Targeting abuse of the R&D tax relief SME scheme

Caroline Walton and Sarah Scala offer a reminder of the background to the Research and Development tax relief and explain the concerns HMRC has about abuse of the relief

Tax reliefs are a key feature of the UK corporate tax system. Research and Development (R&D) tax relief supports companies that work on innovative projects in science and technology. It can be claimed by companies that seek to create a scientific or technological advance in their field, in new or improved products, processes, materials, services, devices or knowledge.

The relief for small and medium-sized enterprises (SMEs) is valuable and allows a company to deduct 130% of its qualifying R&D costs from its annual taxable profit, as well as the normal 100% deduction, to make a total 230% deduction. In the case of a company that has paid or is liable to pay corporation tax, the financial reward is repayment of corporation tax or a reduction in corporation tax due. In the case of a company that is not liable to pay corporation tax because it has no taxable profit, the benefit will be new or increased losses. These can be surrendered in return for a tax credit worth up to 14.5% of the surrenderable loss or carried back/forward and set off against profits in previous/future accounting periods.

Since the SME scheme was launched in the year 2000, over 300,000 R&D tax credit claims have been made and the number of companies claiming is increasing each year. According to HMRC statistics (published September 2021 and updated on 26 April 2022), the estimated total number of R&D tax credit claims for the year ended March 2020 is 85,900, an increase of 16% from the previous year. The increase is attributed to the 16% rise in the number of SME R&D claims to 76,225.

The increase in the number of claims has resulted in HMRC having difficulty in tackling errors and fraud associated with the reliefs. According to HM Treasury's publication titled 'R&D Tax Reliefs Report', published in November 2021 in response to the Government consultation that ran between 3 March 2021 and 2 June 2021, concern over abuse and boundary-pushing involving the R&D tax reliefs has grown in recent years.

Loss making firms claiming repayable tax credits

One of the main causes of the concern is the payable tax credit for loss-making companies which makes R&D tax relief open to possible abuse. HMRC figures for 2019/2020 estimated error and fraud across both schemes as 3.6% of total relief cost, or £311 million.

Concern about the payable tax credit for loss-making SMEs companies claiming R&D tax relief was partially addressed through the imposition of a cap on refundable credits for accounting periods starting on or after 1 April 2021. The amount of payable credit that a qualifying loss-making SME can receive in any one year is capped at £20,000 plus three times the company`s relevant expenditure on workers (total liabilities for PAYE and NIC for the company’s employees and directors together with PAYE and NIC of any connected externally provided workers or connected party subcontracted R&D). The cap is designed to deter unscrupulous companies from claiming subcontracted R&D expenditure where dubious R&D activity has been carried out by unconnected parties overseas.

The introduction of the cap followed a consultation process and concern was expressed during that forum that the cap would penalise small companies carrying out genuine R&D activity. For that reason, the cap includes three features to minimise the impact on genuine businesses. First, a small company claiming a payable credit below £20,000 is unaffected by the cap. Second, a company can include related party PAYE and NIC liabilities attributable to R&D projects when calculating the cap, also multiplied by 300%. Third, a company’s claim will be completely uncapped if it can show that its employees are creating, preparing to create or actively managing intellectual property and its expenditure on work subcontracted to, or externally provided workers provided by, a related party, is less than 15% of its overall R&D expenditure.

2021 consultation into R&D tax reliefs & the outcome

The imposition of the cap was the first measure introduced to stem abuse of the R&D tax relief schemes; however, it has not taken matters far enough and hence the 2021 R&D tax reliefs consultation sought the view of various stakeholders and interested parties as to measures that could be implemented to improve compliance.

Concern was raised as to the recent emergence of R&D advisers, who are typically not members of professional bodies, that are cold-calling SMEs, suggesting they could make an R&D claim. It was stated that these advisers, many with no background in tax, take advantage of customers who are unfamiliar with claiming for R&D, often charging on a commission basis, and submitting numerous dubious claims. The Commission-based payment can lead companies to view a claim as cost-free and some are willing to make questionable claims.

