Cooley

UK Enacts Significant Changes to Research & Development Tax Regime

January 11, 2023

Significant changes to the UK's Research & Development (R&D) tax relief regime are being introduced with effect from 1 April 2023. Some of the changes were announced in the 2021 Autumn Budget, while others were more recently announced in the 2022 Autumn Statement. The changes impact the amount of relief that can be claimed, the types of activities that will qualify and the way in which businesses can claim relief. They are intended to ensure that "**the UK remains a competitive location for cutting edge research**", "**the reliefs continue to be fit for purpose**" and "**taxpayer money is spent as effectively as possible**".

The most recently announced rate changes to the R&D tax relief scheme for small- and medium-sized enterprises (SMEs), discussed below, were unexpected. The impact of the changes – stated to be introduced to target error and fraudulent abuse of the SME scheme – will be significant. The SME regime has proved to be an important incentive and, in some cases, a lifeline to many early-stage companies focused on innovation, particularly those in the life sciences sector. It is disappointing that the government has not found a practical way to target abuse, other than by materially reducing the benefits of the SME regime, which has clearly contributed to the UK's remarkable achievements in R&D and innovation. Although the relevant treasury minister has committed to holding a roundtable discussion with members of the life sciences industry to discuss how companies in the sector can continue to be properly supported by the R&D tax relief scheme, these changes have now been enacted as law.

Changes to R&D tax relief rates

Relief is available for SMEs under the R&D tax relief regime effectively in the form of an enhanced corporation tax deduction of a percentage of qualifying R&D costs. Loss-making SMEs usually have the option of receiving a cash payment of an R&D credit in return for surrendering R&D-related losses. Any such payment is capped at a percentage of the losses available for surrender.[1]

An R&D expenditure credit (RDEC) is also available, primarily targeted at larger companies, although it may be used by – and can prove valuable to – SMEs in certain circumstances. The RDEC uses a different method of calculating corporation tax relief on R&D expenditure. The "above-the-line" RDEC is effectively a taxable credit that may be used to offset liability to UK corporation tax or, in some circumstances, claimed as a cash payment.

For expenditure incurred on or after 1 April 2023, the SME R&D enhanced deduction will decrease from 130% to 86%, the SME R&D credit rate will decrease from 14.5% to 10% and the RDEC credit rate will increase from 13% to 20%. The broad "net" effect of the changes is summarised in the table below.

	Pre-April 2023	From April 2023
Loss-making SME	Enhanced deduction: **130%**[2] R&D credit: **14.5%** Benefit: **33.35%**	Enhanced deduction: **86%**[2] R&D credit: **10%** Benefit: **18.6%**

	Pre-April 2023	From April 2023
Profit-making SME	Enhanced deduction: **130%** Corporation tax rate: **19%** Benefit: (up to) **24.7%**[3]	Enhanced deduction: **86%** Corporation tax rate: **25%** Benefit: (up to) **21.5%**[3]
RDEC company	RDEC credit rate: **13%** Corporation tax rate: **19%** Benefit (after tax): **10.53%**	RDEC credit rate: **20%** Corporation tax rate: **25%** Benefit (after tax): **15%**

The increase in the RDEC is to be welcomed and should make it more competitive internationally. However, the RDEC provides a much more limited cash repayment and therefore is not as valuable to innovative startups.

As summarised by the **UK BioIndustry Association**: “Businesses have made their investment plans based on the SME R&D tax relief providing 33p for every £1 the company itself invests in R&D, the cut proposed … means they can now expect 18.6p for each £1 of in-house R&D they perform and as little as 12p for each £1 of R&D they outsource to universities, hospitals or other companies. Life science SMEs are therefore now facing significant shortages in their R&D cash flow projections.”

The UK government also has stated that it will explore and consult on the design of a single simplified RDEC-like scheme. There is currently no further information about what is envisaged, but further changes are expected.

Refocussing R&D relief toward activities undertaken in the UK

From April 2023, new territorial conditions will be introduced affecting subcontracted R&D expenditure (i.e., payments for services) and payments for externally provided workers (EPWs), which are workers provided by an external company. Subcontracted R&D activity will need to be performed within the UK, and EPWs will need to be subject to UK PAYE (pay as you earn). However, expenditure in respect of overseas activity will qualify in limited circumstances – namely, where the conditions necessary for the R&D (such as geographical, environmental or social conditions) are not present in the UK whereas they are present in the location where the R&D is undertaken, and it would be wholly unreasonable to replicate the conditions in the UK, or where there are regulatory or other legal requirements for the R&D to be undertaken outside the UK.

As such, expenditure on overseas R&D activities can still potentially qualify for relief where, for example, a company runs clinical trials overseas to gain licensing approvals for new drugs or vaccines or undertakes deep ocean research. But the legislation makes it clear that neither the cost of the R&D nor the availability of qualified personnel will be considered as a relevant factor in determining whether the exception applies.

Expansion of the scope of qualifying expenditure

The scope of qualifying R&D expenditure will be extended to include the cost of data licences and cloud computing, as well as the cost of pure mathematical advances, subject to certain limitations.

Currently, R&D relief can be claimed on the cost of computer software used directly for R&D purposes, which HM Revenue & Customs (HMRC) considers as meaning software licence fees and the cost of certain mathematical advances “**representing the nature and behaviour of the physical and material universe**”. The proposed extension is therefore a welcome change showing the government’s recognition that software can be provided as a service (i.e., SaaS) and not just by licensing of software copies, and that pure mathematical advances are often instrumental and underpin the development of machine learning, robotics and other big data solutions.

Changes to the process of making R&D claims

If a company seeks to make an R&D claim for the first time, or it has not made an R&D claim in any of its previous three accounting periods, then it will be subject to a new online pre-notification requirement, meaning that it must inform HMRC of its intention to make an R&D claim, as well as the R&D adviser it will be using, within six months following the end of the relevant accounting period (instead of the usual two-year window), unless the full claim has been submitted within the six-month deadline.

The new measure is likely to be particularly relevant for first-time claimants, who should consider whether any of their upcoming expenditure may qualify for R&D relief and, therefore, whether a "protective" pre-notification is merited.

In addition, as part of making an R&D claim, further additional information will be required to be provided to HMRC relating to the R&D project, the costs involved, the workers involved and (importantly, from HMRC's perspective) details of the agent who helped the company prepare the claim. Further, the claim itself will need to be endorsed by a named senior officer of the claimant company.

The UK government hopes that these changes, once introduced, will tackle abuse in the system without disadvantaging compliant businesses.

Notes

1. In addition, in some cases (not applicable to most biotech or tech companies), the repayment is also subject to an annual cap of 20,000 pounds plus three times the company's total pay-as-you-earn and national insurance contributions' liability.
2. 130%/86% uplift on costs with payable tax credit.
3. 130%/86% uplift on costs and no payable tax credit.

Key Contacts

Jack Jones London	jack.jones@cooley.com +44 (0) 20 7556 4202

Natasha Kaye London	nkaye@cooley.com +44 (0) 20 7556 4339
Eerik Kukebal London	ekukebal@cooley.com +44 (0) 20 7556 4511
David Wilson London	dwilson@cooley.com +44 (0) 20 7556 4473