

A Good System Gone Bad?

Suffolk Chamber of Commerce Report into R&D Tax Relief

What is the background to R&D Tax Relief?

The R&D Tax Relief scheme was introduced in 2000 to correct a market imbalance that made it easier for large companies to fund their R&D because of their size, whereas smaller businesses were disadvantaged by their lack of size.

R&D Tax Relief provides relief to claimants through their Corporation Tax. All Limited Cos or PLCs are allowed under Corporation Tax legislation to claim 100% relief for certain qualifying expenditure.

The specific R&D Tax Credit scheme for SMEs allowed an additional enhancement to their qualifying expenditure specifically incurred to carry out Research and Development.

At its highest, the enhancement was 130% meaning that a SME could effectively claim 100% + 130% = 230% of the cost of the qualifying expenditure against their Corporation Tax liabilities, for loss making business this could be taken as a cash receipt.

The R&D Tax Credit scheme is not regulated and HMRC will often point to the poor quality of claims being submitted. Would the presence of a Regulator improve the quality of submissions? The scheme is becoming more intricate and the changes that came into force in August 2023, require comprehensive write ups to accompany a claim. Previously, this wasn't the case. As a consequence, there has been an increase in the use of specialist advisers to compose and submit claims on behalf of business and this trend is expected to continue. This incurs further non-productive spend which incidentally is not a cost that can be claimed as part of the R&D expenditure.

So, what has changed?

The Autumn Statement in 2022 signalled the Government's intention to merge the two schemes for accounting periods starting after 1 April 2024. The decision on whether a business is an SME or a large company for R&D Tax Credit purposes is the usual metric for determining size for tax and audit purposes, namely the number of employees, turnover and asset value.

Companies were previously allowed to submit R&D Tax Credit claims for the current Accounting Period and the two previous Accounting Periods. This means that typically companies are working up to two years in arrears, giving them the opportunity to complete their statutory accounts and then start the investigative process leading to a successful claim, which can produce a cash refund or be offset against current or future tax liabilities. However, from accounting periods starting after April 2023 companies are only able to claim for the period and not go back two years.

Since late 2019 the number of HMRC enquiries have increased significantly. It is apparent that a volume compliance agenda is being followed, backed up by an aggressive media campaign that seeks to prove that 50% of all claims submitted are 'fraudulent'. Not only is this statistic misleading, it is damaging the confidence that UK business has in HMRC. The misleading aspect is that HMRC include any claims that they receive that may contain errors (eg incorrectly keyed data) as 'fraudulent'. This grossly inflates the reported number of alleged 'fraudulent' cases and creates a misleading perception.

The volume compliance agenda has seen numerous claims rejected on the grounds of there being 'no R&D'. This is particularly frustrating especially where the claimant had made several previous successful claims for projects in the same field. The scheme rules haven't changed, the interpretation of the rules has, and it is stifling and strangling UK business. HMRC recognise that their officers aren't 'specialists in their field', so why are they being empowered to make judgements on technological and scientific advances, presented by experts in the field?

As a result of the recent Spring Budget, the Government has committed to improving the functioning of the R&D Tax Credit system by asking HMRC to establish an expert advisory panel to support the administration of R&D Tax Credits. However, the remit of this this panel is confined to the life sciences and tech sectors alone.

The impact on Suffolk businesses

Suffolk Chamber of Commerce commissioned a survey of its members in January this year. The survey sought responses from business regarding their recent experience of the R&D process and their relationship with HMRC.

Worryingly, 46% of respondents are now deterred from making future claims based on their latest experience, citing the unhelpfulness of HMRC and the additional resource, cost and time it has taken to resolve claims under the volume compliance agenda.

The survey showed that 71% of respondents use a specialist advisor for their R&D claim submissions. As the scheme becomes more intricate in terms of qualifying expenditure, we would expect this % to increase.

The survey captured a sense of 'delaying tactics' being deployed by HMRC, with some respondents citing claims taking over two years to be determined. The proposed merged scheme isn't popular either, with the SME benefit eroded in favour of a flat rate scheme that favours larger businesses previously captured under the RDEC scheme.

