ICAEW
REPRESENTATION 95/23

R&D TAX RELIEFS REFORM: CONSULTATION ON A SINGLE SCHEME DRAFT FINANCE BILL 2023 LEGISLATION

Issued 14 September 2023

ICAEW welcomes the opportunity to comment on the draft legislation regarding a merged R&D Tax Reliefs scheme. Details are available at this link.

For questions on this response please contact our Tax team at taxfac@icaew.com quoting REP 95/23.

This response of 14 September 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.

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OVERVIEW

1. We have spoken to a number of members about the draft legislation for the merged R&D scheme. There was a consistent message from all members we spoke to that a commencement date of 1 April 2024 was too early. Members were concerned that the changes proposed could impact the industry significantly (particularly those around subcontracted R&D expenditure) and therefore more time is required to consult around the proposals and to enable businesses to prepare.
2. Similarly, the rules as they stand, are being implemented with no transitional provisions to mitigate the disruption to long-term commercial contracts. This is a major concern and is explored in more detail below.
3. The concerns about commencement and transition were exacerbated by the lack of confidence members have around 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 has caused considerable uncertainty and a sense of instability.
4. 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 seen to be damaging the attractiveness of the UK as a jurisdiction to undertake R&D. This issue is exacerbated by the restrictions placed on overseas expenditure which will now largely not qualify. Members have advised us that this is already starting to impact investment into the UK with some businesses considering jurisdictions such as Ireland to locate R&D hubs instead of the UK.
5. While some areas of the rules were welcomed, such as the more generous PAYE cap, it is clear what businesses really need is certainty and stability within the R&D tax regime.
6. There is also concern that historically the SME and RDEC scheme have needed very different policy levers. Fraud and error prevention has historically informed the design of the SME scheme while the RDEC scheme has been focused on incentivising inward investment into the UK and ensuring that the UK is a competitive jurisdiction.
7. Another major driver for introducing RDEC was to ensure that the tax credit appears ‘above the line’ in the relevant company’s accounts, which is likely to be important for larger companies. Some members think that by amalgamating the two schemes, the government’s ability to manage these various competing policy priorities is restricted as less targeted measures will be available to them.
8. The changes to subcontracted R&D expenditure are of considerable concern to some members. Some larger organisations think that the changes proposed could have a significant impact on subcontractors and potentially disincentivise investment into the UK. Other members did not regard the proposed changes to be as problematic and are in favour of focusing entitlement to relief on the principal. Given the wide-ranging feedback we have had we would strongly recommend more time is taken to consult with stakeholders before implementing the merged scheme. It could be damaging to rush implementation without fully understanding the ramifications for all affected sectors.
9. Overall, members agreed that while amalgamating the two schemes should, in theory, reduce complexity, as it stands the rules proposed do not simplify matters. The inclusion of additional reliefs for ‘R&D intensive’ SMEs in fact retains much of the original SME scheme in any event, hence keeping two separate schemes in existence. Furthermore, many members commented that the complications (and indeed litigation) around ‘subsidised’ expenditure has previously been limited to the SME scheme, while under the new rules the problems will form part of the merged scheme making these disputes far more widespread.

COMMENCEMENT AND TRANSITIONAL RULES

10. As discussed above, April 2024 was viewed to be too soon to implement the rules. Many R&D projects involve long-term contracts, spanning several years. Ideally, these contracts would continue to be dealt with under existing rules.
11. The sub-contracting changes are of particular concern. The changes could disrupt existing contractual arrangements considerably, particularly if the subcontractor can no longer claim the R&D tax relief from 1 April 2024. Contract negotiations will have been entered into on the understanding that the subcontractor is entitled to the RDEC throughout the life of the contract. Ideally, transitional rules would be introduced to ensure this is the case.
12. Members suggested that an election to apply the old rules for a period of time (or running the old and new rules in parallel as when RDEC was introduced) would be welcome and a period of six years was suggested. This should allow a significant proportion of commercial contracts to exist in their current state without a significant administrative burden to move the claim (or re-negotiate). There is also the potential for businesses to lose out financially if this option is not available and they have to honour existing contractual arrangements.
13. We understand why the existing proposals suggest that the new rules apply to expenditure on or after a given date (currently 1 April 2024) as there is a need for symmetry between the contractor and the principal company. However, this is going to result in 'split' years for many businesses as they move to an 'above the line' regime and potentially deal with changes in subcontracted R&D expenditure alongside this in the same accounting period. For some companies this could be quite complex. Members suggested that January might be a more appropriate month to apply a cut-off given the preponderance of December year-ends within the UK company population. This would minimise the number of companies having to undertake 'split' year calculations.

ACCOUNTING TREATMENT

14. One of the reasons why the RDEC was restricted to large companies was because it is these companies that were calling for the credit to be introduced so that it could appear 'above the line' in the company's accounts. By contrast, SMEs are unlikely to have calculated the credit at the time when their accounts are produced. Therefore, any credit they do calculate is likely to need to be estimated and then amended in subsequent years. It would be useful if such companies had the option to disregard the accounting of the credit and mandate that the relevant add-back is in the period of the claim.

