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R&D Tax Credits Consultation
HM Treasury
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7 February 2022

Dear Sir/Madam

R&D Tax Reliefs

We welcome the opportunity to respond to the further consultation document on the **R&D Tax Reliefs report**.

BDO is a leading adviser in the mid-market, working with businesses across all sectors to support their R&D work.

While the proposal on data and cloud costs, and action against abuse of R&D tax reliefs are a positive development, we have concerns about the impact of the proposals to focus relief on R&D work solely carried out in the UK. This will have a major financial impact on many businesses and, without the creation of some exceptions, could leave businesses unable to claim R&D relief on work carried out overseas because it is just not possible to do it within the UK.

While we have focused our comments primarily on the three key areas of policy decisions highlighted in the report, we are pleased to see that further reforms are still under review. Therefore, where we believe that areas of potential future reforms overlap with the three key areas in this report, we believe it is only right to include specific comments on those now, so that the current policy decisions can be considered in a holistic way.

If you would like to discuss our response, please get in touch.

Yours faithfully

Steven Levine
Partner
For and on behalf of BDO

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Data and cloud computing costs

The expansion of R&D qualifying costs to include data and cloud computing expenses is a positive step forward for software and other high-tech businesses in the UK. However, its introduction needs to be managed carefully for it to have the positive impact intended.

Our particular concern is that the qualifying criteria applied to these costs is workable, pragmatic and not so overly restrictive as to deter companies from claiming such costs.

Cloud computing costs
We can provide examples of such costs and will send anonymised examples of bills from cloud service providers under separate cover. However, we believe that HMRC should engage directly with Google and Amazon and other cloud service providers to identify which of their services HMRC does and does not think will commonly qualify. We note that HMRC expects that costs attributable to "computation, data processing, analytics and software" are expected to qualify, but it would then be helpful for a list of cloud services clearly linked to these activities to be published as part of HMRC's guidance.

From our experience, companies will not always receive itemised bills from their cloud provider splitting out the costs of individual services – making it very difficult to identify the costs that qualify for relief. It appears that the level of itemisation available depends on the level of spend by the business, so this would potentially disadvantage SMEs. It is also the case that packaged services are supplied by providers with little clarity over the respective costs of the package elements.

In such circumstances it may not be possible to conclusively 'prove' that a particular apportionment is 100% accurate, and we would hope that HMRC would only require a level of detail that is appropriate to the quantum of the claim. We would also suggest that HMRC apply a de-minimis threshold for such costs for claims under the SME scheme - ie below the threshold companies would not be required to itemise such costs but may simply apportion their overall cloud computing costs in a sensible way.

It is accepted that there will be many other instances where apportionment of cloud costs will be appropriate to establish how much of the service provided has been used in the R&D work and can be included as a qualifying cost. For example, while we accept that simple data storage over a long period may not qualify in terms of R&D work in all instances, we would argue that the storing of data during a testing exercise is crucial to the outcome of the project – perhaps this could be classified as 'active storage'.

Apportionments are going to be difficult to assess and prove conclusively in many cases, so guidance (including examples of how to arrive at acceptable apportionments of costs for different services) would be helpful. We would hope that HMRC will take a relatively common-sense approach to such apportionments, particularly where the sums involved are not material.

We suggest that HMRC considers setting up a working group with Cloud suppliers and tax advisers to consider these and other issues (or work on them with the R&D Consultative Committee (RDCC to arrive at detailed guidance that companies can use when compiling their R&D claims. Unless this sort of exercise is undertaken, we fear that many smaller businesses will be deterred from claiming their cloud computing costs by the complexity and uncertainty over making a claim. We would also expect that, without a de-minimis threshold, imprecise claims for cloud costs will lead to HMRC spending significant time investigating/disputing R&D claims in this area.

Data
The purchase and use of data sources to support R&D projects is increasingly common in certain sectors – for example FinTech. However, in many circumstances, this is more complex than the purchase of one set of data to use for a discreet project: streams of data may be bought and used in real time, reused over several projects or adapted and updated as the project progresses.

