BIA submission to the House of Lords Finance Bill Sub-Committee: a potential merged R&D scheme and additional relief for R&D-intensive SMEs

Introduction and summary

The UK has a truly world-leading life sciences industry that is growing in size and impact as a result of long-term support from successive governments, most crucially via the R&D tax relief scheme. The BioIndustry Association (BIA) welcomes efforts to simplify and target the R&D tax relief, including the enhanced rate of relief for R&D-intensive SMEs announced at Spring Budget 2023.

However, we do have strong concerns about the detail and implementation, including:

- The merger of the schemes will provide simplification for non-R&D intensive SMEs and large companies, but the new regime as proposed will give rise to additional complexity for R&D-intensive SMEs, which will be subject to new rules and requirements. However, the benefit of the enhanced rate outweighs the impact of this complication and we are grateful for the additional support being provided to these SMEs.
- R&D intensive SMEs are being asked to adapt to multiple changes in a short timeframe with only draft legislation and guidance which is not final, or no public guidance at all. This is impacting investment decisions and hiring plans and creating unnecessary costs for SMEs.
- It is important to note that the enhanced rate of 27% is still not as generous as the 33% rate under the previous SME scheme, making the regime less impactful at leveraging private R&D investment and the UK less internationally competitive than comparable countries, including France (30%) and Australia (up to 45%).

HM Treasury and HMRC have engaged with the BIA constructively throughout the R&D tax reforms, and we have been able to input views and evidence, including providing data to inform the R&D intensive scheme, but remain concerned about the lack of public information. We would be very happy to provide oral evidence to the Committee to elaborate on the points made in this submission.

About the BIA

The BioIndustry Association is the voice of the innovative life sciences and biotech industry, enabling and connecting the UK ecosystem so that businesses can start, grow and deliver world changing innovation.

Our members include start-ups, biotechnology and innovative life science companies, large pharmaceutical companies, universities, research centres, tech transfer offices, incubators and

accelerators, and a wide range of life science service providers: investors, lawyers, IP consultants, and IR agencies. We promote an ecosystem that enables innovative life science companies to start and grow successfully and sustainably.

For any further information on the contents of this submission please contact Dr Martin Turner, Head of Policy and Public Affairs, by emailing mturner@bioindustry.org.

1. How much of a tax simplification would a merger of the two existing R&D schemes be?

Following the proposed merger of the two existing schemes, two schemes will continue to exist: the new merged scheme based on RDEC, and the R&D-intensive SME scheme, based on the current SME scheme and which will offer the "enhanced rate" of relief announced by the Chancellor at the Spring Budget 2023. This situation has arisen because the Chancellor rightly recognised that the cut to the SME scheme announced at Autumn Statement 2022 would damage the UK's life sciences sector, so he introduced the enhanced rate and HM Treasury has signalled its intention that this will continue alongside the merged scheme[1]. Historically, the UK's R&D tax relief regime has given a higher rate of relief to SMEs as they face more financial challenges (market failure) to invest in R&D, but changes at Autumn Statement 2022 sought to equalise relief. We welcome the additional support announced at Spring Budget 2023 for R&D-intensive SMEs and confirmation that this will be maintained and believe that the benefit of the enhanced rate outweighs any loss of simplification.

For those SMEs which are not R&D intensive, and all large companies, the merger will create simplification provided there is no restriction on R&D projects that are subsidised[2]. Under the current regime, SMEs claim under the SME scheme for non-grant funded projects and under the RDEC scheme for grant funded ones (i.e., subsidised ones). Under the new regime, the merged scheme would apply to all projects and there would be one claim. Therefore, for those SMEs which do not meet the R&D intensive definition, the merged scheme provides a simplification.

For those SMEs which are R&D intensive, there is the additional complication of determining and proving that they are R&D intensive to the satisfaction of HMRC, auditors etc. However, the costs (ignoring overseas spend) and claim calculations will be very similar to the current regime.

