

SME R&D tax relief cut in Finance Bill 2022-23

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Summary

At the Autumn Statement, the Chancellor announced an effective halving of the cash credits SMEs can receive from the R&D tax relief scheme, which provides crucial support for innovative businesses, convincing entrepreneurs to start and grow their companies here, helping to attract private investment and accelerate the development of new medicines for patients. It has been announced to tackle fraud but will not do so.

Businesses have made their investment plans based on the SME R&D tax relief providing 33p for every £1 the company itself invests in R&D, the cut proposed in your Autumn Statement means they can now expect 18.6p for each £1 of in-house R&D they perform and as little as 12p for each £1 of R&D they outsource to universities, hospitals or other companies. Life science SMEs are therefore now facing significant shortages in their R&D cash flow projections. This comes on the back of the restriction on claims for activities undertaken overseas which failed to take into account that clinical development is a global activity. Although, with our input, an exemption has now created, the rules are still not finalised and there has been no published guidance to explain their intended application, creating a high degree of uncertainty for companies.

In the face of strong economic headwinds, businesses and investors need certainty and stability. This cut to R&D tax relief, introduced without consultation and effective as soon as April 2023, will mean companies will not receive the investment they have budgeted for, and their R&D programmes will have to be cut back. High-value jobs will be lost and at worst, businesses will move overseas or cease activity altogether. Ultimately the whole UK life sciences ecosystem will suffer from a lack of start-ups and SMEs, leading to fewer clinical trials and large companies operating here.

See Annex 1 for the Finance Bill 2023 text

Proposed solution

We request the Government delay the cut to the SME R&D tax rate and consult on changes to the SME scheme that will prevent fraud whilst continuing to support genuine R&D intensive SMEs.

This could be achieved by focussing eligibility for SME R&D tax reliefs using the Knowledge Intensive Company definition, already in use in other parts of the tax system¹.

To qualify as a knowledge intensive company, the company and any qualifying subsidiaries must have less than 500 full-time equivalent employees and either:

- be carrying out work to create intellectual property and expect the majority of your business to come from this within 10 years

¹ <https://www.gov.uk/guidance/use-the-enterprise-investment-scheme-eis-to-raise-money-for-research-development-or-innovation>

- have 20% of employees carrying out research for at least 3 years from the date of investment - these employees must be in a role that requires a relevant Master's or higher degree

Additionally, companies should spend the following minimum percentage of overall operating costs on R&D:

- 10% a year for 3 years
- 15% in one of 3 years

Features of life science SMEs and the UK ecosystem relevant to understanding the impact of the R&D tax relief rate cut

- 80% of the UK's 6,330 life science companies are SMEs²
- Life science SMEs are typically spin-outs and start-ups, backed by venture capital.
- Drug development timelines are typically 15 years or more and full development of a drug can require £1bn or more in investment³. During this time the SME has no source of revenue and its growth is primarily funded by successive venture capital investments dependent on hitting R&D milestones
- During the R&D phase, almost 100% of the SME's expenditure will be on R&D.
- New biotech companies, rather than established pharma, are the drivers of innovation in healthcare. They are responsible for a 65% of the molecules in the global R&D pipeline without a larger company involved, up from less than 50% in 2016 and 34% in 2001⁴.
- Drug development carries a high risk of failure, only ~10% of drugs make it from Phase I clinical trials to regulatory approval to be given to patients⁵
- Investment in life science companies is therefore high risk and specialist, meaning there are market failures in the funding of UK companies, which is why R&D tax relief is key to leverage investment

How R&D tax reliefs work to support innovation and company creation

- R&D tax reliefs either provide a corporation tax relief for profit making companies or a cash payment for loss-making companies (almost all life science SMEs are loss making due to their high R&D spend). Both tax relief and cash payments are calculated as a percentage of past R&D expenditure
- The purpose of R&D tax reliefs are to increase business R&D investment by subsidising the cost of R&D. This:
 - Helps make the UK a competitive location for new R&D-intensive businesses to start and grow, and for established companies to make new investments. Life sciences is a particularly mobile industry
 - Encourages equity investment into pre-revenue early-stage and scaling R&D-intensive businesses, which may be considered too risky for investment without government subsidy
 - Incentivises existing businesses to invest in R&D

