Analysis

# An update on R&D incentives

**Speed read**

**Two developments in R&D tax incentives could have a significant impact on businesses claiming the relief. From 1 April 2020, rules intended to prevent abuse of the SME R&D tax credit will limit the credit to three times the claimant's total PAYE and NICs liability for that year. This could particularly impact businesses where staffing costs are not a significant element of R&D expenditure. HMRC has also developed a digital form designed to prevent the poor quality information provided by many claimants for R&D relief. While this will set a much more explicit expectation of the information that should be submitted, the forms may only be used by companies that can cover at least 50% of their R&D claim costs within ten projects.**

**Richard Turner**
FTI Consulting
Richard Turner is a senior managing director at FTI Consulting based in London and has over 15 years' experience working in R&D tax credits. Richard leads tax and innovation services encompassing IP planning, R&D incentives and the UK patent box. He also has significant experience in life sciences and technology. Email: richard.turner@fticonsulting.com; tel: 020 3727 1506.

This article primarily covers two important developments in UK R&D tax incentives.

The first was the announcement in the 2018 Budget and subsequent consultation on the proposed cap on payable tax credits under the SME regime. This measure has been proposed in order to counter increasing levels of abuse, where vehicles are being established in the UK simply to access tax credits and there are little or no accompanying UK activities.

The second is the launch of HMRC's R&D digital form aimed at improving the quality of information to be submitted alongside claims.

## Did you know?

To put this into context, it is worth mentioning some interesting facts and figures. HMRC released its annual R&D incentive statistics in September 2018. These have recently been augmented with additional tables and analysis.

- In 2016/17, 38,940 companies submitted R&D claims accounting for £24.5bn of qualifying expenditure. This compares to claims by 5,950 companies in 2003/04, which was the first full year that both regimes were in force for both SMEs and large companies.
- 29,375 of the 2016/17 claims were for less than £50k in value, and 6,975 were made by first time applicants.
- The cost of the regimes was £3.4bn in 2016/17, compared to £0.5bn in 2003/04.
- In 2016/17, the manufacturing sector was the largest claimant at £8.3bn, followed by scientific and technical (including life sciences) at £5.6bn, information and communication at £3.7bn, and financial and insurance at £1.7bn.
- Since the inception of the SME regime in the year 2000, the total incentives are valued at £21.4bn.

Some equivalent patent box statistics are as follows:

- 1,025 companies claimed the patent box, accounting for £0.9bn of tax relief.
- 27.3% of these companies were categorised as 'large' and accounted for 96% of the tax relief.
- 55% of the claimants were from the manufacturing sector.

Note that at the time of publication of the report, claims could still be submitted for 2016/17, so these numbers are likely to be revised upwards.

## SME R&D tax credit cap consultation

The R&D tax credit regime for SMEs is a cornerstone of the measures to stimulate R&D in the UK. Whilst profit making companies receive a reduction in their corporation tax, loss-making companies may receive a payable tax credit.

The 2018 Budget announced that rules are to be introduced for accounting periods starting from 1 April 2020 to prevent abuse of the payable credit. The problem was highlighted by reference to three men in the West Midlands who together had attempted to secure £300m in fraudulent R&D tax credits.

The measure will cap the credit at three times the claimant's total PAYE and NICs liability for that year. At the time of writing, we are still awaiting the results of the consultation that closed on 24 May 2019 (for the consultation, see bit.ly/2FKN10f).

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HM Treasury and HMRC were keen to highlight that 'genuine companies are not the intended target of the cap'. Several potential measures to mitigate the cap were put forward in the consultation, including:

- the cap only applying to claims above a certain threshold (to be determined);
- the inclusion of the PAYE and NICs liabilities of other group or connected companies; and
- the ability to carry forward any restricted credit to future years when sufficient PAYE and NICs liabilities may be generated.

Notwithstanding these potential remedies, it is difficult to imagine that many companies operating genuine commercially structured business models will not be impacted, and potential unintended consequences will follow as a result of the new measure.

