

ForrestBrown®  
R&D tax credit  
consultancy

# Preventing abuse of the R&D tax relief for SMEs: PAYE/NIC Cap

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ForrestBrown Ltd response to consultation



## Introduction

Since their introduction in 2000, R&D tax credits for SMEs have had a powerful impact on innovative UK businesses. At ForrestBrown we are passionate about R&D tax credits as a force for good. Based on our own research and our work with our clients, we have seen the positive impact that this funding can have on a business. Many businesses use the cash received to grow their team, stimulating STEM jobs, and the majority do this in the UK.

As we face a post-Brexit UK, it will become ever more critical to support and nurture UK start-ups. Brexit has caused significant uncertainty and challenge for business in the UK, therefore it is vital that the proposed cap does not simply add another challenge into the mix for these businesses.

At ForrestBrown we support measures which create or improve simplicity, certainty and value for money for genuine UK innovative businesses. Whilst we appreciate the need to discourage fraudulent activity, and were dismayed to hear of the fraudulent and artificial structures identified by HMRC; we believe care should be taken not to punish all for the sake of one rotten apple. UK tax law already benefits from strong anti-abuse mechanisms and HMRC compliance powers. We recommend that HMRC continues to be given the funding required to identify these abusive activities and to prosecute the criminals behind them.

## Question 1

*If the cap is only applied for payable tax credit claims above a defined "threshold", at what level would this be useful at reducing any potential administrative burdens on genuine companies?*

The payable tax credit in the SME scheme provides valuable support to loss making companies. In particular, early stage, innovative start-ups. These businesses are often cash poor, as they invest in R&D to bring a product or service to market. The cash funding that R&D tax credits offer is extremely valuable, and often enables them to commercialise more quickly, and/or grow their team.

We would therefore recommend a de minimis threshold for the cap, to protect these types of business from being adversely affected by its introduction.

As these types of businesses grow, they often increase their employee headcount and therefore would be expected to meet the conditions of the cap at some point in their growth. A threshold would allow them to access the cash R&D tax credit at their early stages. This would then help them to grow their teams sooner and would therefore be a valuable application of the R&D tax incentive.

The threshold should not be higher than £50,000. According to the latest HMRC R&D tax credit statistics, 75% of SME claims are for credits of up to £50,000, and the average SME claim is £53,876. Therefore, a cap of £50,000 would appear to be most appropriate and most effective at protecting the legitimate claimants.

Although we understand that the fraud case which triggered the introduction of the cap involved a number of claims totalling £300m, we also understand that these claims were for far larger sums than this. A £50,000 cap would discourage a similar scale of fraud. It cannot prevent criminals from adapting their approach, however, it would make it much more difficult for them to achieve a similar scale of operation.

## Question 2

*If a group was only able to submit one payable tax credit claim at or below a certain threshold per year, how would this fit with the way that claims are currently made? How common is it for more than one company in a group or common control entity to make a claim for the payable R&D tax credit?*

It is common for more than one entity in a group to make an R&D claim: any collaborative R&D effort would be likely to result in R&D costs sitting in more than one group company. Often, particularly among groups of SMEs, the separate legal entities operate functionally as one business, with a single leadership team. This would be particularly the case where groups have been formed through acquisition and legacy structures have led to expenditure sitting across different entities.

In this scenario, it is clear that any threshold couldn't be applied in full to each entity, as this could encourage artificial structures. However, if both or all of the claims within the group cumulatively remain below the threshold, then it would be reasonable to allow all of them, rather than just one. In its proposed form (with just one below-threshold claim allowed), the cap would limit legitimate claims. To protect their funding, these groups of companies could restructure their activities / expenditure, potentially moving employment contracts. This would be an additional administrative burden on genuine businesses, with a likely negative impact on their access to funding.

Any measure needs to ensure that it does not penalize genuine businesses, which would be the case for some if the threshold was only applied to one company in a group. Similarly, it should not introduce significant additional complexity for all businesses.

