Construction
Leadership
Council

The Rt Hon Jeremy Hunt MP
Chancellor of the Exchequer
11 Downing St
London SW1

12.09.2023

Dear Chancellor,

IMPACT TO THE CONSTRUCTION SECTOR OF THE SINGLE MERGED R&D TAX SCHEME DRAFT LEGISLATION

Please find attached the Construction Leadership Council's response to the request for feedback on the single merged R&D tax scheme draft legislation.

Yours sincerely,

Mark Reynolds
Co-Chair, Construction Leadership Council

cc:
Minister Ghani MP
Gareth Davies MP
Minister Freeman MP

Construction Leadership Council

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Construction Leadership Council

Impact to the Construction Sector of the Single Merged R&D Tax Scheme Draft Legislation

The Construction Leadership Council is a joint BEIS/sector council co-chaired by Minister Nusrat Ghani (Minister for Business and Industry, Department for Business, Energy, and Industrial Strategy) and Mark Reynolds (Group Chairman and CEO at Mace) together with his deputy co-chair Richard Robinson (CEO, Atkins UK and Europe). We work with government and industry organisations to promote industry initiatives that will deliver the CLC's four priorities: Building Safety, Net Zero & Biodiversity, People & Skills and Next Generation Delivery.

Context

The construction industry is worth 9% of GDP to the UK economy each year and employs 2.9 million (8.8% of the entire UK workforce) people across the sector. Through Covid we were one of the only sectors to improve our productivity through enhanced ways of working to keep social distancing, this delivered improvement of over 14% in our productivity against a 5 year average. Since the Construction Sector Deal was issued by Government the industry has collectively invested £2.67Bn in R&D over the last five years, a 5 fold increase on the previous 10 years.

Issue

HMRC issued a consultation Jan – March 2023 which considered merging the two R&D schemes. Although a decision has not definitively been made by HMT to merge the schemes, on 18th July 2023 draft legislation was issued for a merged R&D Tax Credit Scheme, which may come into effect as early as next year. The construction sector is very concerned by a section in the draft legislation that seeks to prevent a claim for tax credits for R&D expenditure if it has arisen by virtue of activities having been "contracted" to the claimant or deemed "subsidised" by a customer.

Benefits of the current R&D Tax Credit Scheme

£375m in R&D tax credits was paid to the construction sector in 2020-21 based on qualifying expenditure in the industry. The credit provides vital support and investment in construction where median profit margins are 2.1% to 2.8%, allowing the sector to take financial risks on innovation and modern methods of construction, which drive the improvements in productivity.

Impact of proposed changes

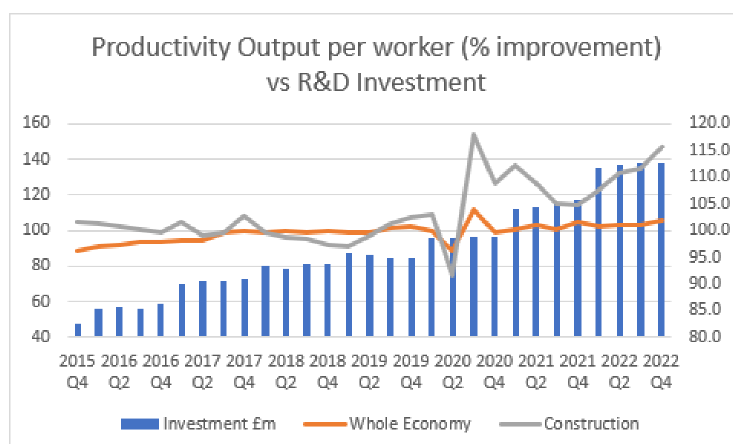
The widely drafted definition of "contracted activities" unfairly disadvantages the construction industry because, by its nature, construction is a service industry that only undertakes projects once work has been contracted to it. The proposed legislation would deliver the tax credit for R&D performed in the supply chain to the end client of a primary contractor. Directing the credit away from the construction sector would remove the construction companies' ability to take the financial risk on innovation, leading to job losses and a flat line in improvements in productivity, digitalisation and net zero.