² Office for Life Sciences (2021) Bioscience and health technology sector statistics 2020: <https://www.gov.uk/government/statistics/bioscience-and-health-technology-sector-statistics-2020>

³ Joseph A DiMasia, Henry G Grabowski, Ronald W Hansen (2016), Innovation in the pharmaceutical industry: New estimates of R&D costs: <https://www.sciencedirect.com/science/article/abs/pii/S0167629616000291>

⁴ IQVIA (2022), Emerging Biopharma's Contribution to Innovation <https://www.iqvia.com/insights/the-iqvia-institute/reports/emerging-biopharma-contribution-to-innovation>

⁵ Chi H Wong, Kien W Siah, and Andrew W Lo (April 2019), Estimation of clinical trial success rates and related parameters: <https://academic.oup.com/biostatistics/article/20/2/273/4817524>

- Cash payments received by companies also provide a form of non-dilutive financing and extend cash reserves, which is very helpful to company survival during periods of difficult fundraising conditions
- Multiple studies by HMRC and independent economists ^{6,7,8} have proven R&D tax relief to be effective

Summary of impacts on UK life sciences

1. Based on HMRC and Office for National Statistics (ONS) data, we estimate that the cash value of lost R&D tax credits for UK life science SMEs is in the region of £400-800m. This is excluding any additional private finance that R&D tax reliefs are proven to leverage. We are waiting for HM Treasury to provide their opinion about this estimate.
2. To put that in perspective, Innovate UK's Biomedical Catalyst competition, which is the main form of R&D grant support for our sector, is only £30m per annum.
3. Life science SMEs are unlikely to be able to find new capital to replace the lost R&D tax credits because:
 - a. The R&D tax relief rate was fundamental to leveraging private capital into high-risk businesses
 - b. Budgeted tax credit income would have funded R&D to produce data required by potential investors for future fundraises, fundraising without that data will be harder
 - c. Budgeted tax credit income extended the length of time until companies would run out of money, this timeframe ("cash runway") is now shorter, which makes the company more at risk of insolvency and therefore a more risky prospect for potential investors
 - d. Fundraising activity is significantly suppressed due to the global economic climate. Fundraising by UK life science SMEs is 50% lower than in 2021⁹
4. The consequences of reduced R&D tax relief are therefore:
 - a. High-value R&D job losses as companies cut back programmes
 - b. Lower venture capital and public market investment in UK life science SMEs (much of which is FDI)
 - c. Reduced attractiveness of the UK as a place to start and grow a life science business
 - d. Movement of life science businesses and jobs to America and European countries
 - e. Increased life science company insolvency
 - f. Development of new medicines slowed or halted
 - g. Less reason for large companies to invest in R&D in the UK due to weakened ecosystem
 - h. Fewer clinical trials in the UK
 - i. Less medicines manufacturing in the UK
 - j. Fewer new medicines for patients

See Annex 2 for a selection of anonymous case studies of the impact on UK life science SMEs.

⁶ HMRC (2020), *Evaluation of the research and development expenditure credit*: <https://www.gov.uk/government/publications/evaluation-of-the-research-and-development-expenditure-credit>

⁷ HMRC (2020), *Evaluation of the research and development tax relief for small and medium-sized enterprises*: <https://www.gov.uk/government/publications/evaluation-of-the-research-and-development-tax-relief-for-small-and-medium-sized-enterprises>

⁸ Irem Gucer and Li Liu (2019), *Effectiveness of Fiscal Incentives for R&D: Quasi-experimental Evidence*: <https://www.jstor.org/stable/26641355>

⁹ As of 31 August

How the government should address fraud and reduce cost in the SME R&D tax relief regime

The Chancellor said in his Autumn Statement that he'd heard "concerning reports of abuse and fraud in R&D tax relief for SMEs", and used this to justify cutting the rate for all companies.

