Reprinted from British Tax Review Issue 4, 2023

Sweet & Maxwell
5 Canada Square
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London
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(Law Publishers)

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Finance Act 2023: Section 4: amount of relief for expenditure on research and development

Section 4 of the Finance Act 2023 (FA 2023) makes various changes to the rates of relief in respect of both 1) the research and development expenditure credit (the RDEC) (which generally applies to "large" companies[1]) and 2) the research and development expenditure relief regime for small and medium enterprises[2] (referred to as SMEs) (the SME Regime).

Background to the changes in FA 2023

Since the publication in July 2020 of the UK Government's *UK Research and Development Roadmap* which set the goal of "revitalising our whole system of science, research and

[1] Corporation Tax Act 2009 (CTA 2009) Pt 3, Ch.6A, s.104K(5)(a).
[2] CTA 2009 Pt 13, Ch.2.

innovation”,[3] it has become somewhat of an understatement to say that the tax landscape of reliefs and incentives has been evolving in respect of expenditure on research and development (R&D).

The first step was taken in March 2021 when the UK Government launched a consultation, *R&D Tax Reliefs: consultation* (the 2021 Consultation), exploring whether, in light of the UK Government’s broader policy approach of keeping innovation “at the heart of the UK’s strategy to boost productivity and economic growth”,[4] the UK’s R&D tax regimes were fit for purpose. In July 2022, draft legislation was released which was intended to implement some of the outcomes of that consultation.[5] That generally included legislation which had the effect of “expanding qualifying expenditure…refocusing support towards innovation in the UK” and “[targeting] abuse and [improving] compliance”.[6]

The UK Government’s focus on the R&D tax landscape has since culminated in yet another consultation, the *R&D Tax Reliefs Review, Consultation on a single scheme* (the 2023 Consultation)[7] which was launched in January 2023. The 2023 Consultation is the most wide-reaching yet, as that consultation invited views around the scrappage of the SME Regime entirely, in favour of a singular “RDEC-esque” regime which would apply to all companies, regardless of size. The *Summary of Responses* in respect of the 2023 Consultation noted that “many large companies were supportive of this”[8] but the same could not generally be said of SMEs, where even the responses which were supportive still “expressed reservations”[9] about a transition to a unified scheme. Nonetheless, at the time of writing this note, the draft legislation has been released for the Finance Bill 2023–2024[10] which 1) confers additional relief on “R&D intensive” SMEs in respect of their R&D expenditure[11] and 2) provides for a “new merged

[3] HM Government, *UK Research and Development Roadmap* (July 2020), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/896799/UK_Research_and_Development_Roadmap.pdf* [Accessed 27 July 2023], p.4, para.4.

[4] HM Treasury and HMRC, *R&D Tax Reliefs: consultation* (March 2021), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965501/Condoc_-_RD_review_.pdf* [Accessed 27 July 2023], para.1.1.

[5] HMRC, Policy Paper, *Research and Development Tax Relief Reform* (20 July 2022),*https://www.gov.uk/government/publications/research-and-development-tax-relief-changes* [Accessed 27 July 2023].

[6] HM Treasury, *R&D Tax Reliefs: report* (November 2021), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1037348/RD_Tax_Reliefs.pdf* [Accessed 27 July 2023], para.1.4.

[7] HM Treasury and HMRC, *R&D Tax Reliefs Review: Consultation on a single scheme* (January 2023), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1128970/20230113_R_D_Consultation.pdf* [Accessed 27 July 2023].

[8] HM Treasury, *R&D Tax Reliefs Review: Consultation on a single scheme. Summary of Responses* (July 2023), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1171402/Summary_of_Responses_-_RD.pdf* [Accessed 27 July 2023], para.2.2.

[9] HM Treasury, *R&D Tax Reliefs Review: Consultation on a single scheme, Summary of Responses* (2023), para.2.3.