'Additional resource and cost' is the headline regarding the impact of the volume compliance agenda on their cashflow and future sustainability. Lengthy delays in decision making (some in excess of two years) and excessive costs (many in excess of £75,000) are strangling the lifeblood from business cashflows.

Additionally, HMRC procedure can involve paying out a cash benefit and retrospectively launching an investigation and demanding repayment. This is untenable for cash restricted businesses who are unsure if well needed funds to continue research can in fact be spent.

Currently the system allows HMRC to operate within a win-win situation, as the cost of any tribunal is likely to outweigh the benefit of the claim value itself, the costs of which are not reclaimable. Thus, most SMEs are in a lose-lose situation, either accept the HMRC's judgement and pay back the tax credit or go to tribunal and pay the legal fees to fight their case. This for most SMEs is not a financially viable pursuit so HMRC is likely to win either way.

Recommendations

Suffolk Chamber's recommendations fall into two categories:

- Improvements to how HMRC administers the current scheme
- Improved regulation of R&D Tax Relief advisers

We recommend:

- That the Government invests in more and better qualified HMRC staff, especially those with a specific knowledge of Research & Development
- That the HMRC's legitimate approach to reducing fraudulent claims is better targeted and more evidence-based than the current volume compliance approach
- That the HMRC employs a more accurate reporting as to the level of fraudulent claims, as opposed to those containing minor, administrative errors
- That the HMRC seeks to develop a more streamlined and fairer approach to R&D Tax Relief appeals
- That the R&D Tax Relief expert panel, announced in the Spring Budget 2024, is focussed upon the experiences of SMEs and its remit is widen to include a broader of sectors
- That an industry regulator to be appointed. The regulator will be the conduit for business, professional advisors, government and HMRC to represent members and ensure that a code of conduct and integrity is upheld. The regulator would also be the catalyst for overseeing an improvement in the quality of submitted claims.
- It be made a legal requirement that all R&D Tax Relief claims to be signed off by a qualified accountant with relevant experience either a CTA or ATT. The introduction of this level of 'sign off' will improve the overall quality of submissions and remove the likelihood of spurious and illegitimate claims being submitted through non-qualified agencies.

The Team

Steve Elsom (chair): chief operating officer, Fiscale Ltd. and managing director of Number 4 Consulting

