How to avoid R&D enquiries: watch for the red flags

OMB Large Corporate



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We explain the steps you can take to avoid R&D enquiries under HMRC's new approach in 2023.

Key Points

What is the issue?

HMRC is trying to reduce the amount of fraud and error in the R&D tax relief system by drastically increasing the number of R&D enquiries and holding applicants to a much higher standard than had been applied before.

What does it mean for me?

Thanks to the subjective definition of R&D for tax purposes, establishing eligibility is the most important and difficult aspect of preparing a claim.

What can I take away?

Check your report for common mistakes. Don’t overcomplicate the narrative, don’t focus on uniqueness, and avoid overstating staff apportionments.

The volume of R&D claims has increased rapidly for years, thanks in part to unscrupulous firms offering SMEs ‘guaranteed’ claims and access to ‘free money’.

HMRC is trying its best to tackle this and to reduce the amount of fraud and error in the R&D tax relief system, which is estimated to be £469 million (see bit.ly/3m9QzCj). In late 2022, HMRC seemed to adopt a bracing new approach to R&D enquiries, drastically increasing the number raised and holding applicants to a much higher standard than before.

All this means that R&D enquiries are now far more common, and much harder to win. Some of the reasons HMRC’s case workers are rejecting claims are because they believe:

- the claimant company doesn’t have a competent professional;
- the R&D has been subcontracted – even where contracts don’t mention R&D at all; and
- there is insufficient evidence of an advance or technical uncertainties.

Because of this strict new environment, it is more important than ever to make sure that claims are technically accurate, and that the company would be credible and comfortable when explaining to HMRC how they consider their projects to qualify for the tax relief.

Start by establishing eligibility

Thanks to the subjective definition of R&D for tax purposes, establishing eligibility is the most important and difficult aspect of preparing a claim. It takes time to thoroughly explain HMRC’s rules, and a certain amount of expertise and experience to map HMRC’s abstract definition against a client’s projects.

R&D for tax purposes is defined in the guidelines by the Department for Business, Energy and Industrial Strategy (BEIS) (see bit.ly/41kuZtV) and the Department for Science, Innovation and Technology (DSIT) (see bit.ly/3GkSzi2). This definition is

used by HMRC, in conjunction with its Corporate Intangibles Research and Development Manual CIRD80000 (see bit.ly/2Lamjn2), to assess the eligibility of claims. It is a good idea to share this with clients, as HMRC often asks whether the claimant read and understood the definition of R&D before submitting their claim.

Yet many SMEs will have heard from less scrupulous R&D advisers that that they can be very liberal in interpreting what can classified as R&D. They may have heard that almost anything can qualify for R&D tax relief, and that HMRC won't check their claim anyway. This can make it difficult to appreciate the need for a more rigorous process.

At this point, it's important to note that part of establishing eligibility also includes being upfront when the company does **not** qualify for the tax relief. This can be a difficult conversation, but one that cannot be avoided when acting in the best interest of a client without any qualifying work.

Once you are comfortable that company personnel understand the eligibility criteria and would present well if required to speak to HMRC, the next step is to speak to the individuals who have the most knowledge and experience of the projects.

For each project, the claim looks to explain:

- the technological or scientific baseline for the industry;
- the advance that the R&D achieved (or attempted to achieve); and
- the technical uncertainties (as defined by HMRC) that had to be overcome.

Each of these terms has a specific definition, detailed in the guidance. It's vital that advisers understand these, so they can explain what they mean in detail.

Write an effective R&D report

With HMRC raising the bar for applicants and their advisors, an effective report has never been more important. HMRC's caseworkers have a limited amount of time to read each report before deciding whether to open an enquiry. To avoid them doing this, your report needs to be clear and concise, so they can easily understand what the claiming did and why the work qualifies.

With HMRC's new 'additional information' forms to be mandatory from 1 August 2023, a well-structured report becomes key to answering those questions in the

digital forms. As a minimum, your report should:

- provide details on each specific R&D project, rather than grouping them into themes;
- describe the industry baseline, advance and uncertainties relevant to each project; and
- list the competent professionals involved in each project.

When describing the baseline, bear in mind that HMRC will be looking for evidence that the competent professionals have scoured the public domain for relevant information and used this to further the project aims; and that competent professionals took sensible, logical steps towards a solution before the R&D started.

Claimants often don't include this information, leading HMRC to conclude that the boundaries of R&D were set too broadly and that the claim is not specific enough.

If they do question when R&D was deemed to have begun, it can be useful to outline:

1. work required to achieve the industry baseline (not eligible);
2. work that was complex and difficult, but which was still achievable using existing knowledge, tools and capabilities (also not eligible!); and
3. work conducted to develop something new and more advanced when standard methods proved to be ineffective.

By setting out the information in this way, HMRC can quickly see that the company knows about and can describe the industry baseline; has made (or attempted to make) an advance relative to this industry baseline; and has experienced technical uncertainties which could not be resolved by using readily available information or applying pre-existing industry-wide solutions.

Check your report for these red flags and common mistakes

There are lots of common mistakes that we see when reviewing claims on behalf of R&D advisors. Here's a few of key ones to avoid.

Don't over complicate the narrative

Stay focused and concentrate on just the details you need to show HMRC how the R&D qualifies. A 25 page report is too much information! A caseworker has limited time to risk assess a claim, so they are more likely to open an enquiry if they can't quickly see why the claim qualifies. Extra details won't necessarily impress them, so focus on clarity rather than word count.

Don't use words like 'bespoke,' 'custom,' or 'unique'

None of these words prove that there is qualifying R&D activity. HMRC will often point out that work can be all these things without necessarily involving an advance in technology. This means that describing something as bespoke, or similar, raises the question of whether the client is claiming for a commercial advance rather than for something that is technologically new. To avoid this, focus less on 'uniqueness' and more on the baseline and how the client was trying to go beyond this.

In other words, ask the competent professionals why their solution was technologically better, not just different. Keep asking them to clarify this until you can confidently explain it in your report.

Avoid overstated or inaccurate staff apportionments

While HMRC's own examples include 100% apportionments, in practice these can be high risk. If you apportion staff at 100%, you are claiming that they spent every hour of every day working on the technical advance and uncertainties you've described.

Even in an SME which has exclusively worked on R&D projects and nothing else, it is very likely that staff will have spent time on non-qualifying activities, like researching the technological baseline, or trying existing and sensible approaches to solve key problems. It's best practice for apportionments to come from the client directly. You can help to facilitate this by asking for details of how everyone spent their time.

How to prepare for an enquiry (just in case!)

Preparing R&D claims can be complex and nuanced work, which is now riskier than ever. The key to a strong claim is giving HMRC what they need to assess the claim qualifies and you can do this by:

- helping company personnel to understand HMRC’s specific definition of R&D;
- establishing which parts of a company’s projects are eligible;
- writing a clear and concise report to support the tax relief claim; and
- avoiding red flags and common mistakes in the claim.

While this will help, nothing can guarantee an enquiry-free claim. In fact, HMRC has confirmed it is opening more random compliance checks, as well as those based on poor standards or unlikely SIC codes.

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If you are want to prepare yourself for an enquiry, download our free guide, ‘How to handle an R&D enquiry: a complete guide to HMRC’s most common questions, and how to answer them in 2023’ at bit.ly/439BIrY.