



PREVENTING ABUSE OF THE R&D TAX RELIEF FOR SMES CONSULTATION

Issued 23 May 2019

ICAEW welcomes the opportunity to comment on the Preventing abuse of the R&D tax relief for SMEs consultation published by HMRC on 28 March 2019, a copy of which is available from this [link](#).

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EXECUTIVE SUMMARY

1. The policy objective is to reduce the number of fraudulent claims for R&D relief, specifically those exploiting the tax repayment available under the SME scheme. While we understand the desire to exclude such claims, we are unclear on the extent to which imposing a blanket cap will prevent those false claims. It appears that such a cap will serve to reduce the availability of relief for many participants in the scheme including those that undertake genuine R&D activity.
2. It was widely agreed that smaller start-up businesses are likely to be the most affected by the introduction of such a cap as well as research-based university spin-outs that are two years old or younger. The introduction of a 'threshold' below which the cap will not apply will help to limit the adverse effect of the policy in this category and was widely supported by all members. However, the quantum at which the threshold should be set was met with some conflicting views.
3. It is acknowledged by all that the implementation of a threshold will not prevent certain genuine companies being affected by the cap. Feedback around alternative measures to prevent abuse involved further compliance checks/activity by HMRC and legislation around nexus (although this is accepted to be complex). It was also suggested that it might be beneficial for certain sectors to be exempt of the cap.

DETAILED RESPONSES

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?

4. There was unanimous support for the introduction of a threshold below which the cap would not apply. This is because companies in the early stages of development, where resources may be very tight, may have little or no PAYE and NIC liabilities. If a cap is introduced based on three times the PAYE and NIC liabilities, such companies' R&D claims would be severely restricted, and in a worst case scenario, where there are no such liabilities, would not be in a position to claim R&D credits at all. Such an outcome is at odds with the underlying policy behind this measure and the introduction of a cap will go some way to addressing the problem.
5. Members' views on the level of the cap have varied with suggestions ranging from £10,000 to £75,000. Although we have not undertaken a detailed survey of member views, member feedback was that a cap of around £20,000 on the repayment (c£60,000 of qualifying R&D expenditure) would be reasonable.
6. One concern is that a cap will not prevent evasion in the form of a larger volume of lower value fraudulent claims, particularly if there is a threshold below which the cap will not apply. We recall that a similar problem occurred in respect of self assessment auto-repayments, where those seeking fraudulent tax reclaims responded by aiming for smaller sums, and we suggest HMRC reviews its internal statistics around this. One option could therefore be to consider a lower threshold below which the proposed cap would not apply, but to include a provision to enable taxpayers to make a special application for a detailed review by HMRC where they consider they would be eligible for further R&D relief in the absence of such a cap. This would enable, by exception, genuine R&D companies to obtain the relief even though their PAYE liabilities might be minimal. HMRC could consider how this process might work to make it as streamlined as possible. For example, a standard application form requiring certain documentation and information.
7. It is important that HMRC has the necessary powers to review any historic claims where concerns arise, in an effective and as timely manner as possible. HMRC may believe that its existing powers are sufficient in this regard but should consider whether any specific further powers need to be drafted for inclusion in the new legislation.

8. We would recommend that any threshold is regularly reviewed to ensure that it is appropriate in minimising the number of genuine R&D claims prohibited by the cap. It is essential that this threshold is set at the correct level so as to maintain the spirit of the R&D legislation in supporting companies undertaking genuine advancements in science or technology.

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?

