

HM Revenue and Customs
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rdtaxreliefdraftguidance2022@hmrc.gov.uk

February 2023

Dear Sir/Madam,

RE: Consultation on Research and Development (R&D) tax reliefs - draft guidance

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.

We are concerned with the Government's overall direction of travel with R&D tax relief and the measures outlined in this consultation. We believe that R&D policy needs to have a balance between being 'mission led' as well as being 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 companies.

We believe that R&D tax relief has been instrumental in encouraging more firms to conduct R&D that would have otherwise not. HMRC seem determined to make it more complicated for SMEs to apply and therefore conduct R&D activity. At a time of a low productivity and with the Government claiming that innovation is crucial to their vision of the economy, we urge HMRC to change course, particularly with pre-notification requirements.

We believe that keeping the R&D tax relief straight forward is crucial. As does the Financial Secretary to the Treasury, who claims in the [HMRC/HMT consultation for a single R&D tax relief scheme](#) that the Government wants the following: *"Overall, the Government would like a system for supporting R&D which drives innovation and growth, is simple to use and administer and underpinned by the effective application of taxpayers' money."*

We completely agree with the Minister. Additionally, to make the changes outlined in this draft statutory guidance a year before potentially merging the two schemes together adds a layer of complexity and confusion that will put off small firms from applying to the scheme and from investing in R&D.

The measures outlined on this consultation appear to contradict the Government's stated ambitions and we urge them to reconsider.

Overall direction of travel

While not subject to this consultation, FSB remains highly concerned about the Government's decision to change the rate of tax relief for the RDEC and the SME R&D tax relief scheme. This announcement along with the measures planned in the draft guidance and the consultation on merging the two schemes together indicates a direction of travel on R&D tax relief, which FSB believes is contrary to the Government's stated ambitions.

R&D tax relief should be celebrated for encouraging more small firms to conduct R&D, when they would not have otherwise done so. Government should delay and reevaluate its planned changes to R&D tax relief. Government's [analysis](#) has overly or entirely been reliant on measures of the intensive margin, whereas there has been a [very clear positive benefit](#) at the extensive margin from SME R&D tax relief scheme, and a huge growth in the number of small businesses carrying out R&D as a result of SME R&D tax relief.

Furthermore, the Government's announcement at Autumn Statement was before the ONS provided updated [Business Enterprise Research and Development \(BERD\) data](#), which indicated 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.

When we surveyed FSB members at the start of this year about the changes to R&D tax relief announced at the Autumn Statement, of those who had recently claimed the relief, one in five (20%) say that the changes will reduce the viability of their existing business. 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. 28 per cent of those who are aware of R&D tax relief and 64 per cent of those who have recently successfully applied for the relief say that will now invest less in 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.

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 the measures outlined in this draft guidance, the consultation on merging the two schemes and the changes to the rate of the relief.

Of the specific changes coming forward with this consultation, FSB is particularly concerned about the proposal for pre-notification.

Pre-notification

We remain highly concerned with HMRC's proposal for firms who have not recently claimed R&D tax relief to provide them with pre-notification. We believe that this will have a substantial impact on firms who could be persuaded to invest in R&D for the first time. The proposals add an onerous extra layer of bureaucracy and it seems unlikely to have much impact on the level of fraud. Small firms [already spend](#) an average of £4,100 a year, and 52 hours a year on tax compliance – the Government should be seeking to reduce this burden through simplification, not adding to it.

We welcome [one Government consultation](#) recognising the need for simplicity in the R&D tax relief system (though oppose its proposal). Yet, at the same time, the intention of this draft guidance appears to be to make the scheme more impenetrable for SMEs. To require small firms to provide HMRC with notification that they are going apply for R&D tax relief will mean more delayed payments and ultimately reduced R&D activity. This change will

result in firms not getting the tax reliefs that they should be entitled to, undermining the fairness of the system and creating an even greater incentive to use intermediaries to navigate the system. It will add administrative cost and complexity, with a consequent negative impact on productivity.

We also think that the template form should be made live before the changes are introduced so that firms are aware of the exact details HMRC will require in the future.

Again, these proposals seem at odds with the Chancellor's stated ambitions and the importance of encouraging more firms to innovate. A [recent report](#) found that HMRC's recent focus on fraud and error is already leading to less R&D being conducted. 35% of respondents reported that this has delayed payments of R&D tax credits, 24% say that these delays have forced them to reduce their R&D budget, and 19% say that the delays have held up R&D activity.

