



HOUSE OF LORDS

Economic Affairs Committee

Finance Bill Sub-Committee

Corrected oral evidence: Draft Finance Bill 2023-24

Monday 13 November 2023

5.05 pm

Watch the meeting

Members present: Lord Leigh of Hurley (The Chair); Lord Palmer of Childs Hill; Lord Rooker; Baroness Valentine.

Evidence Session No. 3

Heard in Public

Questions 37 - 45

Witnesses

[I](#): Mark Davis, Managing Director, ela8 Ltd; Justin Arnesen, Partner, R&D Tax and Government Grants, Business Tax, Evelyn Partners; Benjamin Craig, Associate Director, R&D Tax Incentives, Ayming UK.

Examination of witnesses

Mark Davis, Justin Arnesen and Benjamin Craig.

Q37 **The Chair:** Welcome to the second session today. We will be talking principally about research and development tax credits. We have three witnesses in front of us. I will start by asking you for a quick introduction of who you are and the relevance of your knowledge to this inquiry.

Mark Davis: Hello. I am the managing director of a company called ela8. We are a specialist R&D tax relief provider. We have been helping our clients to make R&D tax relief claims since 2007.

Benjamin Craig: Good afternoon. I am from Ayming UK, Europe's largest innovation funding consultancy. In the UK, we represent around 400 clients ranging, from micro-SMEs to multinationals.

Justin Arnesen: Good afternoon. I am from Evelyn Partners. We are a large professional services firm with a specialist R&D tax incentive unit.

The Chair: Thank you.

Q38 **Lord Rooker:** Good afternoon. Thanks for coming in person. Do you agree with the Government's view that the R&D proposals represent a simplification of the relief? If not, what do you think should be done to achieve that simplification? In addition, should there be the same scheme for everybody, SMEs included, or not? Choose who wants to have a go.

Mark Davis: I am happy to start. There is a little simplification here, but not an enormous amount. It is helpful to have one scheme instead of an RDEC scheme and an SME scheme. Equally, there is an R&D intensive scheme that comes out as part of this legislation. There are also some useful clarifications about things like subcontracting and subsidisation, but in the round I am not sure that we would particularly describe this as a simplification.

Benjamin Craig: I agree with everything that Mark said.

Justin Arnesen: I agree. From a mechanism point of view, it is a simplification, but it becomes problematic when you have an intensive regime with a determination of the benefit potentially coming down the line that is not consistent with the RDEC approach. Simply, moving to an above-the-line credit holistically is probably the preferred option. There are still challenges that need to be overcome in other aspects in relation to a merged regime.

Mark Davis: On the question of what might make it simpler, we have already talked about the R&D intensive scheme and the other scheme. Nothing particularly stands in the way of a unified scheme designed to cover all those different types of things.

The PAYE NI cap is probably achieving a not dissimilar thing to the overseas position that HMRC has already taken. That is an opportunity for a simplification.

It is interesting that the technical question about what R&D is has not been approached in this legislation anywhere at all, yet that would seem to be the thing that causes the greatest amount of consternation. It is a complicated area—it is even more complicated to legislate for it—but perhaps that could be used to add simplicity.

Lord Rooker: Thanks very much. Our next set of questions will, I hope, explain some of that.

Q39 **The Chair:** The merged schemes are a sort of mix-and-match of both. Do you think that HMRC or legislators have taken the best of both? If not, what is missing?

Mark Davis: I probably would not describe it as a mix-and-match of both. It broadly follows the principle of the RDEC arrangement and then adds a number of new components that sit alongside and underneath it. When we talk to our clients, they also describe this as the worst of both worlds, because it looks like it is picking the rate from the less advantageous of the two arrangements that are available. Some components are carried over from the existing designs, but there are definitely some fairly significant new components that go into this design as well.