9. Should such rules be put in place, it is clear members want clarity around what a 'group' will mean in these circumstances and are keen for it to be clear and simple to apply. This is particularly important given that many of those affected could be entities very much in their infancy and unaccustomed to a substantial compliance burden.
10. Some concern has been raised around treating entities as connected if they are under 'common control'. This is because it is understood that 'serial' entrepreneurs might invest in multiple start-up companies which may have several R&D projects running concurrently. It would seem unfair and against the spirit of the legislation to limit the R&D relief of diverse projects simply because of the existence of common directorships or interests.
11. There was some mixed feedback around how common it is for groups to submit more than one claim, although on balance it would appear that this is not uncommon, albeit not in the majority. The point was also made that the threshold will generally affect smaller entities and start-ups where it is more common for only one claim to be made by a standalone company in any event. Subject to our comments at point 10, these entities are therefore less likely to be affected should only one claim be permitted below the threshold.
12. A sensible approach might be that any number of R&D credit claims can be made by a group, so long as these claims don't exceed the threshold cumulatively across the group. The group companies will already need to exchange tax data (eg for AIA purposes) so checking that the group threshold for small claims is not breached should not be difficult providing the definition of a group is not overly complex.

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?

13. If the PAYE and NICs liabilities of another group or connected company were included in the cap, this would reduce the impact of the measure in certain circumstances, and would be a fairly modest burden in most cases (generally all companies in a SME group use the same accountant). The general consensus from members was that this would be limited in complexity and of benefit to companies.
14. We do not understand why the cap regarding the wider group PAYE and NIC liabilities is limited to only those employees directly engaged in R&D activities whereas the PAYE and NIC cap in the standalone company is not limited just to those employees engaged in R&D activities. Clearly this will have an impact on the benefit of this measure. SMEs might have some administrative difficulties trying to ascertain the exact costs attributable to the staff engaged in the R&D activity.
15. The inclusion of group PAYE and NIC liabilities will not always reduce the impact of the cap. This is because we are advised it is quite common for only a minority of employees to be engaged in R&D at the outset. Often start-ups involve key researchers being remunerated via share growth rather than salary. Few other staff are employed and most of the R&D may be carried out by specialist subcontractors.
16. We note that there is some suggestion of permitting the cap to include the PAYE and NIC regarding externally provided workers. However we suspect that this information may be very difficult to obtain in practice. Some labour agencies may even view this as commercially

sensitive, notwithstanding the wider legal and data protection considerations which would need to be navigated. Many specialist subcontractors may have their own arrangements whereby they remunerate themselves via dividend and salary from a personal service company. Any information around PAYE and NIC would only be available retrospectively and in practice the amount of remuneration taken as salary as compared to dividends may be much lower.

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?

17. We consider it would be unusual for group or connected companies to be unwilling to share such information. Some members even indicated that they have never come across this problem before. However, as discussed above, this information might be more problematic to obtain from a third-party.

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?

18. It would be beneficial for SME's to be able to surrender carried forward losses as this would allow a company with small PAYE and NICs liabilities in early years that were capped under the proposals to utilise such claims in the future.
19. As such companies may have small PAYE and NICs liabilities for a number of years (particularly start-ups), a longer time limit such as five years for carried forward claims would be appropriate.
20. Tracking the carried forward losses that can be surrendered would require a simple table and would not be overly burdensome. However there may be an issue where a company changes professional advisers. A record could be maintained in the company's return and a proforma for losses used in R&D could be included which would help maintain a clear record of the relevant information.
21. We note that losses normally can be 'carried back' or 'group relieved' as well as carried forward, the group relief option being redundant if as Q3 suggests the group PAYE liabilities were considered. We note that the prior year is routinely reviewed as part of the annual compliance process for many reasons (2 year claims, comparison of activity, etc.) It would therefore be worth considering enabling a carry-back claim against 'PAYE capacity' of the previous period.

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?

22. There were some conflicting views from members on this. Some thought that this is unrealistic and very unlikely to happen in practice. Other feedback indicated that where a company already had an active payroll this could happen. However, where the company has no staff other than directors, and the directors are not remunerated by payroll then it is unlikely a company would consider taking on more staff purely to unlock some or all of their payable tax credit. This is because the administrative burden of a 'first staff member' is significant and the benefit of a carried forward option would be unlikely to outweigh this.
23. However, it is important to remember that any extra R&D repayment relief received as a result of increased employment in a business would only serve to reimburse a proportion of those remuneration costs and a substantial proportion would still be borne by the business itself. Companies are likely to be very reticent to incur unnecessary costs so, while the carry forward provision might encourage the genuine hiring of essential staff by reducing the net cost of recruitment, increased headcount is likely to be driven first and foremost by the commercial needs of the business at any one time.

