House of Lords Finance Bill Sub-Committee
Draft Finance Bill 2022-23
Written evidence from the UK BioIndustry Association

UK BioIndustry Association

Introduction

We welcome the Government's commitment to ensure that the UK's R&D incentives remain up-to-date, competitive, and well-targeted. Overall, we believe the SME and large company R&D tax relief regimes work very well and are a highly effective policy leaver through which the Government can incentivise private sector investment in R&D.

The UK's R&D tax reliefs regime help make it a competitive location for new internationally-mobile businesses to start and grow, and for established global businesses to make R&D investments. Multiple studies by HMRC and independent economists [1, 2, 3] have proven R&D tax reliefs to be highly effective in incentivising business investment in R&D and delivering spillover benefits for the wider economy and society. HMRC estimates that for every pound spent on R&D tax credits, between £2.40 and £2.70 is additionally invested in R&D by UK companies.[4] They are also crucial for encouraging equity investment into pre-revenue early-stage and scaling R&D-intensive businesses, which may be considered too risky for investment without government subsidy.

The life sciences sector consistently spends more on R&D than any other sector in the UK[5]. £5 billion was invested in in-house R&D by the sector in 2020, and a further £4.3 billion was invested in R&D outsourced to specialist R&D service companies, universities and hospitals. However, both these estimates are likely to be revised up following methodological changes currently being implemented by the Office for National Statistics (ONS) that recognise that SMEs' R&D expenditure was being systematically undercounted.[6]

About 80% of UK life science companies are SMEs[7]. R&D in our sector involves long timelines (typically 10 to 20 years), high capital requirements (£1bn+ per medicine) and a high probability of failure due to scientific risk and uncertainty (less than 8% of medicines make it through clinical trials to achieve regulatory approval)[8]. Life science SMEs typically do not have products on the market to generate revenue when they are in this R&D phase and therefore must raise large amounts of venture capital (£2.5bn in 2021[9]) to finance their R&D programmes. During this time, they incur heavy tax losses due to their high R&D expenditure. These

[1] HMRC (2020), *Evaluation of the research and development expenditure credit:* https://www.gov.uk/government/publications/evaluation-of-the-research-and-development-expenditure-credit
[2] HMRC (2020), Evaluation of the research and development tax relief for small and medium-sized enterprises: https://www.gov.uk/government/publications/evaluation-of-the-research-and-development-tax-relief-for-small-and-medium-sized-enterprises
[3] Irem Guceri and Li Liu (2019), *Effectiveness of Fiscal Incentives for R&D: Quasi-experimental Evidence*: https://www.jstor.org/stable/26641355
[4] HMRC (2020), *Evaluation of the research and development expenditure credit:* https://www.gov.uk/government/publications/evaluation-of-the-research-and-development-expenditure-credit
[5] Office for National Statistics (2021), *Business Expenditure on Research and Development*, https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/researchanddevelopmentexpenditure/bulletins/businessenterpriseresearchanddevelopment/2020
[6] Office for National Statistics (2022), *The Power of Innovation: First new R&D stats are here*: https://blog.ons.gov.uk/2022/09/29/the-power-of-innovation-first-new-rd-stats-are-here/
[7] Office for Life Sciences (2021), *Bioscience and health technology sector statistics 2020*: https://www.gov.uk/government/statistics/bioscience-and-health-technology-sector-statistics-2020
[8] Pharma Intelligence (2021), *Clinical Development Success Rates and Contributing Factors 2011-2020*: https://pharmaintelligence.informa.com/resources/product-content/2021-clinical-development-success-rates
[9] BioIndustry Association (2022), *UK biotech financing in 2021*: https://www.bioindustry.org/policy/finance-tax-and-investment/finance-report-2021.html

characteristics are important when considering how life sciences SMEs interact with the R&D tax relief regime.

About the BIA

The BioIndustry Association (BIA) is the voice of the innovative life sciences and biotech industry, enabling and connecting the UK ecosystem so that businesses can start, grow and deliver world-changing innovation.