Benjamin Craig: A mix-and-match is not inherently a bad thing. In theory, it allows for getting the best of both worlds. I do not feel that that is the case in the proposals as they stand at the moment. A lot of the complexities and challenges of having two schemes are still there when the opportunity is there to simplify it. It has picked up one of the most problematic, and currently most controversial, aspects of the SME scheme as it stands and will apply that to all claimants in future. There is a missed opportunity in trying to sort out that situation. There are also a couple of rather technical niggly bits and pieces, which I described in my written response to your call for evidence. I do not think we want to discuss those in detail today.

Justin Arnesen: I agree with both points. The major point of debate from our perspective is, ultimately, who is eligible to claim. Is it the funder of the R&D activity or the doer? A significant amount of consideration is required before it is determined from a policy point of view who should be claiming and, moving on to a legislative perspective, how that looks.

Q40 **Lord Palmer of Childs Hill:** That leads on very easily into the next question. So much work is subcontracted nowadays; I think that what you were getting at. It seems intended that the client company should be entitled to any relief on any R&D done by the subcontractor. In your view, is that the right result? If not, what alternatives do you suggest? Mr Arnesen started to talk about that.

Where R&D is subcontracted, how easy will it be for the customer even to know that R&D relief is available? Have the Government sufficiently engaged with businesses over the consultation process to understand—I am not sure I understand—how subcontracting works in order to try to

get the scheme right?

Finally, are you confident that the current differences of view on what counts as a subsidy can be resolved before the merged scheme comes into effect? Mr Arnesen touched on this in his previous answer. This question fleshes out the issue.

Justin Arnesen: There are a couple of points to address those various questions. As a starting point, we should talk about the subcontracting of R&D. There are two parts to it. Specifically, one element concerns where R&D is well understood and well known at the outset of a project and is subcontracted to a third party. However, what we are often seeing is R&D occurring on projects where it was not known at the outset, which is a very different situation to be in.

To put it simply, in my mind, a situation where defined R&D in, say, the pharmaceutical space is known at the outset and provided or subcontracted down to someone for them to engage on that activity is well known and understood. What is not so clear is whether, when a package of works or services is outsourced to a party, it is ultimately the client or the contractor who should claim.

From my perspective, in both those scenarios, the entity that should be claiming is the entity that has the technical know-how in that particular area, as opposed to a funder who is ultimately paying for an activity but does not necessarily understand the scientific baseline or the advances or uncertainties that are required or that need to be overcome in order to make that development happen.

Lord Palmer of Childs Hill: Does that need to be incorporated into the legislation?

Justin Arnesen: Definitely. It really needs to be considered. As a practical example, you have multiple engineering organisations or construction businesses that engage with developers to come up with solutions. There is a strong argument for saying that, in the current writing of the law, those developers would be the organisation that is entitled to make the claim, but, as I mentioned, they do not necessarily understand the baseline technology or the types of activities that are required. There are other jurisdictions globally that talk about "on behalf of" rules in relation to who should be entitled to claim. That really needs to be addressed and thought out when thinking about where we go with the regime.

Mark Davis: I agree with everything that Justin said. The legislation, as currently drafted, conflates two types of R&D and tries to treat them in the same way. That causes a whole load of downstream problems when thinking about making R&D claims. Under the legislation as drafted, a whole load of companies will have no idea that R&D is taking place as part of an arrangement that they may have with somebody else. They suddenly become eligible claimant organisations, but they will have no understanding of the R&D, they will not have a competent professional to support the making of an R&D claim, and they will be poorly equipped to

go through the process of making a claim for relief. So you will end up with the ironic situation of R&D taking place but nobody being able to access the relief because of the complexities caused by the way this is currently drafted.

Justin Arnesen: If it is passed like that, you will stifle innovation in the UK, because ultimately your subcontractor—the doer of the activity—will not be incentivised to challenge the status quo and push boundaries. They will revert to what is currently easy to do, because there will be no incentive for them to drive and change.