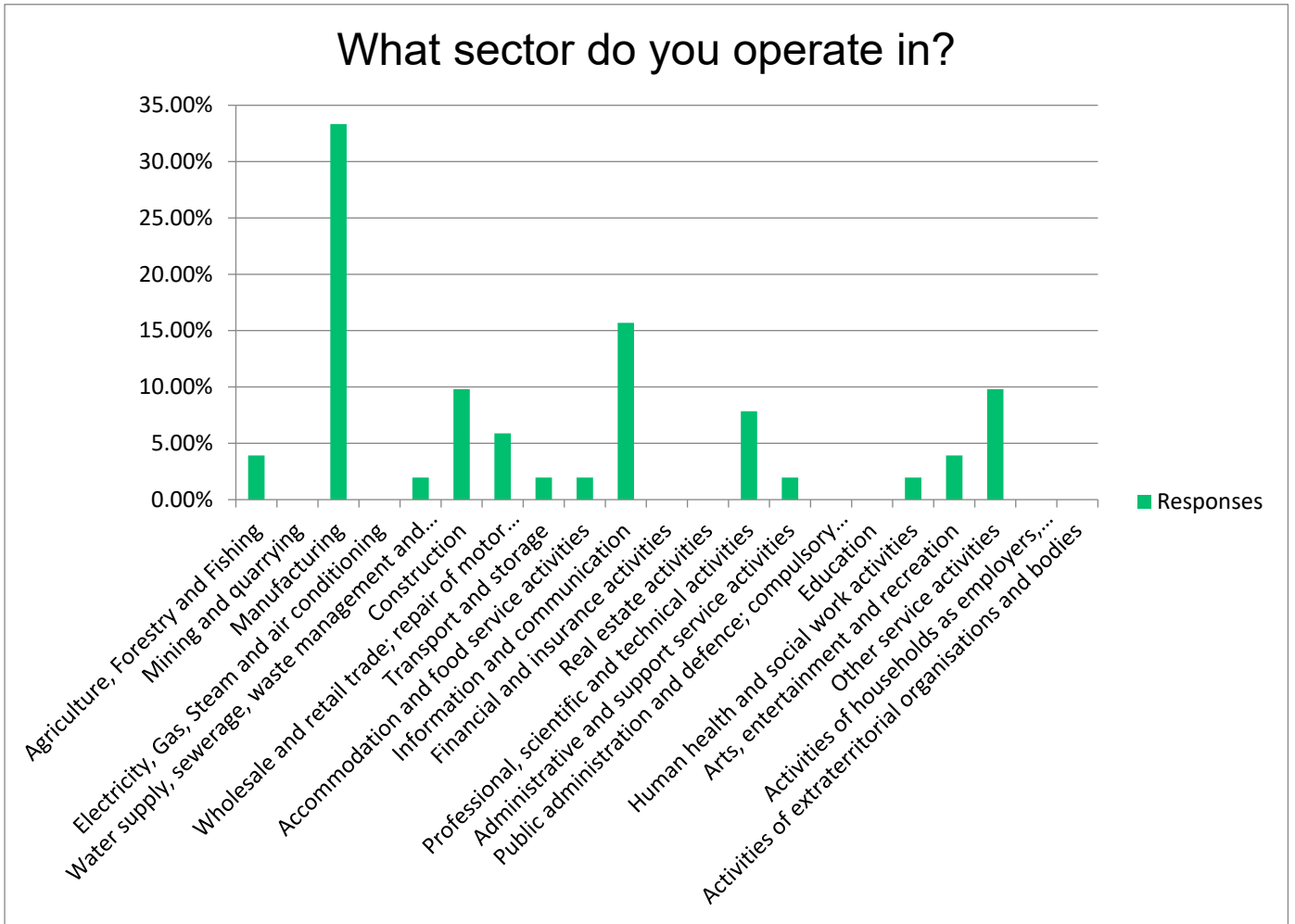
Lisa Jillett (vice chair): finance director, Frugalpac

Mat Waters, partner, Lovewell Blake LLP

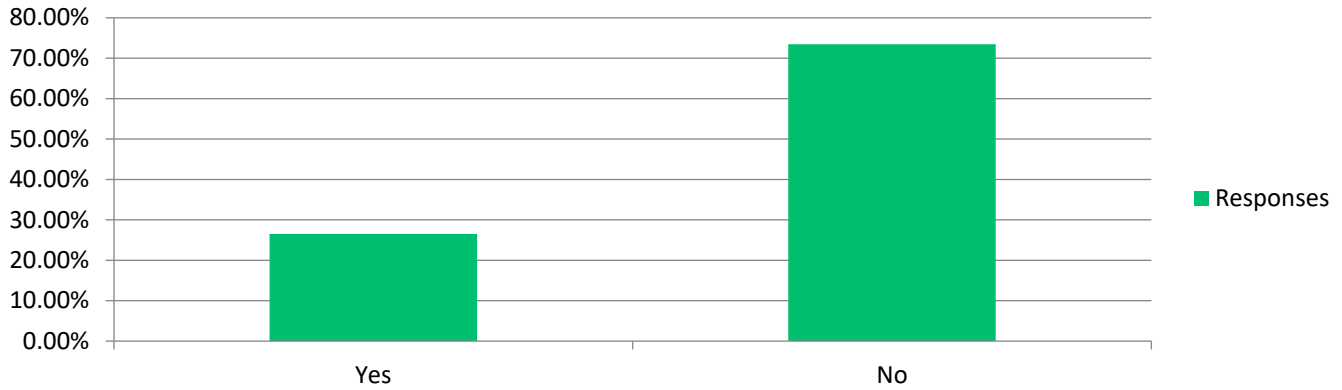
Mark Newton: managing director, LMK Thermosafe Ltd

Stuart Gregory: managing director, Wallis Shipping Services Ltd.

