ForrestBrown®
R&D tax credit consultancy

Preventing abuse of the R&D tax relief for SMEs: second consultation

25 August 2020

ForrestBrown Ltd response

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 the transformative power of R&D tax credits. 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 and post-COVID 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, and the coronavirus pandemic has put them under unprecedented strain, 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 a small minority of poor players. 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.

We participated in the spring 2019 consultation on the proposed introduction of the PAYE/NIC cap to the SME R&D tax credit regime, and this is our response to the second consultation of spring 2020.

Finally, it should be noted that we are professional advisers to companies which undertake R&D and make R&D tax credit claims, and our responses to questions which refer to 'your business' should therefore be read as 'our clients' businesses'.

Question 1

Does your business subcontract to a related party or use EPWs provided by a related party ? Would it be useful to include the PAYE/NICs attributable to these workers in your payable credit?

We have analysed data for our SME clients' claims in order to respond fully to this consultation. Our starting point for this exercise was to analyse all of the SME R&D tax credit claims we submitted in the year ended 31 December 2019. Three quarters of our R&D claims in this period included expenditure on subcontracted R&D and/or EPWs. In around a fifth of SME claims, expenditure on these categories accounted for the largest cost (by contrast, staffing costs were the single largest cost in 74% of claims).

It has not been possible to separately identify expenditure on connected party subcontractors / EPWs in our data. However, anecdotally we would expect the proportion of businesses with connected party subcontractors / EPWs to be smaller, but with potentially the impact being larger (ie a higher proportion of R&D expenditure being on these connected party costs). This is because where there exist the types of structures we have described below, it is typical for the connected party subcontractors or – more commonly – EPWs to account for a large proportion of the total R&D expenditure.

Common examples of claims which include connected party subcontractors or EPWs include:

- Where there is a group of UK companies with one or more companies undertaking R&D (for

example, they may operate in separate but related areas of technology) but for ease of administration only one employs all the staff and operates PAYE. The employees who are employed by one group company but contribute to another group company's R&D are connected EPWs in the other company's R&D claim.

- Similarly, many early stage 'start up' companies will rely on subcontractors or EPWs, and many may contract with connected parties as they look to their network for trusted business partners. An entrepreneur with investments in a number of businesses, for example, may introduce a new company in his/her portfolio to another who provides the services it needs while the start-up is not yet commercially mature enough to commit to employing staff.

- A third example would be where a UK-based company sets up an overseas subsidiary to access particular technical expertise or a readily available workforce with the technical skills they require. The overseas subsidiary would operate as a staff provider to the UK company, providing its employees to work on the R&D projects.

It is hard to see anything abusive in these scenarios, and each example would appear to reflect a company which is genuinely undertaking R&D and which the consultation has said should not be adversely impacted by the PAYE/NIC cap. We would therefore broadly welcome the inclusion of PAYE and NICs in respect of connected party subcontractors and EPWs in the PAYE/NIC cap.

This inclusion would not benefit companies where the employing entity (staff provider) is overseas (the third example above), and therefore these companies would still potentially suffer as a result of the introduction of the cap (subject to the other measures included in this consultation). A decision to exclude any safeguards for these structures sends a message that the government does not support such businesses accessing the incentive. The UK R&D tax incentive does not include restrictions on where R&D activities are carried out; the inclusion of such a restriction should be made transparently and not via a separate measure designed to address fraudulent activity.

Such structures are not fraudulent where there are genuine commercial reasons behind them. While the fraudulent structures involved connected-party subcontracting, it does not follow that all connected-party subcontracting or provision of EPWs is inherently fraudulent or less desirable than other types of expenditure.

Question 2

Would it be practical to obtain information on attributable PAYE/NICs from EPW providers in order to increase the level of your cap?

There are several scenarios which would have different implications for a company wishing to obtain information on attributable PAYE/NICs from an EPW staff provider. One such scenario is outlined in our response to question 1 above, where connected EPWs are provided by another group company which acts as staff provider to the claimant company. In this case, it should be straightforward for the company to obtain information on the PAYE and NICs payable by the staff provider company in respect of the EPWs. This is the scenario envisaged by 4.4 to 4.6 inclusive of the consultation document, and in our response to the spring 2019 consultation we suggested a consolidation principle which would simplify this approach.

It is possible for entities to be connected without sharing the same level of transparency as would be expected within a group structure. For example, where companies are connected by virtue of an individual's shareholding (our second scenario above). This may present challenges or increase the

administrative burden where it occurs, however we would anticipate this affecting a small minority of claimants.

The practicalities of obtaining information aside, if the employing entity is non-UK, there will be no PAYE/NIC to include and genuine businesses will potentially be prevented from accessing relief for genuine R&D expenditure.

