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DRAFT PROVISIONS FOR FINANCE BILL 2023-24 RESEARCH AND DEVELOPMENT RELIEF

Response by Association of Taxation Technicians

1 Introduction

1.1 The Association of Taxation Technicians (ATT) is pleased to be able to comment on the draft Schedule 1 of Finance Bill 2023-24 *Corporation tax: research and development* (the *draft legislation*) and accompanying documents published on 18 July 2023.[1]

1.2 The primary charitable objective of the ATT is to promote education and the study of tax administration and practice. We place a strong emphasis on the practicalities of the tax system. Our work in this area draws heavily on the experience of our members who assist thousands of businesses and individuals to comply with their taxation obligations. This response is written with that background.

1.3 In summary, we consider that:

- Additional support for 'R&D intensive' small and medium sized enterprises (SMEs) should be incorporated into any future single scheme, and not operated as a standalone scheme as is currently proposed (see Section 2).
- The suggested commencement date of April 2024 for the new single scheme is too soon, and more time should be taken for consultation and to ensure that it can be delivered successfully (see Section 3).
- The rules around additional support for R&D intensive SMEs should be amended such that two consecutive years of failing to meet the R&D intensive test are required before companies cease to qualify (see Section 4).

1.4 We have set out our overall comments on the draft legislation in Section 2 below. We have then gone on to discuss the proposed new above the line credit single scheme in Section 3, and the proposed additional tax relief for R&D intensive SMEs in Section 3. Section 4 sets out our other specific comments on the wording of the draft legislation.

1.5 Unless otherwise stated, all paragraph references are to the draft legislation, and section references to CTA 2009.

[1] https://www.gov.uk/government/publications/research-and-development-reform-additional-tax-relief-and-potential-merger

2 Overall comments on the draft legislation

2.1 We were surprised to see that the proposed enhanced relief for 'R&D intensive' SMEs will not be incorporated into the new single scheme once that is launched, but will instead continue to operate as a standalone version of the current SME scheme.

2.2 As noted in our response to the consultation held earlier this year[2], whilst we do not support the introduction of a single, merged R&D scheme, we acknowledge that it would be a significant simplification of the R&D tax relief regime.

2.3 However, what is currently being proposed does not represent any simplification. Instead, under the proposals in the draft legislation there will still be two separate regimes – the new above the line credit 'single' scheme and a separate SME scheme which is only available to a small number of R&D intensive companies. The addition of new rules to define R&D intensive SMEs and the possibility of companies moving in and out of the two regimes as their expenditure profile changes (see Section 4.5 below) will arguably result in an overall increase in the complexity of the R&D relief regime, rather than simplification. This is extremely disappointing given that the simplification was a key advantage identified during the consultation process on the new single scheme.

2.4 As set out below (see Section 4.4), providing enhanced relief for R&D intensive SMEs through a separate standalone scheme is likely to cause confusion and make it difficult for SMEs to plan and budget, particularly as it will often not be clear whether or not the 'R&D intensive' condition is met until after the end of an accounting period. This is concerning, as tax reliefs can only incentivise R&D if they are clear and their value can be easily understood. Anything that can't be understood before the business involved takes a decision whether or not to embark on a project cannot be an effective incentive, and instead may act as more of a 'nice to have' reward or result in many worthwhile projects not getting off the ground.

2.5 We are also concerned that the proposed design will lead to boundary pushing and abuse, with unscrupulous businesses and advisers seeking to ensure they meet the 40% expenditure condition in order to qualify for the more generous repayable credit offered under the proposed R&D intensive SME scheme.

2.6 Whilst we appreciate that the Spring Budget announcement commits the Government to providing some form of enhanced relief for R&D intensive SMEs, we do not see why this could not be delivered as part of the proposed single scheme. If this new scheme is introduced, it should be relatively simple to incorporate the provisions in the draft legislation which define 'R&D intensive' and provide for a higher level of credit where the conditions are met. There would then be no need to continue operating a separate, standalone SME-like scheme, meeting the simplification objective and reducing the confusion of businesses moving in and out of two very different regimes if their expenditure profile changes.

2.7 As set out at Sections 3.1 to 3.5 below, we are also concerned that the proposed April 2024 timetable for introducing the new combined scheme is overly ambitious.

2.8 Our overall recommendation would therefore be:

- To delay introduction of a single merged scheme, allowing more time for consultation and for all involved to prepare.
- In the meantime, incorporate the additional support for R&D intensive SMEs into the current SME scheme.

