

The scope of qualifying expenditures for R&D Tax Credits: Consultation.

Reference ISBN 978-1-913635-53-4, 2988

MMP Response

This document provides MMP's response to the question's posed in the July 2020 consultation on the scope of qualifying expenditures for R&D Tax Credits.

MMP the company

MMP offer breadth and depth in the provision of specialist technology-based tax consultancy for our corporate clients. Specific areas of expertise include tax reliefs for R&D, patents, video games and animation, specialised capital allowances, and corporate investments.

At MMP we combine specialist knowledge of technology tax reliefs with practical experience in engineering and scientific disciplines. We apply these skills in a client-centric way to ensure our clients submit robust and verifiable claims.

The directors have decades of direct experience in technology tax relief from a technical and consulting perspective, in addition to wide-ranging experience in industry. Our credentials range from founding venture capital-backed technology businesses, to running operating divisions of multinational corporate divisions, to professional and academic qualifications in finance, tax, engineering and scientific disciplines.

The digital economy and R&D

The digital economy is the future of the economy. Deep tech, big data and AI are technologies that will become increasingly critical to modern living across the first world economies. If the UK is to stay relevant in this distributed global economy, where rules are all being rewritten, then the UK administration must seek to invest and encourage real, meaningful R&D.

It must clamp down on irrelevant product development masquerading as R&D such that the number of claims reduce in volume and spurious irrelevant small claims that are not R&D by the terms laid out in the guidance nor in Frascati are not allowed. The cottage industry of small claims must be challenged such that policy intent and properly targeted investment wins the day.

Large investments in the digital economy by brave leaders will drive the future, make easy targets – there are fewer of them; but easy targets in this case are clearly the wrong targets. We support the government in seeking to modernise the R&DTR guidance to support our greatest software triumphs.

Question 1a

Are there uses of data that contribute to R&D but which do not currently attract relief through the RDEC and SME schemes? Please provide examples to support your response.

There is a clear opportunity for the government to add a new cost category for the R&D tax relief scheme here relating to the creation or acquisition of data. This would manifest in two types of costs:

- Salary costs associated with time spent creating/curating data to be used only for eligible R&D
- A new cost category: data acquisition costs associated with the purchase of data to be used only for eligible R&D

There are also two additional, essential distinctions that must be made.

- The company can only claim for the data costs where that data is being used for eligible R&D.
- The data must only be associated with a trial or development environment. If the data can or will be used in a live system on an ongoing basis, then the data costs will not be considered eligible.

Example 1 – AI model training

The development of AI models does not currently attract relief through the RDEC and SME schemes. Time spent collecting data internally by employees, the software costs associated with systems that scour and collect this data and paying an external company to provide this data are all currently ineligible costs. It can be argued that the creation of training data or payment to acquire training data for an AI model is an essential part of the eligible R&D process.

Example 2 – Development environment testing

Another example is where a company is purchasing data specifically for use in a development environment, where that data has no use on an ongoing basis and will not be used in a live environment. In this situation the software the company is developing is considered an eligible R&D project. However, time spent collecting data internally by employees, the software costs associated with systems that scour and collect this data and paying company to provide this data which will be used to test this software are all currently ineligible costs. It should be argued that the Company must create or acquire data to adequately test that its eligible R&D software works. Without this data the company cannot test its eligible R&D software.

Question 1b

To what extent are data sets employed in the R&D process consumed? To what extent do they retain value? Please provide examples to support your response.

In determining if data sets have been consumed in the R&D process it is important to consider several aspects:

- Is the data being used to train and improve an AI model? Can the data only be used to train this specific model? Could the company feasibly sell on this data? For the data to

have definitely been consumed, it is important that that the data used to train an AI model is only relevant to this particular model and there would need to be a stipulation in the guidance (like there is for prototypes -CIRD81350) that the data will not be sold and that there is no intention for it to be sold. Thus the data only has value to the company for internal AI training purposes.

