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HM Treasury
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By email: RDTaxReliefs@hmtreasury.gov.uk

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Re: Technical consultation on draft legislation to implement R&D measures in the Finance Bill 2023-24

The BVCA is the industry body and public policy advocate for the private equity and venture capital ("private capital") industry in the UK. With a membership of around 650 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. In 2022, £27.5bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside of London and 90% of the businesses receiving investment are small and medium-sized businesses.

We are writing in response to the technical consultation on the draft legislation published for Finance Bill 2023-24 in respect of additional tax relief for R&D-intensive small and medium-sized enterprises (SMEs) and the potential merged R&D scheme. We would make the following comments.

A single scheme

While we welcome the additional tax relief for R&D-intensive SMEs, we are concerned that running the two schemes (the merged RDEC and the SME code for R&D-intensive companies only) side-by-side would retain existing complexities and introduce additional cliff-edge effects. Given the Government's stated aim of achieving simplification, it should be possible to implement a single merged RDEC scheme, but with higher rates of credit for companies that qualify as R&D-intensive SMEs. These could have a self-contained definition within the new single scheme, without the need to refer to EU rules for the definition of an SME.

Cliff-edge effects

The 40% test in the R&D intensity condition in new s 1045ZA would lead to cliff-edge issues for businesses that meet the test in some years but not others. This is particularly pronounced if, as per our previous point, there continue to be two separate schemes (the merged RDEC, which provides relief "above the line", and the SME code for R&D-intensive companies, which operates "below the line").

The differences in the ways in which these schemes operate mean that businesses that flip between the two can see significant year-to-year variations in their profits before tax, and therefore in their valuations. This can have serious adverse consequences for businesses' commercial success, for instance leading to potential breaches of banking covenants (which may require borrower companies to maintain a minimum level of profits before tax) and having a direct effect on managers' remuneration (which may be linked to their employer company's profitability).

This is an additional reason for our recommendation that there should only be one scheme going forwards. In any event, we would also recommend the Government to consider introducing provisions to smooth this cliff-edge effect, for instance by assessing a business' percentage expenditure on R&D over a period of several years, in circumstances where the threshold might be breached in a single year.

The R&D intensity condition

An additional point on the R&D intensity condition in new s 1045ZA is that the definition of "relevant R&D expenditure" lacks precision and could be open to abuse. The accounting treatment is not set in stone and there are instances in which, entirely legitimately within acceptable accounting standards, the same costs or income could be classified in two alternative ways, which would result in two very different figures for R&D expenditure. In order to avoid the potential for abuse, we would suggest that the Government works with accounting representative bodies to develop standardised rules on how R&D expenditure should be calculated for this purpose. We can assist with identifying appropriate contacts if this would be helpful.

Pre-trading expenditure

We note that the new merged scheme in Chapter 1A of the draft legislation does not include a provision, similar to CTA 2009, s 1045 in the existing SME rules, to enable businesses to claim in respect of pre-trading R&D expenditure. We would urge the Government to consider including such a provision. Science and technology focussed businesses often need to invest significant amounts of capital for substantial periods before they commence trading, and financial support in this early stage is vital for the viability of these businesses. For example, innovators in the field of drug discovery are not able to market their products until they have received the necessary regulatory approvals, which can be many years after their initial investments in the related research projects.

Sub-contracted expenditure

The draft provisions on sub-contracted expenditure (new s 1042E and associated provisions) have the effect that only the principal (the business that has engaged the sub-contractor) can claim the new RDEC for R&D expenditure incurred by a sub-contractor. In practice, the principal may not be aware that the sub-contractor has incurred expenditure on eligible R&D, with the result that no one would be able to claim in these circumstances. In addition, no claim is possible if the principal is not a UK taxpaying entity, for instance if it is a government body, an overseas company or a charity. The result is likely to be that eligible R&D activity misses out on tax relief, despite being the type of activity that the relief is intended to incentivise.

We would continue to advocate, as we did in our response to the related consultation in March this year, for the merged scheme to provide maximum flexibility by allowing subcontractors and principals to elect as to which of them should be able to claim relief for subcontracted R&D expenditure.

Subsidised expenditure

We note that the draft legislation provisionally excludes subsidised expenditure from eligibility for the new RDEC, but that this exclusion is described as still being under consideration. We would observe that this is a complex area that needs to be considered in tandem with the rules on subcontracting. If there is a unified merged regime which includes coherent and effective rules for subcontracted expenditure, there should not need to be separate rules on subsidies.

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Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of these issues in more detail (please contact Rachel Gauke at rgauke@bvca.co.uk).

Yours sincerely

Maria Carradice

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Chair, BVCA Taxation Committee