Established 33 years ago, BIA now has more than 500 members including:

- Start-ups, biotechnology and innovative life science companies
- Pharmaceutical and technological companies
- Universities, research centres, tech transfer offices, incubators and accelerators
- A wide range of life science service providers: investors, lawyers, intellectual property consultants, and investor relations agencies

Answers to questions

1) **Have the changes to the definition of R&D gone far enough in modernising R&D relief, and if not, what more needs to be included?**

The definition of R&D within the scheme is well understood in our view. Recent changes to what activities are considered to constitute R&D, including data and cloud computing, and pure mathematics, are welcome and help bring the definition into the 21st century.

A significant element of R&D investment that is not incentivised through the R&D tax relief regime is capital expenditure. R&D Allowances do provide some relief and therefore investment incentive, but only for profit-making firms, meaning the large majority of life science businesses cannot benefit. Making capital expenditure eligible in claims for R&D tax credit would play a significant role in furthering the Government's ambition to make the UK the world's leading life sciences hub. We know that R&D support plays a key role for companies when making decisions on internationally mobile R&D investments, and that companies making capital R&D investment in the UK are more likely to remain in the UK as they scale-up to downstream R&D and commercial manufacturing.

2) **How effective will the changes be in countering error and fraud resulting from spurious R&D claims and is there more that can be done, or different approaches that could be adopted?**

Unfortunately, the changes will increase the compliance burden on those taxpayers who already make robust claims.

Spurious claims are often made by “no win, no fee advisors”, who have already proven adept at automating large elements of the claim to generate claim submission material as recommended by existing HMRC guidance, even if what is produced is incorrect or inadequate.

Moving guidance into secondary legislation will make little difference.
HMRC are clearly frustrated by this part of the tax advisory market in R&D claims, but they seem unwilling to use existing law, such as the DOTAS legislation, to clamp down on poor practice. Furthermore, there is no substitute for having enough Inspectors, and having them properly trained, to scrutinise claims.

We support the need to prevent fraud but our concern is that the measures introduced will unfairly impact companies undertaking genuine R&D. We have seen this with the introduction of the PAYE/NI cap, introduced in 2021, which reaches beyond its intended target impacting UK companies with completely genuine business models.

An approach that would reduce spurious claims for activity unlikely to be considered genuine R&D would be to exclude claims on back-office systems. In South Africa: Computer software developed for the purpose or for purposes that include the purpose of sale, rent, license, hire or lease to two or more non-associates of the firm is eligible. However, software programmes designed for management or internal business processes are not eligible. This will help address the problem but will not be the entire solution.

3) How successful is the refocusing of the relief in encouraging activity in the UK without adverse consequences?

Due to the specialist nature, high risk and capital intensity of life sciences R&D, SMEs outsource elements of their R&D programmes. Clinical trials in particular, must take place in hospitals or other clinical settings, so cannot be done in-house. UK life science companies who are BIA members are highly motivated to use UK suppliers, as their key drivers are usually supplier expertise and proximity, rather than cost. Where suppliers exist in the UK, they are very high quality. Running a very long-term drug development programme, which pharmaceutical regulators will scrutinise for scientific validity and safety, by trying to save a few pounds on the supplier budget by using cheap overseas providers is not something a company or its investors would countenance. The very highly specialised nature of biotech drug development means that often the highly-specialised suppliers are limited in number and either don't exist in the UK, or have insufficient capacity. Moreover, even if more demand leads to increased supply in the UK, which cannot be assumed due to the highly specialised nature of many services required, there would be a significant lag in its creation, during which time UK companies will be at a distinct disadvantage financially if penalised from April 2023 onwards by the new measures in the Finance Bill. In fact, some companies are already impacted by these not-yet confirmed rules because they are entering into service contracts for projects to be undertaken in the coming years.