A relatively simple solution could be achieved by allowing group companies to elect to "surrender" all or part of the threshold to other companies in the group. A compromise could be to allow this for group relief groups only, where there would already be familiarity with group relief rules.

## Question 3

*If an element of the PAYE and NICs liabilities of another group or connected company were included as a part of the cap (where R&D has been subcontracted to it or EPWs provided by it), to what extent would this benefit companies? How much additional complexity would this add to claiming the payable tax credit?*

It is relatively common in a group of companies for staff to be provided by one group company to another. For example, if all staff are employed and remunerated by one group company, but work on projects carried out by others.

Allowing PAYE and NICs from connected party staff providers and subcontractors would help to protect some legitimate companies. However, the subcontracted R&D and EPW cost categories are already complex. This measure would add complexity and an additional burden on companies, particularly as PAYE and NIC from connected parties would be restricted only to those carrying out R&D.

It is not clear how accurately HMRC would be able to check such calculations for compliance purposes, particularly at a time when the introduction of the new digital submission form for SME claims has highlighted HMRC's intention to tighten and limit the level of data provided to them in support of any claim, regardless of the form of the submission.

If the threshold were to be calculated and applied at group level (see Question 2), the PAYE/NIC liabilities could also be consolidated at group level. This would result in something similar to a group losses schedule, prepared for group R&D claims, demonstrating either compliance with the threshold or with the PAYE/NIC cap, depending on the consolidated value of the R&D tax credits in the group.

## Question 4

*Would it be practical for claimant companies to obtain the PAYE and NICs information from other group or connected companies? Are there any limitations to their doing so? Would the other company be willing to provide this information?*

If connected EPW and subcontracted R&D expenditure has been included in a company's R&D tax credit claim, they will have already requested and received data from the connected party in order to calculate the relevant expenditure for each type of expense. It is therefore theoretically possible for this to happen.

Rather than the proposal to share PAYE/NIC data for an individual company's claim, we would recommend consolidating this data, the R&D tax credit claims and the threshold all at group level. For groups of companies where only one company carries out R&D activities, this would be a simple exercise.

Similarly, for companies operating in a group relief group, they would typically already be familiar with calculating group relief claims and surrenders, so the level of complexity and sharing of information should be manageable.

Applying similar rules to connected parties, not just those in a group relief group, would increase complexity for some, however the benefit to those business would be the ability to obtain a valuable cash credit incentive.

If a claimant company in a group could not obtain sufficient information to report consolidated group figures, it could be prevented from accessing the cash credit in that period, however it would be important that it did not lose the losses generated as well. With the new CT loss rules in place, there would be more scope to utilise these losses in the future.

## Question 5

*How beneficial would surrendering carried forward losses, to claim a future payable tax credit when sufficient PAYE and NICs liability has been generated, be to a company affected by the cap? Would a time limit of 2 years be appropriate? How straightforward would it be to keep track of the origin year of the losses?*

The purpose of the payable R&D tax credit is to enable loss making innovative companies to receive a valuable cash injection when they need it most. Although no doubt a cash boost is always welcome, delaying this reduces its impact.

This would also create an additional record keeping burden for companies, particularly when companies with losses are already required to stream those losses for the new CT loss relief rules. We see many examples of surrenderable losses and tax credits being incorrectly calculated. Adding in carry forward surrenderable losses within a set time period would be likely to result in significantly more errors occurring.

It is not clear how HMRC would review these calculations to check for errors and whether they would be able to spot a high proportion before processing credits. Where HMRC has processed a tax credit, and then opened an enquiry and discovered an error which has resulted in an overpayment of the credit, this can be incredibly distressing for the company, as the cash has usually already been reinvested. More complexity means more scope for error, which would lead to more occurrences of this scenario.

