BIA policy submission

12 September 2023

BIA submission: R&D tax reliefs draft legislation

Introduction and summary

The BioIndustry Association (BIA) welcomes the measures set out in the draft legislation for a merged R&D tax regime ("merged regime") published on 18 July 2023. In particular, the retention of sub-contract R&D as a category of qualifying expenditure is particularly important for SMEs operating in life sciences which must outsource significant elements of pre-clinical and clinical R&D to specialist service providers, universities and hospitals.

Our submission recommends:

- Detailed guidance and clear boundaries for the implementation of the Qualifying Overseas Expenditure rules;
- Clarification of 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, employing a qualifying R&D trading test;
- The adoption of an 'exceptional circumstances' concept to mitigate the risk of R&D intensive SMEs falling foul of extraordinary expenditure in a given year. We also call for clarity on the intended qualification requirements for the R&D Intensive Scheme;
- That the PAYE/NIC cap for the current SME R&D tax regime continues to be the preferred measure to address abusive structures. However, we note that the PAYE/NIC cap design does not cater for groups which disaggregate R&D activities and/or employment between connected parties in the UK. We make recommendations to address this which ensure that companies running specific research programmes without employees in the subsidiary are not unfairly prejudiced; and,

We offer some suggestions on further simplification measures, and on R&D non-compliance.

Sub-contracted out R&D

We support a new simplified regime based on the existing R&D Expenditure Credit ("RDEC") now including sub-contractor expenditure for UK activities and qualifying overseas expenditure ("QOE"). This will put the UK in a more competitive position to launch and scale up the leading life science enterprises of the future.

The inclusion of sub-contracted out expenditure is crucial for SMEs operating in the life sciences sector as multiple elements of pre-clinical and clinical R&D are outsourced. Previous feedback[1] showed that a merged regime based on the sub-contractor claiming the relief would be highly detrimental to SMEs. The framework set out in the proposed merged regime based on the customer claiming will be essential for life sciences companies.

Qualifying overseas expenditure

It is vital for the continued growth of the UK's life sciences sector that the companies continue to be able to claim for overseas R&D through the tax reliefs regime. Although the majority of R&D funded by the life sciences sector takes place in the UK, certain activities such as clinical trials and highly specialise laboratory and manufacturing (of experimental products) activity must be conducted overseas for legitimate and unavoidable reasons. Detailed guidance and clear boundaries are required for the implementation of the QOE rules. The current HMRC guidance provided in January 2023 is relatively high level and general (and explicitly states that it cannot be relied upon), with hypothetical examples that will be difficult to apply effectively to the majority of R&D undertaken in life sciences. We have also received conflicting views from HMRC Inspectors over their potential application of the law.

It is likely that the need for further points of clarification will emerge. Therefore, to help understand the key principles and reduce the compliance burden on both HMRC and claimants, we request that final guidance is published urgently with more examples, andthat HMRC establishes a clear channel of communication with the sector in order ensure that the understanding of the application of the rules and supporting evidence are aligned. BIA would be happy to facilitate this.

This is an essential area of focus for two reasons:

- The amount of qualifying R&D spend; and
- The amount of credit, given that whether overseas expenditure is qualifying will impact the Research-Intensive company percentage

Companies will face very costly consequences if they make incorrect assumptions on this topic, either in HMRC enquiries or on third party due diligence. HMRC Inspectors will find themselves embroiled in highly subjective arguments unless improved guidance is issued.

[1] BIA submission: R&D tax reliefs review consultation on a single scheme: BIA submission: R&D tax reliefs review consultation on a single scheme (bioindustry.org) (Question 7)

UK BioIndustry Association

Specialist R&D service providers/fragmented R&D activities

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[i]. 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. However, 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 therefore do not consider changes to the draft legislation are required.

7. We are aware that some other bodies have raised concerns 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 straight forward 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-contract 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 very keen to arrange a further opportunity to discuss.

Comments on other options

We are aware of two other options being proposed by other bodies 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 able to be obtained. This could lead to some UK companies failing to claim credits to which they are entitled, while others 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.

Subsidised R&D

On the basis that an effective framework for R&D contracted out to service providers can be included we believe that any limitation for subsidised R&D can be removed. At the very least, the definition of subsidy should be limited to grant funded R&D as the currently too broadly drafted.