[2] https://www.att.org.uk/technical/submissions/rd-tax-reliefs-review-consultation-single-scheme

- Once the new single merged scheme is introduced, incorporate additional relief for R&D intensive SMEs into that regime, and remove the SME scheme entirely from that date.

This approach would result in a true 'single scheme' being in place (albeit with enhanced support for some SMEs), rather than the hybrid approach currently proposed by the draft legislation.

3 Detailed comments on proposed new above the line 'single' scheme

Proposed timescale for introduction of new scheme

3.1 We note that the policy paper accompanying the draft legislation indicates that the Government has not yet taken a decision on whether to introduce the new single scheme, but intends to keep open the option of doing so from April 2024. We would strongly recommend that the Government does not attempt to introduce the new scheme this early.

3.2 The detailed consultation exploring the possibility of a combined scheme only closed in March this year, and we are concerned that, in an effort to be able to implement by April 2024, HMRC and HM Treasury have not taken sufficient time to consider the responses received. The published summary of responses[3] highlights significant concerns raised by respondents which have not been addressed, including the impact on SMEs of moving to an above the line credit scheme. Similarly, options explored in the consultation which received a measure of support (such as restricting relief for Qualifying Indirect Activities (QIAs) and introduction of a minimum expenditure threshold) are to be 'kept open' for consideration, but with no indication as to whether or how this will happen before April 2024.

3.3 As set out in our consultation response, we do not believe that April 2024 is a realistic date to introduce a new merged scheme. Such a timescale does not allow for proper consultation, or for the required systems and processes to be put in place by business, agents, software providers and HMRC.

3.4 We also note that this timescale does not allow for the effect of recent administrative changes (including the introduction of additional information and claim notification forms) on levels of abuse and fraud to be properly monitored and considered.

3.5 Given the fundamental nature of the changes proposed, and the impact they may have on R&D activity in the UK, the process should not be rushed, but instead the appropriate time taken to ensure that any new scheme is well designed and operates effectively for all parties.

Treatment of subcontracting and subsidised expenditure

3.6 One feature of the proposed single scheme is that, where R&D is subcontracted, the company contracting out the R&D will be able to claim relief, and not the subcontractor. This follows the current rules under the SME scheme, but is the opposite of the position under the existing R&D Expenditure Credit ('RDEC') scheme. Similarly, it is proposed that, as with the SME scheme, subsidised R&D will not qualify for relief, whereas it has done to date under RDEC (though we note that this aspect of the legislation is square bracketed and therefore subject to change).

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1171402/Summary_of_Responses_-_RD.pdf

3.7 Overall we believe that this approach to subcontracted R&D is reasonable. It appears sensible that the person ultimately funding the R&D and taking the risk receives the incentive. Having one rule that covers all claimants under the new regime (regardless of size) also simplifies matters.

3.8 A simple rule regarding subcontracting should ensure that businesses are confident who is entitled to claim R&D relief. Tax reliefs and credits can only incentivise innovation and influence business decisions if they are clear and understood. Anything that can't be understood before the business involved takes a decision cannot be an effective incentive.

3.9 However, one drawback of this approach is that consideration as to whether R&D has been contracted in to a claimant company or subsidised by customers will continue to be important. Given HMRC's current position on the issue and ongoing disagreements over the implications of the *Quinn* decision[4], we would like to see more clarity in this area. Ideally, the legislation should provide a clear framework to help businesses decide if their R&D has been subcontracted in or subsidised for these purposes. In the absence of this, HMRC should engage with stakeholders to discuss the subject and come up with an agreed set of guidelines and practical guidance as a matter of urgency.

3.10 We note that Condition A in new s1042C provides for an exception to the general rule that the contractor claims, allowing a subcontractor to claim where the contractor is an overseas company. Whilst we appreciate that this exception may be intended to ensure UK subcontractors are not at a disadvantage, it does undermine the simplicity and certainty of having a single rule, and may cause confusion and difficulty in practice.

3.11 In practical terms, a company will only be able claim under this exception if it knows, at the point it submits its claim, that its customer meets the non-UK requirement. Whilst in some cases this may be reasonably obvious, it will not always be. Where the position is not clear, the subcontractor will presumably have to seek confirmation from their customer that they do not have a UK trade, which may prove problematic in practice and could deter companies from claiming. Some companies may also not be aware of this exception (in a similar way that many are unaware of the current ability for SMEs to claim where R&D is subcontracted to them from a large company) further diluting the potential incentive effect of the relief.