24. Some directors of owner-managed businesses may choose to extract more remuneration as salary in order to unlock the tax-credit. However, members have advised us that some early stage companies may have covenants in their bank financing or shareholder agreements that prevent management from taking additional salaries in the early years of the business. These companies would therefore not be able to benefit from hiring additional employees or paying the directors a salary more akin to the market rate. It is also likely that smaller start-ups will not have sufficient cash to simply increase salaries in any event.
25. We are unclear of HMRC perceptions regarding this question. Whether increased employment to achieve a tax credit would be viewed as 'avoidance' or indeed a positive consequence of the new policy? Some members consider any increase in employment regardless of motive an advantageous outcome of new policy.

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?

26. Members were all in agreement that start-up companies or micro companies are likely to be the most affected by the cap where materials, energy and other non-labour costs account for a large proportion of their qualifying R&D expenditure. They may even be prohibited from making a claim at all under the new rules (subject to the threshold discussed at question 1).
27. For many small companies the R&D tax credit can be a vital source of cash flow especially where the companies are being financed mostly by the directors who are also the majority shareholders. There are many companies involved in the technology industry that follow this model. As mentioned at para 24 above, it is not unusual for owner-managers to forgo salary at the outset in the hope of equity reward in the future.
28. Such companies can be heavily reliant on subcontractors to help perform the specialist R&D and these subcontractors would not be part of the PAYE and NIC liability for the company. Therefore these companies would be heavily affected by the proposed cap. A specific example are spin-outs from universities in the life sciences sectors. These are highly research-based and in the first couple of years, such companies will have very little funding and may employ a part-time person on a consultancy basis (0.5 FTE). The company's R&D activity is typically outsourced to external parties, such as Contract Research Organisations (CROs).
29. Members have also advised us that they anticipate companies undertaking research in the development of materials and machinery dependant on expensive base elements (eg graphene) to be some of the most affected companies.

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?

30. One possible policy approach could be to exempt certain key growth sectors from the application of the cap. Similarly, R&D work where there is a clear public interest in the technology being developed (eg environmental benefits) could be awarded an exemption.
31. In the case of university spin-outs (see para 28 above) an exemption might be considered for the first few years, providing the company can demonstrate a connection to a university, such as an equity stake held by the university or a licence to its intellectual property.
32. However, if the cap is aimed entirely at preventing abuse, an alternative method would be to adopt a risk based approach which seeks to identify clear indicators to target the riskiest claims and prevent abuse. This could seek to allocate compliance resources to those claims with the highest risk. It is recognised that HMRC is likely to be undertaking this type of activity already, however, we anticipate investigative work to be the most effective in targeting those abusing the relief available without prejudicing genuine R&D activity.

33. Another method suggested was a light touch compliance visit for the first R&D tax credit claim, although we appreciate there may be resourcing issues here. This could be akin to the visit that many businesses have when they make their first VAT refund claim. The aim of the visit would be to establish that the business is making genuine R&D credit claims and that all of the activities qualify. This would reduce the amount of illegitimate claims and help ensure that R&D relief is being claimed correctly so that any errors are corrected at an early stage before it becomes a problem.
34. Members have suggested some form of jurisdictional restriction or nexus rules, although it is acknowledged that these can be complex to legislate and apply.
35. One suggestion was to introduce an offset against other tax obligations of the group (similar to how crown set-off applies in insolvency). It could potentially even be offset against the shareholders own tax obligations subject to some restrictions. However, for small start-ups with limited profits, there may be few other tax liabilities available for set-off so this may not address the impact of the cap for the most vulnerable ventures.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <https://goo.gl/x6UjJ5>).