- Is the data being used within a testing environment and not a live system? Will this data be useful to the company once the system has been fully tested and gone live? Would the company be able to sell this test data on? For the data to have definitely been consumed, it is important that the data will no longer be useful to the company once the system has gone live (unless for further development/R&D purposes).
- Is the data that is created or purchased being used in a live production environment for ongoing business-as-usual activities? In this situation, whilst data could be said to be consumed, it is not solely used for eligible R&D and therefore should not be included as an eligible data creation cost.

Following the examples stated above:

Example 1 – AI model training

This training data is transformed in the training process and the raw data, once used, is no longer useful to the company, has no value and is thus deleted. The training data has been transformed to make the AI model more efficient or accurate.

Example 2 – Development environment testing

The data used for this testing has been transformed in the testing process to identify if the software works effectively. Whilst the company is still carrying testing on the system, the data will still have value. However, once the system has gone live, this data will no longer serve a purpose, has no value and will be deleted.

Question 2a

Do you already claim for software costs under the current definition? If so, what was your experience of separating out the R&D specific costs for the purposes of the claim?

The current CIRD825000 guidelines on software are very vague and provide very little explanation on what software can be included as an eligible R&D software cost:

“Revenue expenditure incurred on software employed directly in R&D is a category of qualifying expenditure for expenditure incurred on or after 1 April 2004. Software means computer software.

The software must be used in activity that constitutes R&D for tax purposes, which includes ‘qualifying indirect activities’.

...

Expenditure on software not employed directly in R&D is not qualifying expenditure.

So, software used by the human resources department for routine work related to the R&D staff would be included. But software used to train the HR staff would not.”

The definition of software: “*Software means computer software*” is not good enough. We believe that the explanation of what software is in the CIRD guidance needs to be expanded and better defined. The modern software landscape includes licenced software, Software as a Service (SaaS), Platform as a Service (PaaS) and Infrastructure as a Service (IaaS).

- Examples of licenced software includes: SOLIDWORKS, MATLAB, Adobe Photoshop. In these examples, the user purchases a licence for the software and then the user is able to run that software locally on the computer. This is what is traditionally understood as software.
- Examples of SaaS include: Amazon Elastic Compute Cloud (EC2), Dropbox, Slack, Jira. In these examples, the application and surrounding infrastructure is being provided by the service provider, which fully manages the operation of the application. SaaS is now commonly delivered to users in the cloud and often in browser. We consider SaaS as software.
- Examples of PaaS include: Databricks¹, Domino². In these examples, the user does not manage the platform; the user is managing the software application running on the platform. We do not consider PaaS as software.
- Examples of IaaS include: AWS, Google GCP, Microsoft Azure. In these examples, the user is not managing hardware and networking, this is managed by the IaaS provider. However, the user is responsible for managing everything else, i.e. the platform and the software application. We do not consider IaaS as software.

The CIRD guidance then states that costs for software used for eligible R&D and QIAs are eligible. It states that software costs not associated with eligible R&D cannot be included. It then states that HR department software related to the R&D staff is eligible but software for training the HR staff is not. There is large grey area of potentially eligible software costs here which a company can only know is eligible from prior experience. This is not clear enough.

As an R&D tax relief consultancy we have extensive experience in successfully claiming for thousands of claims which have included software costs. Over the course of filing these claims and in resolving multiple enquiries with HMRC which have included discussions related to software costs, we have developed a very strong understanding of what types of software costs are considered eligible by HMRC.

We have summarised a list of software types that, where they have been used in the eligible R&D, we would usually consider them eligible and HMRC agrees with that analysis.

[REDACTED]

We have summarised a list of the software that we would not consider eligible and HMRC has regularly agreed that these are not eligible software costs.

[REDACTED]

Question 2b

¹ Databricks is a US-based company that provides cloud-based big data processing and machine learning.

² Domino is a US-based software company that provide a cloud-based data science platform that enables data science teams to develop and deploy models.

Are there any software costs that currently qualify for R&D tax credits, that could be limited or excluded from relief without materially affecting R&D projects? Please provide examples to support your response.