In addition to merging the schemes, the Government is introducing new rules to achieve other policy objectives, including "refocusing the scheme on UK-based innovation" (by limiting claims for overseas R&D spend) and reducing fraud. These additional rules are introducing complication rather than simplification to the regime. For all claimants, there will be the difficulties of

[1] https://www.gov.uk/government/publications/research-and-development-reform-additional-tax-relief-and-potential-merger/research-and-development-reform-consultation-on-a-single-scheme

[2] The current legislation contains a restriction on subsided R&D but we understand that this may not be taken forward in the final legislation, subject to the resolution of issues around sub-contracting currently being considered by HM Treasury and HMRC.

determining what overseas R&D spend may be included, as this change is being introduced at the same time as the merged scheme, but HMRC guidance for it has not yet been published. For SMEs, this overseas R&D spend change will have the additional implication of affecting whether they are R&D intensive or not.

In our submission to the merged scheme consultation[3], we recommended the following simplification measures that have not yet been incorporated into the legislation:

- No restriction for subsidised R&D
- Removal of the State Aid cap of €7.5m for SME projects. This rarely applies but causes an unnecessary administrative burden and uncertainty
- Removal of reimbursed expenses as qualifying staff expenditure. This would reduce eligible expenditure but simplify the category for staff costs
- Removal of Gripple restriction for Externally Provided Workers. This excludes costs for contractors where an individual is a director of the claimant. This gives rise to difficulties for groups of companies where directors provide services to different claimants

2. How easy will it be for SMEs to adjust to a single RDEC-based scheme for R&D?

As most SMEs are used to claiming for elements of their activity (such as that funded by subsidised grants) under the existing RDEC regime, we do not anticipate too much difficulty for SMEs in adjusting to the new merged scheme. The final RDEC calculation will be a straightforward calculation that is usually carried out by tax software programmes.

However, as noted above, the overseas R&D restrictions and R&D intensity calculations contained within the draft Finance Bill will result in additional work and adjustment for SMEs. The guidance and legislation for these new elements of the future R&D regime are yet to be published and/or finalised, meaning SMEs are currently in the dark regarding the future their claims must follow in future. This is impacting companies' ability to forecast cashflow, with knock-on impacts on investment decisions and hiring plans. The supply chain for life sciences companies is complex (generally involving a number of companies) and, by necessity often needs to be undertaken outside the UK. Clear guidance is needed around the application of these rules and effective communication with HMRC is needed to adapt and develop the guidance on an ongoing basis.

3. If the Government decides to merge the two existing R&D schemes, it has said the merger will take effect from 1 April 2024. What are your

[3] https://www.bioindustry.org/resource-listing/bia-submission-to-the-hmt-consultation-on-a-single-rd-tax-relief-scheme.html

views on this timetable? How prepared are businesses, particularly SMEs, for these changes? What help and support will they need?

In the past three years, the Government has implemented or proposed a series of changes to the SME R&D tax relief scheme that have progressively reduced the level of support to innovative SMEs and created half a decade of instability in tax rules, with different rules needing to be followed every year (see table below). Each change has also been implemented more rapidly than the last, giving businesses less time to prepare and adapt.

Five years of instability for SMEs due to compounded R&D tax credit changes		
Change	**Status**	**Date of impact**
PAYE cap – cash payments capped to 3X the claimant's salary and national insurance costs, with limited exemptions	In effect	Announced October 2018, effective for accounting periods beginning on or after 1 April 2021.
Overseas activity restricted – subcontracted R&D not performed in the UK is no longer eligible for relief, with limited exemptions	In effect	Announced November 2021, for accounting periods beginning on or after 1 April 2023
SME relief rate cut – the cash payment loss-making SMEs receive was reduced from 33p per £1 of R&D spend to 18p (or 27p for R&D-intensive companies).	In effect	Announced November 2022, for spend from 1 April 2023 onwards
Merged scheme – the two existing SME and RDEC schemes will be merged into one. R&D-intensive SME scheme available to companies investing 40% or more of total operating costs on R&D	Unconfirmed	Announced January/March 2023, effective for accounting periods beginning on or after 1 April 2024

As an example, a company with a 31 December year end has and will need to navigate the changes as follows:

- Year ended 31 December 2021 – old rules apply.
- Year ended 31 December 2022 – PAYE cap applies.
- Year ended 31 December 2023 – PAYE cap applies for the whole year. SME rate cut (enhanced rate) applies to spend from 1 April 2023.
- Year ended 31 December 2024 - PAYE cap, SME rate cut (enhanced rate) and overseas activity restriction applies for the whole year.
- Year ended 31 December 2025 – Merged scheme applies, replacing all previous rules except where SME is eligible for the R&D-intensive scheme.