Recommendations

- **Amend Section 1042C from the draft legislation published 18th July 2023 to specify it refers to "subcontracting R&D activities" with further guidance offered to clarify how this is identified and remove reference to "subsidised".**
- **Work with industry to ensure this does not reduce the level of R&D investment across the construction sector.**
- **Delay the merged scheme beyond 1 April 2024 to allow appropriate time for further consultation with the industry to ensure no adverse effect of the merged scheme.**

Impacts

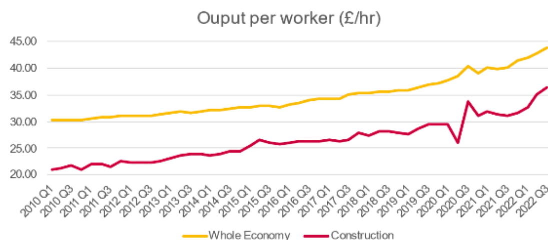
HMRC's latest statistics[1] highlight approximately £375m of R&D tax credits was paid out to the construction sector in 2020-2021. Although this is a 15% reduction from £440m in 2019-2020, largely explained by the covid-19 pandemic, it is still significantly higher than the previous figures of £235m in 2018-2019 and £220m in 2017-2018, demonstrating an upward trend in R&D claims.
FEEDBACK
The increase in R&D Tax Credits correlates with an increase in output and productivity across the construction sector. The investment in innovation to enhance ways of working to keep social distancing, delivered improvement of over 14% in our productivity against a 5 year average.



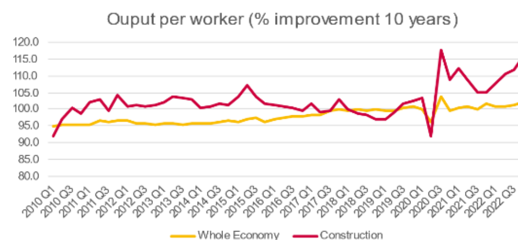
[1] HMRC R&D Tax Credit Statistics

Construction productivity has performed well since April 2020 – but the outlook is more challenging

Construction Output per worker hour: 2010 -22



Productivity gains: 2010 - 22



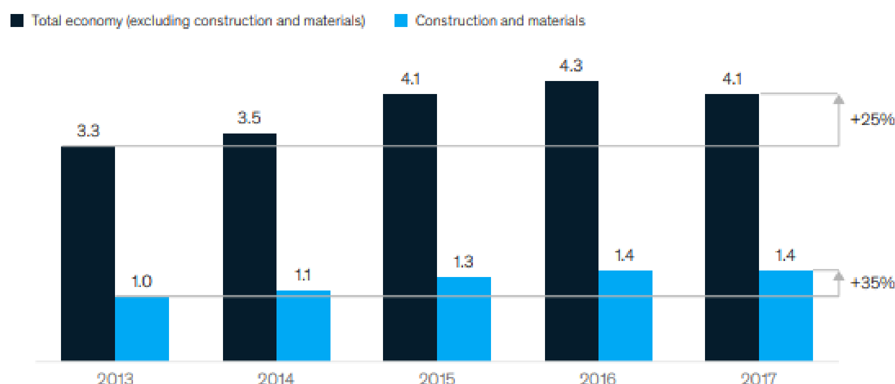
If the proposed draft legislation were to take effect, the construction sector will see a large proportion of its R&D tax credits directed towards its customers e.g., property developers, landowners, and other wealthy UK-based customers who may not be the performers or even the instigators of the R&D.

A 2020 study by the consultancy McKinsey & Company, 'The next normal in construction[2]', indicated that global R&D spending in construction, at around 1.4 percent of net sales (based on a sample of the 2,500 companies), still lags behind other industries, which spend approximately 4.1 percent. However, R&D spending has increased in construction by 35% between 2013 and 2017, compared with 25% for the total industry.
The report indicates that the low-margin in the construction industry is increasing its emphasis on R&D investment as a means of improving productivity.

