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13/3/2023

R&D Tax Credits consultation team
HM Treasury

By email to: RDTaxReliefs@hmtreasury.gov.uk

Dear Sir/Madam

R&D Tax Reliefs Review: Consultation on a single scheme

The IoD is an independent, non-party political organisation representing around 20,000 company directors, senior business leaders, and entrepreneurs. It is the UK's longest-running organisation for professional leaders, having been founded in 1903 and incorporated by Royal Charter in 1906. Its aim is to promote good governance and ensure high levels of skills and integrity among directors of organisations. It campaigns on issues of importance to its members and to the wider business community with the aim of fostering a climate favourable to entrepreneurial activity in the UK.

We therefore value the opportunity to respond to the consultation on changes to the R&D Tax Reliefs system.

Overall approach

There are currently two separate ways in which the tax system supports R&D expenditure: the Research and Development Expenditure Credit (RDEC) and the small and medium enterprises (SME) R&D relief. The RDEC is calculated as a percentage of a company's qualifying R&D expenditure and is taxable as trading income so can be thought of as an 'above-the-line' credit. It is open to those who are not eligible for the SME scheme, that is large companies and certain SMEs. The SME scheme, however, works by allowing companies to make a deduction against profits of 186% of qualifying costs – cut from 230% from April 2023 at the Autumn Statement 2022. Both systems allow loss-making companies to carry forward the credit in different ways to future years.

As part of a wider review on the operation of the R&D tax credits system in 2021, the government included questions on whether to merge the two schemes. This new consultation in 2023 seeks views on proposals on how a single scheme, based on the RDEC model, could be designed and implemented.

There are good reasons to consider merging the two schemes into a single 'above-the-line' taxable credit system based on the current RDEC scheme, notably the greater impact it would have on decision-making, the impetus to involve qualified accountants in advising on the claim as opposed to bespoke R&D tax credit agents, and simplification benefits through combining the two schemes.

Set against this are concerns around SME bandwidth to absorb the implications of a change, the recent reduction in the generosity of the scheme, the importance of maintaining the option to take a cash payment for pre-profit firms and an apparent sense from the consultation that some types of R&D may be more worthy of support than others depending on the size of the claim or the R&D intensity of the company making the claim.

To this end we wrote to the Chancellor on 2 March 2023 urging that the cuts made in the Autumn Statement be reversed and that there should be no lower limit to claims in future. The points made in that letter, which can be accessed here, should be considered alongside this consultation response.

We are also concerned that the imperative to crack down on spurious claims may be driving a desire to reduce the overall volume of claims *per se*, which runs counter to the stated aim of the policy to increase the volume of private sector R&D in the UK.

We welcome the recent announcement of more HMRC resources to clamp down on abuse, and also the recent reforms designed to highlight anomalous cases. We urge this investment to continue but also urge the government not to conflate the desire to maximise the impact of the R&D tax relief system with the separate imperative to minimise spurious claims or abuse of that system.

Our responses to specific questions draw on our understanding of how our members are currently using the scheme and data gathered from a bespoke survey undertaken from 23 February – 8 March 2023 of 45 IoD members screened to ensure they were users of the SME scheme. We also drew on a small number of qualitative interviews, including with accountants dealing with R&D tax credit claims on behalf of their clients.

Our sample for the poll had the following characteristics:

Industry sector

Manufacturing	27%
Professional, scientific and technical activities	24%
Information and communication	18%
Health and social work	11%
Other	21%

Company turnover

Under £250,000	20%
£250,000 - up to £2 million	25%

£2 million - up to £10 million	36%
£10 million - up to £50 million	16%
Over £50 million	2%

Response to individual consultation questions

1. Do you agree a new scheme should be an above the line RDEC like credit? If not, what alternative would you propose?

There are good reasons to consider merging the two schemes into a single 'above-the-line' taxable credit system based on the current RDEC scheme, notably the greater impact on decision-making, the impetus to involve qualified accountants in advising on the claim as opposed to bespoke R&D tax credit agents, and simplification benefits. However, it is important that the overall financial impact of the scheme is not affected, and that unprofitable firms remain able to receive the credit as a cash payment if they decide to do so.

Set against the case for change are concerns around SME bandwidth to absorb the implications of a change, the recent reduction in the generosity of the scheme, and an apparent sense from the consultation that some types of R&D may be more worthy of support than others depending on the size of the claim or the R&D intensity of the company making the claim.