Therefore, it will be important for HMRC to produce guidance on reasonable apportionment of data costs, with clear examples of when data should be regarded as having been consumed during an R&D project, so it can be identified as a qualifying cost at that point. For example, if it is known that data is going to be used at several stages of a project or for several projects, companies should be guided to only claim the appropriate proportion of the data cost at each stage/for each project.

Equally, the use of live data to test tracking and predictive software is now common, and it should be recognised that once consumed, this data may have no residual value to the R&D project. While such data is usually provided under a license for a specific period of time, it should be recognised that this period may not always align with the testing period. For example, if the data is only available through a 6-month license, but the R&D testing is completed in 4 months, we believe that the whole of the 6-month cost should qualify (rather than 4/6ths), because the testing would not have been possible at all without paying for a 6-month period of access.

As for cloud, some of the underlying contracts can be onerous, and aspects previously commented on by HMRC, including publishing and reusing rights, could be easily triggered if regulatory authorities need to see it.

We hope that HMRC will take a pragmatic approach to such issues - maybe relying upon “intention” - and that detailed guidance on such apportionment issues can be agreed (perhaps with the RDCC\RDCF and other interested parties), to make such issues easier to finalise for all parties.

Refocusing the reliefs towards innovation in the UK

We appreciate the government's objective to focus R&D relief on companies carrying out R&D in the UK because of the additional benefits that brings to the UK economy. In the Budget Red Book, it is stated that:

> **2.75** While UK companies claimed tax relief on £47.5 billion of R&D expenditure in 2019, the ONS estimates that businesses only carried out £25.9 billion of privately financed R&D in the UK.47 This gap is partly explained by companies being able to claim for activity taking place overseas. This suggests that the UK is not effectively capturing the benefits of R&D funded by the UK taxpayer through the reliefs. Many other countries, including Australia and the USA, do not offer relief for R&D activities performed overseas.

It is clear that government intention is to focus reliefs geographically, whereby companies are compensated through R&D Relief for engaging UK rather than non-UK resources.

We would be interested to learn how much of the gap between HMRC's figures and the ONS estimates is "partly explained by companies being able to claim for activity taking place overseas". While the sums related to overseas costs will no doubt be significant, we believe that an approach of excluding overseas costs entirely is not without risks of its own.

Companies and groups that already outsource some R&D work overseas will have to review their whole operational structure as a result of these changes. It is quite possible that some multi-nationals that currently carry out part of their R&D in the UK and part overseas will restructure so that all R&D work is carried out overseas – regardless of the R&D tax relief available in the UK.

Equally, non-UK companies can qualify for R&D Tax Relief by virtue of UK employment carried out through UK permanent establishments and the fact that they are subject to UK corporation tax on their profits and UK employment taxes on their UK staff. Clearly this brings the additional benefits to the UK economy that the government seeks to achieve through focussing R&D relief on UK activity, so it would be counter-productive if relief for UK branches and permanent establishments of overseas companies is removed.

Therefore, alongside this reform, we recommend that the government takes a much wider look at how to make it attractive for companies to carry out R&D work in the UK. Part of the solution for achieving this will fall within the ambit of the R&D relief rules, but action in other tax areas (e.g. patent box) and in sector grant schemes will also be necessary.

It is critical that whenever multi-national groups review their operational structures, they benefit from as much lead time as possible. An early release of the proposed draft legislation would be desirable. Additionally, phasing in the exclusion of overseas costs through a series of 'transition years', allowing a reducing scale of overseas costs, would allow businesses time to recruit and where necessary train UK staff. This is particularly true for sectors such as life sciences where drug discovery is a multi-year exercise and long-term employment, testing and study commitments are made.

Current issues relating to location of R&D activity
We would point out that there are also inadequacies in current UK R&D tax legislation that distort the Chancellor's underlying requirements to benefit the UK economy and UK employment.