Exhibit 20

R&D spending in the construction industry has increased faster than the rest of the economy.

Benchmark of R&D spend of top 2,500 companies globally, R&D spend as % of net sales



[2] McKinsey & Company: The next normal in construction

The Office for Budget Responsibility (OBR) has certified the R&D tax reform will have a net neutral impact on R&D expenditure. The Chancellor added in his Autumn budget speech that *"these measures have no detrimental impact on the level of R&D investment in the economy."* R&D tax relief is forecast to support £60 billion of R&D by businesses in 2027/28, a 60% increase from 2020/21[3]. We disagree that the current draft legislation is aligned to this commitment as it will clearly have a detrimental impact on the construction sector.

The Construction Sector Deal

The Department for Business, Energy and Industrial Strategy published: *The Construction Sector Deal* in 2019[4], setting out the government's ambitions to transform and innovate the construction sector. The key policies include:

- Raise total research and development (R&D) investment to 2.4% GDP by 2027
- Increase the rate of R&D tax credit to 12%

The intent of the strategy set out by the Department for BEIS was to ensure more R&D tax credits were available to construction companies to raise investment in innovation. Since the Construction Sector Deal the ONS reported output is now at its highest levels since September 2019, this follows an increase of 2% in December 2021 and is the third consecutive monthly growth greater than 1%.

Customer-led R&D and financial risk

Among the views expressed in the consultation responses was the notion that the entitlement of R&D tax credits should align with the company that carries the financial risk. It has been assumed in the drafting this is the customer or end client.

This is a flawed assumption when under the DSIT Guidelines, the definition of R&D for tax purposes relies upon the self-assessment of a competent professional employed by the claimant working within a field of science or technology. It is the competent professionals that determine whether a project is seeking to achieve an advance and whether that advance constitutes an increase in overall knowledge or capability in a field of science or technology. The expertise therefore lies with the employer of the competent professionals

[3] Reforms to R&D Tax Relief: Summary of impacts
[4] The Construction Sector Deal

and not the customer. Other key identifiers to align the credit with the performer of the R&D could be:

i. What is under contract – people, services, a product
ii. Whether the customer has technical expertise in the relevant field
iii. Who is taking the economic risk
iv. Who has the technical risk
v. On what basis is work invoiced - fixed price, time and materials
vi. Who retains the rights to any IP arising

The R&D tax regime would possess a fundamental failure if it rewarded companies that lack the ability to identify R&D, do not have a vested interest in the R&D and who cannot benefit from the knowledge and advancements made by the R&D.

A primary contractor will construct buildings to the requirements of their customers, the owners and ultimate users of those buildings, in specific examples, have been, a major London hotel and a Premiership football club. Due to the nature of the buildings required, R&D has been undertaken in the supply chain to meet the technological challenges encountered on the build. Under HMRC's interpretation, this R&D has been subcontracted to the primary contractor, which is then ineligible to claim. Instead, it would be the customer in this instance who is eligible to claim, but this creates the situation that a hotel and a football club are entitled to claim for R&D conducted in civil engineering when they themselves have no technical resource and no use for the advancements learnt. Even if they are *aware* that R&D is being undertaken, it is unlikely that they have the competence to properly evaluate the extent to which the work is eligible, nor is the potential to claim likely to influence their decisions as to whether to proceed.

A culture of innovation in construction

The role that R&D tax credits have played in unlocking investment in innovation in the construction sector cannot be downplayed. Historically, construction has been perceived as slow to adopt new technologies and ways of working. The 2017 'Reinventing Construction' report from McKinsey stated the construction was the second slowest sector in adopting digital innovation, ahead of only agriculture. The built environment business model is a significant inhibitor of innovation investment, with construction companies regularly making less than a 3% margin. Median profitability for construction contractors ranged from 2.1% to 2.8% for the last six years for which data is available. As such, construction businesses have limited capacity to invest in research and innovation through their normal operations. Over the last few years, the R&D tax credit has provided that necessary headroom.

