HM Treasury and HM Revenue & Customs
By email: RDTaxReliefs@hmtreasury.gov.uk

2 June 2021

Dear Sir, Madam,

Re: BVCA response to the consultation on R&D Tax Reliefs

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital ("PE/VC") industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

Importance of R&D tax credits in the PE/VC industry

R&D tax credits play an important role in the companies that BVCA members invest in and are an efficient way of ensuring that companies can easily reinvest in their future growth. Venture capital, growth capital, and private equity funds have a strong track record of supporting and growing the types of R&D intensive companies that will help the Government meet its ambition for total R&D spend to reach 2.4% of GDP by 2027. Our members invest in companies that are critical to the growth of the UK economy, including start-ups, university spin-outs, high growth tech companies, and established businesses in the most innovative sectors of the economy, which make positive contributions in terms of GDP and employment[1]. The BVCA Report on Investment Activity shows that our members invested a total of £1.3bn in IP/technology rich firms across the tech sector in 2019, which included sectors such as biotech and life sciences that received £310m of investment across 105 companies[2].

Key recommendations

BVCA members have reported that their portfolio companies encounter difficulties in obtaining repayable R&D tax credits where HMRC have suggested that, when testing whether a portfolio company meets the size requirement (taken from the EU definition of a SME) the figures of all portfolio companies of funds with a common manager should be aggregated. We believe there is no economic justification for aggregating portfolio companies in a single fund (as each portfolio company "stands on its own" and the resources of other portfolio companies or the fund are not available to it), still less portfolio companies of different funds with the same manager. Now that the UK is no longer required to follow EU law, the SME definition should be operated in a way which recognises portfolio companies as the independent enterprises they are.

We were supportive of the proposals in last year's consulation on scope of qualifying expenditures for R&D tax credits as the UK faces competition from other jurisdictions that would like to attract high-value, R&D-intensive companies. The generation and use of data for R&D is increasing exponentially,

[1] See the BVCA 'New Horizons' report – available here
[2] BVCA Report on Investment Activity 2019 – available here

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and how software is defined under the current rules can be updated to reflect how research is carried out on cloud-based systems. Data and cloud computing are integral to how R&D is conducted across all tech sectors and we are pleased to see that the government is considering how to bring data and cloud computing costs into the scope of reliefs.

We have only answered certain questions based on the feedback we have been able to receive from members. We will follow up with further feedback as it arises.

Response to consultation questions

Structure and Administration

Question 3: What do you think explains the difference in additionality between the two schemes? How could the schemes be improved to incentivise the R&D your business does or might consider doing? Can you give evidence to support your suggestions?
Question 4: To what extent do the rates of relief available to you impact your investment decisions and/or your choice of location? Is the balance of relief between the two schemes appropriate? Is there any evidence of significant deadweight where investment decisions would proceed without relief?

Feedback from BVCA members shows a preference for access to the SME scheme as this is significantly more advantageous than the RDEC scheme. We have heard of experiences from members where start-ups have lost access to the SME scheme after being acquired by a PE/VC fund or a large company. Please refer to further detail in our answer to question 9. Specifically for tech busiiesses, it would be beneficial if the SME status threshold were increased to better reflect and the level of investment required prior to scalability.

Question 7: How can the responsibilities of HMRC, agents and the company be better reflected in the claims process?
Question 8: What other changes might help claims to be dealt with more smoothly, while ensuring better compliance? Is there a way HMRC and advisers can work more effectively to improve the quality of external advice available to companies? If you claim R&D tax reliefs in other countries, how does the claim process differ and what are your views on this?

BVCA member portfolio companies have reported challenges interpreting what constitutes a qualifying R&D cost for non-technical teams. Currently, there are no clear guidelines on how to calculate these costs, or what to include in a claim for roles that include a mix commercial, technical and operational activities. It is uncommon, especially for small businesses, to have the resources to precisely track each individual's hourly activity. In order to simplify a companie's R&D claim process and the HMRC review, the following suggestions have been made:

- The creation of an official 'rate-card' to be applied for specific roles and potentially other characteristics of the business (e.g. whether they are in tech or the stage of their growth journey).

- A system where companies apply for an HMRC-approved R&D certificate (similar to those used for the EMI valuations) based on their level of development and technical sophistication. After a company applies, it would be reviewed at regular intervals by HMRC inspectors. Then, based on the certificate, a company's payroll system would calculate the

qualifying portion of salary costs attribtied to R&D. Potentially, it could generate a PAYE credit from the monthly payroll run. This would vastly simplify the R&D process and would improve the business cash-flow compared to current timings for R&D refunds.

Qualifying expenditures and R&D definition

Question 9: Is there evidence to suggest areas of activity other than those currently covered by the R&D definition drive positive externalities which should be recognised by the tax system?

