Increasing the scope of R&D

Large Corporate OMB

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Lindsey K Copland puts forward ideas to increase investment in research and development, by enhancing the tax relief rules

Key Points

What is the issue?

Since the inception of research and development (R&D) tax relief for SMEs in 2000 and for large companies in 2002, successive governments have enhanced the R&D tax relief and credit system on a piecemeal basis.

What does it mean for me?

In a post Brexit world, the opportunities to enhance and extend the relief may provide the Treasury with far greater scope to be creative and inventive, ensuring that the relief fulfils the intention of attracting and encouraging investment in innovation in the UK.

What can I take away?

There has never been a better time for the government to drive in enhanced investment for innovators than right now.

Since the inception of research and development (R&D) tax relief for SMEs in 2000 and for large companies in 2002, successive governments have enhanced the R&D tax relief and credit system on a piecemeal basis. Some changes have been pivotal, such as the transition to the R&D expenditure credit (RDEC) regime; others more simplistic, such as the one percentage point increases to RDEC. It must be said that other than the aim to increase the overall attractiveness and reward of the scheme, the changes have been unconnected and to a degree not part of any obvious strategy.

On prime minister Boris Johnson's first day, he announced on the steps of Downing Street that he intended to enhance and extend R&D tax relief; a welcome signpost from a new PM that his government remains committed to this valuable relief. Further, in the Conservative manifesto a 1% increase in the RDEC rate was signalled too, which may be a counter to the expected withdrawal of a 17% rate of corporation tax. This would of course increase the net RDEC amount, as the tax take would be less, but reduce the net SME tax benefit relief.

By contrast, and for the first time, Labour's manifesto indicated that they would remove the RDEC regime, whilst setting a target of 3% of GDP to be spent on R&D by 2030.

The impact of Brexit

In a post Brexit world, the opportunities to enhance and extend the relief may provide the Treasury with far greater scope to be creative and inventive, ensuring that the relief fulfi ls the intention of attracting and encouraging investment in innovation in the UK.

Whilst the RDEC scheme is a creature of solely domestic tax legislation, the SME scheme is an EU notified state aid and is subject to EU law. Much will depend on the trade terms agreed over the course of this year, as I'm sure the EU will want to retain as much of a level playing field as possible. With that as a backdrop (and polishing a very large crystal ball), a number of opportunities to enhance and extend the relief are possible.

If, post Brexit, we will no longer be bound by the EU definition of a small and medium size enterprise, this may present an opportunity to redefine what constitutes an SME.

For example, if the thresholds were raised to more than 1,000 staff or more, to turnover of €200m (£187m) or to €172m (£153m) on 'A statement of financial position' (balance sheet), a tranche of smaller 'large' companies would be able to access the preferential higher SME tax relief rates. This would enhance the relief for companies that may have recently outgrown the existing SME limits or are ‘small’ large companies.

Currently, work funded either by notified state aid (impacting the whole of the project cost) or third-party funding (on a pound for pound matching basis) for SMEs can only be claimed under the RDEC scheme. Legislation in this regard is at present restricted as the SME scheme is a notified state aid and therefore no further aid may be given. After the Brexit transitional period, we may be presented with the opportunity to remove the funding restriction and SMEs will be able to claim funded project costs under the SME scheme, which would align with the RDEC as this has no such stipulation for funding.

Extending micro SME benefits

For all businesses, cash is king but for none more so than for micro SMEs. HMRC’s Advanced Assurance scheme for SMEs was a welcome initiative to encourage small businesses to claim tax relief on their investments in innovation. This approach gives them confidence that their claim will be accepted for three accounting periods if it remains consistent with the initial discussion with HMRC.

Extending the Advanced Assurance scheme to the RDEC regime would also go some way to increase and encourage claimants to invest, safe in the knowledge that the tax credit will be approved. Given HMRC’s R&D tax claims workload (where there have been complaints about the extended time to approve claims), assuring claimants in advance would mean only a light touch would be required at audit.

