

The New Cap on R&D Tax Credits: The Exemption, Pitfalls and Potential Remedies

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Background to the Cap

For accounting periods beginning on or after 1 April 2021, HMRC have introduced a PAYE/NICs cap on payable SME R&D tax credits in order to counter perceived avoidance. The legislation is in Finance Act 2021.

The payable tax credit in the SME scheme provides valuable support to loss making companies and is a core part of the government's support for innovation.

However, because it generates a cash payment to the company from HMRC, it has become a target for abuse. Since the previous PAYE cap was removed in 2012, HMRC have noticed an escalation of fraudulent claims. They have identified a number of structures where expenditure outside the UK has been re-routed through a UK entity which has little or no employment or activity and is set up wholly or mainly for the purpose of accessing the payable tax credit.

Whilst HMRC recognizes that there will be circumstances in which a UK company would benefit from carrying out R&D outside the UK, their concern is that companies are manipulating the scheme to gain a benefit for activity which would have taken place anyway and would not otherwise have anything to do with a UK business.

They also understand that some genuine companies may have low PAYE and NIC liabilities relative to R&D spend, particularly those in Life Sciences that follow an outsourcing model, and therefore could be affected by this measure. As genuine companies were not the intended target of the cap, HMRC requested to hear industry responses via consultation before the legislation was finalized. FTI Consulting actively participated in this consultation in conjunction with the BIA, and this has resulted in an exemption that should minimise the impact on genuine companies.

The Cap

Following several consultations, the legislation has now been finalised and applies to accounting periods beginning on or after 1 April 2021. The rules are:

- The cap on the repayable credit for a claim by a loss-making company under the SME scheme will be £20,000 plus three times the claimant's total PAYE/NICs.
- PAYE/NICs of employees of connected parties providing services to the claimant may also be included in the above calculation if attributable to eligible projects.
- Claims below £20,000 will not be impacted by the cap.

The cap will only be applicable to accounting periods that begin on or after 1 April 2021.

The Exemption

- There will be an exemption for genuine businesses subject to the following criteria:
 - i. The claimant must be creating or preparing to create relevant intellectual property (IP), or undertaking a significant amount management activity in relation to the relevant IP it holds, and this must be undertaken wholly or mainly by employees of the company. For this purpose, management activity includes formulating plans and making decisions in relation to the development or exploitation of the IP.
 - ii. No more than 15% of the eligible R&D expenditure is incurred on either subcontracting R&D to connected parties, or on the provision of externally provided workers (EPW's) by connected parties.

Note that relevant intellectual property is created in circumstances in which the right to exploit the IP vests with the claimant (whether alone or jointly with others). Intellectual property is described as any patent, trademark, registered design, copyright or design right, or any rights under the laws of territories outside the UK which are similar to these

rights. It also includes information that is not protected by a right described above, but has industrial, commercial or other economic value.

The exemption is a welcome remedy and in line with the proposals that FTI Consulting had put forward in response to the consultations.

Firstly, the revised cap will create additional headroom by including attributable PAYE and NICs of connected parties working on the same project(s).

For the exemption, the claimant must be undertaking the following activities;

- Taking, or preparing to take, steps in order that relevant IP will be created by it; or
- Creating relevant IP; or
- Undertaking management activity* in relation to relevant IP that it holds.

**Management activity includes formulating plans and making decisions in relation to the development or exploitation of the IP.*

For all these activities, they should be wholly or mainly undertaken by employees of the company.

In some instances, companies may make use of third party contractors to assist in these activities – for instance the involvement of third party IP lawyers to assist in patent applications. HMRC have made it clear that the aim of this legislation is to make a comparison between the activities undertaken by the claimant company and the activities undertaken by connected parties. Work subcontracted to a third party who is unconnected is therefore not within the scope for assessing whether the activities have been undertaken and the requirements for the exemption have been met.

If R&D expenditure fluctuated such that this threshold temporarily breached, we understand that HMRC interpret the legislation such that a company could opt to limit their claim on connected party R&D to the 15% threshold in order not to be subject to the 3x cap. It may, nevertheless, be advisable to request clearance from HMRC in order to obtain certainty on this point, particularly as HMRC are yet to publish their guidance on the application of the rules.

The majority of UK headquartered life sciences companies should qualify for the exemption in circumstance where the cap would otherwise apply. It will, nevertheless, be important that this is suitably evidenced not just in the event that HMRC enquire prior to agreeing the payment of the R&D credit but also to satisfy auditors or potential investors or acquirers. FTI Consulting, being a leading specialist in providing tax advice for life science companies, can provide guidance in preparing a concise synopsis of the company's activities to achieve this objective.

Pitfalls and potential remedies

Unfortunately, the exemption as it is currently designed will not be sufficient to protect all business structures. Groups of companies where key decision makers are not employed by the company making the claim may be unable to satisfy both conditions above. This might be the case where key decision makers are employed by a parent company or an overseas affiliate. Companies set up to develop a single programme with no employees in order to facilitate partnering or new investment will be unable to meet the first condition. There are a number of remedies that could be considered from restructuring to joint employment contracts. Each case should be considered on its own merits. For companies with December year ends the application of the cap and, if needed, potential remedies should be assessed shortly in order to take any pre-emptive steps before 1 January. Other companies may already be subject to the limitation.

The decision on whether the exemption applies will be undertaken by the company under the principles of self-assessment. We would recommend keeping records of the rationale behind the decision, and supporting evidence where relevant.

For further guidance please contact **Richard Turner** (Tel: +44 (0) 20 3727 1506).

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