The law changes are unlikely to make a meaningful difference to the amount of UK R&D activity in our sector – instead we expect significant harm could be done to the competitiveness of the sector and its ability to do R&D in the UK. We have had very positive engagement with the Treasury and HMRC on crafting an exemption to the overseas expenditure restriction, for claimants who have no genuine alternative to using non-UK R&D subcontractors. This is to a large extent reflected in the draft legislation being considered by the Committee. However, we have recommended that the conditions listed in Subsection (3) include "technical" and "medical", to account for the highly specialised nature of life sciences R&D.

Our key concern now is how the overseas expenditure restriction will be implemented in practice by HMRC. The legislation is high level and guidance will be required to allow inspectors and claimants to understand how it applies to their specific circumstances. Existing HMRC R&D tax relief guidance contains life science-specific details and we strongly believe this will be required for the new rules, and that HMRC should work closely with the BIA as the UK-wide industry trade association to ensure new guidance is fit for purpose.

A further concern regarding implementation is the administrative burden it will place on businesses. Even a relatively small business of 200 scientists will procure hundreds of service contracts if varying levels of complexity each year. Companies will need to put in place new procurement processes, which would cost money and use up scientists' valuable time on paperwork. As a result, these businesses will be less efficient and R&D activity will be disincentivised.

4) How aware are smaller businesses of R&D relief? Is there more that HMRC could be doing in practice to help smaller businesses access relief to which they are entitled?

The level of awareness among biotech companies of R&D relief is very high. The beauty of the system is that if you meet the requirements, then you will get the relief. Conversely, the level of awareness and access to Government grant funding is much lower, given the burdensome nature and the lower probability of success.

5) How helpful is HMRC and BEIS guidance in interpreting and applying the R&D relief rules?

The guidance is very useful. Unfortunately, the lack of tax expertise in the R&D tax credit advisor market means that much of the guidance is not really used or understood.

A better staffed and trained HMRC team would be able to hold these advisers and fraudulent claimants to account for not having used the guidance.

6) What view do you take of the requirement to give advance notification of R&D claims? What effect would you expect it to have on genuine and spurious R&D claims respectively?

As mentioned above, many claims are cut and paste, or automated. I would expect spurious claims to continue, with the notifications being automated.

For genuine claimants, this just increases the compliance burden, and raises the possibility that a genuine claimant will miss the opportunity to claim purely on administrative grounds – they are being made to suffer for the sins of others.

7) What is your experience of HMRC's approach to dealing with claims to R&D relief which it suspects to be invalid, either through misunderstanding of the rules, or fraud?

We have no experience of fraud. The HMRC enquiry system picks up claims on a seemingly random basis, unrelated to size of claim or materials provided. The frustration is that HMRC usually use a standard long list of questions, to which they require full answers, even if the question is irrelevant or has already been explained in the original submission. This results in delayed payments to genuine claimants, which is unhelpful for SMEs that want to focus on executing their R&D programmes.

The greater frustration, however, is that poor claims simply slip through without HMRC raising enquiries, resulting in waste in the system and anti-abuse measures being implemented with the collateral damage to genuine businesses, as described above.

8) Are there lessons the UK could learn from the tax systems of other countries about how to encourage R&D

Other countries, such as Australia and Canada, take a stricter view of only giving credit where R&D is done in-country. However, this has still led to a lot of adviser input into structures which allow the benefit of upfront R&D credits but downstream flexibility over where IP and operations are located, outside the country. There is no shining example of how best to tackle this issue of encouraging R&D.

9) How successful are the changes in R&D relief likely to be in encouraging innovation and development?

The UK is already a world leader in life sciences innovation, the industry has grown in recent years and R&D tax credits have been an accepted part of the tax landscape since 2000. Overall and with the exception of the expanded definition to include data, cloud computing and mathematics, these changes are unwelcome for the industry and we are in damage limitation mode. Companies are trying to model the scale of the change, which involves best case and worst case scenarios of how the exemption to overseas spend is ultimately drafted and policed. If not implemented carefully, with life science-specific guidance developed collaboratively with the sector, the changes will have an overall negative impact on encouraging innovation and development.

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