Yes. There are many businesses managed by PE/VC funds that ought to benefit from the R&D tax reliefs but are prevented from doing so because of how their ownership is structured.
BVCA members have reported portfolio companies encountering difficulties in obtaining repayable R&D tax credits where HMRC have suggested that, when testing whether a portfolio company meets the size requirement (taken from the EU definition of a SME) the figures of all portfolio companies of funds with a common manager should be aggregated.

The vast majority of PE/VC funds are not required by UK and international accounting standards to prepare accounts which consolidate the portfolio investments, including in cases where the investment fund holds a majority of the shares and/or voting rights in the underlying company. This is appropriate because each of those underlying companies (together with its subsidiaries) is operated independently, with its own financing structures and management. It would not make sense to treat the companies as a single entity for financial reporting purposes and would give rise to misleading information for the users of the financial statements and narrative reports.

However, this treatment is not consistently applied across all legal, tax and reporting regimes, even though the same logic applies, and the differences frequently give rise to complexity and anomalous results. The EU definition of an SME and concept of linked enterprises is also another cause of these issues. There is an opportunity to change this inconsistent and illogical treatment now that the UK is no longer a member of the EU.
In order to address this issue, we would propose that the Government makes clear that, unless the contrary is clearly provided and policy considerations make it essential, any tax, legal and regulatory provisions should not treat PE/VC funds or fund managers as parent companies or parent undertakings, and that portfolio companies should not be treated as members of the same group as each other or otherwise associated for any relevant purpose. Future legislation should take account of that general statement of principle.

Our introductory comments summarise the role of the industry in investing in innovative businesses and these ought to benefit from the same reliefs as companies that have not received investment from a PE/VC fund.

Question 10: Do you think R&D tax reliefs could better incentivise R&D with specific social value, for example developing green technology? Could R&D tax reliefs be used to disincentivise R&D in certain fields?

The UK's green technology and green finance ambitions will require investment in early stage technology and entrepreneurs. Case studies in the BVCA's 'New Horizons' report show companies rethinking how we shop, to reduce packaging; to companies pioneering low carbon electricity and services; to companies revolutionising textiles manufacturing to reduce our reliance on high carbon materials. In addition to this, many VC-backed companies are developing technologies to support

business reduce carbon emissions and achieve net zero targets. R&D tax reliefs in this area will further support businesses who will in turn reinvest funds to further their growth.

Question 11: What is your experience of conducting R&D in different regions across the UK? How do R&D tax reliefs benefit these activities, and how could the offer be improved to better support these activities?

PE/VC firms have created an investment footprint in all parts of the UK, supporting a wide range of communities and business sectors. Of the £43bn invested by BVCA members into 3,230 UK businesses from 2015- 2019, £2.3bn of this was in Scotland, Northern Ireland and Wales, £4.5bn into the Midlands and £6.6bn in the north of England5. Some of the most exciting new developments in particular sectors, such as pharmaceuticals, medtech and AI, each supported by venture capital, are having a positive impact across the UK - and this is expected to continue: Bristol, Manchester and Edinburgh received substantial venture capital investment to fund university spinouts in 2020.

Our response to questions 9 and 12 would further benefit these activities.

Question 12: Are there any other areas of qualifying expenditure that should be included within the reliefs? How would this influence your investment decisions?

In our previous submission we explained that whilst software licence costs do qualify for R&D tax credits at present, but the current regime does not reflect the way modern companies use data. Software that is long established and recognised by HMRC is easily processed under R&D claims, but newer software often does not qualify or takes longer to be claimed for if it is not already established and recognised by HMRC. Software costs that are included as part of cloud computing are also hard to identify which make it difficult for companies to claim for these costs and for HMRC to identify them. Aspects of cloud computing such as storage rental, support and processor running times do not currently qualify, and these are important in the development of large datasets.

Cloud computing licences are very expensive and play a key part in the development of data in the R&D process. They often make up a large proportion of a company's R&D expenditure, especially at the start-up stage, and cannot be claimed for under the current R&D tax credits system. The feedback we have received suggests that server costs are usually the third biggest item in the budget in SaaS/Tech start-ups after salaries and rent, therefore including them would make a significant difference cash-wise.

We believe that more of the costs incurred in the generation, processing or analysing of datasets should be eligible for relief under the R&D tax credits regime. It is now widely accepted that the use of these datasets is a key driver in the creation of new technology and is an area that has developed exponentially in the last decade[3]. Companies incur high costs when producing large, sophisticated datasets that are used in AI and other types of advanced software, which are often key to the growth of start-up companies. These raw datasets also require processing and analysis before they can be properly studied, often using cloud-based software and storage. This is a costly but highly productive process where value is generated, but one where companies cannot claim under the current R&D tax credit system.

[3] As outlined in the DCMS National Data Strategy in September 2020

The formulation of datasets and the use of cloud computing would allow more companies to include R&D tax credits in their business plan and therefore make additional investments in R&D as they plan for future growth.

We would be very keen to discuss the contents of this letter with you and look forward to hearing from you.

Yours faithfully,

Mark Baldwin
Chair
BVCA Taxation Committee