(i) Currently, UK legislation allows UK companies in large groups to claim RDEC where people are supplied to a non-UK group company to work on qualifying group R&D activities. This is

useful, as large multi-nationals are rewarded for investing in UK people and UK resources.

SME companies do not benefit from the same eligibility. SME companies in SME multi-national groups can only claim R&D tax relief where they work on their own qualifying R&D activities. Their provision of people to other group but non-UK companies means that there may be no qualification for UK tax relief (or even non-UK R&D tax relief). Our fear is that without an extension of the criteria currently afforded to UK companies in large groups, these SME companies will simply transfer jobs overseas, thereby depriving the UK economy of higher value employment.

(ii) Currently, there is a problem where large UK companies provide testing services to other large companies (whether UK or non-UK) outside the same group, as these companies are not working on either their own or a group R&D project. This is also known as dispersed R&D and is particularly relevant for Contract Research Organisations (CROs).

Again, as the underlying intention is to create and/or retain higher value employment in the UK, we fail to see why the restriction of dispersed R&D exists. There is an existing risk that without RDEC, CROs are not establishing in the UK. This is a good time to correct this anomaly.

(iii) Companies in groups (whether large or SME) are usually subject to mandatory transfer pricing provisions under separate tax legislation. To the extent that transfer pricing is mandatory, and the UK companies are SMEs, there is a theoretical risk that an over-eager Inspector could contend that a mandatory transfer pricing provision is a subsidy. Clearly, this sort of contention, if successful, could deny the SME a higher rate of R&D tax relief – merely because separate tax legislation has imposed it.

Different group structures – clarity required

There will be a number of UK companies that have branches is other tax jurisdictions where R&D work is carried on behalf of the UK business. As the business profits of such structures will all be taxed in the UK, and the UK company will benefit from the R&D work carried out, we assume that the cost of such work will continue to qualify for R&D tax relief under the new rules.

Conversely, we would expect that a group that outsources R&D work to a subsidiary based in another country not to be able to claim for the costs, as the profits related to the R&D work are taxed in the other jurisdiction. However, it might also be the case that a UK member of staff is seconded to work in the overseas R&D facility of another group company in a foreign jurisdiction. In such a case, the individual would remain on the UK payroll, and all benefits arising from their work would accrue to the UK company: in our view, their wages should be a qualifying cost under the new rules, notwithstanding that the actual work is carried out outside the UK. Naturally, the reverse would be true if R&D work was outsourced to an overseas company (within a group or not) and the overseas company seconds members of staff to a UK research facility to carry out the work – although they remain on the overseas company's payroll.

These examples clearly illustrate that just specifying that the work must be carried out in the UK does not offer sufficiently detailed criteria to enable businesses or HMRC to operate the new rules efficiently.

We suggest that HMRC sets out an agreed set of criteria establishing the dividing line between qualifying and non-qualifying costs. Ideally, we believe that the criteria should focus on where the profits of the engaging company are taxed, However, we accept that this may create complexities, and that it may be more practical to consider payroll (and even personal residence issues of the workers) as a simpler way of demarking qualifying costs. Whatever approach is decided, it is obvious that there will be real world scenarios that fall on the boundary of the rules, and we suggest that HMRC works through these in active consultation with RDCC.

Mooted exceptions to the ban on overseas costs
We understand that the government is considering creating a narrow list of exceptions to the blanket ban on non-UK R&D activity qualifying for relief from April 2023 onwards. We welcome the fact that the government realises it is not always practically possible to carry out R&D activity in the UK, and can comment on the proposed exceptions as follows:

Regulatory/registration exception
There is a clear case here for overseas testing and other R&D work to qualify, where an overseas regulatory regime requires local testing before a product can be marketed in that jurisdiction or products have to be 'registered' locally (again requiring local tests and studies) prior to sale. The requirement for clinical trials in the USA before drugs and medical devices are approved for use is the classic example, but there will be many others. Such costs should continue to qualify for R&D tax relief where the company can prove that they are necessary to enter the market in that jurisdiction and the costs have been borne by the UK company.