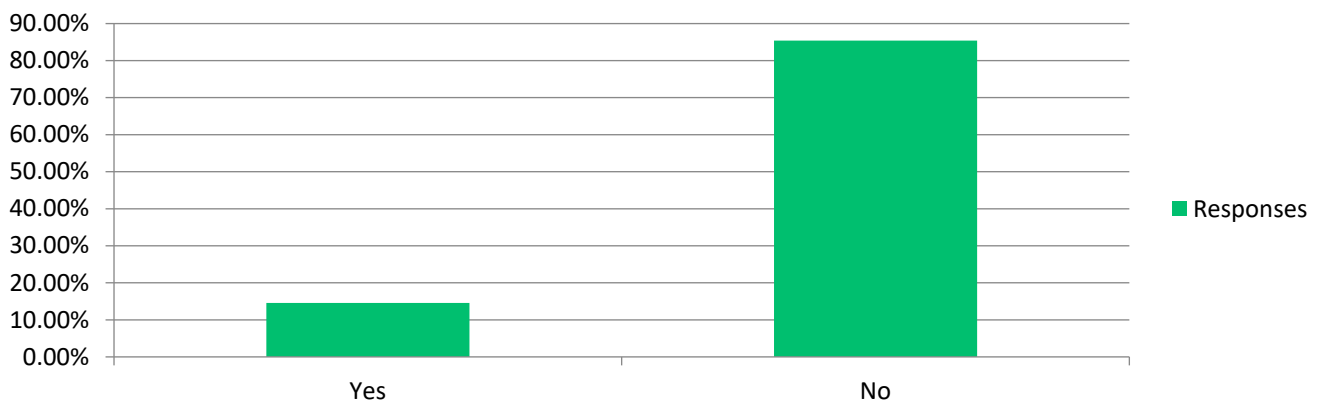
Appendix One



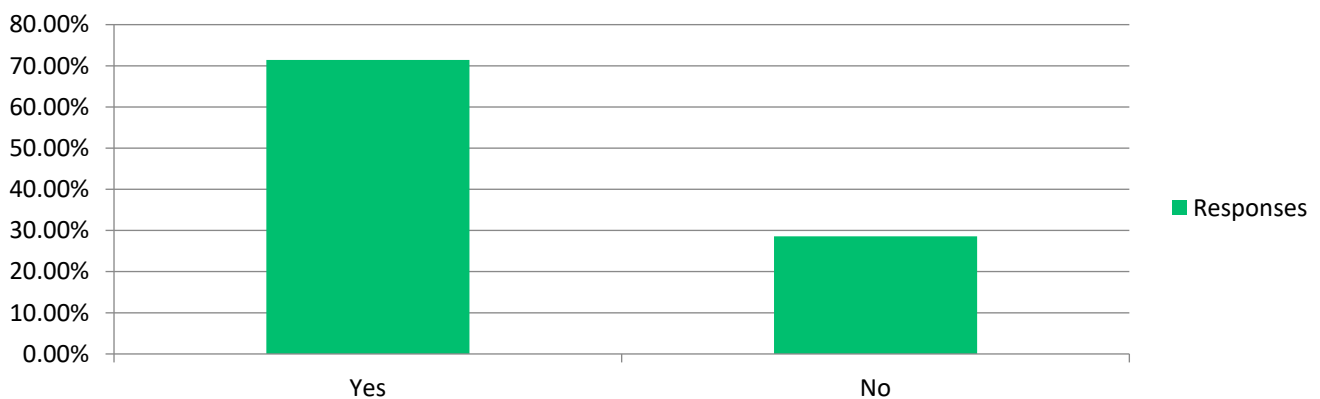
Have any claims been investigated and/or disqualified?