We believe that the [House of Lords Economic Affairs Finance Bill Sub-Committee](#) is correct in their judgement that:

"The requirement for pre-notification of claims, however, appears to be uniquely onerous, without any direct precedent within the tax system. It risks companies being unable to make legitimate claims, while its benefits in countering abuse are questionable.

"We recommend that the requirement that companies give notice of claims within six months after the end of their accounting period is dropped from the draft Finance Bill 2022–23 before it is introduced into Parliament."

Of course, FSB does not want to see any fraud to take place. While we have seen statistics published from HMRC on the amount of fraud and error with the scheme, we have not seen any explanation of how much of this is fraud, and how much is error. With a scheme as complex as HMRC is making R&D tax relief, it is not unexpected that there is a large amount of error.

From [previous FSB research](#), 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). This compares to 9 per cent who applied themselves. We estimate that on average, intermediaries take 16.1% of the resultant tax savings as payment for this service. Therefore in 2019-20, of the £4.4bn spent on the SME R&D tax relief scheme, £641 million went to intermediaries. This is money that could be used by these firms to fund even more R&D activity. Adding a pre-notification requirement will make it more likely that firms need to use intermediaries for their claims, due to the additional complexity this will introduce.

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. It also appears reasonable that a cap could be placed on the intermediary payment share for successful claims. Together, these measures will help HMT balance the objectives of minimising abuse in the system, whilst maximising the uptake from businesses.

R&D conducted abroad

While we are eager to see more R&D conducted in this country and recognise that it would be better for the economy if this was the case, we have some reservations about this measure. As outlined in the recent book by the academic Dan Breznitz, *Innovation in Real Places*, the process of R&D and innovation has undertaken a globalisation process in recent years. In which, different stages of R&D and innovation have increasingly been conducted at various places the globe. This is a trend that is seen with not just small firms outsourcing but by large firms who increasingly outsource different stages of their R&D.

If the choice facing SMEs is either to conduct R&D with some of it being outsourced to foreign companies or for small businesses not to conduct R&D due to either a lack of suitable British firms or them being too expensive, we believe it is preferable for the SME to carry out R&D activity.

We believe that the [House of Lords Economic Affairs Finance Bill Sub-Committee](#) is correct in their judgement that:

“While we understand the Government considers it cannot justify unrestricted relief for R&D expenditure overseas, it should consider introducing a form of transitional relief for expenditure on specialised resources which are not currently available in the UK, especially for R&D being carried out under contracts already entered into.”

At a minimum, this change and the others suggested by HMRC to the scheme need to be carefully monitored so we can understand the impact.

Data licences and cloud computing services

It is welcome that the Government will allow firms to claim costs on data licencing and cloud computing services to be included within qualifying expenditure when used for purposes related to R&D.

However, when firms are using these technologies for multiple purposes including R&D and non-R&D activity, we hope that HMRC will give significant leeway to firms estimating proportions between these activities. Firms should provide reasoning to back up the proportions they ascribe but the examples HMRC use in their guidance suggest the HMRC are expecting this reasoning to be very thorough and time consuming.

HMRC outlines that: *“A strong source of evidence would be a real-time record that included detail of the person accessing the data or service, the length of time accessed, and the reason for the access.”* To expect firms to do this would mean that for many firms the cost of tracking the use of the software will make applying for the tax relief redundant.

We know from [other research](#) on covid-related regulation that FSB undertook with Newcastle and Birmingham universities, that where the distinction between what you must do, and what you could do is unclear, many small businesses will end up gold-plating their compliance due to fear of reprisals. It would be much more helpful, and likely to reduce administrative burden, if HMRC were to state in the guidance what the minimum level of evidence would be for compliance, instead of the time-consuming example that is included.

We hope to see HMRC not requiring small firms to provide a huge amount of evidence for these claims as this could be very counter-productive.

Additional information

Of the additional information listed, FSB believes that most of this is sensible for HMRC to ask firms to provide, including the contact details of main internal R&D contact at the company. However, some aspects seem quite burdensome for companies to complete and without seeing the Additional Information form, it is unknown how much information companies will need to provide under each of the description sections.

Again, to reiterate FSB's concern that HMRC's desire to make R&D tax relief even harder for small firms to apply for is highly contradictory to the Government's stated ambition of the UK becoming a "science superpower." We urge HMRC to carefully consider the proposals in this draft guidance and their general direction of travel with R&D tax relief.

Yours sincerely,

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