Jumping the R&D hurdles

Jesminara Rahman examines changes in Research and Development tax credits and the Alternative Dispute Resolution (ADR) process

The tax landscape of Research & Development (R&D) has become hostile in the past few years with red lines inserted regarding certain technical principles as no-go areas for HMRC with 'Do not pass' signs. HMRC used to have the approach of process first and check later, but it now has become check and reject.

There appears to be three main hurdles that have to be crossed for an R&D claim (subjected to a tax investigation) to be accepted and the stumbling block appears to be mainly at the second hurdle and third hurdle.

First hurdle – does HMRC recognise it is R&D?

We have this juxtaposition when HMRC as lay people are judging what is research and development and rejecting the expert's opinion, who is the competent professional.

In regard to R&D tax claims, the first hurdle appears to be getting HMRC to agree that it is R&D in the first place. It is understandable why HMRC cannot see the advance in technology or science if they don't have any expertise in the area.

It is difficult for the claimant or agent to gauge what level the narratives should be aimed at, too simplified and HMRC can't see how it is R&D? Too technical and HMRC can't see it, either!

There are cases where the advance in technology or science cannot be evidenced and can't be seen especially if its put together by a third party after the fact. Then it is reasonable for HMRC to reject the claim. However, I have had cases where the claimant has won awards for their work or where another independent expert as agreed that it is indeed research and development, but HMRC initially rejected the claim anyway on the grounds that this is not R&D. I know of other agents who have come across this blank unreasonable refusal of HMRC to consider genuine R&D claims as qualifying R&D.

ADR meets R&D tax claims

I have had success via ADR where HMRC have accepted that it is R&D. It helps when the competent professional is present to provide oral evidence. It does takes time to prepare for an ADR and you need to have an expert in ADR as well as R&D tax legislation to navigate this mediation in R&D cases.

Apparently, on the smaller claims HMRC won't even engage in any meetings as the cases are processed more in a conveyor belt style churning out closure notices. It is important to note that it is compulsory for HMRC to attend the ADR meeting once the ADR application has been accepted. But one needs to weigh whether it is cost effective to go to ADR with the size of the claim.

I have already written extensively on ADR for HMRC, Enquiries, Investigations & Powers (June/July 2019 issue), which you can read for further reference on ADR, so I won't repeat it here.

Changes to ADR

However, there has been some changes in the ADR process since I wrote my article on ADR in 2019.

On 1 February 2023, HMRC published its first Alternative Dispute Resolution guidance as part of its internal manual.

The Civil Mediation Council (CMS) states that Mediation is a confidential process and that "whatever is said and done, whatever unsuccessful offers are made to settle, none of it can be shared outside the mediation group unless agreed" and "cannot be repeated in court" (CMC website). This approach has now changed in the HMRC ADR mediation process.

ADRG01900 states that "tax facts are not treated as confidential to the mediation" and "are not covered by the 'without prejudice' rule". This means HMRC may rely on tax facts shared within the ADR, outside the mediation process to establish tax assessments or at a tribunal hearing.

ADRG01700 defines a tax fact as "a fact which has legal and technical implications for a taxpayer's liability", including one which "has an impact on any other HMRC tax or duty" (ADRG01300). Basically, any tax fact that effects the material tax position of the taxpayer.

ADRG01900 also outlines some examples of tax facts such as "the receipt of a payment, the making of a supply, the identity of a customer, the place of supply".

Furthermore, documents provided during mediation may end up being used in future investigations or litigation. ADRG02000 states that "documents exchanged during the ADR process are treated in the same way as any other information sent to HMRC and are on the formal record". This means where "a document affects the customer's tax liability and the customer wishes to proceed to litigation following the conclusion of ADR, the mediator will make such documents readily available to HMRC's legal teams before litigation".

ADRG02100 provides that the mediator's notes may also be disclosed if "the customer were to share tax facts with the mediator which were hitherto unknown to HMRC and HMRC believes that these facts are ones which the Tribunal should have regard to in coming to its decision". Hence, the ADR process now loses it 'without prejudice' and 'confidentiality' mantle.

The taxpayer will need to consider very carefully what is shared in the ADR meeting and what documents are brought to the table, which is why an ADR expert would be useful during this process. I would still endorse the ADR process as at least all parties are on the same page in making all efforts to reach a resolution.

Recently, I had in one of my cases, the HMRC solicitor also supported the ADR application as at the least, the ADR mediation helps to narrow the scope of the dispute if we can at least agree what is R&D, rather than go to tribunal on all three main issues described as hurdles in this article.

Second hurdle – subsidised expenditure

Subsidised expenditure under s1138 of CTA 2009 is defined as:

- S1138(1)(a) – any amount of expenditure is covered by a notified state aid.
- S1138(1)(b) – otherwise, to the extent met by any other grant or subsidy which is not a state aid.
- S1138(1)(c) – "to the extent that it is otherwise met directly or indirectly by a person other than the company".

It is mainly on S1138(1)(c) that HMRC tends to stall the R&D claims under as there is a contract in place where a customer pays the claimant. It is through this payment that HMRC deems that the expense has been subsidised as in their view there is a clear link between the payment and the price paid by the customer and the R&D expenditure.

