



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Lord Leigh of Hurley
Chair of the Economic Affairs
Finance Bill Sub-Committee
House of Lords
London
SW1A 0AA

28 November 2022

Dear Lord Leigh,

Thank you for your letter of 11 November and for inviting me to give evidence to the Committee. I welcome your timely inquiry into the draft Finance Bill's Research and Development (R&D) tax relief proposals. I apologise for the delay in providing a response.

I will respond to your letter in detail now and write to you again in the coming weeks to deal with any outstanding matters from my appearance in front of the Committee. As you know, the Chancellor has announced further changes to the R&D tax reliefs at Autumn Statement. From 1 April 2023 the Research and Development expenditure credit (RDEC) rate will be increased to 20% from 13%, the small and medium enterprise (SME) additional deduction rate will be reduced to 86% from 130%, and the SME credit rate decreased to 10% from 14.5%.

These reforms will ensure that taxpayers' money is spent as effectively as possible. The changes will also help to support fiscal sustainability by raising revenue and reducing fraud and error, without materially changing the levels of R&D expenditure over the forecast period. The Government remains committed to supporting R&D, and the amount of support provided to innovative businesses through R&D tax reliefs is forecast to increase.

These rate changes will be legislated for in Autumn Finance Bill 2022. The matters you are considering through your inquiry will be legislated for in Spring Finance Bill 2023.

Please see responses to your questions below

1. Of the "tax gap" in R&D, how much is down to error, and how much to suspected fraud?

HMRC is committed to tackling error and fraud within the R&D reliefs. HMRC estimates the level of error and fraud within Corporation Tax R&D reliefs at £469 million or 4.9% of related expenditure in 2021-22. This comprises £430 million (7.3%) in the SME scheme and £39 million (1.1%) in the RDEC scheme. The estimate is based on outcomes of

compliance cases completed in 2020-21 and 2021-22 and assumptions on error and fraud within unreviewed cases.

HMRC has implemented a mandatory random enquiry programme (MREP) for small and medium sized enterprises and is developing a new methodology which will use the MREP data to produce the 2022-23 error and fraud estimate that will be published in HMRC's 2022-23 Annual Report and Accounts. This new data and methodology will allow HMRC to provide indicative breakdowns between error and fraud for small and medium sized businesses only.

For ease of reference the response to questions 2 and 3 have been combined.

2. The recent revision of ONS estimates of R&D activity has narrowed the gap between its figures and those of HMRC. Some witnesses have suggested that the narrowing of the gap may mean that suspected fraud is less than HMRC thought. How has the ONS's work affected your view of the need for some of the draft Finance Bill's proposals?

3. Following the ONS's revision of their estimates of R&D activity, what action is being taken to review the analysis on which the Finance Bill proposals were based?

Whilst it is good news the UK is doing more R&D than previously estimated, HMRC's estimates of error and fraud are based on its own data and are not affected by the ONS Business Enterprise Research and Development (BERD) conclusions. HMRC is working to improve its estimates of error and fraud and will base future actions on those estimates.

There are significant differences between the Office for National Statistics (ONS) and HMRC measures of R&D expenditure. For example, the ONS includes capital expenditure, and expenditure on arts, humanities, and social sciences innovations, whereas these do not qualify for R&D tax reliefs, and so are not included in the HMRC statistics.

As part of the ongoing review, at Autumn Budget 2021, the Government announced several changes to the R&D schemes, and published draft legislation in July 2022. The R&D tax reliefs will be reformed by expanding qualifying expenditure to include data and cloud computing costs to support modern methods of innovation. In order to refocus support towards innovation in the UK, some overseas activity will no longer qualify for support under the schemes.

The proposals were developed after a consultation with stakeholders, published at the start of the review. They took account of the views of stakeholders and evidence based on HMRC data. The analysis did not depend on the ONS BERD data, and the proposals are not impacted by the ONS revision. Given that there is still significant error and fraud in the SME scheme of 7.3% or £430 million in 2021/22, the measures included in the draft legislation to tackle error and fraud remain necessary.

4. What were the original estimates for the cost of R&D relief (both in 2000 (when the SME scheme came in) and in 2002 (when RDEC was introduced), and how has it grown since?