Some 183 responses to the consultation were received and HM Treasury’s R&D Tax Reliefs Report sets out the next steps to improve compliance. HMRC has committed additional resources to R&D tax relief compliance and a new team has been created to focus on abuse associated with R&D tax credit compliance. Additionally, the following steps will be taken:

- A requirement for all future claims for R&D tax relief to be made digitally and more detail to be provided on what expenditure the claim covers, the nature of the advance sought, the uncertainties overcome, etc.
- A requirement for each claim to be endorsed by a named senior member of a company.
- A requirement for a company to inform HMRC in advance of the intention to make a claim.
- A requirement for each claim to include details of any agent who has advised the company on compiling the claim.

The Government states that these changes are necessary to protect the integrity of the reliefs. The Government is considering additional measures to discourage unscrupulous agents from exploiting the SME scheme. The changes are planned to come into effect from

April 2023 and HMRC is now working to deliver them. Any necessary legislation will be published in draft in the summer of 2022 for comment from stakeholders and will then be included in Finance Bill 2022/2023.

Fraud or genuine mistake?

Of course, the deliberate abuse of R&D tax reliefs has to be distinguished from errors that have occurred due to carelessness or despite taking reasonable care, although these are also examples of non-compliance which have to be investigated and rectified. Deliberate abuse of the R&D tax reliefs would involve the claimant knowingly making a claim that was incorrect. Examples of deliberate behaviour could include projects where no R&D activity or spurious R&D activity has taken place, projects that have never occurred at all, and claims for expenditures that have not been incurred or don't relate to the R&D activity.

Deliberate behaviour, however, also includes exaggerated or misleading claims. Examples include extending the life of an R&D project thereby increasing the expenditure to be claimed or inflating the level of costs claimed beyond that which have been incurred.

The number of R&D tax relief claims submitted each year makes it difficult for HMRC to police every claim however HMRC is investigating more claims and prosecuting businesses and advisors that exaggerate or make misleading or fraudulent claims. An example of this is the case of men jailed for a total of 21 years in November 2020 at Birmingham County Court for involvement in a fraudulent claim for R&D tax relief involving an IT project.

The lack of regulation of R&D tax advisors in the industry is a problem and there are currently no plans to impose formal regulation although all agents are expected to comply with HMRC's Standard for Agents-Professional Conduct in Relation to Taxation (PCRT). These standards, and compliance overall, will be exacted and enforced more vigorously once the requirement for each claim to include details of any agent who has advised the company on compiling the claim comes into effect.

It is more difficult to coin inaccurately or incorrectly compiled R&D tax relief claims as fraudulent or abusive where a genuine mistake has been made in preparing the claim or where there is evidence of negligence. There is no doubt that substantial time and money is spent by HMRC on investigating claims that are considered to be inaccurate/incorrectly calculated on account of it being submitted through the wrong R&D tax relief scheme. The recent tax tribunal decisions of Haddee [Haddee Engineering Co Limited v Revenue & Customs (Corporation tax – Research and Development (R & D)[2020] UK FTT 497 9tc) 10 December 2020)] and Quinn [Quinn (London) Limited v HMRC (2021) UKFTT 0437 (TC)] centred around the issues of whether R&D expenditure was subsidised or the company's own or whether the company's R&D activity was subcontracted or its own and hence whether it should have been claimed under the R&D scheme for Small and Medium Enterprises (SMEs) or Research and Development Expenditure Credit (RDEC). These issues are ones of compliance for the R&D tax agent, however, they should be minimised once case law and guidance are available to aid interpretation of the legislation.

Benefit to genuine, innovative companies

We welcome the tightening up of the R&D tax relief schemes, which will benefit the genuine tax-payer in leading to improved efficiency in the administration of the schemes and availability of the reliefs. There is no doubt that concern about abuse/fraud, coupled with difficulties caused by the Covid-19 pandemic, contributed to HMRC's delay in the processing of R&D tax relief payments in the period 2020/2021.

Measures to satisfy HMRC on compliance with the scheme requirements will benefit those companies that are genuinely carrying out R&D activity and submitting robust claims. Many companies rely on R&D tax relief to fund continued innovative activity and faster repayments will enable a company to grow faster and ultimately, to carry out activity in line with the Government's innovation policy.

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