ICAEW
REPRESENTATION 3/24

FINANCE BILL 23-24
CLAUSE 2 AND SCHEDULE 1: NEW REGIME FOR RESEARCH AND DEVELOPMENT CARRIED OUT BY COMPANIES

Issued 5 January 2024

Briefing for MPs on the Finance Bill by ICAEW Tax Faculty.

For questions on this paper please contact ICAEW's Tax Faculty at taxfac@icaew.com quoting REP 3/24.

> For the reasons set out in more detail below, there is a serious concern that the FB legislation will not achieve the government's policy objectives and needs to be reconsidered.

This response of 5 January 2024 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, 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* are summarised in Appendix 1.

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EXECUTIVE SUMMARY

1. For the reasons set out in more detail below, there is a serious concern that the FB legislation will not achieve the government's policy objectives and needs to be reconsidered.

THE MEASURE

2. As noted in the Explanatory Notes, in this clause HMRC intends to implement a new merged research and development (R&D) scheme replacing both the current R&D tax relief for small or medium-sized companies (SMEs) and the R&D Expenditure Credit (RDEC) mainly claimed by larger companies.
3. The new merged scheme will apply to accounting periods beginning on or after 1 April 2024.

KEY CONCERNS AND RECOMMENDATIONS

4. Members are concerned that the FB legislation will not achieve the government's policy objectives and needs further consideration.
5. Given the concerns with the proposed legislation, in addition to the need for reconsideration of the provisions we believe that a commencement date of 1 April 2024 is far too early. This is exacerbated by the fact that there are no transitional provisions. ICAEW reiterates its earlier recommendation that the commencement is postponed.
6. We would also stress the need for guidance and education. It is imperative that such guidance is both accessible and practical. The new rules will significantly affect all sizes of companies including those smaller entities with limited professional tax resource. HMRC should seek to reduce complexity and assist companies in dealing with such rapid changes. If quality resources are not made available to aid companies to manage the transition, there are serious concerns that the changes will not improve compliance.
7. Members have indicated that a lack of confidence exists when claiming R&D tax relief within the UK more generally. This has arisen due to the various changes made to the rules in quick succession over the past few years. This is made worse by HMRC's current adversarial compliance approach which is significantly impacting compliant companies. These matters have caused considerable uncertainty and a sense of instability. This will be intensified by the restrictions placed on overseas expenditure which will now largely not qualify for additional support.
8. The speed at which these rules are being implemented, coupled with the fact there has not been a great deal of time to consult on the draft legislation, is perceived to be damaging the attractiveness of the UK as a jurisdiction in which to undertake R&D. Members have advised us that this is already starting to impact investment into the UK. Anecdotally we are receiving numerous reports of companies moving their R&D operations overseas as a result of the current environment.
9. While amalgamating the two schemes was supposed to simplify matters, the inclusion of additional reliefs for 'R&D-intensive' SMEs retains much of the original SME scheme in any event, hence keeping two separate schemes in existence.
10. There are also widespread concerns around subcontracted R&D, most notably the loose drafting of s1133, which is explored in more detail below.
11. Paragraph 16, Sch 1 suggests that the changes will apply to accounting periods beginning on or after an "appointed day". When will regulations be laid by the Treasury to confirm that appointed day? Is there a possibility that it might not be 1 April 2024?

THE DETAIL

Subcontracted R&D

12. The largest area of concern is the changes to contracted out R&D. It is disappointing that ICAEW's advice to defer the commencement date and to introduce transitional provisions to assist in managing these changes has not been taken on board. It appears that the answer as to who is eligible to claim R&D is largely dependent on the terms of the contract and the surrounding circumstances at the time of entering into the arrangements.
13. This means that parties subject to arrangements in place prior to the introduction of the merged scheme will need to refer back to negotiations and discussions that took place when the arrangements were entered into to determine who will be entitled to relief. This could prove problematic, especially where arrangements have been in place for quite some time. We believe that transitional provisions would have helped to mitigate the disruption to long-term commercial contracts involving subcontracted R&D. Such provisions would also provide breathing space to companies to enable them to understand the new rules over time and with adequate advice.
14. Those members that made comments on the Finance Bill clauses, without exception, raised concerns about the drafting of s1133 indicating that it was ambiguous and far too open to interpretation. To achieve the policy intent, this complexity should be removed. While the draft guidance shared with ICAEW and other stakeholders will assist in managing interpretation, wherever possible the law should be clear from statute to avoid ongoing technical disputes. Such debates have been an unwelcome feature of R&D tax relief historically.
15. Members consider that more detail is needed to articulate under what circumstances a contractor would be eligible to claim the R&D relief. The draft guidance provides some useful examples, but these set out circumstances in which it is fairly clear which party would be entitled to the relief. More nuanced cases may be more difficult to determine in practice. For example, what happens where the management of the customer to a contract is undecided whether what is being contemplated is R&D? The proposed wording looks at what the principal 'contemplated' or 'intended' at the time of entering the contract. This test is subjective and could be the subject of considerable case law over time. Also, if companies are to remain compliant with the rules, it will be important that they fully understand whether R&D is in fact being undertaken and the costs involved in executing such R&D, irrespective of whether they are a contractor or a principal. An intention or contemplation of R&D on entering a contract may be insufficient in helping them to determine whether or not they are entitled to relief, but this is exactly what the legislation says needs to be analysed.
16. While the proposed legislative wording is clearly designed to ensure that relief sits with the principal, it will likely cause commercial issues in practice and potentially disputes between contractual parties. In order to create certainty, the legislation should put beyond doubt who is eligible for the relief.
17. The legislation also appears to assume a high degree of cooperation between customers and suppliers. For example, how will a customer estimate the proportion of R&D spend within their payments to contractors that form part of a larger contract? Similarly, how will they identify overseas costs that need to be excluded? There is also little motivation for a supplier to provide this information and maintain its accuracy given that they will not be claiming the R&D tax relief. This will be an increasingly difficult problem in cases where expenditure is partly carried on outside the UK.
18. The new rules will take effect for accounting periods starting on or after 1 April 2024. However, this could lead to a situation where the subcontractor and principal are subject to different rules if they have non-coterminous year ends (eg, 31 December and 31 March).