Question 3

The government welcomes views on the sorts of activities which are undertaken to manage IP, as well as the types of information and evidence on the active management of intellectual property, which genuine claimant businesses would be able to provide in supporting their R&D tax relief claim.

In our experience, only a small proportion of companies which undertake R&D seek to formalise IP in the form of, for example, a patent. A larger proportion recognise its value on their balance sheet, however this has largely been driven by adoption of international reporting standards, so there are still many who continue to expense the cost of R&D activities. The linkage between the undertaking of R&D and the ownership and recognition of an IP asset is less close than might at first sight be assumed, and this was implicitly recognized by the removal of the requirement for any IP generated by the R&D to vest in the company[1].

The proposed legislation should therefore be open-minded as to the form this IP may take. Most IP generated by R&D remains in the form of know-how, and the commercial decision whether to protect this knowledge by formalising it as a patent should not be influenced by any tax factors. Similarly, we would suggest a pragmatic approach to the type of evidence which the government expect such a company to provide. The evidence referred to at 4.14 is all documentary evidence, but it would be reasonable to expect the directors of the company to be able to explain verbally the activities they undertake to manage IP, and this would almost certainly present a more three-dimensional picture of active management of IP than documentary evidence alone. Legislation or guidance should make clear what evidence government considers reasonable, with examples, to prevent relief being unduly denied to genuine businesses as a result of disputes over the quality and extent of documentary evidence records.

Similarly, it is recognized in 4.13 that commercial exploitation of IP is a form of active management. For a company whose IP takes the form of know-how, this could be evidenced by marketing materials, or tenders or proposals, which showcase the company's expertise.

Finally, it should be recognized that the undertaking of R&D to grow and develop a company's IP is itself a form of active management of IP. This may sound like a circular argument, but for a tech start-up in its first or second year, whose IP takes the form of, for example, the codebase for its software, its priority will be the continued development of this codebase and it is unlikely that much activity will be undertaken to commercially exploit any IP before the minimum viable product stage is reached, much less to formally protect it.

[1] Former ss. 1052(4) and 1053(3) CTA 2009

Question 4

Does your business subcontract work to a related party (including using EPWs provided)?

Our data shows that 74% of all SME R&D tax credit claims we submitted on behalf of our clients during year ended 31 December 2019 included qualifying expenditure on subcontractors, EPWs, or both. However, this includes both connected and unconnected subcontractors and EPWs, and for the purposes of this consultation it has not been possible to isolate only connected subcontractors and EPWs.

Many of these claims will be made by group companies whose R&D is undertaken at least in part by employees of another group company. Provided that those employees are in the UK and that PAYE and NICs are therefore payable, although the company will be caught by the PAYE/NIC cap, the availability outlined in 4.4 to 4.6 of group companies' PAYE/NIC should ensure that it is not detrimentally impacted by the cap.

The same would not, however, be true for employees of group companies outside the UK. As noted above, there are clearly genuine businesses who rely on subcontracting or engaging EPWs from an overseas connected party. This may have been a common feature in the abusive structures, but it does not follow that the activity itself is abusive, as the incentive includes no condition that R&D activities must be physically carried out in the UK.

Question 5

Where your business does subcontract to a related party, does this represent less than 10% of R&D expenditure? If no, please provide an indication of the percentage of your claim related party subcontracting does represent.

Our data shows that subcontractor and EPW expenditure accounted for more than 10% of total R&D expenditure in 55% of all SME R&D tax credit claims we submitted on behalf of our clients during year ended 31 December 2019[2].

The question itself only asks about connected subcontractors, but 4.19 which accompanies it refers also to EPWs. We assume this will be made clear in the draft legislation.

Given that the stated aim of the PAYE/NIC cap is to combat abusive behaviour, and that the maximum of 10% of qualifying expenditure on connected subcontractors or EPWs test is in addition to the active management of IP test, 10% is too low a threshold.

It is stated that in the abusive structures, there was little or no activity within the UK, with the vast majority of expenditure being subcontracted to related parties. We assume that this is activity of any sort, rather than R&D activities specifically, and that this negligible level of any substance in the UK was an important feature of the fraud.

This description does not appear to be conducive to a threshold of 10%. Such a low threshold adversely affects genuine businesses who subcontract to or engage the services of employees of overseas group

[2] Again, it has not been possible for the purposes of this consultation to isolate only connected subcontractors and EPWs from our data.

companies. It is important that a sense of perspective is maintained within a measure designed to prevent an abusive structure which relies almost entirely on connected party outsourcing.

This approach risks catching too many genuine businesses in its net, and we would therefore recommend increasing the proportion, potentially up to 50%.

As we have noted above, this consultation should not result in tarnishing the concept of connected party transactions entirely, when the extent of the reliance was such a key feature in the abuse.

For further information, please contact:

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