The forecast published at Budget 1999 for the SME scheme and the forecast published at Budget 2002 for the large company scheme are below, along with the outturn cost of both schemes for the years up to 2004-05. **Table 1: Forecast and historic cost of the SME scheme and the large company scheme (£ million).**

Year	SME scheme forecast (Budget 1999)	SME scheme outturn	Large company forecast (Budget 2002)	Large company outturn
2000-01	100	70	-	-
2001-02	150	170	-	-
2002-03	150	210	200	200
2003-04		195	400	340
2004-05		190	400	390

Since the original forecasts were produced the generosity of the schemes has been increased, the reliefs have been made easier to claim, and additional categories of qualifying expenditure have been included. The large company scheme was also replaced by the RDEC scheme (announced at Budget 2012). Together this has meant that the latest estimate for the total cost of the two reliefs in 2020-21 was £6.9 billion.

5. How many staff units are currently employed on dealing with R&D claims, and what is the estimated return for each unit?

HMRC has staff deployed on R&D from across the department. This includes a dedicated specialist team focusing on compliance with the R&D small and medium-sized enterprises (SME) scheme, as well as teams working with large businesses on the RDEC scheme. These teams work with HMRC’s specialist Fraud, Risk & Intelligence colleagues as well as with customer service colleagues, lawyers, and policy teams to support R&D claims and tackle error and fraud.

The specialist R&D team focused on SME compliance has more than doubled in recent years in response to the growing levels of error and fraud. This team is part of HMRC’s Incentives and Reliefs area of the business. Incentives and Reliefs teams undertake compliance activity on R&D as well as other reliefs, including Creative Industries and Venture Capital. The total FTE for this wider team (excluding teams in Large Business, Fraud Investigation Service and Risk and Intelligence Service) is 245 and includes staff at all grades, working across the range of incentives and reliefs

6. In what percentage of enquiries, where claims are challenged as fraudulent, is HMRC successful? And how much tax relief is recovered from enquiries into R&D claims in general (i.e., whether fraud is in point or not)?

So far in 2022-23 claims are determined to be inaccurate in 84% of closed 1-2-1 enquiry cases in the SME R&D scheme. Of those R&D claims challenged and closed in 2022-23, the average additional amount due as a result of the inaccurate claim is £128,000. Although closed in the current financial year, these enquiries may have been opened in previous years.

These statistics exclude our Mandatory Random Enquiry Programme as this programme is not yet complete. Also, by its very nature of being a random enquiry programme, it is not designed to be risk-based focusing on error or fraud.

Specifically looking at fraud, HMRC Fraud Investigation Service currently have eight live R&D criminal investigations covering over 1,300 claims. A recent operation, which is the subject of recent media coverage, has resulted in nine arrests, including one accountant suspected of failing to prevent criminal facilitation of tax evasion, and involves over 100 R&D relief claims, totaling over £16 million.

In response to the separate criminal attack in April 2022, between 15 June 2022 and 21 September 2022, HMRC Fraud Investigation Service (FIS) wrote to 1,685 claimants (who are not already part of a criminal investigation). The letter explains that their claim has triggered an alert on HMRC systems and has caused HMRC to believe that they have fraudulently claimed money to which they are not entitled. So far, 80% of these claimants have failed to respond within the 30-day response window, indicating that we are targeting appropriately. A further 15% required further investigation after they'd replied to the letter with more information about the claim. This action suggests action has been proportionate and it has resulted in HMRC having protected £46 million of public money to date, with work ongoing that will see this figure increase.

7. What is your estimate of how much R&D relief is likely to cost over the next five years (or if that information is not readily available, the life of this parliament)?

Government estimates for the forecast cost of R&D tax reliefs prior to the reforms are set out in Table 2 below. The Treasury has produced a forecast using the OBR's latest determinants.

Table 2: Forecast receipt cost of the reliefs pre-R&D review reforms (£ million)

Scheme	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
SME scheme	4,200	4,200	4,900	5,200	5,600	6,200	6,700	7,300
RDEC scheme	2,600	2,600	2,600	2,700	2,600	2,700	3,000	3,200
Total R&D tax reliefs	6,700	6,800	7,500	7,900	8,200	8,900	9,700	10,500

Following reforms announced at the Autumn Budget 2021 and the Autumn Statement 2022, the Treasury has estimated the forecasted cost of R&D tax relief as set out in Table 3 below.

Table 3: Forecast receipt cost of the reliefs post R&D review reforms (£ million)

Scheme	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
SME scheme	4,200	4,200	4,900	4,900	3,700	3,200	3,300	3,700
RDEC scheme	2,600	2,600	2,600	2,700	3,800	4,700	5,100	5,500
Total	6,700	6,800	7,500	7,700	7,600	7,900	8,500	9,200

Following the recent reforms R&D expenditure is estimated to increase to around £60bn by the end of the scorecard period, 2027/28. This forecast is provided on policy measures costed with the OBR so far. The government further aims to merge the schemes into one RDEC like scheme which may result in revised forecasts depending on the final policy design.