Geographic/environmental exception
There will be many R&D projects where testing is required in a particular location or environmental situation that cannot feasibly be replicated in the UK, e.g. desert or arctic temperatures and conditions. Again, we agree that such costs should continue to qualify for R&D tax relief where the company can prove that they are necessary to conduct proper testing for the project.

Skills-based exceptions
If it is not possible for companies to find workers with the appropriate skills in the UK to carry out specific tasks required for R&D projects, it seems counter-productive to disallow the costs of engaging such workers overseas to help complete a project. We understand that this area is perhaps subjective, and timing of projects and the availability of suitably qualified workers is a potentially complex area.

However, the UK does collect data on skills shortages in the UK – to the extent that it offers UK work visas on a 'skilled worker' basis. It will not always be relevant or practical to seek a work visa for an overseas-based skilled work for what may be a relative short period of work so that the R&D can be carried out in the UK. Therefore, we suggest that where there is a known shortage of UK skills in a particular area (shortage occupations), companies be allowed to claim the cost of overseas workers for R&D work that lasts less than a specified period (eg 60 days).

General/technical exception
While the above exceptions are helpful, we suspect that there will be many other situations where it will not be possible to carry out required R&D work in the UK. We suggest that the legislation includes a facility to apply for other exceptions to be agreed with HMRC on a case-by-case basis through a non-statutory clearance system. This would put the emphasis on the claimant to meet a high standard of proof that the R&D work was not practically possible in the UK. In providing such proof, it will be clear that the relative cost of carrying out the work overseas versus the cost of completing the project in the UK will be irrelevant, and that to qualify under this exception, carrying out the project in the UK must be impossible for other reasons. These might include that the testing facilities required only exist in the overseas jurisdiction and/or the provision of non-UK worker qualification certificates (eg MSc, PhD or equivalent).

Wider measures required to make the UK a more attractive location for R&D work

Rate of R&D relief
An overall increase in the rate of R&D relief under both schemes (or one new combined scheme) can only enhance the attractiveness of carrying out R&D projects in the UK – we believe that this should be actively considered as part of the further reforms.

UK costs not currently qualifying for relief
From discussion with companies we act for, we believe that including accounting depreciation on tangible fixed assets used in qualifying R&D activities as an eligible cost for the R&D tax credit regime, would further encourage businesses to base themselves in the UK, thereby increasing job creation and investment in the UK. This is also in line with other OECD jurisdictions R&D credit regimes, e.g. France.

As we pointed out in our initial response to the consultation, we believe that, where relevant, the costs of applying for a patent arising from a successful R&D project should also qualify for R&D relief. Including the R&D nexus fraction as part of the Patent box relief calculation has brought these reliefs into alignment, and we believe that further positive alignment could be achieved by promoting patent applications in this way – the creation of more patents can only be a positive for the UK economy.

Patent box
We believe that the government should revisit and expand the types of intellectual property that can qualify for patent box relief, to enhance take-up and align with R&D work commonly carried out in the UK already and to open up the relief to a wider range of UK companies. This could bring the UK patent box in line with similar regimes across Europe, such as the Irish Knowledge Development Box (which includes certain copyrighted software). Currently, many UK companies patent their software under US patent law as it gives greater recognition to the value of innovative software than is given under EU or UK patent law. A straightforward solution would be to allow US patents qualify as IP rights for UK patent box purposes.

Given the strength of the UK technology sector, if the patent box could be widened to allow greater access to companies developing software, this would align with the expansion of the UK R&D tax relief for data and cloud, and further encourage these businesses to onshore jobs to the UK.

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Abuse and compliance

We welcome the creation of the new 'cross-cutting' task force to deal with abuse of R&D relief. We suggest that the taskforce should liaise with HMRC's Counter-Avoidance Directorate and Intermediaries Directorate. The former may be able to share knowledge on successful approaches used for avoidance issues which might be applied in relation to R&D claims. Similarly, the task force could liaise with HMRC's Fraud Investigation Service (FIS) on specific cases, in order to determine whether they would be better taken forward by FIS under Codes of Practice 8 or 9, or via a criminal investigation with a view to prosecution.