Benjamin Craig: Lord Palmer, you asked a very interesting question earlier when you asked what should happen when R&D is subcontracted. In a scenario where a contract says that company A is paying company B to do some R&D, there is a clear understanding among all concerned that R&D forms the scope of it. The problem, as I see it, is that in HMRC's current interpretation of the legislation, which has been copied almost verbatim into the proposed merged scheme, any activities carried out to fulfil a contract are deemed to be subcontracted.

I will give a couple of suitably anonymised examples. We currently represent businesses in the civil engineering sector that have carried out R&D to construct a new football ground and to extend a major hotel in central London. HMRC's argument is that those businesses have been subcontracted to do the R&D: hence, under the proposed merged schemes, it would not be the civil engineers making the claim but the major London hotel and a Premiership football club.

I do not feel that either of those businesses—the hotel or the football club—knows that R&D is going on. I do not think they are particularly bothered that R&D is going on, and I certainly do not feel that they would be incentivised by the scheme being targeted at them rather than, as Justin said, at the civil engineers who are deciding whether to do R&D. If the scheme is to function effectively, it needs to be targeted at the people making those decisions, who in many cases are the subcontractors.

The Chair: Could you see a situation where the subcontractor simply certifies to the client that they have carried out R&D to the value of X and the client then makes the claim?

Benjamin Craig: That would work in the scenarios where everybody knows that R&D is going on. In scenarios where they do not, where potentially even the subcontractor does not know until after they have signed the contract, it could be very problematic. It would closely parallel the way the French CIR—its equivalent of R&D relief—works. In France, typically we see only pure research organisations being contracted specifically to undertake R&D do that, simply because of the administrative payload in complying with that requirement.

The Chair: Okay.

Lord Rooker: I fully accept that this is a really naive question, but I want to ask it having listened to what you have said. Let us take the example of the football ground and the hotel. I assume that the two contractors agreed a price for the new ground and the hotel extension, presumably on the basis of tenders or whatever. If, when they come to do the hotel, the person doing the work—the contractor—says, “Bloody hell, we’ve put this bid in, but we need to do a bit of research on this”, and then claims the tax relief on the research, does the original contractor say, “Hang on a minute. You put a bid in, but you had a tax relief that we didn’t know about when you did the contract”? Does it actually happen like that?

Benjamin Craig: Not always, but sometimes.

Mark Davis: Typically, the firm doing the R&D work would have thought about that throughout the tender process and would factor some of that thinking into the commercial proposition that it puts forward afterwards. The fact that the R&D will take place and its own view on the extent to which that might be eligible is a factor when offering a price onward at the end of a tender process. It is kind of factored into the process to offer a price in the first place.

Lord Rooker: Okay. Thank you.

Q41 **Baroness Valentine:** My question is about R&D intensive business. What are your views on the definition of R&D intensive business, and how easy will it be for businesses to determine whether they satisfy that requirement? Are HMRC’s revised estimates of the costs to business of dealing with the new R&D intensive relief scheme realistic?

Benjamin Craig: The definition of an intensive business has a number of significant complexities, which brings us back to the first question. The biggest challenge is that essentially it says that your R&D expenditure needs to be at least 40% of your expenditure deductible for your corporation tax calculation. In most cases, businesses will be fairly squarely on either side of that line, but those that are on the cusp will not know whether they are in the intensive scheme until they do their corporation tax calculation, which could well be up to 12 months after the end of the year, and so potentially nearly two years after they spent the money on the R&D in the first place.

That creates the scenario that businesses will not know which scheme they can claim through until long after they have made the decision. Business leaders, being what they are, will have to work on the worst-case assumption that they are not going to be eligible. That is a problem that needs to be considered.

Lord Palmer of Childs Hill: Does that mean that it is no incentive?

Benjamin Craig: It is a less effective incentive than it could be. I do not think it is no incentive at all, but it is less effective.

Mark Davis: I would agree. Anything that offers instability will not be helpful in making strategic planning decisions to do R&D activity. Not knowing until sometime after you get eligibility for the relief certainly will not help.

The Chair: Presumably, if you get it when you had not planned for it, that is not a problem because it is a bonus.