However, it does nothing to prevent fraud, only reduce the amount fraudulent companies claim by half, whilst simultaneously penalising genuine R&D intensive companies.

BIA has repeatedly and publicly raised our own concerns about fraud and provided ways in which HMRC could tackle it:

1. **Ban contingent fees (no-win-no-fee) tax agents.** Genuine R&D-intensive SMEs are regularly cold-called by these agents offering to increase their R&D tax relief claims. Life science companies use reputable tax advisers and understand what activities are genuinely eligible for claims, so do not use these agents. However, we understand that companies in less R&D-intensive sectors can be tempted by these offers of "free cash". This results in boundary pushing and abusive claims. HMRC should require claiming companies and their agents to declare the fee structure they are using and ban contingent fees.
2. **Resource HMRC sufficiently to scrutinise claims.** Our members' experience of making R&D tax relief claims is that the majority are processed automatically, leading us to believe that HMRC are insufficiently resourced to challenge the volume and nature of claims (see below), which further encourages fraudulent claims to be made.

The BIA has also recommended a focussing of R&D tax reliefs on genuinely innovative R&D activity to lower the overall cost of the scheme to the Exchequer. A large proportion of claims are for 'soft innovation' which are activities that companies undertake regardless of the availability of incentives. They are generally for technical maintenance rather than a genuine advance in a field of technology and they do not generate "spill-over" benefits to the wider economy. These are very difficult and time consuming for HMRC to disprove and is where much of the no win/no fee activity is focussed. They should not be supported by R&D tax relief and removing them from eligible expenditure would reduce the cost of the scheme to the Exchequer and eliminate the majority of the fraud and boundary pushing.

Annex 1: Finance Bill text

4 Amount of relief for expenditure on research and development

- (1) The Corporation Tax Act 2009 is amended as follows.
- (2) In Chapter 6A of Part 3 (trade profits: R&D expenditure credits), in section 104M (amount of R&D expenditure credit), in subsection (3), for “13%” substitute “20%”. 20
- (3) In Chapter 2 of Part 13 (relief for SMEs: cost of R&D incurred by SME) –
 - (a) in section 1044 (additional deduction in calculating profits of trade), in subsection (8), for “130%” substitute “86%”,
 - (b) in section 1045 (alternative treatment for pre-trading expenditure: deemed trading loss), in subsection (7), for “230%” substitute “186%”, 25
 - (c) in section 1055 (tax credit: meaning of “Chapter 2 surrenderable loss”), in subsection (2)(b), for “230%” substitute “186%”, and
 - (d) in section 1058 (amount of tax credit), in subsection (1)(a), for “14.5%” substitute “10%”.
- (4) The amendments made by this section have effect in relation to expenditure incurred on or after 1 April 2023. 30

<https://bills.parliament.uk/bills/3376>

Annex 2: Anonymous case studies of impact on UK life science SMEs

1. Pre-clinical start-up developing treatments for liver cancer - established and headquartered in the UK

We are currently fundraising and have circa 15 months’ cash left in the bank. Our runway projections have been predicated on a significant R&D Tax Credit for this year. With the proposed change, our calculations suggest that we should only anticipate just over half of the expected amount, which would bring forward the date **we will run out of money to less than 12 months from now**. This shortening of our cash runway makes a significant difference for our ability to raise funds now, as it now puts us in a much higher risk category of investment, and as such could put the brakes on our current fundraise and potentially **spiral the business**. An unforeseen change like this, with little warning, will have a dramatic effect on the early-stage growth companies and innovators the current government intends to support.