To further enhance and extend the relief, the introduction of a tiered approach to the tax relief available to micro SMEs could be considered. This would mean that start-ups, incubators and accelerators can access a higher rate of return, and coupled with the Advanced Assurance programme this would create a world class R&D scheme.

Like most of these examples, the precise amount of change is moot. What’s important is the principle. As an example, however, a micro SME rate of 300% uplift for businesses with over 100 full time equivalents (FTEs) would drive investment into the incubator/accelerator market. Further, increasing the ‘cash out’ percentage for loss making companies where they surrender losses for cash will provide much needed additional cash for SMEs to re-invest in staff and technology.

Corporation tax rates

Although the much trailed 17% rate of corporation tax (CT) is expected to be withdrawn in the Budget, any reduction of the rate has a positive effect on RDEC claimants as it reduces the net tax take from the gross RDEC credit, but has the opposite effect on the SME rate.

Some may argue that the SME rate at 230% is generous enough and that increases in the super deduction multiplier have largely off set falling CT rates. However, there is an opportunity to ensure the benefit remains unchecked by rate movement by linking the super deduction multiplier to the tax relief benefit.

The same argument applies to the patent box scheme, where falling CT rates have eroded the tax benefit. This could be simply remedied either by maintaining a 50% patent box rate benefit against the prevailing CT rate or by locking and tracking a ten percentage point differential, resulting in a consistent benefit for claimants.

With the drive to simplify tax in mind, the SME tax relief scheme and the RDEC could be combined into a single enhanced tax credit of 20% for businesses with over 100 FTEs. This would simplify the eligibility criteria and the tax benefit calculation, and consequently the attractiveness of the scheme.

Investment support

Currently, the legislation and guidance are clear that eligible software costs relate to licence costs alone, but companies now use and pay for software in very different ways, such as monthly hosting charges. Whilst conversations have been held at a policy level regarding changing this criteria, HMRC's treatment of costs other than licence costs is currently inconsistent nationally. A change in the legislation would provide much needed clarity for claiming companies and advisors alike.

When you consider the full project lifecycle from idea generation to monetisation, it would make sense if the incentive to invest in innovation and the subsequent profits generated by the developed IP fell into one single, simple scheme. The SME and RDEC schemes are front end reliefs, while the patent box scheme is a back end relief. They work in very different ways. Merging them into a single innovation relief scheme could provide greater clarity and simplification of the claiming process.

Claiming tax relief

There are large variances in how claiming companies submit an R&D claim. The minimum requirement is a number in the tax return, which is all that some claimants provide. This is often a short cut to an enquiry, as the inspector has no evidence that the claim has been properly made.

Conversely, reports running to hundreds of pages are sometimes produced to support a claim, which often results in only testing an inspector's reading stamina.

To provide a level playing field and to aid audit, HMRC could mandate the content of the supporting documentation provided by claiming companies, similar to the Canadian R&D scheme. This would provide a nationally consistent approach and clarify the expected shape and form of claim submission documentation, removing the uncertainty about HMRC views as appropriate content and length.

Externally provided workers

The redefinition of IR35 may lead employers to attempt to convert externally provided workers to full time employees, thus removing the risk of a charge of disguised employment. As a further incentive, the rate at which staff costs are included in an R&D claim could be enhanced by, say, 10%. Currently eligible staff costs are included in a claim at 100%. Providing a 10% uplift to the staff cost element claimed will incentivise staff cost over any other cost type in an R&D claim. This would support skills and talent and encourage companies to employ staff rather than engage temporary labour. The PAYE/NIC cap would, of course, need to remain in place.

Current externally provider worker legislation requires a minimum of three parties to be a potentially eligible cost, ruling out many people who are engaged directly with claiming companies. This requirement is often ignored, and its removal would simplify the process and allow the cost of self-employed consultants engaging directly to be included in a claim.

Conclusion

Many of these ideas are mutually exclusive and recent conversati ons with the R&D policy unit and the Treasury have indicated that any changes to the relief must be cost neutral. Whether that means cost neutral in terms of the R&D budget or the overall budget remains to be seen. Nonetheless, there has never been a better time for government to drive in enhanced investment for innovators than right now.