Currently server hosting costs are not considered eligible cost. However, we are aware that many companies have successfully claimed for server hosting costs but have never had an enquiry or any questions from HMRC. As a result, they have been telling other companies that they should include all these costs because they are eligible. HMRC needs to do a better job of detecting this abuse and punishing guilty parties.

We believe that a more aggressive approach by HMRC to detect fraudulent claims relating to server hosting costs claimed under the software cost category would yield a significant saving for the exchequer.

Question 2c

Are there any software costs, partially or wholly for R&D purposes, that do not currently qualify for R&D tax credits, that should be if the regime is to better reflect the nature of modern R&D? Please provide examples to support your response on whether these costs could be separated out straightforwardly.

The modern digital economy rests on the development of software as the goal of the development, rather than as a part of a larger project. UX and UI historically were simply ways of presenting information to enable human interaction. This is no longer the case and the UX/UI development is often an intrinsic part of achieving the overall technological advance and time spent on this should be considered eligible activity and related costs. These are straightforward to separate, unlike cloud computing costs, which can be difficult to separate.

With regards to the above discussion of data being transformed in Question 1b. If a cost category for eligible R&D transformed data, then it follows that server hosting costs should also be included as they relate to the item which is being consumed, similar to water, fuel and power consumable items as stated in CIR82300.

“The term ‘consumable items’ covers consumable or transformable items (CIR82400). This includes water, fuel and power of any kind. Software is not within consumable items as it is not consumed or transformed (CIR82500). The same meanings are adopted for the large company scheme by FA02/SCH12/PARA17 (c).”

This should relate to physical server costs incurred directly by the company for use in R&D or cloud based storage costs related to the storage of transformed eligible R&D data. The storage of this data is an essential part of the eligible R&D process. The consumables items category should be expanded to allow these costs.

Question 3a

What experience do you have of claiming R&D tax credits in other jurisdictions, where expenditures pertain to data or cloud computing?

N/A

Question 3b

What evidence can you provide that a scope expansion in these areas would drive you to make additional investments in research and development.

N/A

Question 4

Would changes to the R&D tax relief rules in the areas outlined above lead to any change in the commercial relationships between companies, insofar as expenditure is outsourced to a third-party provider?

Introducing the purchase of data as an allowable cost could present problems and opportunities for abuse. The problem is that many companies need to collect data themselves, cleanse it and/or modify it in some way to be useable. This work would not currently be eligible under the R&DTR scheme. So, allowing the purchase of the data may have perverse incentives in that this data enhancing work could be pushed further down the supply chain. If this data cost was eligible under the R&DTR but doing it in-house is not, then you are in effect providing a subsidy to these data providers. We could imagine companies seeking to overcome this by creating complex group structures, with one company in the group carrying out data creation and charging this out to the main R&D claim company, so they could claim for this R&D in-house.

Question 5a

Are there expenditures on indirect activities which should be limited or excluded from eligibility for relief? Please provide examples to support your response.

We understand that the exchequer is keen to balance the books by widening eligibility related to data and cloud computing costs and reducing eligibility elsewhere. However, it must be clearly stated that widening eligibility related to data and cloud computing costs will only benefit a small subset of R&D tax relief claimants. If the eligibility level of an area such as qualifying indirect activities is reduced, this will punish a much wider range of companies. Therefore, we suggest that HMRC tackles the likely huge number of R&DTR claims, which are routinely made each year which contain ineligible expenditure or ineligible R&D by asking more questions and opening enquiries on a larger number of these types of small claims, which will result in a significant cost saving to HMRC. Consulting firms can filter out marginal or ineligible activities assuming they have competency to act and if they are minded to do so. Many smaller claims we see are simply submitted by accountants that have no specialist understanding nor the technical capability to assess whether an activity qualifies under the legislation and guidance.

Question 5b

Are there other expenditures on routine work which should be limited or excluded from eligibility for relief? Please provide examples to support your response.

N/A