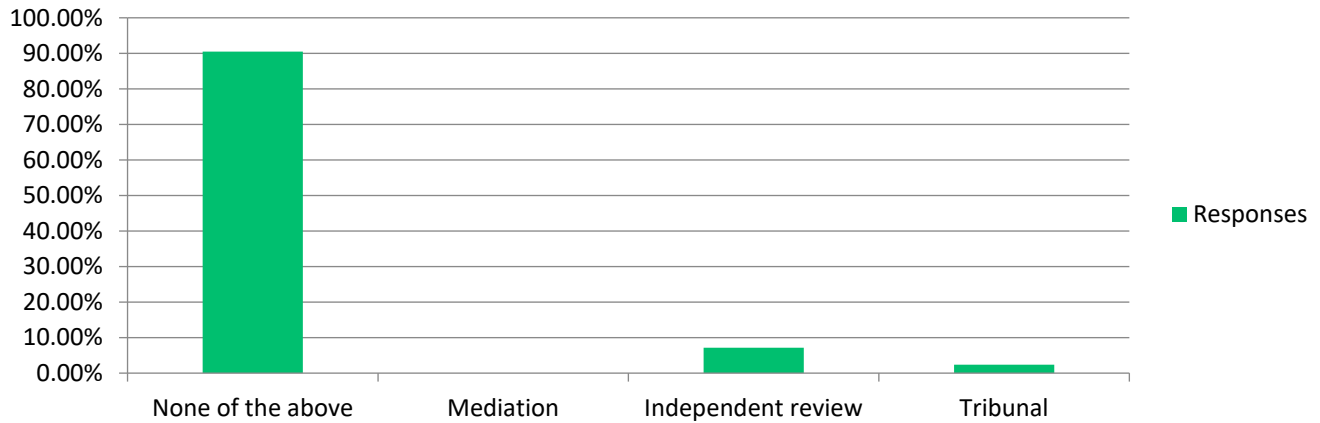
Are you in a loss-making position and therefore, requesting the relief as a cash benefit?



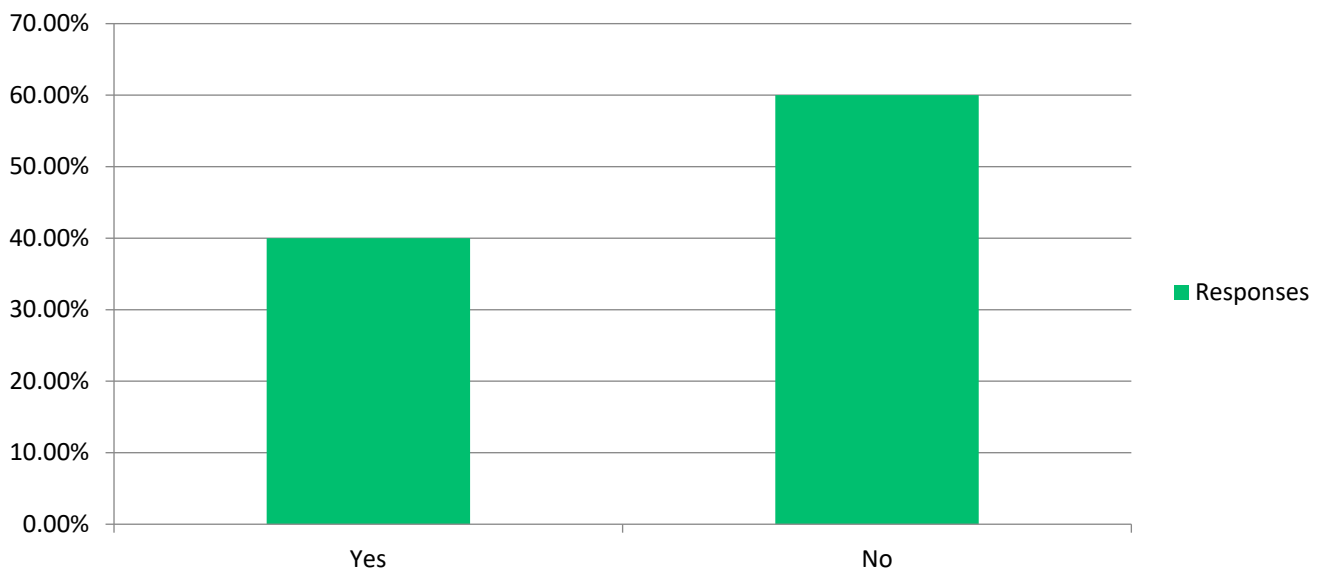
Have you employed the services of any 3rd party specialist?



