Federation of Small Businesses

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February 2023

Dear Sir/Madam,

RE: R&D Tax Reliefs Review: Consultation on a single scheme

FSB is a non-profit making, grassroots and non-party political business organisation that represents members in every community across the UK. Set up in 1974, we are the authoritative voice on policy issues affecting the UK's 5.5 million small businesses, micro businesses and the self-employed.

It is not possible for the UK to become a "science superpower" while also cutting R&D tax relief support for SMEs. While we note the Government's protestations that this consultation is not about saving money, we believe that the measures outlined in this document will lead to fewer SMEs applying for this relief and therefore conducting less R&D. The changes to the rates of the SME R&D scheme and the RDEC scheme will directly have this impact, merging the schemes together will indirectly have this impact.

We believe that R&D policy needs to have a balance between being 'mission led,' as outlined by Professor Mariana Mazzucato, and to be led by entrepreneurs and business. The UK Government is currently highly focused on the former over the latter. These changes to R&D tax relief will further tip the balance towards a state-led approach and away from innovative small companies.

FSB believes that the primary aim for R&D tax relief should be to encourage small businesses to either conduct R&D in the first place or to carry out more R&D than they would otherwise. As outlined below, the changes announced by the Chancellor at the Autumn Statement on changes to R&D tax relief, including merging the two schemes, will do the opposite of this.

In a survey conducted in early 2023, we found that for the SMEs who had successfully applied for R&D tax relief in the past three years, 20% were concerned about the future viability of their business due to the Autumn Statement announcements. 64% said they would invest less in R&D. For those SMEs with awareness of the scheme, 28% said they would invest less in R&D. This is over 200,000 firms who see the changes to the R&D tax relief scheme as a deterrent to investing in the future.

As outlined below, the SME R&D tax relief scheme has been a success. We believe an objective analysis of the scheme would demonstrate this. We note that the consultation contains, without reference, outdated and misleading statistics on the relative benefits of the two schemes:

"Additionality in the SME scheme is lower than the RDEC, incentivising as little as 60p to £1.28 of additional R&D for each £1 spent, compared to as much as £2.40 to £2.70 additional R&D per £1 of RDEC. At the same time, the SME scheme costs more than RDEC and has grown at a faster rate than RDEC."

These figures only refer to the incrementality ratio at the intensive margin, rather than the extensive margin. It is intuitive that the impact of the SME scheme would be greater at the extensive margin, in encouraging more businesses to undertake R&D for the first time (or new businesses focused on R&D to be created), whereas the RDEC scheme is likely to have an impact on the intensive margin in larger firms, where it will impact capital allocation across different business groups. This is supported by the increase in smaller firms investing in R&D.

The figures quoted in the consultation are taken from studies based on ONS data on business spend on R&D that is now badly out of date. The updated ONS figures, Business Enterprise Research and Development (BERD) data, indicate that SMEs spend £24.3 billion in 2021 with a total business spend of £46.9 billion. This is a large change in estimates with the ONS' BERD data published in November 2021 estimating total business R&D spend in 2020 was £26.9 billion of which £19.8 billion (74%) was spent by businesses with more than 250 employees.

We ask whether HM Treasury has done an updated evaluation of the schemes given the updated BERD numbers. We believe that any evaluation of policy should be based on accurate and up to date figures. Therefore, it is concerning to see the Treasury using these statistics.

The consultation also states that: *"the UK has one of the most generous R&D tax relief systems in the world, spending, as a percentage of GDP, more than any other country in the OECD."* While it is true that the UK spends more on R&D tax relief, this is largely due to the amount of firms applying for it rather than the rate of relief being higher than OECD countries. Indeed there are currently 11 other OECD countries with R&D tax relief that offer higher rates, even before considering the announcements made at the Autumn Statement.

The UK spends more on R&D tax relief then other OECD countries as we have had a consistent and successful scheme that has encouraged more firms to invest in R&D. It is due to the investment SMEs make in R&D that the Government has reached its target of 2.4% of GDP being spent on R&D activity.

The Chancellor's recent speech outlined the importance he gave to enterprise and innovation. He stated that *"if anyone is thinking of starting or investing in an innovation or technology-centred business, I want them to do it here [in the UK]."* Yet a recent report found that 70% of firms are planning to move R&D activity abroad, 36% of whom say this is due to more favourable R&D tax credit schemes in other countries. We are concerned that the policies announced on R&D tax relief, will make the UK even less of a favourable place to conduct R&D. The changes announced to the SME R&D tax relief scheme seems contrary to the Government's stated ambitions and we urge the Government to delay and reconsider.