One would be in the old regime, while another is in the new rules. This will be very difficult to navigate commercially and could result in double claims.

19. In both new s1053 and s1042E (which deal with contracted out expenditure) there is a condition D that the expenditure is not attributable to a foreign permanent establishment (PE). Does this apply to the PE of the claimant company, the subcontractor or both? Could HMRC provide some examples in its guidance?
20. New s1053A deals with situations where R&D is contracted out to a company and the contractor is "ineligible" for relief or is not carrying on a trade, profession or vocation within the charge to tax. This needs to be made clearer as "tax", per s1119, CTA 2010 includes corporation tax and income tax. A similar wording to that used in s104C, CTA 2009 could be used here instead.

Merged scheme – specific points

21. We would appreciate seeing examples (perhaps in HMRC's updated guidance) of situations referred to in new s1112B(4) where a company claims under both chapters 1A and 2.
22. Does the Treasury have any plans to limit chapter 2 relief through the power to make regulations through s1112J? Will there be an opportunity to provide feedback on any proposed regulations before they come into effect?
23. How will amounts carried forward under the RDEC scheme be dealt with under the merged scheme? Can they be carried forward into the latter scheme or are they lost in transition?

R&D-Intensive companies

24. Clarification is required as to whether it is intended that total relevant expenditure for this purpose is calculated by reference to the entire worldwide group, not just entities subject to UK corporation tax (ie, UK group costs). Section 1045ZA uses a connected companies definition, which we understand is based on s1122, CTA 2010. This section considers the concept of control. The test does not therefore appear to be limited to UK connected companies but is, rather, a worldwide test.
25. Similarly, in s1045ZA(5), the test applies to total costs brought into account to calculate profits of the trade under generally accepted accounting practice. This will not necessarily limit the costs to UK only.
26. Therefore, it seems that it is intended to bring worldwide costs of worldwide companies connected to the claimant into the calculation of total relevant expenditure. This will likely reduce the number of claimants that can access the regime and may also make the necessary calculations more complicated. We would appreciate clarification as to whether this is the correct interpretation.
27. We also note that the threshold for qualifying R&D expenditure will be lowered from 40% to 30% for accounting periods beginning on or after 1 April 2024. While we welcome the fact that this will bring more claims into the scope of the R&D-intensive regime, we believe that having two different tests for accounting periods beginning pre- and post-1 April 2024 creates unnecessary complexity.
28. New s1043(1), CTA 2009 refers to "associated trading profits". We assume that this is referring to the fact that the R&D-intensive company regime only applies to loss-making companies claiming tax credits, but it would be helpful if this was explicitly explained in the legislation. A similar issue arises in respect of the reference to a "loss-making trade" in s1043(2). Does this include trades that only become loss-making for corporation tax purposes once the additional deduction for qualifying R&D expenditure is applied? Section 1043(8) appears to suggest that it does because it refers to losses increased or generated by relief under s1044 or s1045 but it would be useful if this could be clarified.

29. There is a small 'typo' in proposed s1043(3) (it should presumably say "is made in the course of activities....")
30. Will R&D-intensive SMEs have the option to carry forward enhanced losses, rather than surrendering them for a payable credit, when they have claimed the additional deduction? If a company qualifies for the enhanced tax credit under this regime, will it be required to claim or would it be able to elect into the merged scheme instead? The wording to be inserted into ss1044 & 1045(2A) needs to be clearer. It introduces the grace period where the company fails to meet the R&D intensity condition for an accounting period and refers to "its most recent prior accounting period of 12 months; duration" but doesn't explain what happens if the most recent accounting period was of a different length. Do you then look back at the position in the company's most recent 12-month accounting period before the longer/shorter period?

Going concern - Section 1112G(5)(b)

31. Members understand that this provision would not allow a claim to be made where a company's intention to transfer its trade to another group company is known when preparing the accounts, but the transfer does not take place until the following period.
32. As an example, on 31 December 2024 a decision is taken to transfer the trade and the accounts are therefore not prepared on a going concern basis. The actual transfer takes place on 1 January 2025. The claim for year ended 31 December 2024 appears not to be possible under the legislation as drafted.
33. It would be helpful to amend this provision so that a claim is still permissible in this scenario, as these circumstances are not unusual in group restructuring arrangements.

Carried forward amounts under RDEC

34. The treatment of any amounts carried forward as a result of the PAYE/NIC cap under s104N(2) step 3(b) isn't explicitly covered in the "new" RDEC in the Finance Bill. We can infer that any step 3 amounts carried forward under "old" RDEC come into scope as "new" RDEC, though for clarity this point could be addressed in the legislation.

Suggested amendment to CTA 2010

35. In the consequential amendments to the patent box, at para 13(3)(b), members have queried the reference to s357BLN(7)(e) and whether it should in fact be s357BLB(7)(e).

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).