8. HMRC statistics show the number and amount of claims: but how does the Government measure the effectiveness of R&D relief as per its policy objective? Given the cost of the relief, how is the Government continuing to monitor that it represents value for money?

HMRC has an ongoing evaluation programme that includes recent evaluations of the impact of the two R&D tax reliefs on business spending, which is known as additionality – the amount of extra units of R&D business spending that takes place per unit of tax subsidy.

The most recent studies from HMRC, published in 2019 and 2020, show that for every £1 of support, the RDEC incentivised £2.40 - £2.70 of additional private R&D expenditure, and the SME scheme incentivised £0.6 - £1.28. A number of independent studies in the UK and across the OECD have found that R&D tax reliefs incentivise additional R&D than would have otherwise happened, which has a positive impact on spillovers both regional and sectoral.

HMRC will also continue to monitor year-by-year costs and claims. The Government keeps all tax reliefs under review, to ensure they strike the right balance between keeping taxes simple to administer, well-targeted and effective.

9. How is the success of the draft Finance Bill proposals, particularly around combatting fraud, to be measured? In terms of the new compliance measures, how will you test their effectiveness? For example, what impact are they expected to have on the number of fraudulent claims in the next five years?

The Government’s aim through the measures in the draft Finance Bill is to progressively reduce the level of error and fraud over future years.

Each measure is designed to contribute to reducing error and fraud as part of a package:

- Requiring all claims to be made digitally will ensure that HMRC has information available, in digital form, to enable easier risk assessment of claims.
- The requirement that each claim should be accompanied by additional information will mean that HMRC has information about the claimed R&D and a breakdown of the types of expenditure, helping risk assessment.

- Requiring each claim to be supported by a named officer of the company will address claims being submitted by agents without the company's knowledge or understanding.
- Requiring details of any agent associated with the claim will allow HMRC to spot the involvement of agents with a track record of facilitating spurious claims
- The new claim notification requirement will limit the ability of agents who facilitate spurious claims to do so for earlier years where a company has correctly not previously claimed the relief. It will also provide information and time for HMRC to reach out, on an educational basis, to companies whose claims do not appear to be genuine R&D before the claim comes in.

Measuring the success of these measures requires a good understanding of the baseline levels of error and fraud. HMRC is currently conducting a Mandatory Random Enquiry Programme (MREP) to build that better understanding, and this could show that our current levels of error and fraud are underestimated.

HMRC has agreed to provide a more accurate estimate of the error and fraud to the Public Accounts Committee by summer 2023. This will be alongside a clear action plan to reduce error and fraud. Any further measures to combat error and fraud will be announced separately.

HMRC regularly assesses criminal intent and capability to abuse R&D relief schemes. HMRC will also monitor the effectiveness of the new compliance measures through this lens.

10. Please tell us about the “one to many” letters HMRC recently used to counter abuse of R&D claims, and why HMRC has adopted this approach.

HMRC is undertaking one-to-many (OTM) compliance activity into sectors it would not normally expect to see claims from in order to reduce the risk of non-qualifying claims being paid. This will help support around 6,500 customers to make sure any claims they make are accurate and in line with the rules.

This activity is undertaken post-payment/claim and the first of these projects launched in October 2022 and involved HMRC contacting around 1000 customers who had made a claim for the first time. The aim is to educate customers to prevent future errors. The letter signposts customers to HMRC guidance on gov.uk and includes a reminder of customers' responsibilities. Customers are then asked to amend any incorrect claim via their Government gateway.

The second project is scheduled to launch in late November 2022. HMRC have identified claims from some industries that are unlikely to have undertaken activities that would qualify for the relief. These customers will be contacted as HMRC opens enquiries into the R&D aspect of their tax return and will be asked to provide further information in support of their claim.

The OTM approach is a cost effective and proportionate way for HMRC to highlight to higher volumes of customers that they might not have fully understood the qualifying criteria when claiming.

In addition to these OTM activities HMRC Fraud Investigation Service (FIS) have also written to 1,685 claimants as detailed in response to Question 6.

11. Some witnesses have told us that specialist R&D units which used to exist have been shut down and those now working on R&D claims are less experienced and skilled. Why and when were these units abolished, and is there any reason why they should not be reinstated?