2. Clinical-stage company developing novel cancer immunotherapies - established and headquartered in the UK

At short notice it feels like the rug has been pulled out from under us in this blunt and crude approach to tackling the abuse of the SME scheme. We welcome reform to the R&D tax credit SME scheme to tackle fraud, but not in the manner proposed.

The changes detailed in the Autumn Statement will have a material impact on our current spending plans in the near term with an annualized £5M increase in net operating cash out flows from April 2023. **Given the current market environment and depressed equity valuations, fund raising is extremely challenging and uncertain.** We do not anticipate being able to raise money in 2023. In order to maintain our cash runway projections, following the announcement, we would need to reduce our R&D spending plans through **staff reductions (current or planned hires) and the halting of R&D programmes. ~50 jobs would meet the reduction in R&D tax credit over the next 2.5 years.**

We would also need to evaluate the costs of taking forward additional R&D activity in the future as we scale and raise additional funds. We have long term plans to expand our GMP manufacturing capacity in the UK including investment of up to £100M into a GMP facility to support our registrational clinical trials and commercial manufacturing in the UK. This facility would potentially generate up to **250 direct jobs at Achilles as well as many other indirect jobs in the supply chain and wider ecosystem.** We may decide to focus this longer term investment in other jurisdictions which are more receptive to R&D spending through the tax incentives they provide and scale back or stop the planned investment in the UK.

3. Pre-clinical biotech developing therapies for eye diseases - established and headquartered in the UK

Our company was founded by a highly successful US CEO. He was willing to headquarter the company and build a management and R&D team in the UK in large part because of the R&D tax credit, which in our case amounts to £12m of credits over two years. Our CEO was able to attract £55m Series A into a UK headquartered company in February 2022, a time of limited investment in the industry, in particular in the UK. I think it is fair to say that one of the largest biotech start up investments in the UK in recent years happened **as a direct result of the R&D tax credit, that would not have happened in this country otherwise.**

In light of this change, at a critical phase in hiring our team, I will not receive support for hiring or contracting in the UK and will be pushed to hire in the US where biotech development talent is far easier to come by and existing networks can be used. It will result directly in less investment in talent in the UK, reducing rare opportunities for trans Atlantic cross-pollination in this field that is of huge value to individuals in the industry, and the industry as a whole.

This change will materially effect our business plans and **I anticipate that some £17m of investment in R&D staff is now at risk of leaving the UK.**

4. Pre-clinical immune-oncology company - established and headquartered in the UK

I have quantified the impact to the business of the changes to the rates – it will be about £1.1m for the 2023 claim and £1.7m to the 2024 claim. We are not currently forecasting beyond 2024 but as we will be running at least two clinical trials by 2025 our costs will continue to increase and the detrimental impact will only grow.

The most obvious impact is that more funds will need to be raised from investors. So far we have received a high proportion of our funding from private investors but that is already constrained by EIS limits. **Needing**

to spend more time raising funds is likely to lengthen the research timescale and therefore the route to making taxable profits.

Our employees are highly skilled and in international demand. Several have relocated to the UK to take up employment with our company (both UK and non-UK citizens). The tax regime for R&D companies and individuals is becoming more and more hostile so we would expect recruitment to become more difficult. Given the type of work and the make-up of the team, there is no intrinsic reason to base the research in the UK. **The positive tax and regulatory environment are the big draws so if this becomes less advantageous it will have an impact on where future businesses set up.**

5. Pre-clinical company in cancers and autoimmune diseases - established and headquartered in the UK

As a small pre-commercialisation biotech, it will severely adversely impact our R&D budget and our ability to create new jobs. Having budgeted carefully for the next 5 years we will have to look at short term, medium term and long term mitigations. If these changes do come in **we will need to run a significantly paired down R&D programme and could result in us losing the market opportunity to overseas competitors.** A paired down R&D programme would also impact on our collaborators which include a number of UK Universities. We are currently waiting to kick off work with UK suppliers and we are waiting on our R&D tax credit coming in before signing contracts. This funding is a lifeline for small companies.