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How might the R&D tax relief regime review affect investment in the life sciences sector?

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Introduction

In the 2022 Autumn Statement, the chancellor announced a review of the fiscal landscape governing the United Kingdom's "five key growth industries", one of which is life sciences, to "reduce unnecessary regulation and boost innovation and growth". In 2020, by the UK government's own estimate, the life sciences sector had an annual turnover of £89 billion. That number is seemingly one which is growing – so-called "healthtech" venture capital investment in the United Kingdom increased by 245% between January and November 2021 compared to 2020, making it the third most attractive location globally for inward investment projects.(1)

As UK investment in this sector continues to grow, a natural consequence is that the research and development (R&D) tax regime will play a key role in incentivising investment by reducing the costs of innovation. To that end, recent proposed changes to the United Kingdom's R&D tax regime (among other things) extend the availability of these reliefs and tighten up compliance requirements under the regime.

This article focuses on some of the recent developments coming out of the UK government's review of the R&D tax relief regime and how those changes might impact R&D investment in the life sciences sector. To summarise the background of the recent changes, on 20 July 2022, the UK government released draft legislation intended to implement a number of changes to the R&D tax relief regime in the United Kingdom with those changes largely being focused on small and medium-sized enterprises (SMEs). These reforms were aimed at addressing a number of issues identified by the UK government in its March 2021 consultation and the summary of responses published in November 2021. This was followed by further announcements in the 2022 Autumn Statement (presumably upon a fresh review by Jeremy Hunt when he took over as chancellor in October 2022) where the UK government somewhat refocused its efforts on R&D investment by large companies.

SMEs – deductions, tax credits and growth

In 2020, SMEs made up 85% of life sciences businesses in the United Kingdom, employed 24% of the industry total and generated 10% of the turnover.(2) The hoped-for trajectory for a start-up will often be that a large company offers to buy out the founders and/or seed stage investors at a point when the start-up is still a SME. In such cases, cash tax credits available to the target company under the United Kingdom's R&D regime would likely be valuable assets and sellers may request to receive the benefit of any such credits available in respect of the accounting period current at closing. Under the current legislation, this would likely create an additional hurdle to the deal-making process.

The legislation currently provides that, if an SME loses SME status during an accounting period – for example, because the SME is acquired by a "large company" and therefore breaches the employee or financial limits necessary to qualify as an SME – it loses its entitlement to R&D relief (as it applies to SMEs) in respect of the entire period. The proposed changes published on 20 July 2022 include new transitional period provisions. These new provisions would, in certain circumstances, effectively grandfather SME status for the entire accounting period during which it is lost. This means that the taxpayer in question may continue to submit a claim for R&D relief in respect of that entire period, notwithstanding that, in reality, the taxpayer will have lost its SME status at some point during that accounting period. This may prove particularly useful going forward where SME status is lost on closing in a transactional context.

Notably, and in stark contrast to the treatment large companies received, in the 2022 Autumn Statement there came a twofold scaling back of the R&D tax regime as it applies to SMEs – both of which will come as unwelcome news for SMEs and those seeking to invest in SMEs. The first change is the reduction of the "enhanced deduction" available to SMEs of 130% of qualifying R&D expenditure down to 86%. The second change is the reduction of the payable cash tax credit from 14.5% down to 10%. However, to an extent, these should not be viewed as two wholly independent changes because the reduced 10% cash tax credit available to SMEs is calculated on the basis of the reduced 86% "enhanced deduction" (rather than 14.5% of a 130% "enhanced deduction").

Large companies and RDEC

On the other hand, the headline rate increase of the Research and Development Expenditure Credit (RDEC) scheme from 13% to 20% of qualifying R&D expenditure, incurred on or after 1 April 2023, announced in the 2022 Autumn Statement, will come as good news for large pharmaceutical and life sciences companies in the United Kingdom incurring or planning to incur large amounts of R&D expenditure. This is effectively a taxable credit that may be used to offset liability to UK corporation tax or claimed as a cash payment. This increase may signify a broader move to support R&D activities for large companies in the United Kingdom – especially in light of Jeremy Hunt's statement that the UK government is making these changes with a view to "rebalancing the reliefs" as between large companies and SMEs.