Overall proposal

FSB does not believe that merging the two schemes together is a good idea. This is for several reasons:

- It is clear from the consultation that HM Treasury are basing their plans on R&D tax relief on misleading and outdated analysis. We recommend a proper analysis of the schemes using updated BERD data and publicly published before HM Treasury progresses with their plans.

- Tax relief is successful when it is consistent. The reason there have been a higher level of applicants from SMEs is increased awareness of the scheme and therefore more use of the scheme. To make radical changes to the scheme will change this dynamic. For FSB, we want to encourage more SME spend on R&D not to discourage small firms from doing so.
- For those SMEs who still apply for the scheme, their reliance on intermediaries to explain and apply for R&D tax relief will increase. We are already concerned that SMEs are heavily reliant on this support, and this will only increase with fundamental changes to the scheme.
- Many SMEs outsource their R&D to third parties, changing the rules on this will lead to more SMEs deciding not to conduct R&D at all.
- The schemes are quite different, and the time scales outlined in the consultation makes it hard to implement the merger of the schemes in a successful way. Given that HM Treasury seem to have the desire for the joint scheme to be primarily based on the current RDEC scheme, it will be innovative small firms who lose out.

We instead suggest that the schemes should remain separate. The announcement at the Autumn Statement regarding the rate of relief with both schemes should also be reversed. HM Treasury could also consider how the rate of relief under the SME R&D tax relief scheme is equal when the firm is loss-making or making a profit and limit the scheme to companies with less than 250 employees. HM Treasury should also consider other ways to make the scheme more straight-forward for firms to navigate.

We also believe that more could be done to regulate intermediaries and place a cap on what they are able to charge. From FSB's research in 2021, we found that of those SMEs that applied successfully for SME R&D tax relief, 84% said that they applied via a third party (e.g. an accountant, agency, R&D tax credit specialist). Compared to 9% who applied themselves. We estimate that on average, intermediaries take 16.1% of the resultant tax savings as payment for this service. In 2019-20, of the £4.4bn spent on the SME R&D tax relief scheme, £641 million went to intermediaries.

FSB is also supportive of proposals by Onward for tax agents named on R&D tax credit claims having to be members of a regulatory body and to adhere to a code of practice to reduce abuse of the schemes.

If the Treasury is insistent on merging the two schemes, we would suggest that firms with less than 250 employees should receive a higher rate of tax relief. There are several OECD countries that have a similar system to this, including Canada.

Impact of the announcements made at the Autumn Statement

In a survey earlier this year, FSB asked our members about R&D tax relief. Firstly, asking those who successfully applied for the relief, the impact of the relief on their business. Secondly, asking all those who are aware of R&D tax relief, about the impact of the Autumn Statement announcements related to R&D tax relief. This included both the changes in the rate of relief and the proposed merger of the two schemes. We hope the results will give HM Treasury pause for thought and to re-consider their plans.

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The impact of successfully claiming R&D Tax Relief/Credit (Multiple choice, only asked to those who had successfully claimed R&D tax relief in the past three years.)

Impact	**Response**
Improved cashflow for my business	64%
Easier to secure finance	2%
Undertaking project(s) that wouldn't have happened otherwise	35%
Increased investment in R&D	55%
Increased investment in future projects	41%
Hired additional staff	14%
Other, please specify	2%
Don't know / Not sure	4%
No impact on my business or R&D investment	2%

We can see from the above table, that the impact of successfully applying for R&D tax relief has been huge. Only 2% of firms said that it has had no impact. The majority of firms (55%) said that they increased investment in R&D and a substantial number of firms said that they had either decided to increase investment in future projects or are undertaking projects that would not have happened otherwise. Almost two-thirds (64%) also said that it improved cashflow for their business. While this is not the primary purpose for the R&D tax relief, cashflow is crucial for small businesses and start-ups looking to grow. If the Government's aim is indeed for innovative businesses to grow, then the current structure R&D tax relief must be seen as a success.

The survey also asked all those aware of R&D tax relief about the impact of the changes announced at the Autumn Statement. With the below table outlining the impact for those aware and those who had successfully applied.