In our survey we asked respondents' views on the proposed change and received the following results:

- 47% agreed that 'it would make no difference as long as the financial cost was the same' (13% disagreed, 40% neutral)
- 51% agreed that 'a credit is no use to us on our tax account unless it can be paid to us in cash' (31% disagreed, 18% neutral)
- 38% said the proposed change would be easier to understand (9% disagreed, 42% neutral, 11% didn't know)
- 31% agreed that 'it would make us less likely to use an external agent to help us with our R&D claim' (42% disagreed, 20% neutral, 7% didn't know)
- Only 9% agreed with the statement 'it would make us more likely to invest in R&D' (42% disagreed, 44% neutral, 4% didn't know)

2. Does the taxability and subsequent different post tax net benefits impact your decision making when allocating R&D budgets?

When asked the question 'To what extent has the existence of a tax credit scheme directly caused your organisation to increase their R&D spend at the point that budgets are decided?' 60% agreed that it had done so 'significantly' and a further 24% that it had done so 'slightly'. Only 13% disagreed with this statement, suggesting that the current scheme has a substantial additionality impact.

We also found strong evidence that the reduction in the deductibility rate from 230% to 186% at the Autumn Statement 2022 had already reduced the amount of R&D taking place in the UK: 47% agreed with the statement that the change 'has caused us to reduce our total planned spend on R&D'.

Typical comments were:

> *"This change has a material effect on my business - we are a pre-revenue health technology business, that is solely doing research and development….This change directly impacts innovative companies and sends the wrong message about the UK's commitment to innovation."*
> (IoD member, health technology, 100-249 people, R&D spend £100K+)
>
> *"As a small, highly innovative SME (currently loss making but with full shareholder support) the proposed changes will have a significant impact on our ability to invest in R&D and hence impact our current leadership position in our market (competing against U.S. companies)"*
> (IoD member, ICT, 10-49 people, R&D spend £100K+)
>
> *"The recent change has caused us to reconsider doing R&D in the UK and we are looking at other EU countries as a result."*
> (IoD member, health sector, 10-49 employees, R&D spend £100K+)

We are now very concerned that the change will lead to less innovation in the very near future just at the time that the focus of government policy is rightly shifting to measures designed to raise the sustainable rate of economic growth.

3. If you use RDEC now, is there anything in your view that should be changed?

We did not consider this question as our interest lies in users of the current SME scheme.

4. Do you agree the same treatment of subcontracting should apply to all claimants in the merged scheme?

Yes, in order to reduce the complexity of the scheme.

5. If so, where R&D activity is subcontracted, do you think that the customer should claim the tax relief, as in the SME scheme, or the subcontractor, the person carrying on the R&D, as in the RDEC?

The tax relief should apply to the organisation that is taking the risk, in order to tilt the balance of that risk in a way that encourages more R&D to take place, to the benefit of the economy as a whole. A common-sense approach suggests that this will be the customer. Companies taking on the risks associated with R&D should not be penalised if a lack of in-house capability means some of the operational work is subcontracted. A subcontractor, by definition, receives a payment regardless of whether the outcome of the research and/or development can be commercialised; they are not therefore taking the risk.

We understand the rationale of preventing double payment by restricting claims for R&D that are already separately paid for through a publicly funded grant. This would suggest applying the rules that are currently in force for the SME scheme.

6. Can you see any positive or negative impacts on your business or sector from the Government adopting either approach?

If the government prevents those firms that are taking the risk from claiming the credit if they subcontract part of the operational work of the project, it will lead to less R&D in the SME sector because they may not have the ability to undertake the work in-house.

It is possible that in some areas the cost of subcontracting may rise if subcontractors had previously claimed relief that is now claimed by the customer. However we still believe there is a better public policy outcome from focusing the incentive on those taking the risk. It is also worth noting in this regard that a change would also mean the customer(s) would have more funds at their disposal to deal with any rising costs.

7. Do you have an alternative model you think could apply all claimants in the new scheme? Please provide qualitative and quantitative evidence with your proposal.

We have not considered this question.

8. What are your experiences of the PAYE / NICs cap?

In our survey of business leaders undertaken for the purpose of this consultation we asked the following question: 'At present there are rules that cap the maximum claim for R&D tax credit. This cap is a multiple of the staffing costs of the individuals engaged in the R&D. Has this rule prevented you from undertaking more R&D in the UK?' 22% of respondents who used the SME scheme answered that it had prevented them from undertaking more R&D (63% that it hadn't).

We therefore think the cap should be removed because (a) it adds to complexity and (b) without it the amount of R&D taking place in the UK would be greater.

9. Are there any ways the Government could simplify the PAYE / NICs cap whilst ensuring there is protection against abuse?