The most significant change is the limitation for R&D undertaken overseas. Further guidance and engagement with industry is needed to ensure that the application of the rules is properly understood, including sector-specific guidance on how the rules should be applied – modern R&D in life sciences and many other sectors is extremely complex, it will be important that both claimants and HMRC inspectors have a detailed and accurate understanding of how the rules should be applied in specific situations.

We also want to emphasise that legislation and guidance on the R&D intensive scheme is not in place, which is also a significant change that SMEs will need to adapt to but are being given little time to do so.

4. Are HMRC's estimates of the costs to businesses of adjusting to these changes realistic? How costly is it likely to be for businesses to adapt?

SMEs are currently investing management time and paying for tax advice to understand the implications of the proposed changes. This is adding to business costs at a time of high inflation. There will also be future enquiries from HMRC that will be costly to respond to.

5. What are your views on how a merged R&D relief scheme should deal with the treatment of subcontracted R&D?

The draft legislation does not clarify the position for R&D service providers established in the UK. We have set out proposals for how we believe an effective framework could be operated. We believe our proposal should work for the different forms of sub-contracting seen across sectors. We also think that the solution will have positive benefits for increasing overall UK R&D activity by supporting the R&D services industry, especially in life sciences – as discussed before, in life sciences, a significant proportion of R&D needs to be outsourced to R&D service providers including Contract Research Organisations (CROs) and Contract Development and Manufacturing Organisations (CDMOs), which are a vital part of the UK's life sciences ecosystem employing highly skilled professionals: according to ONS data, Contract Manufacturing/Research Organisations and Clinical Research Organisations account for 17% and 9% of total employment in the biopharmaceutical sector respectively . In 2021 there were 4,375 sites operating in the 'core' life sciences sector, and a further 3,224 sites in the service and supply sector – split between biopharmaceutical and medical technology segments. The biopharmaceutical service and

supply sector accounted for 24% of all life sciences sites in 2021. As set out in the response to the initial consultation, clinical development and manufacture and the management of clinical trials are highly complex processes and fall within Category 2 (fragmented R&D).

1. These proposals are only intended to address claims under the new merged R&D relief scheme by a sub-contractor (service provider) limited to circumstances where the customer is not subject to UK corporation tax. They would have no impact on most claims which are made by UK companies which contract out UK expenditure or qualifying overseas expenditure under Section 1042E, for which the current proposed rules should work effectively.

2. R&D arising on activities contracted out can be considered in full under three scenarios:

   Category 1: The R&D project is contracted out in its entirety (which is relatively uncommon) and is currently addressed under Section 1042C of the proposed merged regime.
   Category 2: Key components of an R&D project are contracted out to other companies with the requisite specialist skills and expertise (fragmented R&D) we believe, the most significant of the three categories.
   Category 3: A commercial project is contracted out by the customer and the service provider undertakes R&D on order to be able to fulfil the contract (Quinn based R&D per Quinn (London) Ltd v HMRC [2021] UKFTT 437 (TC))

3. The current proposals in the draft Finance Bill include a specific exemption that should allow a company to claim for activities where the entire project is contracted out to that company by a person who is not a UK corporation taxpayer under Condition A of Section 1042C (Category 1). This should apply if the entire project was contracted out as the claimant company is clearly carrying on relevant R&D per section 1042.

4. Circumstances where R&D projects are contracted out in their entirety are relatively uncommon and it is much more likely that components of the project are contracted out to specialists with specific expertise (Category 2). Consequently, the legislation as currently drafted fails to achieve its policy objective of supporting R&D service providers established in the UK. This is because the R&D service provider is likely to be carrying on some activities that are routine, and not R&D, when considered in isolation, but they are essential to a wider R&D project being

carried on by the entity that is subcontracting out (the customer). Addressing this is essential to encourage specialist service providers to base and build their resource in the UK to enhance the UK based R&D supply chain.