[10] HMRC, Policy Paper, *Research and Development reform — additional tax relief and potential merger* (July 2023), *https://www.gov.uk/government/publications/research-and-development-reform-additional-tax-relief-and-potential-merger* [Accessed 27 July 2023].

[11] HMRC, Policy Paper, *Research and Development reform — additional tax relief and potential merger, Explanatory Note* (July 2023), *https://www.gov.uk/government/publications/research-and-development-reform-additional-tax-relief-and-potential-merger* [Accessed 27 July 2023], para.2.

research and development scheme"[12] but only "should the Government decide to introduce it".[13] This mirrors the UK Government's response in the *Summary of Responses* to the 2023 Consultation where it was emphasised that the UK Government is yet to take a decision "on whether to merge schemes, but intends to keep open the option of doing so from April 2024 with a decision being made at the next fiscal event".[14]

Section 4(2) FA 2023

The standalone change made, by section 4(2) FA 2023, to the RDEC was to increase the headline rate of the credit from 13 per cent to 20 per cent.[15] Generally, the RDEC works as an "above the line" credit; this credit appears as a taxable item in the taxpayer's income statement which reduces the taxpayer's liability to corporation tax.

The headline rate change was *formally* announced in Chancellor Jeremy Hunt's 2022 Autumn Statement (which, itself, was delivered by the Chancellor "at a time of significant economic challenge for the UK"[16] alongside record spending on debt interest[17] and the risk of the economy falling into recession in 2023[18]).

However, *informally*, an increase in the headline rate of the RDEC seemed to be brewing for some time. A headline rate increase for the RDEC had been implicitly floated in the 2021 Consultation, in which it was recognised that "compared to global competitors, the rate of relief provided by the SME scheme is significantly more generous than that provided by RDEC".[19] Some responses to the 2021 Consultation suggested that the RDEC "lags behind"[20] the SME Regime and that the headline rate of the RDEC should be increased—the UK Government, at the time, did not take that proposal forward (perhaps on the basis that only a single respondent had actually argued that the gap between the RDEC and the SME Regime should be closed).[21]

Despite the apparent failure by the UK Government to take a headline rate increase forward following the 2021 Consultation, the idea must have been on the minds of policy makers throughout 2022 because just a week before the 2022 Autumn Statement, the Department for Business, Energy & Industrial Strategy released a research paper which sought to dispel the

[12] HMRC, *Research and Development reform — additional tax relief and potential merger, Explanatory Note* (2023), para.1.
[13] HMRC, *Research and Development reform — additional tax relief and potential merger, Explanatory Note* (2023), para.1.
[14] HM Treasury and HMRC, *R&D Tax Reliefs Review: Consultation on a single scheme, Summary of Responses* (2023), para 3.2.
[15] CTA 2009 s.104M.
[16] HM Government, *Autumn Statement 2022* (November 2022), CP 751, *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1118429/CCS1022065440-001_SECURE_HMT_Autumn_Statement_November_2022_BOOK.pdf* [Accessed 27 July 2023], p.1, para.1.
[17] HM Government, *Autumn Statement 2022* (2022), p.1, para.2. Debt interest spending is expected to reach £120.4 billion in 2023.
[18] HM Government, *Autumn Statement 2022* (2022), p.1, para.1.
[19] HM Treasury, *R&D Tax Reliefs: consultation* (2021), para.3.9.
[20] HM Treasury, *R&D Tax Reliefs: report* (2021), para.A.14.
[21] HM Treasury, *R&D Tax Reliefs: report* (2021), para.A.14.

myth that large companies (particularly publicly listed ones) are "short-termist" in their R&D investment behaviour.[22]