R&D intensive ("RI") threshold

We are very grateful for the Spring Budget enhanced rate for SMEs that meet the definition as R&D intensive, and for officials' collaborative approach within the sector leading up to that announcement. This is particularly important as the economic backdrop means fresh equity investment is hard for companies (across all innovative sectors) to secure at

present, and cash runways are under pressure due to inflation. These conditions raise the prospect of bankruptcy, layoffs and the loss of UK IP overseas for those affected. Our feedback to the draft legislation is as follows:

1. Scope of the cost base

   Given that the RI threshold is to be applied from 1 April 2023 urgent clarification is needed around the basis of the calculation.

   Determination of the numerator is clear, apart from our comments above on the difficulties of determining what overseas expenditure is qualifying, where improved guidance is required. Nevertheless, the exclusion of the 35% restriction to sub-contract expenditure will mean that pre-revenue loss making companies developing drugs towards the later stages of clinical trials are likely to fall outside the 40% threshold given the high levels of R&D that are contracted out to CROs. We would therefore propose that the 35% restriction is added to the numerator.

   There is still a great deal of uncertainty around the basis of the calculation of the denominator.

   Expenditure forms part of a company's total relevant expenditure for an accounting period if it is brought into account in calculating for corporation tax purposes the profits for the period of any trade carried on by the company.

   For example, is it the current intention that 'expenditure' for this purpose would include:

   i) Deductions under Part 12 CTA 2009 for employee share acquisitions

   ii) Capital allowances

   We would recommend that the research intensity should be a measure of R&D expenditure only in relation to a claimant's general operating costs.

   Costs in relation to financing and foreign exchange differences could push a company out of the R&D intensive threshold although they are carrying out the same activities but with a different capital structure. A company, looking for new sources of finance, could be put off debt or a convertible loan (the latter being a common financing option during poor funding climates we are currently experiencing) as this could potentially move them out of being a legitimate research-intensive company.

   There is also an incentive for companies to disallow expenditure for corporation tax purposes in their tax filings, to artificially shrink the denominator and make themselves research intensive. Having obtained the higher rate of credit they

could then refile the return later to claim the spend. Given the level of abuse in the current system by companies outside the life sciences, we trust you can agree that this new type of abuse is not unlikely.

2. Structural aspects

   We understand the reason to include all group companies in the calculation is to avoid fragmentation to access the enhanced regime. By limiting the definition of total relevant expenditure to amounts brought into account in calculating for corporation tax purposes, it would appear that overseas connected parties not subject to corporation tax are excluded. We would agree with this given the complexities that their inclusion would introduce to the calculation. However, given the importance of the enhanced relief it is critical that it is not open to abuse by companies channelling non-R&D expenditure to affiliates outside the UK. We would be keen to discuss options with you to ensure that an effective measure is included so that this aspect of the regime is robust against avoidance but simple to operate.

   We are assuming there needs to be an exclusion for costs incurred between connected parties to avoid double counting which is not currently addressed in the draft legislation.

3. Exceptional items

   We are concerned that some companies that are intended to be helped might be unintentionally missed by the policy due to exceptional circumstances pushing them just below the 40% R&D-intensive threshold in a particular year.

   There are many exceptional costs that can arise in R&D intensive companies that could affect the denominator and are likely to artificially reduce the RI percentage in a particular year, thus excluding genuinely R&D intensive companies from the support targeted at them. Examples of such costs may include:

   - Significant foreign exchange losses
   - Transaction costs which can arise when a company is licensing IP rights to another party as part of a research collaboration which is common for biotechnology companies.
   - Impairments to intangible assets, in particular, if there are sub-optimal clinical trial results the company may have to write-off capitalised intangible assets for accounting purposes.
   - IP related costs and, in particular, litigation. While rare, small biotechs do on occasion get sued for patent infringement by larger companies to

prevent the biotech's new medicine displacing the incumbent medicine. In many cases there may be no real patent infringement, but small biotechs do not have the money to fight. The small biotechs will lose out even more by falling out of the RI definition as a result of fighting such cases.

Any one of these, or a combination, can result in significant non-R&D eligible costs being incurred, meaning companies falling below the threshold, even though nothing in their business has fundamentally changed to make them less R&D intensive (and the following year they would probably be over 40% again).

These exceptional circumstances by their very nature are hard to predict so companies are unable to be sure that they will qualify for the enhanced rate until their year-end. This will make cash projections much harder, and weakens the value of R&D tax relief for leveraging private investment into companies.

Proposed solutions:

We suggest using a 'common-sense' override, using an 'exceptional circumstances' concept to adjust an unfair result. This is a concept used elsewhere (as per section 357BLH CTA 2010 for the Patent Box) and so consistent with other approaches and familiar to companies and HMRC.