While we realise that the government would not want to deter companies from claiming R&D tax relief, the task force should make it clear that companies should not use unscrupulous advisers.

In addition to the initial proposals set out in the R&D tax relief report (see our comments below) we recommend that HMRC takes a range of actions intended to limit the use of unscrupulous advisers.

Creating education packs for companies setting out what to expect from their R&D adviser, and what no respectable adviser would do, may be a good starting point. For example, companies should be warned that no reputable R&D adviser would request the company's HMRC portal login so that they can enter claims on the clients' behalf (without disclosing their involvement). Similarly, companies should be educated about the level of supporting data that a reputable tax adviser will require to submit a valid claim and that it is more likely that their claim will be challenged if an unscrupulous adviser is used.

We understand that some R&D agents' staff are remunerated (in part) by commission based on the cash value of R&D claims they submit on behalf of clients – with the obvious danger that this may lead to over-inflated claims. HMRC will no doubt regard such firms as high risk. However, the reality of the current market is that all firms, for commercial expediency, will have to offer contingent fee arrangements if they want to win R&D advisory work – this is very different to remunerating staff on commission.

The Chartered Institute of Taxation has produced a very helpful 'Guide to choosing a specialist R&D adviser', and we suggest that this or similar guidance is include in HMRC's education packs for companies. Equally, HMRC may consider creating further guidance for companies similar to this guidance for individual taxpayers on not getting embroiled in tax avoidance.

HMRC should also consider engaging with the Advertising Standards Authority, to take action against unscrupulous advisers making false or misleading claims in their marketing material, as was done for Tax Avoidance arrangements.

If HMRC considers some R&D agents' claims on behalf of their clients to be knowingly incorrect, it is already possible for HMRC to take action under the Dishonest Tax Agent rules, including issuing information notices and penalties. Publishing the names of dishonest agents (as is already possible under Sch 38 FA 2012) may send a clear 'deterrent' message to other unscrupulous advisers.

We also note the judgment in *Online Tax Rebate Ltd v HMRC* [2019] UKUT 0167 (TCC), which HMRC won using existing Anti-Money Laundering (AML) legislation. HMRC has supervisory powers over all unregulated tax advisers and, whilst Online Tax Rebate were not engaged in delivering R&D Tax Credits, identical principles apply.

Digital claims
We agree that it is sensible for all R&D claims to be submitted electronically, provided the list of acceptable formats for submitting supplementary data for claims is broad and clear guidance is made available about submission requirements. Whilst we can see that providing data to HMRC in a digital format may make it easier for HMRC to analyse claims to identify cases for investigation, we do not consider that this requirement will significantly reduce the abuse of the relief.

Given that the government wants to encourage companies to undertake R&D, we would encourage HMRC to consult on the system to be used for such digital claims (if they are to be made separately to a tax return), to ensure that it is user friendly and has sufficient capacity for all the back-up documentation to be submitted alongside the claim.

Increased data requirement
We agree that R&D claims should contain the full data that HMRC needs to assess the claim quickly and efficiently – this is the approach BDO takes to all the R&D claims it prepares and submits for clients. However, we would suggest that any new requirements in this area are applied reasonably, so as not to disadvantage SMEs.

Collating extensive data to support an R&D claim is usually within the administrative and budgetary means of large companies, and many will be able to work with their CCM to agree sampling methodologies that are appropriate when collecting cost data. SMEs should not be disadvantaged by their lack of access to a CCM, so it would be helpful if a 'CCM type' contact could be provided by HMRC's R&D team, so that smaller companies can similarly agree sampling methodologies as needed in order that they can also collect suitable data cost-effectively.

We also recommend that HMRC should set out clear guidelines about any enhanced data requirements and produce educational packs for companies (particularly SMEs) to help them undertake the process, with the aim of maximising the number of claims that can be accepted without in-depth enquiries. It would be regrettable if the cost of preparing and evidencing a R&D tax relief claim to HMRC's satisfaction (including any compliance check costs) exceeds the available R&D tax credit and deters companies from undertaking R&D in the UK.