HMRC has stated in one of my cases that HMRC "considers it is necessary to artificially limit the scope of this section to preserve the viability of the scheme to situations where there is a clear and direct link between monies received (i.e. actually paid, not just earned) and the expenditure in question".

In contrast to HMRC's view, in the case of Quinn (London) Ltd v HMRC [2021] UKFTT 0437 (TC), the Tribunal held that a 'clear link' was absent between the price paid by the client/customer and the R&D expenditure, therefore the expenditure could not be said to be subsidised.

The Tribunal judge stated it would be "out of kilter with the overall SME scheme, if an SME were to be denied enhanced R&D relief solely because, in doing what is envisaged by the legislation. Namely, the claimant in utilising the relevant R&D for the purposes of its trade, it is expected of an entity carrying out a trade on a commercial basis, to recover some or all of the relevant costs of the R&D under its commercial contracts with its clients entered into in the course of its ordinary trading activities.

"Indeed, if HMRC's approach were to be adopted, the circumstances in which an SME could claim enhanced R&D relief would seem to be confined to those where it has no prospect of exploiting the R&D for commercial gain."

HMRC does not agree with the Quinn tribunal decision, but has not taken the appeal to Upper tax tribunal for undisclosed reasons.

Guidance at CIRD81650 sets out HMRC's view, which remains unchanged despite the fact it was not upheld in the Quinn tribunal case.

Third hurdle – subcontracting issue

HMRC appears to be rejecting R&D claim where there is a customer and contract in place under the S1052 and S1053 Corporation Act 2009 legislation.

In-house expenditure on direct R&D must meet the condition under s1052 (5) to form part of a company's qualifying for the R&D SME scheme "…that the expenditure is not incurred by the company in carrying on activities which are contracted out to the company by any person".

This same condition appears at s1053(4) (subcontracted R&D) as condition C.

HMRC guidance at makes it clear in HMRC's view that activities carried out by a taxpayer in order to fulfil a contract constitute activities contracted out to the taxpayer.

The examples that are provided as not R&D carried out under a contract, but still may not qualify for the R&D tax credit are outlined, (but not limited to) under CIRD84250 :

- Where a company carries out R&D on its own account and simply receives a subsidy from another entity, this is not subcontracting - it is subsidised expenditure.
- Where two companies are both carrying out R&D on the same subject they may decide to pursue the R&D jointly with each making a contribution and each free to enjoy any fruits of the R&D. This is collaborative research and each company would potentially be eligible for R&D relief on its share of the qualifying expenditure.
- Where one company carrying out R&D pays another company for the provision of workers or materials this is not subcontracting of the R&D.
- Where one company engages another company to carry out R&D activity on the first company's behalf in exchange for payment then that is subcontracting of the R&D to the second company.
- Where, for example, a consultant simply provides expert advice and charges for their time, that does not amount to subcontracting of R&D.

The Hadee Engineering Co Limited HMRC (2020) provides further guidance on what HMRC considers to be as R&D carried out under a contract.

The judge confirmed that the contract between the two entities was key here since the work contracted out could be the product, the R&D or both. The judge referred to four key points:

- intellectual property (IP) ownership;
- financial risks and rewards of undertaking the work;
- degree of autonomy in undertaking the work;
- and deliverables/milestones.

The tribunal judge focused particularly on the financial risks and rewards (i.e. where design was paid on an hourly basis, this was taken as a conclusive factor). Unfortunately, for the taxpayer, further evidence even included on one project that their customer successfully filed for a patent for its design work demonstrating its ownership of the R&D design. The claimant even carried out the work on the customer's premises and the contract outlined the work that the taxpayer was claiming as R&D.

Conclusion

The landscape is murky as HMRC are not abiding by the First Tier Tribunal (FTT) decisions unless it supports HMRC's position, like the Hadlee Engineering case. HMRC has stated that the Quinn tax case is not legally binding, failing to point out that all FTT decision are not legally binding, but one would expect HMRC to at least follow the rationale of the tribunal judge.

This summer (2023) HMRC are looking to go to tribunal and there are some lead cases in the pipeline. Hence, if there are any cases that are reaching the same technical impasse then there is always the option for the case to be stood behind the lead cases. This will help those taxpayers who cannot afford the costs of going to tribunal.

It will also be interesting to see how the loss of without prejudice status pans out for the ADR mediation process. Especially as this goes against the tenets of mediation as described by the CMS. Previously, in the HMRC ADR process it was always understood that any facts that indicate tax fraud would have to be shared outside ADR, but now the threshold has been lowered to include any material tax facts that effect the tax position.

Interesting times ahead as we have HMRC selecting the FTT decisions that best fits with their interpretation just as HMRC now can select the tax facts from a previously confidential mediation process. We are working in a challenging tax landscape that has to be carefully navigated.

- *Jesminara Rahman is the Director of Tax Resolute with over 23 years of experience in tax investigations. She also implemented ADR as the ADR design lead in HMRC from 2012-14. Call her on 07508034311 for any further queries*