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

HM Treasury and HMRC

Submission from the Royal Academy of Engineering

May 2019

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1. The Royal Academy of Engineering welcomes the opportunity to respond to the HMT and HMRC consultation on *Preventing abuse of the R&D tax relief for SMEs*. The Academy's submission has been informed by the expertise of its Fellowship, which represents some the nation's best practising engineers, and draws from the Academy's experience of running the Enterprise Hub.

2. The Enterprise Hub, founded in 2013, is a national resource for the UK's most promising engineering entrepreneurs. The Hub forms part of the Academy's commitment to stimulate excellence and promote creativity and innovation in engineering. The Hub does this by making awards to exemplars of excellence in innovation in engineering, who will be the founders and leaders of tomorrow's high-tech companies. To date the Academy has supported Hub members who have created 75 companies and raised over £83 million in funding.

3. In the context of the government's ambition to achieve 2.4% of GDP invested in R&D by 2027, ensuring the UK's business environment remains attractive for R&D intensive businesses of all sizes is crucial. Tax incentives are a significant part of that landscape. Therefore, any changes to the UK's R&D tax relief for SMEs need to be weighed against these considerable stakes.

4. The Academy has heard time and again that R&D tax credits are highly valued by engineering companies of all sizes, and the UK system is perceived as competitive in comparison to many other countries.[1] However, since the financial crisis of 2008, tax incentives for R&D have become more generous in many countries, including the UK, to improve competitiveness and stimulate long-term economic growth.[2]

5. The Academy agrees that abuse of R&D tax relief for SMEs should be prevented. Retaining the integrity of the UK's system to ensure the benefits are directed only to genuine claimants, where the spill over benefits to the UK will be most widely felt, is essential.[3] However, measures to prevent abuse must be proportionate to the scale of fraudulent activity and must not disincentivise or actively disadvantage genuine claimants. While the broader engineering community regard the process for claiming credits as relatively straightforward, the bureaucratic burden remains a problem for some time- and resource-poor SMEs[4]. Therefore, there is a risk that the proposed measures will increase the bureaucratic burden, real and perceived, and result in genuine innovative companies not applying for valuable relief they are entitled to, and therefore not growing as fast as they potentially could.

6. For the small high-tech companies, tax credits play a crucial role in increasing their available finance. Unlike grants allocated to specific projects, tax credits allow them to respond to emerging business opportunities and threats as they arise, including further R&D investment. However, the Academy is concerned that the proposed measures may negatively impact on some technology-intensive SMEs with genuine claims, including in the following scenarios:
    I. Engineering companies that develop physical products or engineering processes, which involve costly equipment and materials, yet are not personnel-intensive.

[1] Increasing R&D investment: business perspectives, Royal Academy of Engineering, 2018
[2] Oxford University Centre for Business Taxation (2015). Effectiveness of fiscal incentives for R&D: quasi-experimental evidence.
[3] 'Have R&D Spillovers Changed?', Centre for Economic Performance, May 2018
[4] Increasing R&D investment: business perspectives, Royal Academy of Engineering, 2018

II. Early-stage start-up companies where salary costs are minimal as founders and early employees do not draw market rate salaries, if at all, and may be rewarded by other means such as shares in the company.
III. High-tech SMEs that undertake significant amounts of R&D through contractors. For example, this may arise as they need to access specialist expertise, if they cannot afford staff, or if it is the most appropriate business model for them.

7. While the number of genuine SMEs who could be negatively impacted by this proposal is likely to be relatively low, these early-stage, small high-tech companies are a vital part of the UK's engineering business and innovation landscape. Penalising these companies could negatively impact their prospects to succeed and grow to scale in the UK, and reduce the likelihood of attracting such companies to the UK.

8. It is unclear whether building upon the usual channels of inquiries to investigate suspect and fictitious claims has been fully weighed as an alternative option, and how this would compare to introducing a mechanism that will require legislation and the risks associated with changing a successful scheme. Given the success of R&D tax relief for SMEs, it is possible that there is still more that can be done to use relief to further incentivise more business-driven R&D which will be critical to achieving the government's target of 2.4% of GDP invested in R&D. Thus, additional measures to lessen bureaucracy, improve signposting and guidance, and additionally stimulate collaborative R&D should all be considered.