Whilst that might suggest the increase in the headline rate was simply a product of a broader change in government policy to extract the best value for taxpayer money, the increase was equally motivated by the need to refocus efforts away from the SME Regime which was identified as having an ongoing problem with error, abuse and fraud (the SME Regime being responsible for approximately £430 million in fraud and error compared to just £39 million for the RDEC from 2021 to 2022[23]). HMRC also completed a new analysis for 2020 to 2021 and, in its Annual Report and Accounts published on 17 July 2023, the results of that analysis showed £1.04 billion worth of fraud and error within the SME Regime (equal to 24.4 per cent of public expenditure on the SME Regime).[24] It stands to reason, therefore, that the estimates for 2021 to 2022 are likely to be much lower than the reality. This is not a novel concern by any means; in the response to the 2021 Consultation, it was specifically noted that there was "concern over abuse and boundary-pushing"[25] in the SME Regime. The same point was made by the Chancellor himself in his 2022 Autumn Statement.[26]

Another motivating factor for the increase in the headline rate for the RDEC is perhaps best summed up by the phrase "return on investment". Before a meeting of the Finance Bill Sub-Committee in November 2022, the Financial Secretary to the Treasury, the Right Honourable Victoria Atkins MP (Victoria Atkins MP), admitted that the SME Regime had turned out to be far less value for money than the RDEC. The latest figures from 2019 and 2020 revealed that the SME Regime incentivised between 60p and £1.28 of R&D expenditure for every £1 invested; that paled in comparison to the RDEC, which incentivised between £2.40 and £2.70 of R&D expenditure for every £1 invested, over the same period.[27]

It is also worth pointing out here that the headline rate increase took effect in relation to expenditure incurred on or after 1 April 2023.[28] The alignment with the increase in the headline rate of corporation tax to 25 per cent is no coincidence. As described above, the RDEC works as an "above the line" credit, so the amount which appears "above the line" is subject to a higher corporation tax rate (which results in a higher corporation tax liability). It is that higher amount which is then reduced by the amount of the RDEC—in other words, as the corporation tax rate increases, the post-tax benefit of the RDEC decreases. Therefore, the stars had effectively aligned for a headline rate increase for the RDEC (and in any case, some keen-eyed respondents to the

[22] Department for Business, Energy & Industrial Strategy, *The impact of listing on business investment. Evidence from UK corporation tax data* (November 2022), BEIS research paper number 2022/018, *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1116391/impact-of-listing-on-business-investment.pdf* [Accessed 27 July 2023], p.46, para.1.
[23] HM Treasury, *R&D Tax Reliefs Review: Consultation on a single scheme* (2023), para.1.12.
[24] HM Treasury and HMRC, *R&D Tax Reliefs Review: Consultation on a single scheme, Summary of Responses* (2023), para.1.8.
[25] HM Treasury, *R&D Tax Reliefs: consultation* (2021), para 3.21.
[26] HM Government, *Autumn Statement 2022* (2022), p.18, para.2.14.
[27] House of Lords, Economic Affairs Committee, Finance Bill Sub-Committee, *Corrected oral evidence: Draft Finance Bill 2022-23* (21 November 2022), *https://committees.parliament.uk/oralevidence/11607/pdf/* [Accessed 27 July 2023], Q65.
[28] FA 2023 s.4(4).

2021 Consultation had already flagged the point to the UK Government[29]). It is curious why this motivating factor was not explicitly articulated in the rhetoric, save for an offhand comment from Victoria Atkins MP who seemed to be under the impression that the RDEC had to be increased to offset a general drop in investment because of an increase in the headline rate of corporation tax (rather than the RDEC itself becoming less valuable as a result of the increase in corporation tax).[30]

Section 4(3) FA 2023

Arguably a natural consequence of the UK Government recognising that the RDEC is better value for (taxpayer) money was that the SME Regime would fall out of favour. The UK Government's view quickly became that the SME Regime was far too generous and far too expensive.[31]

In general, section 4(3) FA 2023 makes two changes to the SME Regime (both of which are headline rate decreases). The first change is the reduction in the additional deduction available to SMEs in respect of "qualifying expenditure" on R&D (from 230 per cent of the qualifying expenditure down to 186 per cent[32]) and the second change is a reduction in the cash tax credit available to (loss-making) SMEs from 14.5 per cent to 10 per cent.[33]

The SME Regime is more complex than the RDEC. Whilst the RDEC confers the same benefits on a large company regardless of whether the company is loss-making or not, the SME Regime offers different benefits depending on whether the company in question is loss-making. The basic benefit of the SME Regime is that an additional deduction is available in respect of certain items of expenditure. Prior to FA 2023, that additional deduction was 230 per cent of the qualifying expenditure in question.