3.12 We are also concerned as to how this exception will operate if a non-UK customer subsequently starts a UK trade. Would that retrospectively invalidate the UK company's claim? What if the non-UK company starts a UK trade between the end of the accounting period and the date the claim is submitted?

3.13 Given these practical difficulties, it may be simpler to just remove the exception for overseas contractors entirely. The end result of this would be a simple, clear position that companies cannot claim for R&D they've been paid to carry out, regardless of where their customer is based.

4 Detailed comments on proposed scheme for R&D intensive SMEs

4.1 As discussed above in Section 2, our main concern regarding enhanced relief for R&D intensive SMEs is that this should ultimately be incorporated into the new single scheme, and not operate as a standalone scheme. Our comments in this section look in more detail at the definition of 'R&D intensive' for these purposes.

4.2 Per new s1045ZA, an SME will be 'R&D intensive' if its 'relevant R&D expenditure' amounts to at least 40% of its 'total relevant expenditure'. For these purposes, 'total relevant expenditure' is defined as that which is

[4] *Quinn (London) Ltd v HMRC* [2021] UKFTT 437 (TC)

brought into account for corporation tax purposes – i.e. only expenses which are deducted in the tax computation can be taken into account, and not disallowed or capital items.

4.3 Whilst we can see the logic in using this measure of expenditure, we are concerned that it will make it extremely difficult for companies to assess year on year whether they will qualify as being 'R&D intensive'.

4.4 In order to identify total deductible expenses, companies will have to go quite a long way down the route of preparing their tax computation, or perform significant amounts of work in year. These difficulties will be exacerbated where there are connected companies whose expenditure also needs taking into account. As a result there will be significant uncertainty, with businesses often unsure of whether or not they qualify for the R&D intensive regime until after their accounting period end, when the R&D in question has already been undertaken. This will make it incredibly hard for companies to factor tax relief into their R&D budget.

4.5 Where claimants are close to the 40% threshold, they could see themselves move in and out of the R&D intensive SME regime year on year, causing increased complexity and uncertainty. This will cause particular problems if, as proposed, the R&D intensive regime continues to be maintained as a standalone scheme once the new single scheme is launched. If that approach is taken, businesses may not only be unsure of the level of relief they will receive until after the end of the period, but also whether that relief will be via an above the line credit or repayable credit. Any movement between schemes will also cause further practical problems – for example, what happens to credits carried forward under the new above the line credit scheme if the company moves into the R&D intensive scheme?

4.6 As discussed above, tax reliefs and credits can only incentivise innovation and influence business decisions if they are clear and understood. Anything that cannot be understood before the business involved takes a decision cannot be an effective incentive, and instead may act as more of a 'nice to have' reward.

4.7 Finally, we are concerned that the definition of 'R&D intensive' could lead to boundary pushing, manipulation or even abuse by unscrupulous claimants and advisers. In particular, where a company is just below the 40% threshold, there could be the temptation to increase the amount of expenditure allocated to R&D, or even disclaim other expenses to ensure the test is met. This temptation will be increased if meeting the R&D intensive condition means a company can receive a generous repayable credit under an SME-like scheme, instead of an above the line credit under the single scheme.

4.8 One possible way to address these concerns would be to base the test for being R&D intensive on statutory accounts figures. However, whilst this might be simpler and could provide earlier certainty, it would also provide greater opportunities for boundary pushing and abuse, as accounts figures are subject to materiality, and may be more easily manipulated.

4.9 Alternatively, the 'R&D intensive' test could be performed based on the previous year's deductible expenditure. Whilst this would provide earlier certainty as to whether or not a company qualifies in any one year, it would seem counterintuitive if the level of relief in any one year was based on the level of R&D taken in the previous period.

4.10 We therefore agree that the best option is to base the R&D intensive test on current year expenditure taken into account for corporation tax purposes, as is currently proposed. However, to provide more and earlier certainty to businesses, a mechanism should be built into the legislation such that businesses are only excluded from the R&D intensive scheme where they fall below the 40% threshold for two consecutive years.

4.11 This could operate in a similar way to the current transition rules where a company temporarily breaches the SME threshold.[5] For example, assume Company A has the following percentages of relevant R&D expenditure each year:

- Year 1 – 45%
- Year 2 – 35%
- Year 3 – 42%

Under the draft legislation as it currently stands, Company A would qualify for the R&D intensive regime in Year 1, move into the single scheme in Year 2 and then move back into the R&D intensive regime in Year 3.

