses were more likely to seek professional advice when the claims were higher, whereas smaller value claims can preclude the use of an adviser due to cost constraints.
23. There was also unanimous feedback that such a move would need to be balanced by introducing a further policy initiative to support fledgling R&D projects. Many members suggested that a grant system should be implemented to support smaller R&D initiatives. This is because grant payments tend to be subject to more rigorous due diligence and a cash injection would likely encourage investment more effectively than a tax credit scheme.

## **PAYE AND NIC CAP**

24. We did not receive a great deal of feedback on this point but members who did have views suggested that a PAYE and NIC cap somewhere between the limits currently in place within the SME and RDEC schemes would not be unreasonable and would represent a fair compromise.
25. Some members did query whether this measure was still necessary given the restriction on overseas costs now in place.

## **QUALIFYING INDIRECT ACTIVITIES**

26. Qualifying indirect activities were not regarded by members as a key driver in making decisions about R&D, therefore we did not receive a great deal of feedback on this area.

27. Members considered overall that the ability to include these was welcome and can add genuine value to the R&D activities being undertaken.

## COMMENCEMENT

28. Members were keen to ensure that there was sufficient time to educate businesses ahead of the change, particularly SMEs. They did not feel implementing the rules from April 2024 would give sufficient time to do this especially given the consultation is currently at an early stage.
29. Uncertainty is one of the biggest blockers to investment, therefore it is important that changes are managed in an efficient manner and well communicated in conjunction with transitional rules which minimise commercial disruption. Please see above regarding comments around a transitional joint election in respect of subcontracting changes.
30. We have been advised by the capital investor sector that a 24-month timeframe is typical for investee businesses when forecasting funding needs, therefore any change inside of 24 months will likely have an impact. Investors typically spend quite a lot of time with companies planning budgets and forecasts to ensure they have enough capital to hit key milestones. Those milestones are usually key to unlocking the next round of funding. Any changes that come into force by April 2024 will likely cause disruption and require many companies to significantly adapt plans.
31. Implementing a new scheme abruptly will especially disadvantage those businesses that are partway through a project. Some members report that businesses have already responded to changes coming into effect on 1 April 2023 by reducing costs including those for recruitment. The possible implementation of a single scheme from 1 April 2024 is not sufficient lead time for plans to be re-adjusted further, if necessary.
32. Any lack in lead time before implementation is likely to have a severe impact on the ability of SMEs to budget for large innovative projects and hamper their ability to employ the technical talent required for these projects thereby delaying innovative projects being undertaken in the UK. This runs contrary to the government's growth agenda and funding for innovative net zero projects could be at risk.
33. There has been a significant amount of change in quick succession. For example, there has been no time to assess the impact of the overseas restrictions before the rates change and now there is a consultation on an SME scheme redesign. Whether the changes make a positive or negative impact the Treasury will have no idea which change caused the effect.
34. Members did suggest that there should be a dedicated HMRC helpline for SMEs that are transitioning into a new scheme. While we appreciate resourcing could be an issue here, it illustrates the concerns members have around ensuring SME's have appropriate support in place to help manage the changes.

## OTHER POINTS

35. Thought could be given as to whether R&D tax relief might be extended to unincorporated businesses as well as corporates. This would extend the scope of businesses which would qualify which might assist in encouraging investment, balancing out any decline which might occur as a result of changes in the rules.

## 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>).