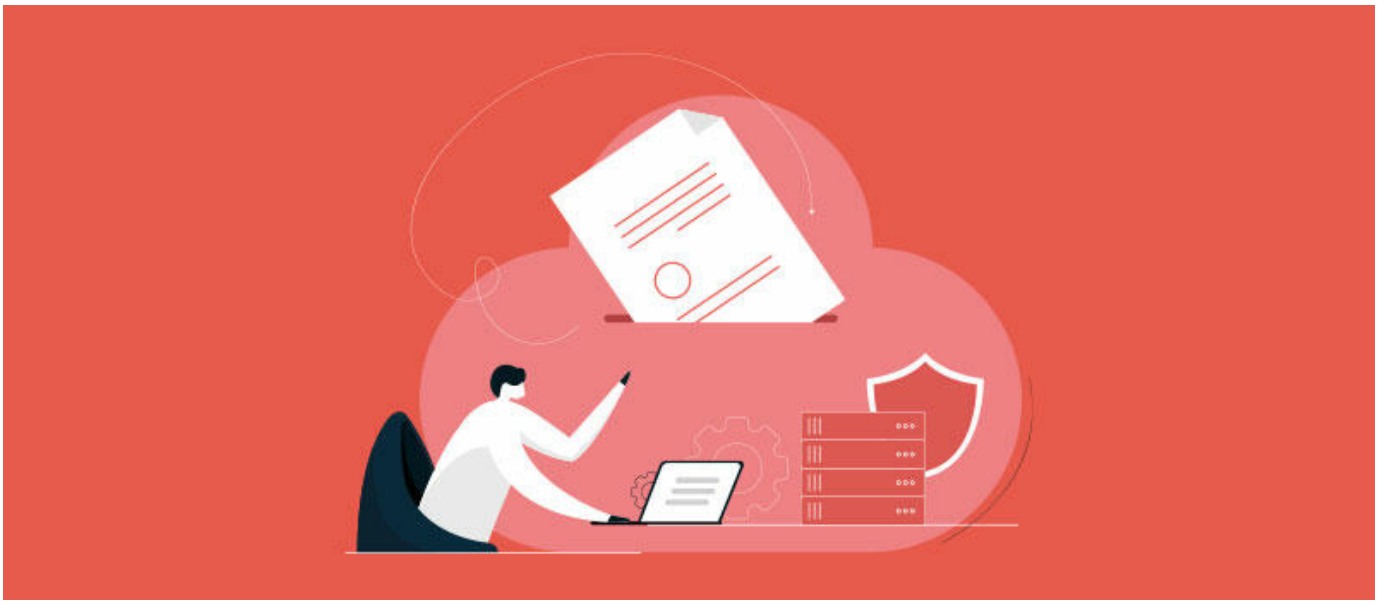
The extension of R&D rules to reflect working practices

Large Corporate OMB



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The R&D rules are set to see significant changes, with further categories of qualifying expenditure. But is all as it seems?

Key Points

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What is the issue?

The Autumn Budget announced big changes in the R&D expenditure that companies will be able to claim, with a welcome expansion in data and cloud computing costs offset by a restriction in offshore costs.

What does it mean for me?

Big questions remain over what a focus on innovation in the UK could mean for multinational businesses or organisations sourcing skilled labour from across the world.

What can I take away?

Advisers should note that the R&D landscape is likely to see some significant changes in the next year and they will need to start working with clients to plan for this.

The Autumn Budget 2021 saw significant changes to the R&D rules, with the inclusion of further categories of qualifying expenditure corresponding to modern working practices, offset by a refocusing of the R&D rules on innovation in the UK. There were also long overdue measures to tackle abuse.

The Budget announcements were short on detail, however. Big questions remain over what a focus on innovation in the UK could mean for multinational businesses or organisations sourcing skilled labour from across the world.

The government has since issued its R&D Tax Reliefs Report (see), which sets out further details of these proposals, as well as details of further consultation required for their implementation by April 2023. With R&D reliefs playing an increasingly important role in the promotion of research and development within UK companies, how can you ensure that your clients are maximising their claims?

All legislation references in the following article refer to Corporation Tax Act 2009 unless stated.

Modernisation of R&D?

The scope of qualifying expenditure for both the SME Scheme (Part 13) and R&D Expenditure Credit (RDEC) Scheme (Part 3) has long included the costs of computer software, to the extent that it is employed directly in relevant R&D. This includes the costs of systems used both for the purposes of directly resolving technological uncertainties, and software used for qualifying indirect activities, such as routine administrative or HR work related to the R&D staff.

HMRC regards software as the digital code or instructions that tell a programme how to achieve a task. This definition does not include the costs of servers, data storage

or hosting, which HMRC has always regarded as more akin to a digital rental cost than of software.

The increasing adoption of cloud-based Software as a Service (SaaS) has created uncertainty amongst both companies and HMRC's own officers regarding whether SaaS costs can be claimed. Other businesses have noted that while SaaS itself clearly meets the definition of software, it is often bundled with other cloud services such as hosting and storage, which clearly do not qualify for relief. This presents distinct problems for apportionment as many invoices don't separate the various components of overall cost. This can lead companies to exclude significant R&D costs, rather than incur the time and expense necessary to quantify the qualifying spend.