The principal categories of qualifying categories of expenditure for the SME R&D tax credit are staffing costs, consumables, externally provided workers and sub-contract R&D. As the cap is based on the PAYE and NICs liability of the claimant company, any business with R&D expenditure primarily in categories other than staffing costs is at risk of being restricted.

For example, early stage companies in the UK life sciences sector need to outsource R&D in pre-clinical and clinical research as they do not have the internal capacity and specialist knowledge to perform these tasks. With such an inherent high risk of failure in drug development, it is not viable to recruit all the necessary skills and resource to undertake the research in-house. As it is currently structured, the measure, notwithstanding the proposed remedies, would therefore be very damaging to this sector.

In a survey of more than 60 biotechnology companies, the results indicated that 54% would be impacted, even taking into account the remedies put forward in the consultation. This is clearly beyond what HMT and HMRC were expecting, but it is equally clear that effective remedies must be put in place to bring these genuine companies out of the scope of the restriction, the purpose of which is to prevent abuse. At the time of writing, we are aware that alternatives are being considered by HMRC.

## R&D digital form

HMRC's *Corporate Intangibles Research and Development Manual* (at CIRD80550) confirms that:

'There is no record keeping requirement specifically for the purposes of claiming R&D relief, but the general corporation tax self-assessment (CTSA) requirement to keep sufficient records applies. Therefore, HMRC officers should be flexible in considering what records will be of assistance.'

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This has proved to be problematic. Whilst many claimants provide HMRC with a good level of evidence to support their claims, there are still numerous instances where companies have either tried to overwhelm HMRC with too much information or simply not provided enough. In many cases, no detail has been provided beyond a single amount in the computation. This prevalence of poor quality information has resulted in HMRC having to initiate enquiries to request an adequate level of detail, leading to the creation of the R&D digital form. The SME version went live in February this year, and the equivalent version for the research and development expenditure credit (RDEC) was launched in June.

Companies are able to provide both quantitative and qualitative data in the forms. The forms are not mandatory but clearly set a much more explicit expectation of the information that should be submitted. Broadly, if the company is claiming up to three projects, it must include details for each one. If four or more projects are claimed, the company must include all details of at least three to a maximum of ten projects which between them cover 50% or more of the total qualifying R&D costs. Therefore, the forms may only be used by companies that can cover at least 50% of their R&D claim costs within ten projects.

Following a detailed consultation with both advisers and companies making R&D claims, HMRC has concluded on the following fields for documenting a project.

### What scientific or technical knowledge existed at the start of your project that you planned to improve?

This question allows HMRC to understand the baseline from which the advance in science or technology is being sought.

### What advance in that knowledge did you aim to achieve?

Companies need to ensure that the advance being sought is an advance in the overall knowledge of capability of the field of technology and not simply that of the company's own knowledge or capability. It is important to avoid the temptation of describing the innovative features of a product, rather than the underlying technological advance.

### What scientific or technological uncertainties did you face?

Uncertainties may arise when a company either does not know if it is possible to create or improve the product or process, or knows the product or process can be created from its research but it is too costly. To reiterate the BEIS Guidelines, uncertainties that can readily be resolved by a competent professional working in the field are not scientific or technological uncertainties.

### How did your project overcome these uncertainties?

Companies should set out both the qualifying direct activities to resolve the uncertainties, i.e. experimentation, and the qualifying indirect activities that form part of the project but do not directly lead to resolving the uncertainty.

To encourage claimants to be succinct and accurate in the information they provide, companies can only enter up to 3,000 characters per question, i.e. around 500 words.

The aim of the digital forms is to ensure that companies provide HMRC with accurate and relevant details to support their R&D claims. With better information, HMRC will be able to speed up its review process, and in turn companies can receive their repayments sooner. Companies are not obliged to use the forms but they indicate the key areas that HMRC focus on when it reviews R&D claims. ■

*The views expressed in this article are those of the author and not necessarily the views of FTI Consulting.*

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