Mark Davis: It is not a problem after the fact, but it might make you think, "Actually, I'm not going to do this", because there is no incentive to do it.

Benjamin Craig: That stability is a very good point. R&D reliefs generally have been subject to quite a lot of change over the last couple of years, some of it through legislation and some through HMRC's increased compliance work. One lesson that Ayming has observed around the world is that R&D schemes are most effective when there is stability and predictability, because businesses can factor that into their decision-making processes.

Lord Rooker: Would it be fair to assume that all the businesses that you might be contacted by or involved with are aware of the changes that are about to take place, particularly in the SME sector?

Mark Davis: Where a business has a professional adviser, there is an excellent chance that the adviser will have told them that things are changing and that those changes could be fairly significant. Where a firm does not have a professional adviser involved, there is a very strong chance that it will not know that any of this is happening or understand the consequences on them of it.

Benjamin Craig: I agree. Virtually every business that I have spoken into, with very few exceptions, had not heard about these changes until we spoke to them about it. For context, we hosted a round table a couple of months ago—including eight of the top 12 construction companies in the country—and not one of them had heard of these changes until we reached out to them. It is potentially quite concerning that changes are going through and there is a real risk that businesses, through no fault of their own, will get things wrong simply because they do not know that changes are happening.

Lord Rooker: Is there an argument for any kind of transitional arrangements when bringing in the changes?

Mark Davis: I would suggest that, with a sensible timetable, transitional arrangements are probably not required. If there were a very aggressive timetable, transitional arrangements would be an eminently sensible thing to do.

Lord Rooker: Thank you for your worrying answer.

Q42 **The Chair:** I forgot to disclose that my employer has a commercial relationship with Evelyn Partners, which I am not sure is relevant but I

put on the record anyway.

In your view, what is the impact of the new schemes on R&D? That is a big question, but do you have any feel for what the effect might be, particularly for SMEs?

Justin Arnesen: It really depends on the route that one goes down with regard to subcontracting and how that works. Currently, SMEs can claim for subcontracted R&D, to the extent where they might not necessarily even have involvement in activities that they subsequently subcontract out. That will have a significant difference to the amount that they claim. However, provided we get that right, holistically a lot of the changes will be positive in the long term.

Mark Davis: I agree with some of what Justin said, but there is an element of change fatigue going on for firms across the UK with this set of reliefs. The rate of change has been significant over the last few years. The benefit levels have been cut once, and this proposal would cut them again. There is a potential risk of firms in the UK, particularly SMEs, looking at this and starting to debate whether, in the context of the benefit available and the additional work required to support making a claim through additional information forms, along with a fear of the compliance environment, they want to make a claim for relief. That will cause the consideration downstream: "If we don't want to claim this relief, what do we do with our R&D activity and where do we do it?".

The Chair: That leads neatly into Lord Palmer's next question.

Q43 **Lord Palmer of Childs Hill:** I was quite frightened by your idea that these large construction companies had to be told about the changes, which leads you to the fact that if you are not one of the lucky people employing one of your firms at the round table, your SME will be unlikely even to know about it. That leads me to my question: if the merger is aimed at making R&D relief more central to decision-making, will the proposals achieve this objective even if, in your view, many of the companies do not even know that it is there?

Benjamin Craig: I think that, once they are aware, there are some positives in this. Moving the SME scheme to an above-the-line credit similar to RDEC is a very positive change and long overdue, fundamentally because it means that it can affect the key financial metrics that decision-makers at SMEs care about and are incentivised by. That is a good thing. We have certainly seen changes in behaviour from the larger businesses since the move to above-the-line RDEC for large companies 10 years ago.

However, as Mark touched upon, the ongoing flux and uncertainty with various changes going on means that businesses are starting to say, "How reliable is this?". If they are making a decision now, in November 2023, about a project that they are undertaking in 2024, they do not know what relief will be happening, because there are things still awaiting legislation. They might also be making longer-term commitments for 2025 and beyond and do not know what the scheme will be. As I said

earlier, if you do not know what relief is going to be available, it is very hard to rely on it coming in. It becomes a bit more of a “nice to have” than an incentive.