The UK government's rationale behind increased support for SMEs (as opposed to large companies) in this area was premised on the thinking that so-called "short-termism" should be discouraged and incentivising R&D investment at an early stage will discourage that in the long run, particularly where those same SMEs grow and eventually become publicly listed (as 4basebio – the specialist gene therapy and DNA vaccine company – did in 2021) where they may begin focusing more on creating immediate shareholder value rather than long-term investing.

The welcome change in tack as far as large companies are concerned is that the above thinking is now at odds with a recent Department for Business, Energy and Industrial Strategy research paper published on 9 November 2022, which found that "publicly listed companies invest up to 1% more of their assets in R&D when compared with similar private companies" and which generally reached conclusions that were "not consistent with the hypothesis that publicly listed companies are short-termist in their investment behaviour". As the UK government becomes increasingly comfortable that supporting large companies with their R&D activities is good value for (taxpayer) money, the more likely the balance of (tax) incentives moves towards benefitting large companies. R&D can be a large source of expenditure for even the biggest listed life sciences companies. For example in 2021, GSK announced an expansion of its core R&D hub in Stevenage, England with an estimated cost in excess of £400 million.

Compliance and mitigating abuse

While not an issue specifically coming out of R&D investment in the life sciences sector, the summary of responses to the 2021 consultation noted that "concern over abuse and boundary-pushing involving the R&D tax reliefs has grown in recent years" and that "HMRC [His Majesty's Revenue and Customs] has already allocated additional resources to R&D tax relief compliance". The draft legislation includes measures to improve compliance and combat abuse. It would require businesses to pre-notify HMRC of new R&D relief claims (or risk the claim itself being invalid) and to make R&D claims online through the HMRC portal. The R&D claims would have to be "endorsed" by a senior officer of the taxpayer company and include additional information, such as a description of the R&D undertaken and details of the relevant R&D adviser. The UK government hopes that these changes, once introduced, will tackle "abuse and boundary-pushing" in the system, without disadvantaging compliant businesses.

The increased requirements, however, in terms of supporting documentation are likely to impact the life sciences sector. In order to meet the proposed expectation that filings should be accompanied by details on what expenditure the claim covers and the nature of the scientific advances and uncertainties, it is possible that many life sciences companies will need to revisit their submissions and claims processes to ensure ongoing compliance. Documentation needs to ensure the appropriate level of technical depth to satisfy HMRC's requirements, yet be clear and concise – this is likely to require input from specialists.

The relationship between these additional compliance requirements and powers being granted to HMRC to tackle fraud should be viewed together with the twofold scaling back of the SME R&D tax regime discussed above. Indeed Jeremy Hunt has made his view clear that it is the "generosity of the [SME] relief making it a target for fraud" and the hard reduction in the cash tax credit benefit was intended to further address the aim of mitigating abuse.

Comment

It is clear that the UK government's reform of the R&D tax regime is not at an end and as a result those interested in life sciences sector investment should be monitoring this area closely. As he highlighted life sciences as a key growth industry, Jeremy Hunt reiterated the UK government's commitment to public spending on R&D of £20 billion by 2024-5 to hit the target of UK R&D expenditure reaching 2.4% of gross domestic product by 2027 (which data suggests the United Kingdom is close to meeting).

Perhaps the largest potential change to the R&D tax regime is the UK government's proposal to explore and consult on the design of a single R&D tax regime (something which was floated in the UK government's 2021 consultation but failed to gain traction following responses). To what extent a single R&D regime would further incentivise R&D investment (and indeed, how that might affect R&D investment in the life sciences sector) is unclear.

One thing is for certain, however: the Treasury is focused on looking for "better value" and once again the R&D tax regime is on its radar.

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Endnotes

(1) See "2022: The year for UK Life Sciences? - Bioscience Today" and "Life Science Competitiveness Indicators 2021".

(2) See "Life sciences - what's next for this top UK sector" and "Bioscience and health technology sector statistics 2020".