If that SME is loss-making, however, it is recognised that, effectively, the additional deduction is of little to no use. With no taxable profits in a current year for large deductions to have an effect upon and (given the fact that SMEs tend to be loss-making for many years before turning an eventual profit) the benefit of a carried forward loss being of little value, under the SME Regime the company may "surrender" what otherwise would have been the total of the additional deduction[34] to HMRC. In return, HMRC will pay out a cash amount (known as the "R&D tax credit"[35]) to the company in question (prior to FA 2023, that cash amount was equal to 14.5 per cent of the total loss surrendered). This application of the SME Regime was explicitly called out by respondents to the 2023 Consultation as a source of anxiety around moving towards a singular R&D tax relief regime modelled on the RDEC.[36]

[29] HM Treasury, *R&D Tax Reliefs: report* (2021), para.A.13.
[30] *Hansard*, HC, Vol.723, col.926 (30 November 2022).
[31] *Hansard*, HC, Vol.723, col.926 (30 November 2022).
[32] CTA 2009 ss.1044 and 1045.
[33] CTA 2009 ss.1055 and 1058.
[34] CTA 2009 s.1055.
[35] CTA 2009 s.1058.
[36] HM Treasury and HMRC, *R&D Tax Reliefs Review: Consultation on a single scheme, Summary of Responses* (2023), para 2.3.

It will likely come as no surprise that SMEs generally used the SME Regime for the cash tax credit and the receipt (and maximisation) of the cash tax credit was (and still is) important to many SMEs (some even factor the receipt of the cash tax credit into their cashflows).

It may, therefore, seem harsh that, at a time when companies (of all sizes) are struggling and when a key strategic priority is securing investment, the UK Government chose to take an axe to the SME Regime. Indeed, the UK Government, in the same breath as reducing the headline rates, recognised that SMEs may need further support immediately following the rate reduction.[37] The Chair of the Finance Bill Sub-Committee, Lord Leigh of Hurley, raised this same point, querying whether the UK Government had considered other methods of combatting abuse and fraud in the SME Regime, such as “aggressive analysis of claims”,[38] or, alternatively, other methods of reducing R&D expenditure. Pulling on the same thread, the key accusation from Lord Turnbull, also of the Finance Bill Sub-Committee, was that the point could not be one about overall expenditure because the UK Government was effectively “taking [money] out of the SME pot and putting it in the RDEC pot”[39] (Matthew Henty, a Deputy Director at HMRC, agreed that the changes left overall expenditure on R&D “unchanged”[40]).

All things being equal, the UK Government has made clear that the bases for the changes are, generally, twofold: 1) the SME Regime, in the eyes of the UK Government, is simply not good enough value for (taxpayer) money and 2) the fraud and error risk in respect of the SME Regime needs something of a blunt instrument to soften the cost, time and effort expended in mitigating this risk on the basis that, the less lucrative the SME Regime, the less of a target it becomes. One might also argue (as Victoria Atkins MP did) that the headline rate reduction was simply a means of moving towards “a possible simplified single RDEC-like scheme for all”[41] (though that reasoning does give the impression of being an afterthought rather than a key driving factor behind the changes).