Impact of the R&D tax relief announcements at the Autumn Statement (Multiple choices, only asked to those who were aware of R&D tax relief/credit.)

Impact	**Response for all those aware of R&D tax relief**	**Response for those who had successfully applied for R&D tax relief in last three years**
It will reduce the viability of my existing business	7%	20%
Less likely to invest as much in R&D	28%	64%
More likely to choose less risky R&D investments	8%	24%
More likely to invest in R&D	0%	1%
Need to secure additional external funding for R&D	8%	23%
Change existing plans for R&D	9%	22%
Make cuts to other budgets (e.g. training)	8%	25%
Make staff redundant or stop planned hiring	5%	12%
Other, please specify	3%	3%
Nothing – I would not have invested in R&D anyway	36%	2%
Nothing – I will continue to invest as much in R&D regardless	20%	21%
Don't know / Not sure	9%	3%

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While about one in five (20%) say that they will continue to invest as much in R&D despite the changes to tax relief, a large proportion will be less likely to invest as much in R&D as previously planned. 28% of those who are aware of R&D tax relief and 64% of those who have recently successfully applied for the relief say that will now invest less in R&D activity.

7% of those surveyed said that the changes announced at the Autumn Statement will reduce the viability of their existing business. This increases to 10% in manufacturing and 10% in information and communication sectors. For those who recently successfully applied for R&D tax relief, this figure jumps up to one in five (20%). If we consider that there were 78,825 successful applications to the SME scheme in 2020 to 2021, this means that the Autumn Statement announcement would potentially put 15,765 innovative firms out of business.

For those who had recently been successful in their application for R&D tax relief, we can see that the changes to the scheme will have other impacts. Including the need to change their plans for R&D (22%) and to make them more risk-averse (24%). There will also be less demand for employing people in these highly skilled roles (12%) and other budgets including training will be cut (25%). Almost a quarter (23%) will need to secure additional external funding for R&D. This is concerning as we know that small firms are having difficulties in currently accessing finance.

From these two survey questions, we can conclude that R&D tax relief has been a successful incentive for firms looking to invest more in R&D and the Government's plans for changing this incentive need to be reconsidered.

If HMT does go ahead with merging the schemes

As outlined, we believe that the announcements made about R&D tax relief at the Autumn Statement are contrary to the UK Government's stated ambition to become a "scientific superpower." We do not think that merging the schemes together are a good idea but if the Treasury are insistent on this direction of travel, we have comments about the various proposals in the consultation document.

Timeframes

The aim to merge two schemes together by April 2024 is far too ambitious. If HM Treasury is to consider the implications of combining two very different schemes in a measured way, taking on board feedback and not harming the R&D activity of SMEs, this is a very short timeframe. Additionally, businesses set their R&D plans over several years and require certainty if they want to make R&D investment. Once these plans are concrete and HM Treasury has set out clearly what the new provisions are, there needs to be a period of time before implementation to raise awareness of the plans and provide business certainty.

PAYE / NICs cap

If R&D can no longer be subcontracted to firms based outside the UK, it is difficult to see how fraud of the nature outlined in the consultation could continue to take place. To make the scheme more straightforward, we would like to see the cap removed.

We understand that if such a move was applied then there would need to be careful monitoring of the claims in relation to the size of a company's pay PAYE and NIC liabilities, at least initially. Though as the consultation recognises, there will often be legitimate reasons for why a micro business will be claiming for over 100% of its PAYE and NICs liability.

If the Government does not feel this is a tenable solution, we would like to see the cap based on an updated version of the current cap for SMEs. Currently the cap is £20,000 plus 300% of a business's total PAYE and NICs liability for the period. We would like to see this changed so that it is less dependent on the overall size of a company's pay packet. For instance, it could be updated to £50,000 plus 200% of a business's total PAYE and NICs liability for the period.

Subcontracting
FSB strongly believes that the current rules from the SME R&D tax relief scheme should be maintained on subcontracting R&D. That is maintaining the rule that it is possible to claim relief for 65% of a payment for qualifying work subcontracted to an unconnected party. We believe that a change in these rules will lead to less R&D activity amongst SMEs.