Company signatory
We note that the corporation tax return form (in which R&D claims are often submitted) already carries a clear declaration at the end which must be completed by a named person. The declaration reads:

> "*I declare that the information I have given on this Company Tax Return and any supplementary pages is correct and complete to the best of my knowledge and belief.*
>
> *I understand that giving false information in the return, or concealing any part of the company's profits or tax payable, can lead to both the company and me being prosecuted.*"

Whilst corporation tax returns are often submitted by agents, the vast majority of these will show the draft return to the company for review and approval prior to its submission (so the company sees the declaration on the return). Consequently, it is unclear whether requiring the claim to be endorsed by a named person will make a material difference to the rate of errors. We suggest that, even where an agent submits the CT return, a director is required to have their name on the return in the declaration section and approve the declaration. Similarly, the same declaration could be used if the digital claims process set out in the "R&D Tax Reliefs" report becomes standalone (i.e. outside of the return).

Being required to personally approve the declaration may result in fewer excessive claims. However, the extent to which this measure will reduce erroneous claims is unclear, as directors may not realise the company is receiving poor advice, may nevertheless rely on the advice which

may not appear obviously wrong, and thus may submit incorrect claims without realising they are incorrect.

If any company submits an incorrect R&D claim despite knowing it is incorrect, HMRC can already impose 'deliberate behaviour' tax-geared penalties on the company under Sch 24 FA 2007. Those penalties can be transferred to the director(s) responsible for the deliberate error under Para 19 Sch 24 FA 2007. S94 FA 2009 empowers HMRC to publish details of deliberate defaulters where statutory conditions are met. Doing so may raise the profile of HMRC's work in tackling deliberately incorrect claims, if such publication is sufficiently publicised. Having a specific person endorse the claim may make it easier for HMRC to decide who to penalise under Para 19, but this requirement may be a more effective deterrent if the document they are endorsing contains the declaration in italics above with the words "*or being charged significant tax-geared penalties*" added at the end.

Large companies are also subject to the Senior Accounting Officer (SAO) regime. The director who is the SAO already faces penalties in some situations. Mistakes in returns affect companies' business risk ratings too.

Collecting agents' names
A new requirement to notify HMRC of the name of the tax agent that prepared the claim is clearly designed as a way for HMRC to collect data to help it identify R&D tax agents who are frequently associated with dubious claims. While this is clearly welcome, it will only have a significant impact if HMRC acts on this data and takes enforcement action (as outlined above) against such agents.

Advance notice of claims
We appreciate that this idea is intended to deter retrospective R&D claims, as it appears that HMRC anticipates that many such retrospective claims are made speculatively as a result of sales activity by unscrupulous R&D agents.

While this may be true to some extent, our experience suggest that many companies (particularly SMEs) fail to recognise when they are carrying out a R&D project for which tax relief may be available. It seems contrary to public policy (which encourages businesses to undertake R&D) for such businesses to be disadvantaged simply because they have not notified intention to claim in advance. Equally, not all R&D projects are planned years in advance: it is common for R&D projects to arise on an unexpected basis during an accounting period, so requiring advance notification would not be viable, and could act as a disincentive for UK businesses to undertake R&D here, even for R&D which would meet the criteria for relief.

If such a proposal were introduced, reputable agents would be bound by their duty to clients to advise them to make protective R&D claim notifications to HMRC, some of which may subsequently prove to be unnecessary. Moreover, unscrupulous agents may encourage submission of more notifications. We therefore do not consider pre-notification to be an effective additional administrative requirement if the intention is to deter abusive claims and encourage valid claims. The other proposed administrative changes set out at paragraph 2.36 of the Report are more likely to achieve the desired objectives. Consequently, if they are to be introduced, then they should be introduced and evaluated as to their effectiveness before HMRC considers introducing any pre-notification requirements.