Quinn: the complexity of enhanced R&D rules

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The First-tier Tribunal's decision in a case looking at enhanced R&D relief shows the complexity of the rules.

Key Points

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What is the issue?

In *Quinn*, HMRC argued that fees paid by the clients amounted to meeting the costs of R&D, and therefore did not qualify for the additional R&D reliefs as the work fell within the exclusion of 'subsidised expenditure'.

What does it mean for me?

The knowledge obtained as a result of the R&D was found to be no value to the company's clients, who often have no knowledge of the technical solutions developed, and the taxpayer's appeal was therefore allowed.

What can I take away?

R&D work undertaken in the course of providing a service for a client, the costs of which are subsumed within the overall fee, will not necessarily be denied the enhanced relief given under the R&D rules.

Until a couple of years ago, relief for research and development expenditure was a subject that did not attract much attention in the professional press (except for the occasional reminder of its potential availability and generosity, where available). However, the past couple of years have seen discussions about a concern that many taxpayers were being encouraged to make dubious claims by rogue advisers and, in parallel, a more hardened approach by HMRC to claims (whether genuine or less so).

Over the past two decades, there have been different versions of the research and development rules, some depending on the size of the claimant company (the reliefs cannot be claimed by unincorporated businesses) and also depending on who carries out the actual research and/or development. However, a common theme is that the relief is not available in respect of what the legislation calls 'subsidised expenditure'. This is defined in the Corporation Tax Act 2009 s 1138(1) (broadly) as expenditure:

- that is subject to a notified state aid;
- in respect of which a grant or subsidy (other than a notified state aid) is obtained; or
- that is otherwise met directly or indirectly by a third party.

The precise scope of this exclusion is the subject of a recent First-tier Tribunal decision, *Quinn (London) Ltd v HMRC* [2021] UKFTT 437 (TC).

The facts of the case

The taxpayer company, Quinn, carries out construction and refurbishment works to a range of clients, for which it charges an agreed price. In the course of carrying out its work, Quinn undertakes some research and development.

This research and development relates to developing technological knowledge or capability so as to assist Quinn in the carrying out of its functions and which it can use in the course of future projects. Examples discussed by the tribunal include work on a 17th century mansion house and surrounding parkland structures, where Quinn developed a number of novel techniques for the refurbishment of heritage properties, including:

- providing safety features on a pond using innovative designs to recreate Victorian appearances but which nevertheless comply with modern health and safety requirements;
- devising a process to replace load-bearing timber floor joists with steel supports, without compromising or damaging the listed structure;
- devising methods to measure the strength and integrity of a 17th century stone cantilevered landing and staircase; and
- the adaptation of a micro-pile system to allow for installation of a lift shaft into the listed structure.

When pricing for the work, Quinn would consider the likely costs it would incur in delivering a particular project, including the probable research costs, and then agree a fixed price with the clients in advance of carrying out the works, although this price is often varied by agreement in the course of the project.

HMRC accepted that the expenses incurred qualified as an allowable business expense in the normal way. However, it considered that the expenditure did not qualify for the additional research and development reliefs on the basis that the work fell within the exclusion of ‘subsidised expenditure’. HMRC’s argument was that the fees paid by the respective clients amounted to meeting the costs of the research and development and therefore fell foul of the third limb of the statutory definition in s 1138(1).

The First-tier Tribunal’s decision

The case came before Judge Harriet Morgan.

Both parties had presented a wealth of case law to the First-tier Tribunal, although none of the authorities was precisely on the point that the tribunal had to address. As far as the third limb of s 1138(1) was concerned, Judge Morgan considered that expenditure would be caught by this provision if:

1. the expenditure was not actually caught by the previous two limbs (state aids or grants, etc);
2. a person other than the taxpayer met the expenditure; and
3. that person met the expenditure either directly, such as by paying the relevant cost direct to the person charging it or, indirectly, such as by reimbursing the taxpayer for sums it has already paid.

The judge continued to note that HMRC's argument relied upon the fixed price paid by a client for a particular project amounting to the meeting of the costs incurred by Quinn in providing the service contracted for. On a natural reading of the test as viewed in the context of the legislative scheme, the judge concluded that the rules were not intended to cover such cases. This view was reinforced by the fact that the previous two limbs were focused on cases where the taxpayer had received some form of grant towards the costs of the research and development and the judge considered that this context framed the meaning of the words 'otherwise met'.

Judge Morgan noted on the facts of the case that the knowledge obtained by Quinn as a result of the research and development is of no value to the company's clients, who often have no knowledge of the technical solutions that Quinn have come up with (or tried to come up with) during the work on their site.

The taxpayer's appeal was therefore allowed.

Commentary

From my perspective, the First-tier Tribunal's decision makes complete good sense. As the judge herself noted: '[I]f HMRC's approach were to be adopted, the circumstances in which an SME could claim enhanced R&D relief would seem to be confined to those where it has no prospect of exploiting the R&D for commercial gain.'

The judge also criticised HMRC's reliance on the High Court case of *Gripple* [2010] EWHC 1609 (which incidentally was one where I had represented the taxpayer). HMRC had tried to suggest that, according to the High Court, relief was not available in relation to expenditure that can otherwise qualify as a business deduction.

However, as the judge made clear, by reference to the actual words found in the High Court judgment, all that was said by the High Court judge on that point was that, even if certain expenditure fails to qualify for relief under the generous rules

for research and development, that does not necessarily prevent it from qualifying as a deduction in the usual way.

This is not the first time that HMRC will have put forward a plausible assertion as to the law, with reference to established authority, where on closer inspection that authority does not back up the assertion being put forward.

I have heard from a reliable source that HMRC does not wish to appeal against the decision but refuses to accept its correctness. This is somewhat surprising because, rather unusually, HMRC instructed a QC to represent it at the First-tier Tribunal, which suggests that it was taking this case as a lead case. Furthermore, there was evidence before the tribunal that there were between eight and ten other cases turning on the same point being handled by Quinn's specialist advisers.

However, if what I have heard is correct, HMRC is likely to continue to resist claims in similar circumstances on the basis that a First-tier Tribunal decision does not represent binding precedent. This approach, if true, is in my view rather disingenuous as the concept of binding precedent is strictly of little relevance. The First-tier Tribunal's decision is the best (and only) authority as to what the statutory words mean and HMRC should abide by it or, if it considers the decision to be wrong, it should take the case to the Upper Tribunal and beyond. Indeed, there is case law to show that it can do so without any adverse effect on the particular taxpayer. I hope that the representative bodies will take up this matter with HMRC because it is unreasonable for HMRC to ignore the First-tier Tribunal's decision simply because it does not like it.

What to do next

Although advisers should be aware of the risk of continued HMRC challenge in this regard, the First-tier Tribunal's decision should put it beyond doubt that one cannot generally treat elements of a fee paid by a client as a subsidy. As a result, research and development work undertaken in the course of providing a service for a client, the costs of which are subsumed within the overall fee, will not necessarily be denied the enhanced relief given under the R&D rules.