SMEs often subcontract at least part of their R&D activity. For FSB, it is important that it is not just R&D intensive firms who are eligible for tax relief but that the tax relief is an incentive to firms who are undecided whether to conduct R&D. The latter are unlikely to have huge R&D teams and will outsource much of the work. Maintaining in-house R&D services can be a costly affair for many enterprises, especially SMEs in certain sectors. These costs include significant overhead and administrative expenses, which can be cut out if outsourcing R&D activity.

However, even R&D intensive firms increasingly outsource part of their R&D activities. It is estimated that about one in two companies that conduct R&D have "hybrid approach", where some percentage of R&D activity is outsourced. It was estimated in May 2022 that the global R&D outsourcing services market is due to grow by $8.04 billion during 2022-2026.

We are concerned with the way the Treasury has framed this section in the consultation document and it seems a decision has already been made. However, we hope the Government recognises the importance of small firms conducting R&D and the practicalities that means this will need to be outsourced from time to time.

The consultation's claim that HM Treasury are concerned about duplications of claims surely could be overcome through the application process and the looking at the details of claims provided by those conducting outsourced R&D.

The rules on outsourcing for the current RDEC scheme seem sensible when a large firm is likely to conduct R&D regardless. However, for many small firms unsure of whether to conduct R&D activity, applying these rules will ensure that they do not.

Additional support for specific companies
FSB maintains that if the R&D tax relief schemes are to be merged, a higher rate of relief could be set for SMEs (defined as 250 or less employees) could be applied. This is the model in many OECD countries. As outlined in an HMRC commissioned study, the SME R&D tax relief scheme has been highly successful at encouraging more firms to spend on R&D. SMEs in the UK now spends more on R&D than large companies or universities or the Government, this is a great achievement.

FSB is highly concerned for the reasons outlined above that the changes announced at the Autumn Statement will significantly damage this and having reached the 2.4% of GDP target, this will now be undone by short-sighted policy decisions.

Intellectual property and big data are two areas that are considered fundamental to R&D; two areas that large companies have natural competitive advantage. Therefore, having a higher rate for SMEs has not only been demonstrably effective, but one could argue a way to try to even out these advantages.

We have concerns with the suggestion of Whitehall deciding which R&D deserves more tax relief than others. This seems to be a policy of picking winners and it is important that innovation policy has at least some element of being led by businesses and entrepreneurs. We believe that it is important for R&D activity not to be entirely dictated from Whitehall.

Policy makers must recognise that while setting 'missions' is important, innovation policy requires inventions that entrepreneurs are able to think of and develop. As outlined by Professor Jonathan Haskel and Stian Westlake, having government and large companies investing in large scientific projects is important for some large scientific goals, such as landing on the moon. Yet all the scientists and civil servants who worked on that project could not have come up with an idea as basic as the wheelie suitcase. In a recent podcast, Professor Jonathan Haskel put it as follows:

> *"So those are the two kind of rival models, and what we think is that we've probably gone a bit too far, at least in the UK, of putting science policy around the centralised directed side, too many metrics, too much specificity, and what one loses by having those centralised kind of directives is the type of synergies and the type of serendipitous encounters that, as I say, a person who thought of the suitcase and the person who thought of the wheel kind of bring forward."*

Government policy needs to be balanced between these types of innovation. We need to ensure that entrepreneurs and small companies have the incentivises to develop and implement new ideas. We already believe that UK innovation policy is too centralised and top-down, R&D tax relief is one of the few existing policy mechanisms that enable more business-led innovation. Therefore, we do not think it is the best direction for HM Treasury to use R&D tax relief as yet another way for Government to pick winners in this policy space.

Patent Box

While not subject to this consultation, we wonder about the wisdom of making cuts to a scheme that is proven to have boosted R&D activity in the UK while maintaining a scheme that has no proven impact on R&D activity.

Government spends about £1billion per year on patent tax relief, 95% of which goes to larger companies. A substantial body of evidence demonstrates that patent box policy has little to no impact on R&D being conducted within the country. The changes to R&D tax relief announced at the Autumn Statement are estimated to save the Government £1 billion per year. Therefore, reversing the changes to the rate of the SME R&D Tax Relief Scheme and scrapping the Patent Box Scheme would be a cost neutral way to increase R&D activity.

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Again, FSB urges the Treasury to proceed with caution and to re-evaluate its plans based on up-to-date evidence. For Government to progress at haste with these reforms will be deeply damaging to the R&D activity carried out by SMEs.

Yours sincerely,

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