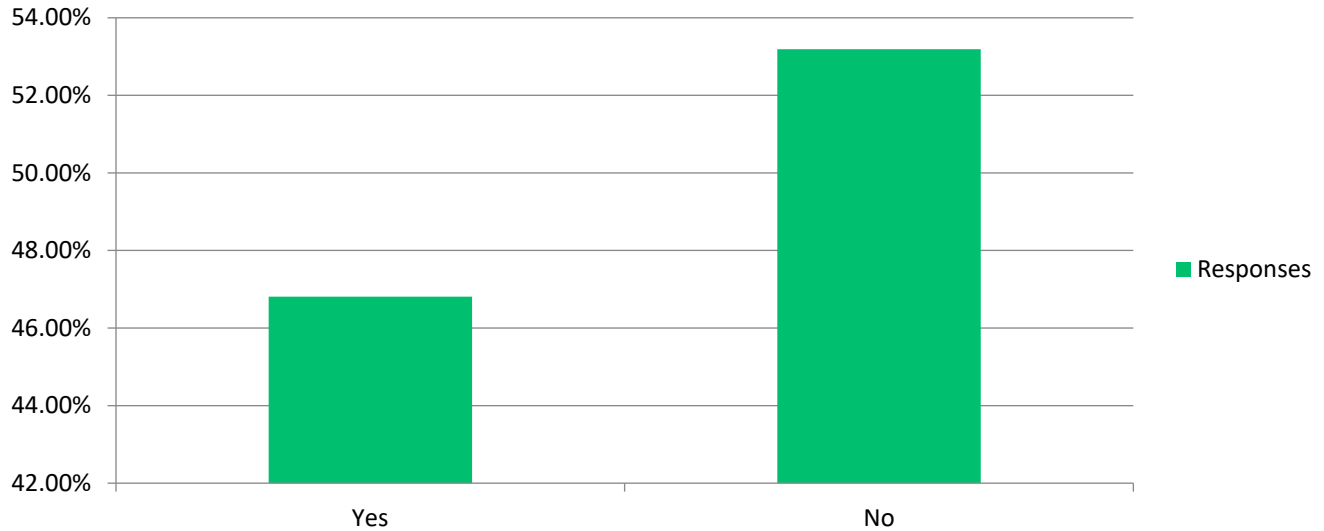
In the event of any 'appeal' - have you opted for mediation, an independent review or tribunal?



Was the outcome of any investigation positive?



Does the thought of HMRC investigation deter you from making a claim?



Appendix Two Detailed case study

A business has made R&D claims for a number of years without challenge from HMRC. As part of Lovewell Blake's "best practice" guide, the client has always prepared detailed project narratives that detail the R&D projects.

This particular client has a laboratory onsite, employs PhD Chemists and seeks to develop brand new products that are considered significantly more advanced than products currently available in the market.

As a result of the generous R&D incentive scheme, this client was planning significant investment in its R&D activities and were intending to increase the size of the laboratory to extend its capabilities as the overall capital costs are "less painful" for business if there is tax relief available when the work is completed.

In its period to 31 December 2021, the Company made its R&D claim as normal, including a detailed R&D report. As expected HMRC provided a tax credit of c.£48,000 to the Company in September 2022.

On 27 February 2023, the client received an Enquiry Notice/Compliance Check Notification from HMRC. This was simply a copy and paste of the standard R&D enquiry notice. The letter included no reference to any information which had already been provided to HMRC in the full technical report which contained a full cost breakdown.

Our first response was to refer HMRC to the documents which were submitted when the claim was filed. But in the spirit of helpfulness, we did provide some additional information to aid HMRC understanding of the project.

The next response from HMRC came on 19 May 2023 (50 days from our first reply).

Within this letter, HMRC did not reference our previous response but simply stated:

"Unfortunately, your response and the information supplied has not provided us with enough information or detail of the Research & Development (R&D) projects claimed for within the accounting period ending 31 December 2021."

And asked for further information as follows:

1. **A detailed project plan and timeline, for all projects including details of**
 - *How and when the uncertainties were identified*
 - *How and when the uncertainties were overcome*
 - *All stages from planning to deployment*
 - *Individuals' involvement at each stage*
 - *Contemporaneous project documents that informed and support the R&D relief claim*

2. **Contracts & Invoices**

Please provide copies of any contracts or invoices you hold for **all** the projects you have claimed R&D tax relief for, within accounting period ending 31 December 2021.