However, if a measure was introduced to require two consecutive years below the threshold before a company was excluded from the R&D intensive regime, they would continue to be entitled to the R&D intensive regime for all years.

4.12 Such an approach would be a real practical simplification, and allow businesses to better plan and budget for their future R&D relief. It would also remove some of the complications around businesses moving in and out of the R&D intensive regime due to one-off events, such as an unexpected and large deductible expense in one year.

4.13 An alternative, more radical, approach would be to revise the structure of the R&D intensive relief entirely, such that it is focused more on the nature of the R&D being carried out and less on the expenditure profile of the company.

4.14 This could be achieved through a form of advanced assurance process. For example, to receive a higher rate of relief companies would have to receive advance approval from HMRC that they qualify as 'R&D intensive'. This approval could be made available in the first 12 months of a project starting and last for the life of the project.

4.15 Whilst this may be a more involved process than is currently proposed, it would have the advantage of allowing HMRC to know in advance who is entitled to claim enhanced relief, aiding compliance activity and limiting possibilities for abuse. It would also give businesses much more certainty and ensure that the enhanced support acts as an incentive, rather than as a retrospective 'reward' where businesses do qualify.

5 Other specific comments on draft legislation

5.1 We have set out below some specific comments on the wording of the draft legislation, arranged by paragraph number within draft Schedule 1.

5.2 Paragraph 4:

- In new s1039(1) the wording of 'aids within the corporation tax system' is unusual. It would be more appropriate for this to be described as 'payable credits and reliefs'

5.3 Paragraph 5:

[5] https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird92000

- In the title of new Chapter 1A, the reference to 'R&D Expenditure Credit' is likely to cause confusion with the previous RDEC regime in Chapter 6A. We would recommend renaming this Chapter to clarify that this is a new scheme, with different rules.
- In new s1042H the words 'from the total remaining after step 2.' should be added to the end of step 3 for clarity.
- In new s1042J(3) the notional tax deduction is calculated based on the main rate of corporation tax, regardless of whether or not the company is eligible for the small profits rate or marginal relief. This is the same as under the current RDEC regime, but has not been a problem to date due to the single rate of corporation tax in place until April 2023, and the likelihood of smaller companies claiming under the SME regime instead. Further consideration should be given to whether this needs to be changed under the new single scheme.
- In new s1042M(1) the words 'wholly or partly; should be added after 'is surrendered'.

5.4 Paragraph 6:

- New s1045ZA(6) requires connected companies' expenditure to be aggregated for the purposes of deciding if a company is R&D intensive. We assume that the definition of 'connected company' will follow that in s842, but it would be helpful to signpost this.

5.5 Paragraph 8:

- New s1112A(2) refers to 'R&D expenditure credit or R&D tax credit' whilst s1112A(3) refers to 'R&D expenditure credit, and the entitlements under Chapter 2'. Is a difference intended? If not, consistent wording should be used.
- Para 8(4) amends s1113 to apply the State Aid based cap on relief to the R&D intensive SME regime only. We would query why such a restriction is needed now that the UK is no longer part of the EU?

5.6 Paragraph 17 discusses the commencement of the higher rate for R&D intensive SMEs. This refers to accounting periods beginning before 1 April 2023 and ending on or after that date. However, it is unclear how this will apply to short accounting periods in FY23 – e.g. 1 May – 31 December 2023. It would be helpful to clarify this.

6 Contact details

6.1 We would be pleased to join in any discussion relating to this consultation. Should you wish to discuss any aspect of this response, please contact our relevant Technical Officer, Emma Rawson on 07773 087111 or erawson@att.org.uk.

The Association of Taxation Technicians

7 Note

7.1 The Association is a charity and the leading professional body for those providing UK tax compliance services. Our primary charitable objective is to promote education and the study of tax administration and practice. One of our key aims is to provide an appropriate qualification for individuals who undertake tax compliance work.

Drawing on our members' practical experience and knowledge, we contribute to consultations on the development of the UK tax system and seek to ensure that, for the general public, it is workable and as fair as possible.

Our members are qualified by examination and practical experience. They commit to the highest standards of professional conduct and ensure that their tax knowledge is constantly kept up to date. Members may be found in private practice, commerce and industry, government and academia.

The Association has more than 9,500 members and Fellows together with over 5,000 students. Members and Fellows use the practising title of 'Taxation Technician' or ‘Taxation Technician (Fellow)’ and the designatory letters 'ATT' and 'ATT (Fellow)' respectively.