Lord Palmer of Childs Hill: It does not incentivise; it is just a bonus at the end of the day if you get it.

Q44 **Baroness Valentine:** My question is about fraud and error. Will the proposed changes help or hinder HMRC’s efforts to tackle error and fraud in R&D relief?

Mark Davis: I think these proposals reduce the benefit further in relation to fraud. That will serve to further reduce fraud in that it makes it less appealing as an object for fraud. There is an obvious connection there. The obvious cost is that it also becomes less potentially helpful for people who need the relief in order to do their R&D activity.

This scheme potentially introduces some new complexities, which offers new opportunities for error. But some of those new complexities are also areas where there is potential for fraud. The nature of a cliff-edge step-off in an R&D intensive scheme might stimulate people to wonder how they might think about their expenditure during a particular period to manage that. Some of that might be legitimate and some of it might not.

The construct of the way subcontracting is being treated in this legislation might lead to some creative contract writing between firms and their chosen subcontractors, which again may give rise to things being done in a way that perhaps was not the intention.

Benjamin Craig: I do not feel that the purpose of this phase of legislation is to tackle error and fraud. A raft of new measures brought in by the Finance (No. 2) Act 2023 earlier this year were targeted at that. One can debate the effectiveness of those measures, but that has happened. I do not feel that the purpose of these measures is to support that work. I think that is done and dusted, but I agree with Mark that the pace and magnitude of this legislation brings in the potential for businesses to make more errors than previously.

Justin Arnesen: With the introduction of the additional information form in August this year, HMRC will have a better understanding in more detail of the types of claims going in. We have spoken at length in the past about the review potentially placed on advisers. My understanding is that circa 90% of claimants utilise an adviser to make that submission. More can be done in relation to reviewing advisers.

The Chair: Okay. That is a slightly out of scope, but thank you.

Q45 **Lord Rooker:** In general, what are your views about the idea of a minimum threshold for claims?

Mark Davis: It is a difficult question. You could argue that small firms at the bottom end are perhaps most in need of R&D support, but the statistics from HMRC would make quite a strong case for there being a

threshold. If the small claims are driving a significant volume of error and fraud, it would seem sensible to put a threshold in. That would perhaps enable HMRC to target its compliance activity in a different way and potentially allow supplementary benefits to be provided elsewhere to claimants.

Justin Arnesen: When looking at low qualifying expenditure, we always ask ourselves how scientifically or technologically complex the activity or what one is attempting to overcome is. My view is that a threshold should be introduced. We have seen it in other jurisdictions around the globe.

Benjamin Craig: If a threshold is to be introduced, there needs to be a clear understanding of the motivation for it. In the consultation leading to the changes in the spring, it felt very much as though the primary driver was simply to reduce the volume of claims going in and hence reduce the workload on HMRC in managing it. If that is the motivation, I do not think that is a reasonable justification for introducing a threshold. Certainly, there are problems with low-value claims that have perhaps been getting away with it for a few years, which needs to be tackled.

Justin raised the very legitimate question of just how hard it is if you are not spending very much money on it. I would equally observe that once upon a time Google consisted of two guys paying themselves a pittance in a garage. I doubt its R&D claim would have been very big in those days, had it been in the UK. That certainly is the type of business that UK plc ought to be encouraging.

Mark Davis: If there is not going to be a threshold, this set of arrangements needs to arrive at a point where a small company with one or two people in it could make a claim for relief. The borrowed wisdom on this side of the table would probably be that it would be extremely difficult for a small company to make a claim without professional support in this space at the moment, given how complicated these regimes are to operate within. If there is not going to be a threshold, it needs to be sufficiently straightforward for small companies to do it for themselves.

The Chair: Thank you for your very helpful answers, for which we are very grateful.