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Dear Sirs

**Preventing abuse of the R&D tax relief for SMEs:
Second consultation**

We welcome the opportunity to respond to the March 2020 Consultation Document regarding the proposed PAYE/NIC cap for SME R&D tax credit claims. Since 2006 we have acted as advisers to companies making claims for R&D tax relief and R&D Expenditure Credit across a broad range of industry sectors.

We support the efforts by HM Treasury and HM Revenue & Customs to tackle abuse of the R&D tax incentive schemes through fraudulent activity and artificial avoidance. The R&D schemes are a valuable source of support for innovative businesses in this country and it is important that they are targeted at genuine UK companies. A cap based on a company's PAYE and NIC liabilities is a reasonable proxy for identifying these. At the same time, it is important that any measures do not have an unfair adverse impact on businesses that have structured their employment arrangements in a particular way for bona fide commercial reasons. We recall seeing instances of this during the previous PAYE/NIC cap regime prior to 2012.

By way of background we have identified that some 5% of our clients would be affected by the proposed cap. When the original PAYE/NIC cap was in place a similar number of clients were so impacted.

We present our responses to the various questions below.

Question 1 Does your business subcontract to a related party or use EPWs provided by a related party? Would it be useful to be able to include the PAYE/NICs attributable to these workers in your payable credit?

As advisers to companies claiming R&D tax credits we have seen numerous situations where clients have subcontracted to or used EPWs from connected parties. We believe it is sensible and fair to use the PAYE/NICs of related parties but see our response below.

Question 2 Would it be practical to obtain information on attributable PAYE/NICs from EPW providers in order to increase the level of your cap?

Whilst it would be possible in most cases to capture the attributable PAYE/NIC, we feel that it is unnecessarily restrictive to limit the connected parties' figures to that relating to R&D workers as proposed. We see no reason why the limit should not be the same as for the claimant company itself i.e. based on the total PAYE/NIC relating to all employees. In this situation the limit could be restricted to one times the PAYE/NIC. If the intention is to target the credit at genuine UK businesses then surely companies under common ownership where at least one is in the UK, employing staff and generating payroll taxes here would meet that criterion.

One additional aspect of the EPW rules is where staff have employment contracts with both the claimant company and the company directly employing them and paying their salaries. Here, a claim under the EPW provisions is disallowed because of Condition B at CTA 2009 S.1128. This would appear also to prevent that individual's PAYE and NIC from counting towards the cap since they would not be within the definition of EPW. In our view there should be an exception made for such a situation or better still the opportunity should be taken to remove the condition completely, since it does not appear to serve any purpose other than to prevent claims for genuine R&D expenditure.

Question 3 The government welcomes views on the sorts of activities which are undertaken to manage IP, as well as the types of information and evidence on the active management of intellectual property, which genuine claimant businesses would be able to provide in supporting their R&D tax relief claim

In our experience many SME companies would have difficulty satisfying the IP management test, not because there is no genuine IP but because formal recognition of IP and active management of it is rare amongst smaller companies. Many businesses do not register IP, the main reasons being cost and commercial sensitivity, and hence it would prove difficult to obtain evidence to demonstrate meeting any test. Software companies in particular seldom take steps to register ownership of IP and patents for software are uncommon.

Question 4 Does your business subcontract work to a related party, (including using EPWs provided)?

Modern product development activities often involve a range of technologies and as a result, it is very common for the 'lead' company in a product development effort to require the support of specialists in specific areas relating to their R&D projects. A high proportion of our clients' R&D projects involve EPWs on this basis.

Question 5 Where your business does subcontract to a related party, does this represent less than 10% of R&D expenditure? If no, please provide an indication of the percentage of your claim related party subcontracting does represent

We have had instances where a client has either subcontracted much of its R&D work to or used EPWs from (representing significantly more than 10%, in one case as much as 100%) a related party. However, in these situations the companies would have been able to use the PAYE/NIC of the other party to cover the R&D tax credit claimed.

As a general point on the dual IP/related subcontract or EPW test, we would not expect SME companies to welcome the additional compliance burden. The SME scheme already contains numerous complexities such as mixed SME/RDEC claims for subsidised expenditure as well as the SME test itself.

Example of how the cap might work in practice

Whilst writing, we would draw your attention to an error in the first example in your Annex. It is stated the company is loss making and the additional deduction increases the loss by £65,000 but in your calculation only the £65,000 is surrendered for a payable credit, instead of including the lower of the pre-R&D claim loss or the actual qualifying expenditure of £50,000.

I hope our response is useful in adding to the discussion on the proposals. If there is anything you need clarification on or to discuss more fully please let me know.

Yours sincerely

A handwritten signature in black ink, appearing to read "Richard Lewis".

Richard Lewis
Pronovotech