Having an upper limit is a suboptimal way of protecting against abuse. We see no difference in the risk of abuse through submitting a knowingly incorrect claim for R&D tax relief to the risk of abuse through any other type of misstating of information for tax purposes across the entire tax system. Simplification, enforcement, and focusing on the point of decision, is the solution to the issue rather than setting an entirely arbitrary cap.

10. Which of the SME and RDEC PAYE & NICs cap should the Government implement in the new scheme?

Neither

11. Should the Government change the way either cap is calculated if is taken forwards? And if so, how?

It should be abolished.

12. Do you consider the government should provide more generous support for different types of R&D or more R&D intensive companies relative to less R&D intensive companies?

No. The purpose of the policy is to encourage more R&D across the board in order to raise the productive potential of the economy. We do not think it is possible or desirable to judge the additionality impact of the policy on the basis of the size of the budget or the nature of the company concerned.

The current issue is not that R&D intensive SMEs should receive more generous support as a point of principle. The problem is that these companies disproportionately felt the impact of the arbitrary cut to the SME scheme at Autumn Statement 2022 because of their research-intensive nature, as demonstrated by the answers to question 2 above.

To restrict claims to R&D intensive businesses going forwards would risk undermining the purpose of the policy, which is to raise the amount of product innovation taking place across the economy. It is important that the policy is designed to encourage greater R&D in firms that do not currently innovate which by definition are less research intensive at this point in time. Our research has found evidence that the scheme helps change the culture of those firms that have not historically engaged in R&D in a positive way.

For example, in the words of our members:

> *"There were a number of years when we were unaware of the R&D tax credits. We then used them and have got the processes and mindset for R&D embedded now. "*
> (IoD member, ICT, 10-49 people, current R&D spend £25K-100K)
>
> *"Some of the best R&D in history comes from SME organisations."*
> (IoD member, 10-49 people, current R&D spend £25K-100K)

Overall, we feel that to help raise the amount of R&D taking place across the economy as a whole, the scope of R&D tax credits should be blind to the quantum of applicable research undertaken in a particular organisation or the nature of the company concerned.

13. In the event this were to be done, how might this best be achieved within an overall cost envelope?

We are opposed to the idea.

14. If the schemes are merged do you agree the Government should implement the merged scheme on 'accounting periods starting on or after 1 April 2024?

This feels extremely soon given that many budgets are allocated on a timetable greater than one year. Our survey showed that half of R&D budgets are allocated greater than one year in advance (half under a year).

In the words of an accountant supporting SMEs many of whom are engaging in eligible research: "SMEs are put off by complication. It took quite a few years for many of them to take to the current scheme, and a new one called RDEC with a credit in Cost of Sales isn't going to help."

In addition our survey picked up a measurable resistance to change among a minority of those affected: 20% agreed with the statement 'any type of change is unwelcome' (27% disagreed)

15. How can Government ensure SMEs are supported in the transfer into a new scheme?

There needs to be considerable investment in education as to how the new scheme works, including worked examples, informed by testing the language and information directly with SME claimants, potential claimants and their accountants. The overriding aim should be that the system feels so simple that claimants can access it with the minimal amount of help.

16. Does claiming for expenditure on qualifying indirect activities influence your decision to undertake R&D?

For smaller companies it is very important that a proportion of overheads that support the main R&D activity should be included in the claim. Our suggestion is that this is kept to a very simple formula so that it is easy to understand and administer.

17. Do you think a threshold should be implemented? If one was implemented what at what level should it be introduced?

We feel very strongly that a threshold should **not** be implemented.

It feels as if this is being undertaken for fear of having a large volume of small claims that is overwhelming for the compliance department of HMRC. However having a large uptake in R&D activity from smaller companies is exactly what this policy should be aiming to achieve. Often it is the smaller, marginal decisions around whether to engage in R&D that are most impacted by government intervention and so exhibit the greatest degree of additionality.

The driver of abuse, to the extent that it exists, is not the lack of a threshold but instead an over-complex scheme that can be claimed for well after the point of decision and a lack of investment in compliance, guidance and explanation by HMRC.

18. What is the average amount of R&D expenditure per year per firm in your business or sector?

Our survey asked 'Roughly how much does your organisation spend on R&D each year?" The options we presented were distributed as follows:

£10,000-£25,000	4.4%
£25,000-£100,000	42.2%
Over £100,000	53.3%

We hope that this response is helpful to your team in their deliberations on a future scheme.

Yours faithfully

Kitty Ussher

Chief Economist, Institute of Directors