MEANING OF "GOING CONCERN"

15. We understand the government's position that it does not think that companies should rely on the R&D tax credit to remain in business, but our members have indicated that some companies do rely on the credit as a lifeline for maintaining their cashflow, especially in the early years of their business. We understand that this is one of the reasons for the introduction of the SME R&D Intensive company regime, namely to support companies in the early stages of their growth when R&D is likely to take up a significant proportion of their expenditure. Following the UK's exit from the European Union, is this an opportunity to review the going concern condition, in particular by removing subsection (b) from the draft s1112G (1)? We would be happy to explore this aspect further,but appreciate that the policy purpose of the R & D credit is not to prop up unviable companies.

SUBCONTRACTED R&D EXPENDITURE AND EXTERNALLY PROVIDED WORKERS

16. As noted above, views from members were mixed on this issue which leads us to conclude it is possible that the impact of the changes proposed is not yet fully understood and therefore more consultation time is required.
17. It will be necessary to understand the structure of the supply chain in more detail to establish how many entities who will lose their relief under these proposals. For example, some members indicated that there are many large organisations in the supply chain acting as the 'subcontractor' (eg parts manufacturers) who will not be able to claim relief going forward. We are advised that this could have a significant impact on the UK's manufacturing and tech industries, predominately based in the UK's industrial heartlands (the Midlands and North of England) so this measure therefore could run counter to the government's 'levelling up' agenda.
18. If the principal company becomes the claimant company in cases previously qualifying for the RDEC, it is likely the principal would need to obtain third party information about whether a project meets the definition of R&D. Similarly, much of the records to evidence qualifying expenditure will rest with the subcontractor, and the principal will be reliant on the subcontractor to share these details with them. Enquiring into these projects will likely prove more complex for HMRC and could even involve third-party information powers.
19. One of HMRC's main concerns in moving to a 'subcontractor claims' regime is to ensure that two companies do not both claim relief for the same expenditure. One way to deal with this would be for the principal to notify the subcontractor in writing that it cannot also claim the R&D tax credit for the work it has been contracted to carry out. We understand that this is a feature of the Irish R&D tax relief regime that HMRC could study further.
20. It is not clear to us what the position is where the principal is not entitled to the R&D tax credit (eg where it is a non-taxable entity). Would the subcontractor be entitled to the credit in these cases, as it is under the SME scheme? This could cause subcontractors to lean towards working for overseas customers, rather than UK ones, therefore potentially having a negative effect on the UK economy.
21. For example, if a UK subcontractor does work for a company resident outside the UK and with no UK permanent establishment, that company will be outside the scope of UK corporation tax. Hence, the subcontractor would be able to claim relief for the work it has done in a way that would not be possible if it were performing work for a UK resident client.
22. One possible way of levelling the playing field would be for there to be an option for the principal and the subcontractor to jointly elect that the subcontractor receives the relief
23. There is an additional layer of complexity applied to claims relating to externally provided workers (EPWs). S1132A (1) & (2) appear to restrict claims to the amount a worker is paid by their employer rather than the amount the supplier is paid by the principal. This creates practical issues. Are suppliers expected to provide their payroll data to the principal? This brings up issues around confidentiality.
24. In addition, the 65% restriction on EPW expenditure appears to be applied too, which means that the claimable amount is being restricted twice. Is this what the government intends?

SUBSIDISED EXPENDITURE

25. The proposed approach will also exacerbate disputes around 'subsidised' R&D expenditure, making this a problem of the merged scheme and arguably a much more widespread problem. For example, it is not clear from the wording of s1138 CTA 2009 whether a project

which is only partially funded by way of a grant or subsidy will, in its entirety, be ineligible for R&D tax relief (or only to the extent that the expenditure is so funded).

26. In the interests of simplification, it is very important that these complications are addressed in any merged scheme. This uncertainty is another contributing factor in making the UK less attractive for R&D when compared to other jurisdictions (eg the US where it is possible to 'layer' multiple reliefs and incentives). It would appear sensible to postpone implementation to ensure that any new legislation can take account of these issues adequately. We also urge this to be addressed largely in statute (not guidance) to eradicate any ongoing confusion and future litigation as much as possible.
27. We note that the subsidised expenditure rules are currently in brackets in the draft legislation which suggests to us that HMRC has not decided yet whether to include them. This is a highly unsatisfactory level of uncertainty less than seven months before the rules are planned to be introduced.

INTERACTION WITH THE PATENT BOX RULES

28. We are advised that these changes will disrupt the way the patent box rules complement the R&D tax relief rules. Currently these incentives work well together to encourage subcontractors to invest in R&D and then exploit the resulting intellectual property in the UK. The proposed changes will make the UK a less attractive place to develop and exploit IP from because, when calculating the patent box deduction, the relevant R&D/nexus fraction will need to be applied, without the company concerned being able to claim the related R&D tax relief.

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).