This should include evidence relating to both clients, and any subcontractors related to your R&D claim.

3. An explanation of what the scientific or technological uncertainties involved in the projects were

Your response must include:

- Explain how any projects are not an application of existing science or technology as explained in Par 12 & 24 BEIS (2004) guidelines.
- What was the gap in technological knowledge or capability which necessitated the commencement of the R&D?
- What was the state of your platform before the R&D commenced, after the R&D activities completion and how does this compare to the rest of the market?
 - For all projects, please provide an explanation on whether the methods used to solve the uncertainties were not already established in the public domain

4. An explanation of what the scientific or technological advance is

Please send us a detailed explanation on why you believe all the projects to be an advance via an appreciable improvement in the field of science or technology relative to what is already in the public domain or already deducible.

Your response must include evidence to support:

a. Uncertainty

- Please provide details on the uncertainties for all projects. These uncertainties must be more than challenges or complexities.
- Please provide any research and analysis you have undertaken to establish that the uncertainties listed on your R&D report and supporting information were uncertainties and not complexities and challenges. Refer to Para 13, 14, 29 & 30 BEIS (2004) guidelines when formulating your response

b. Competent Professionals

- For all projects, please can you give the name and credentials of the competent professionals that you consulted, and who are knowledgeable about the relevant scientific and technological principles involved.

c. Knowledge Baseline

- The baseline must be measured in the field of science and technology as a whole and not just within the company's own field. Please provide details of the research conducted to establish your baseline for **all** projects

- *Describing the baseline in technology that the advance sought was being measured against and*
- *Describing the advance or appreciable improvement in the overall field of technology sought or achieved, and its impact on the field as a whole*

5. Costs

- a. *We require you to provide individual cost schedules or a costings breakdown that demonstrate apportionments for each project you have claimed R&D tax relief for, within accounting period ending 31 December 2021.*
- b. **Sub-contractor payments**
 - *Where the subcontractor worked on more than one project, can you apportion the percentage of costs associated with each project.*

It is worth noting that at this stage, HMRC are yet to refer to any information provided to it by us or our client nor have they sought to define what information is missing.

Since this point there have been a further 3 rounds of correspondence, each time we and our client have provided further information (as requested by HMRC), but each time this is responded to with a generic letter. Our client has requested a phone call with an inspector and has even offered HMRC to visit the site and discuss the enquiry. These offered have not been acknowledge let alone taken up.

HMRC decided to close this enquiry and issued a decision letter on 30 November 2023 denying the R&D tax relief in full and demanding repayment of the tax credit. In our view this was closed prematurely. As such, we have since appealed the decision and have instructed tax barristers to fight this case. It is in our view, the view of the barristers and the view of our insurers (and their third-party advisors) that this is an eligible claim and our client has been treated unfairly. In the barristers' view "HMRC have been remarkably lazy" and we will "comfortably have this decision overturned once it is reviewed by a senior inspector". However, at the time of writing, the enquiry rumbles on **350 days** after the enquiry was opened.

The cost of defending this claim has now, with the engagement of the tax barristers, incurred significant professional fees.

A feature of the R&D tax relief enquiry has been the requirement to provide HMRC with 'proof' or 'evidence' that advancement in technology has been made. This was a theme which was explored in a recent First Tier Tribunal case – Grazer Learning Limited v HMRC – where the tribunal stressed that the burden of proof is on the claimant company to demonstrate an advancement has been made. Whilst we accept that position, it is not clear what "proof" is enough for HMRC.

As part of one of our responses we asked what form this 'proof' may take? The inspector dealing with the enquiry could not answer this point. Despite statements from the competent professional at the claimant company outlining where the advancement was, as well as statements from the customer who had placed an order for the technology, the inspector was still unable to accept the evidence that an advancement had been made.

This appears at odds with the HMRC Charter of:

- a. Working with you to get tax right
- b. Getting things right
- c. Making things easy
- d. Being responsive
- e. Treating you fairly
- f. Mutual respect

As a result of this enquiry and the experience, cost and stress, our client is considering moving the R&D projects overseas. This is not a unique situation and many businesses will be considering whether it is worth being a UK innovator.