We would also recommend explicitly excluding items that are less controllable for companies (such as those cited above) from the denominator for purposes of RI calculation and would be happy to discuss that, but we came to the conclusion that being exhaustive is difficult and it risks making the legislation complex.

Alternatively, the inclusion of a transitional period operated in a similar way to the SME threshold could be included such that entry and departure to RI regime are determined if the threshold is met or breached in the second consecutive period.

Finally, we would be grateful if you could provide clarity on the intended qualification requirements for the R&D Intensive Scheme. From the draft legislation at Part 3 as well as public announcements, it would appear that claimants under this scheme would need to be both R&D intensive and loss making i.e., having a Chapter 2 surrenderable loss. Is the loss-making requirement intended to apply only to accounting periods beginning before 1 April 2023, or to subsequent periods as well?

PAYE/NIC cap

We agree that the PAYE/NIC cap for the current SME R&D tax regime is the preferred measure to address abusive structures. Unlike the RDEC step 3 PAYE/NIC cap, the

exception for the creation and active management of IP in the SME R&D tax regime is important for genuine UK businesses which need to outsource R&D to third party specialists.

The PAYE/NIC cap design does not cater for groups which disaggregate R&D activities and/or employment between connected parties in the UK to manage the risk of individual drug development programmes and to facilitate licensing and collaborations with partner companies. This has resulted in incentives being forfeited by UK groups with no operations overseas structured for commercial purposes unaware of this limitation of the exception. This arises where a development project is separated into a new company with no employees but, instead, commissions the services from employees of a UK affiliate. We would recommend that the IP creation/active management activities of the personnel recharged from UK connected parties should be considered for the purposes of the exception to ensure that companies running specific research programmes without employees in the subsidiary are not unfairly prejudiced.

To meet the exception for the PAYE/NIC cap, HMRC guidance in CIRD90600 implies a requirement that the claimant must also own all the IP rights and is not eligible if the rights are licensed in. This goes beyond the requirements of section 1058D(3) which requires that the whole or greater part in terms of value is created by the company and the rights to exploit the IP vests in the company. To rectify this HMRC guidance should be amended as currently this unfairly impacts the life sciences companies, particularly start ups or early stage companies, where it is very common for IP rights to be licensed in from universities and other research institutions. The requirements under section 1058D(3) would generally permit claims and works effectively but the additional condition implied by CIRD90600 is problematic and is giving rise to significant uncertainty.

If the IP ownership remains a concern, the legislation for an 'exclusive licence' for patent box purposes under section 357BA CTA 2010 should be sufficient to address this.

Other simplification measures

Merging the R&D regimes offers a valuable opportunity to significantly simplify the regimes. Other design features to simplify the current features of the R&D tax regimes could include:

1. Removal of the restriction for directors to be included as externally provided workers under Condition B of Section 1128 CTA 2009 and affirmed by the Gripple case precedent, in particular, for connected parties even if the directors are involved in R&D. This impacts spins outs from universities which is a common way to set up a company in the life science sector. Often, the university contracts out

their employee(s) as a director of the company to lead the R&D work. The costs for the directors in this case would not be qualifying as they are caught by Gripple. However, if they were not a director of the company, they would be treated as an EPW and therefore, could be claimed for.

2. Removal of reimbursed expenses as qualifying staff expenditure. This continues to create anomalous positions depending on how companies manage their expense arrangements and so its removal could add to the cost envelope without any impact on R&D activities.
3. The removal of any restriction for subsidised R&D.
4. The removal of the State Aid cap.

R&D non-compliance

We recognise and share the concern around non-compliance in R&D tax incentives and supports the recent measures introduced by HMRC to address this. We retain the view that measures put forward in our previous submission to the consultation to limit eligibility to companies with dedicated R&D teams focussing on leading edge science and technology and removing 'soft innovation' from the ambit of the regime would largely address this.

Soft innovation is where there are minor and low risk technical enhancements to existing products or internal platforms that businesses would undertake regardless of the availability of incentives and is therefore a deadweight cost. In many cases, eligibility for these activities under the BEIS guidelines is questionable but this is very difficult for HMRC to disprove. We believe that this would result in significant cost savings allowing other changes to be implemented without impacting the cost envelope.

One of the main concerns for us is that measures that are introduced to attempt to target avoidance and non-compliance, extend beyond this and instead impact the majority of compliant companies. An example of this is the original PAYE/NIC cap introduced for SMEs which would have significantly impacted many companies had it not been for the subsequent introduction of the exception which still merits some refinement.

We would welcome engagement ahead of the introduction of any new measures to ensure that any wider impact is assessed and taken into account.

About the BIA

The BioIndustry Association (BIA) 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.

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