R&D Specialist Units have not been shut down, rather HMRC now has a national team instead of separate groups in different locations.

The Corporate Intangibles Research & Development (CIRD) manual published on gov.uk refers to R&D Specialist Units, in that R&D claims made by companies who do not have a Customer Compliance Manager, will be dealt with by one of the specialist units.

Previously part of the CIRD guidance referred to the specific locations of the historical R&D Specialists Units across 3 sites. This guidance has been updated to remove this reference as it is no longer accurate. HMRC's R&D specialists are now located in more geographical locations, operating as a national business, as HMRC have expanded its R&D compliance resource. Customers are given a mailbox address to contact the R&D teams rather than there being referred to units in specific locations.

HMRC is increasing its resource on R&D and has training programmes in place to help new staff develop their knowledge and understanding as R&D specialists.

12. Our witnesses saw no added value in the proposal to require a senior officer of a company to endorse a claim to R&D. Why does HMRC want this particular endorsement, and how does this help HMRC's compliance activity?

This measure is designed to improve accountability within companies over the content of the R&D claim by ensuring that an officer of the company has properly reviewed the claim, including the additional information also required as part of this package. HMRC have encountered scenarios where agents have submitted spurious claims and where the company subsequently denies that it claimed or knew what the claim was for, and this will prevent this.

13. Witnesses supported digital claims but felt that this would not result in simplification given that it just means another digital submission. Please set out what will be involved in the online process and how might it be simplified.

HMRC is developing a new service via gov.uk which will require a simple form, including details of the R&D project (in the case of a company with many projects, details of a sample), a breakdown of the expenditure by category (e.g., staff costs, externally provided workers etc.) and details of the company senior officer and any agent involved.

This is alongside and in addition to the current online CT process, which most companies already use. It does represent an additional task for the company but is a reasonable and proportionate requirement to increase HMRC's ability to do appropriate risking of claims.

14. How does HMRC know/test whether something is innovative when considering a particular claim?

R&D is defined (in BEIS Guidelines) as taking place when a project seeks to achieve an advance in science or technology. The activities that directly contribute to achieving that advance, through the resolution of scientific or technological uncertainty, are R&D.

The BEIS definition goes on to provide details of what each of the terms means and some examples to illustrate various issues and distinctions.

The BEIS definition is based on the international OECD (Frascati) definition. However, the BEIS definition is narrower in that it restricts R&D to advances in science and technology. The Frascati definition also includes advances in other fields of human knowledge, such as social sciences.

HMRC guidance in the CIRDS manual supplements the BEIS definition to assist in determining whether a project qualifies for R&D tax relief. For example, HMRC guidance provides further information on distinguishing between an R&D project and any wider commercial project.

Policing the definition of R&D can be complex, given that its frontier is constantly moving forward. However, the sorts of examples that have been discussed in recent media coverage and before the committee do not involve subtle issues of interpretation. These kinds of activities clearly sit outside of the definition of R&D, and HMRC will challenge such cases.

The additional information requirements which are being introduced from April 2023, including that the company must explain upfront what scientific or technological advancement they are seeking to achieve, will strengthen HMRC's ability to identify and challenge invalid claims

15. What steps does HMRC take to learn from how other countries use their tax systems to support R&D to ensure the UK remains competitive?

Over the course of the review, the Government has reviewed OECD international comparisons. The Government monitors these in terms of competitiveness (rates, what is included and excluded), design (which taxes are used, are payments available, are they capped or otherwise limited) and operation (how does the company apply). We hold conversations with other tax administrations to understand how their reliefs work, and to discuss issues of mutual concern.

In 2021 the UK spent more than any other OECD country as a percentage of gross domestic product on R&D tax reliefs and had the highest number of claims. RDEC was ranked 24th on generosity using the OECD methodology. The reform announced at Autumn Statement ensures that taxpayer support is effective as possible, the competitiveness of the RDEC scheme is improved, and is a step towards a simplified, single RDEC-like scheme for all.

All of this is taken into account in designing and operating the R&D reliefs, although differences between tax and administration systems mean that experience is not always comparable – for example the UK reliefs are claimed, in arrears, under a self-assessment system, so the experience of a country which uses pre-approvals may be different.

Thank you for your questions, I look forward to reading your report.

Yours sincerely,

A handwritten signature in purple ink that reads "Victoria Atkins". The signature is written in a cursive style with a large initial 'V' and a long, sweeping underline.

VICTORIA ATKINS MP