The proposal – a qualifying R&D trading test

5. Under the current RDEC regime companies undertaking R&D on behalf of another group company (fragmented R&D) are eligible to claim under Section 104W CTA 2009 and under Section 1042N in the proposed legislation. On the basis that sub-contract R&D is included in a merged regime, our previous recommendation was that the principles of Section 104W CTA 2009 are retained in cases where the service provider's qualifying trade is to provide R&D services and the company contracting out R&D is not subject to corporation tax. Restricting eligibility to such companies established to provide R&D services with the necessary specialists and expertise ensures that it is sufficiently transparent that the activities would qualify had they been undertaken in house by the customer. This qualifying trade test should ensure that only genuine R&D service companies which are established for that purpose are entitled to claim. The burden of proof should be on the claimant company to evidence that their trade is to provide services that would otherwise qualify if they were not fragmented. This could be measured in a similar way to the trading test for the substantial shareholding exemption but applied to R&D services.

6. The third sub-section of sub-contracted R&D is **Category 3**. Provided that the restriction for subsidised R&D was removed, this could be claimed under the proposed Condition A of Section 1042C where the customer is not subject to corporation tax. This would exclude activities where the customer is subject to corporation tax. Relative to the aggregate of the activities under Categories 1-3 above, this would be a very small subsection and so could be left as a necessary exclusion to reduce complexity. We do not therefor consider changes to the draft legislation are required.

7. We are aware that concerns have been raised that this type of activity might not be considered eligible for R&D relief by HMRC. If HM Treasury consider that these concerns need to be addressed and are a matter for legislation rather than HMRC guidance, then the rules could be extended to cover these arrangements (UK to UK) by requiring the claimant to request notification from the customer that they (the customer) were not intending to claim R&D incentives on the same activities.

This should be relatively straightforward for three reasons: i) the customer would be subject to corporation tax and so would be more familiar with the context in which they were providing the confirmation, ii) the contract, from the customer's perspective, would be for commercial products or services and so there should be no conflict on entitlement to claim and iii) this is a notification, not an election, so there is greater certainty over who is entitled to claim.

8. In conclusion, we believe that these proposals present a coherent and comprehensive framework to address the challenge of sub-contracted R&D that should be easy to administer for both the taxpayer and HMRC. Category 2 (fragmented R&D) is the most significant of the three and we believe that the qualifying R&D trading test would fulfil policy objectives, reduce scope for avoidance and be significantly more straightforward to understand and administer than the current proposals for the contract-based test or notification requirement. This will provide an incentive for UK companies and multinationals to retain, grow or create high value research capabilities in the UK but ensure there is no double counting. If there are aspects of these proposals that are unclear or cause concern. We would be keen to arrange a further opportunity to discuss this.

Comments on other options

We are aware of two other options being proposed to address the eligibility of subcontractors to claim, neither of which we favour, as follows:

Contractual Eligibility – It is not clear whether this is intended to address fragmented R&D, but if it is intended to include fragmented R&D then most service contracts in R&D supply chain should meet the proposed requirements. However, assessing this at the contractual level would present a high compliance burden. Companies undergoing due diligence from third party investors or acquirers would be subjected to extensive documentation requests. This would also increase the cost of HMRC enquiries and compliance checks for both taxpayers and HMRC.

Customer Notification – This does not appear to be workable, as obtaining notifications would involve UK R&D procurement staff, as well as finance/tax departments in attempting to obtain notifications from customers who have no incentive to comply. Where there is already an imbalance of power between a large non-UK customer and a small UK subcontractor, it is likely that notifications will not be obtainable. This could lead to some UK companies failing to claim credits to which they are entitled, while others

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ignore the requirement, and double claim anyway. The comments above on problematic due diligence if the contractual eligibility option is adopted would be even worse for the customer notification option.

Please note that our proposals on subcontractor claims are intended to affect the new merged R&D relief regime only. They are not intended to apply to the R&D intensive scheme.

6. What are your views on the proposed R&D scheme for R&D intensive SMEs? Has Government listened to business, as it said it would be doing, in designing this new scheme?