It is worth finally noting that the UK Government did offer some brief respite to SMEs in Chancellor Jeremy Hunt’s Spring Budget 2023. There, the Chancellor committed to “introduce an increased rate of relief for loss-making R&D intensive SMEs”.[42] The specifics of that became clear once the draft legislation for the Finance Bill 2023–2024 was published which provided that, for SMEs which are “R&D intensive”, the headline rate for the cash tax credit would revert to 14.5 per cent[43] (and, for the avoidance of doubt, for SMEs which do not qualify as “R&D

[37] *Hansard*, HC, Vol.723, col.926 (30 November 2022).
[38] House of Lords, Economic Affairs Committee, Finance Bill Sub-Committee, *Corrected oral evidence: Draft Finance Bill 2022-23* (21 November 2022), Q66.
[39] House of Lords, Economic Affairs Committee, Finance Bill Sub-Committee, *Corrected oral evidence: Draft Finance Bill 2022-23* (21 November 2022), Q67.
[40] House of Lords, Economic Affairs Committee, Finance Bill Sub-Committee, *Corrected oral evidence: Draft Finance Bill 2022-23* (21 November 2022).
[41] *Hansard*, HC, Vol.723, col.926 (30 November 2022).
[42] HM Treasury, *Spring Budget 2023* (March 2023), HC 1183, *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1144441/Web_accessible_Budget_2023.pdf* [Accessed 27 July 2023], para.3.75.
[43] HMRC, Policy Paper, *Additional tax relief for Research and Development intensive small and medium-sized enterprises* (18 July 2023), *https://www.gov.uk/government/publications/research-and-development-reform-additional-tax-relief-and-potential-merger/additional-tax-relief-for-research-and-development-intensive-small-and-medium-sized-enterprises* [Accessed 27 July 2023], para.1.

intensive"[44] the headline rate remains at 10 per cent and the additional deduction for all SMEs remains unchanged at 186 per cent).

Much like the RDEC, the reduction in headline rates for the SME Regime aligns with the increase in the rate of corporation tax to 25 per cent which took effect from 1 April 2023.[45] For something which was already considered generous, a regime (like the SME Regime) which operates on the basis of affording increased deductions becomes more valuable for a taxpayer as the headline corporation tax increases (that is because the deduction reduces the overall taxable amount which otherwise would have been subject to a higher rate of corporation tax). Much like the stars may have aligned for an increase in the headline rate for the RDEC, one does get the impression that the generosity of the SME Regime was doomed to come to an end by the time the corporation tax rate increase took effect.

Conclusions

The general view to be taken from the above is that the UK Government has shifted its focus away from the SME Regime and towards the RDEC (or, in broader terms at least, the UK Government has taken the view that it must look to incentivise large companies, rather than SMEs, to invest if its various economic and growth targets are to be met).

In any case, with the 2023 Consultation closed for responses[46] and the UK Government having expressly reserved the option to move to a unified R&D tax relief regime,[47] it may be the case that in the foreseeable future there will simply no longer be a specific regime for SMEs to speak of. Indeed, that does seem to be the most likely outcome in light of the draft legislation released for the Finance Bill 2023–2024 which proposes a singular R&D tax relief regime operating in substantially the same way as the RDEC.[48] The Explanatory Note does, perhaps indicating that a decision has been all but finally taken, somewhat ominously state "there is now scope to simplify the R&D tax system and merge schemes".[49] In any case, one would expect any new regime to come with its own points of contention and there is little doubt that a new R&D tax relief regime will be an exception to that.

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[44] The draft legislation for the Finance Bill 2023–2024 proposes inserting a new s.1045ZA into the CTA 2009 which specifies that an SME meets the new R&D intensity condition where its relevant R&D expenditure totals at least 40% of its total relevant expenditure for that period.

[45] FA 2023 s.4(4).

[46] HM Treasury, *R&D Tax Reliefs Review: Consultation on a single scheme* (2023),p.26. The consultation closed for responses on 13 March 2023.

[47] HM Treasury and HMRC, *R&D Tax Reliefs Review: Consultation on a single scheme, Summary of Responses* (2023), para.3.2.

[48] HMRC, Policy Paper, *Research and Development reform — additional tax relief and potential merger, Draft Finance Bill Measure*s (July 2023), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1171387/Research_and_Development_reform_draft_legislation.pdf* [Accessed 27 July 2023], p.2.

[49] HMRC, *Research and Development reform — additional tax relief and potential merger* (2023), para.101.

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