The administrative burden on a company of tracking these losses seems high for a two-year time limit. Assuming a company continues to invest in R&D, therefore making a claim against its expenditure in each year, this may require it to significantly increase its PAYE and NIC to be able to surrender current year and prior year losses. We often find this with losses, where an R&D tax relief deduction decreases current year profits which would otherwise have been sheltered with brought forward losses. It is often a number of years until the company is sufficiently profitable after its current year R&D tax relief deduction to start utilizing those brought forward losses. A similar principle would apply to surrendering brought forward losses against PAYE/NIC. In summary, 2 years would not be long enough to be of value.

## Question 6

*Would carrying forward losses make companies consider taking on more staff in the future – to unlock some (or all) of the rest of their payable tax credit?*

Many companies who claim R&D tax credits do use the funding to take on skilled staff, this is one of the key attractions of such an incentive. Not being able to access the funding before making the decision to commit to headcount increases would be a discouragement. Many companies are keen to take on staff, but will only do so when they are comfortable with the risk level. Whilst the future benefit of being able to claim the payable R&D tax credit may be taken into account, it is not likely to have a significant impact on such decisions, which are complex.

The cash element of R&D tax credits enables companies to hire new staff when they need them – if this cash is not available, it might prevent start-ups getting off the ground. First-time R&D tax credit claimants are likely to want cash in the bank before committing to increasing headcount.

Some companies will be affected by the cap due to a commercial decision to locate staff outside of the UK. An example would be a management and sales team in the UK, with a development team employed by an overseas subsidiary. These companies would be unlikely to bring these overseas staff to the UK purely because of the change to R&D tax incentives. Often they have structured their business this way to access a particular skillset or to access a low-cost skilled workforce. These companies would be more likely to look for other sources to fund their R&D efforts. This would be likely to make other countries more attractive to these businesses, as they would seek out countries that offer them a way to reduce the cost of R&D.

If such companies are to be excluded as a result of a deliberate decision to limit their access to R&D tax credits, this should be a transparent measure. Whilst stimulating STEM jobs is an important outcome of R&D tax credits, since 2012, these businesses have legitimately been accessing funding in compliance with the law.

## Question 7

*The government is interested in the characteristics of companies that could be affected by the cap. For example, if you are or represent a company likely to be affected by the cap, how large is the company in terms of employees? How many staff are primarily engaged in R&D activity? How old is the company? What sector does it operate in?*

Examples of companies potentially affected:

- Start-ups that cannot yet afford to employ staff,
- Companies where directors carry out R&D, but take nominal salaries, relying on third party subcontractors to support R&D efforts,
- Companies with a management team in the UK, but large teams of R&D workers offshore, supplied via third party agencies,
- Groups of companies where staff are employed by one company, but supplied to another to work on R&D projects.

The first two categories above are likely to be small or micro firms, some are likely to have no PAYE or NIC at all. However, these businesses are also likely to grow and often intend to employ staff in future periods.

The second two categories could be sizeable, established businesses, with potentially over a hundred employees or contractors.

The sectors most likely to be affected would be construction and software. Both of these sectors are still suffering from the financial crisis, which has affected their attitude to risk and access to funding. They rely heavily on contract workers and subcontract relationships to enable them to safely dial up or down their workforce based on the commercial projects they win.

## Question 8

*What else could the government consider, regarding how the cap is applied to preventing abuse, to ensure genuine companies can continue access the payable tax credit? Are there any alternative measures that could prevent abuse of the payable tax credit?*

The threshold is critical to exclude a high volume of genuine smaller companies from this measure, which is targeted at preventing large-scale abuse.

More and clearer guidance from HMRC should be provided on how to accurately calculate R&D tax credits, to reduce errors due to carelessness or ignorance of the detailed rules.

R&D tax credits benefit from targeted anti-abuse provisions, which prevent an R&D tax credit where a transaction is artificial or entered into solely for the benefit of obtaining the credit. These provisions would seem to apply in the fraud case detected. In which case, it is important that HMRC has the resources and investment necessary to identify and stop such abuse, given that the measures already exist.

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