As described above, historically, the UK has offered a higher rate of relief for SMEs, recognising the greater challenges (market failures) they face to invest in R&D. BIA members and global investors in UK life sciences report that the UK's R&D tax relief regime has been the most effective policy for driving the growth of the UK's innovative life sciences and biotech sector, which has seen equity investment rise 1000% since 2012[4].

For this reason, the BIA engaged closely with Ministers and officials after the cut was announced at the Autumn Statement and we have been consulted in detail on the R&D-intensive scheme, which is very welcome. However, in recent months we have been concerned about the lack of guidance and clarity on the new regime, particularly on how the 40% R&D intensity threshold will be assessed.

We welcome the R&D intensive scheme and believe an enhanced rate is absolutely required to support highly innovative SMEs that are developing economically vital technologies of the future. However, the 40% R&D intensity calculation currently has three key defects:

(i) The R&D spend for work done overseas can only be included if it is 'Overseas Qualifying Expenditure'. This definition requires taxpayers to prove a negative, that it would be wholly unreasonable for the work to have been done in the UK. We still have no life science specific guidance and have received hugely differing views from different HMRC Inspectors of how harshly this test will be applied, and the evidence that will be required for presentation to HMRC.

[4] https://biotechfinance.org/

(ii) The calculation is open to manipulation by non-R&D intensive claimants, while one-off events could cause genuine claimants to drop in and out of the regime on a year-by-year basis.

(ii) The restriction of eligible sub-contract expenditure to 65% of the amount paid means that companies progressing through to later stage clinical trials are unlikely to meet the research intensity test given the need to contract work out to contract research organisations. Once the rules for the calculation are finalised and understood, we would recommend revisiting the 40% threshold.

While this uncertainty exists, businesses are unable to plan effectively and are already having to make the worst-case assumption that they will not qualify. This makes the UK R&D system for R&D intensive SMEs appear less favourable, and less globally competitive, which is not the Government's intention.

The enhanced rate of 27% cash credit for loss-making SMEs is not as generous as the 33% rate enjoyed in the previous SME scheme. This again makes the UK less intentionally competitive for attracting and retaining innovative industries and the overall regime will leverage less R&D due to the lower rate. For comparison, France offers a 30% rate and Australia 45% in some circumstances. Returning the relief rate to 33% or better is essential if the UK wants to build an innovation-led economy.

7. Is the additional support for R&D intensive SMEs appropriately targeted to incentivise the types of innovation the Government wants to encourage?

An R&D-intensive calculation to identify SMEs eligible for a higher rate of relief is an appropriate way to target the higher rate of relief. As described above, we have concerns about its precise implementation, but the overall policy is sound because R&D intensity correlates with SMEs bringing innovative new products to the market or innovating internal processes[5].

However, as described above, the rules around how this additional support will be implemented are yet to be finalised so this could affect the appropriateness of its targeting. Moreover, the 40% threshold was developed at speed between the Autumn Statement 2022 and Spring Budget 2023, without time for proper testing and using imperfect data available to HM Treasury (including some provided by the BIA). It will

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1023591/niesr-report.pdf

therefore be important to monitor its use in the real world and evaluate whether it is appropriately targeting the relief to companies as intended by the policy; we have concerns that companies at which the policy is aimed may not be appropriately targeted by the mechanism.

HM Treasury should also undertake further econometric analysis of the effectiveness of R&D tax reliefs on R&D intensive SMEs as defined by the legislation and also whether sector differences are observed when assessing the effectiveness of R&D tax reliefs to drive additional R&D investment and generate spill-over benefits. The 2019 study of the SME R&D tax relief regime[6] and 2020 RDEC study[7] did not provide this level of detail but have been used to justify wide-ranging changes to the regime, including the merging of schemes and reduction in relief rates, which have negatively impacted all SMEs and sectors, including life sciences.

[6] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935191/HMRC_Research_Report_598_R-and-D_tax_relief_for_SMEs.pdf

[7] https://assets.publishing.service.gov.uk/media/5faad42ed3bf7f767a564f65/Evaluation_report_-_R_D_RDEC.pdf