The announcement that qualifying expenditure will be expanded to include data and cloud computing costs to better incentivise modern R&D methods came as welcome news to many companies and advisers. However, for many the proposals will be a little disappointing as they still contain the same carve-outs as before.

It was announced that qualifying expenditure will be expanded to include the following costs.

Cloud computing and software costs used directly for R&D

This would include costs which can be attributed to computation, data processing, analytics and software, but as previously would exclude costs commonly included within a cloud computing package, such as hosting and data storage. This appears to be little more than a reaffirmation of the status quo.

Licence payments for datasets used directly for R&D in a qualifying R&D project

Datasets are regarded as an essential input for companies undertaking R&D based on or utilising the latest computational analysis techniques.

The aim is for R&D relief to only be available for licence costs incurred solely for R&D and not for costs that can be reimbursed, or that will be a lasting asset to the company and are analogous to the existing rules for consumable or transformable materials. A licence will not qualify if it grants:

- any rights of resale over the data;
- any rights to publish, share or otherwise communicate the raw data within the dataset to a third party; and
- any ongoing rights of use, beyond the expected term of the R&D project.

Staffing

The report also clarifies that any staffing costs incurred in collecting, cleansing and analysing data would already have qualified, provided the data is collected to resolve a project's scientific or technological uncertainty.

Focus on innovation in the UK

The UK's current R&D rules are unusual in that, under both schemes, companies can claim relief for the costs of R&D activity that is undertaken outside the UK. This offers a number of benefits, including making the UK highly attractive as the focus for a group's R&D activity, especially when combined with the UK's skilled technical workforce and favourable IP regime.

However, the government has become increasingly concerned that the costs to the exchequer are outweighed by the benefits to the UK economy, with the business investment resulting from investment far lower than other comparable nations. The recent review considered how to ensure the R&D reliefs are effectively targeted to drive a greater level of UK R&D activity. The report therefore proposes a significant restructuring of the UK rules. In future:

- Companies will be only be able to claim relief for the costs of any R&D activity subcontracted to a third party where the subcontractor carries out the R&D activity in the UK. A similar principle will apply for the RDEC scheme where a company claims for and contributions it makes to independent R&D of a qualifying body (s 104L).
- Under both schemes, companies will only be able to claim relief for expenditure on externally provided workers (s 1127) where the workers are paid through a UK payroll.

This will apply to both unconnected supplier costs, and connected party costs (broadly, relevant R&D expenditure recharged from related parties, such as group companies). The changes will not impact any other categories of qualifying

expenditure; therefore, overseas staff, as well as software or consumables sourced overseas, would be unaffected.

While the motivations for this change are clear, many firms will suffer, including UK based firms that are unable to source the skills they need locally, or multinational groups that share skills across the group. Interestingly, the government has promised to consult on whether there is a case for any narrow exceptions for some overseas activity, and so practitioners and industry professionals should review their R&D activities in anticipation of this.

Groups that subcontract elements of their R&D to other jurisdictions for commercial reasons will also be caught by the new changes. This will not be covered by an exemption and so planning will need to be undertaken to compare these benefits against the UK tax relief foregone.

Managing R&D risk

Meanwhile, the ever-increasing number of spurious R&D claims has prompted the government to further tighten the R&D regulations. Recent years have seen a steady tightening of the R&D compliance regime, most recently with the introduction of last year's CT600L supplementary pages for R&D claims and the addition of the PAYE cap on the R&D tax credit to counter artificial arrangements for overseas firms to benefit from UK R&D relief.

We have also seen further HMRC resources to check R&D tax relief compliance, and a number of recent cases ruled in favour of HMRC show its hardening stance and a willingness to challenge R&D claims. However, the report acknowledges that additional resources alone are not sufficient to manage the scale of the problem. Without more data to select the high-risk cases, there is also the risk they are a blunt instrument, that risks discouraging companies making genuine claims.

The government therefore intends to make the following changes:

1. All R&D claims must be made digitally and must provide more detail of the claim. Specifics are yet to be determined, but examples include: what expenditure the claim covers; the nature of the advance sought; the field of science or technology; and the uncertainties overcome.
2. Claims must include details of any agent who has advised on preparing the claim.

3. Claims must be endorsed by a named senior officer of the company.
4. Companies must inform HMRC in advance that they plan to make a claim.

For the majority of R&D advisers and the companies they advise, these points should not prove a significant challenge. The additional details suggested are set out under HMRC's existing guidance for the submission of an R&D claim and will already be provided by the majority of reputable R&D advisers. The hope is, however, that the additional disclosures will ensure companies take greater responsibility for claims, and allow HMRC to identify those less ethical advisors.

Summary

The government's review of the R&D regime is not complete, and further consultations are planned to inform the exact shape the measures above will take. Hopefully, this will see further relaxation of the rules surrounding cloud computing, although this remains doubtful. The report also notes that further areas are being considered for reform as part of the ongoing review and all measures will inform the draft legislation for the summer of 2022 to take effect from April 2023.

In the meantime, advisers should note that the R&D landscape is likely to see some significant changes in the next year and they will need to start working with clients to plan for this. This comprises major changes to the structure of the reliefs, both for how R&D claims are considered and justified going forward and for how the costs themselves are calculated, with potential significant financial implications for clients.