This has resulted in funding and support for a range of innovation activities across the built environment sector. Figures from the Office for National Statistics suggest that direct investment in R&D has increased fourfold in the last 10 years. This increased ability to invest in innovation and research has supported government efforts to deliver sector improvement via industry transformation programmes including the Transforming Construction Programme and via the Construction Sector Deal.

Directing the incentive and rewards of R&D tax credits away from construction companies towards its customers would undo the success of the R&D tax regime to date and undermine government efforts to drive sector improvement. The drive to use innovative construction materials, technologies and methodologies is at the heart of making a construction company competitive and enabling it to deliver value to its clients. A culture of knowledge-sharing and risk-taking lies with the sector's engineering expertise, not its customers. Compared to companies in the financial services or the pharmaceutical sectors, R&D tax credits have a relatively higher impact on a construction company's profit margin. R&D incentives have worked effectively in focusing the senior leadership of construction companies on how it can grow a culture of innovation and enhance its technological knowledge and capability. The recent increases in the rate of RDEC have allowed the culture of innovation to gain momentum in construction and it is vital that any changes to the R&D tax regime allow that growth to continue.

Context around R&D

The 2022 Autumn budget confirmed the rate of Research & Development Expenditure Credit ("RDEC") and R&D tax relief for SMEs is set to change. For expenditure on or after 1st April 2023:

Research & Development Expenditure Credit

The rate of RDEC will increase from 13% to 20% of qualifying R&D expenditure.

Research & Development Tax Relief (for SMEs)

The SME deduction will reduce from 130% to 86% of qualifying R&D expenditure. The SME credit rate will also decrease from 14.5% to 10%

Under the RDEC scheme a claimant is not generally permitted to claim any costs for R&D work it subcontracts. Under the SME scheme a claimant can claim up to 65% of the cost of R&D work it subcontracts.

The government has confirmed that one of the key drivers for reforming the R&D tax regime was to tackle growing levels of abuse and non-compliance. The updated estimate for the 2020 to 2021 overall level of error and fraud in the

SME scheme is 24.4% (£1.04 billion) compared with 3.6% (£90 million) for the RDEC scheme.[5]

> *"This reform ensures that taxpayer support is as effective as possible, improves the competitiveness of the RDEC scheme, and is a step towards a simplified, single RDEC-like scheme for all. The government will consult on the design of a single scheme, and ahead of Budget work with industry to understand whether further support is necessary for R&D intensive SMEs, without significant change to the overall cost envelope for supporting R&D.[6]"*

The Government has not yet taken a decision on whether to merge and intends to keep open the option of doing so from 2024. A decision on whether to merge will be made at the next fiscal event.

During the 2022 Autumn Statement, the Chancellor announced *"R&D tax credits will be reformed to ensure public money is spent effectively and best supports innovation"* [7].The government published a consultation which ran from 13th January 2023 to 13th March 2023: R&D Tax Reliefs Review: Consultation on a single scheme. Following industry responses to the consultation, draft legislation was published on 18th July 2023 for a single merged scheme. One particular clause has caused alarm for the construction sector:

1042C Qualifying expenditure: general

(1) Expenditure is qualifying Chapter 1A expenditure if—

(a) it is either eligible in-house expenditure (see section 1042D) or eligible sub-contractor expenditure (see section 1042E), and

(b) it satisfies conditions A[, B] and C in this section.

(2) Condition A is that the activities in the course of which the expenditure is incurred are not contracted out to the company by another person in the course of a chargeable trade carried on by that person.

(3) For that purpose a "chargeable trade" is—

(a) a trade, profession or vocation carried on wholly or partly in the United Kingdom, the profits of which are chargeable to income tax under Chapter 2 of Part 2 of ITTOIA 2005, or

(b) a trade carried on wholly or partly in the United Kingdom, the profits of which are chargeable to corporation tax under Chapter 2 of Part 3.

(4) [Condition B is that the expenditure is not subsidised (see section 1138).]

(5) Condition C is that the expenditure is not attributable to an exempt foreign permanent establishment (see section 1138B).

The draft legislation is supported by the explanatory notes Explanatory note (accessible version) - GOV.UK (www.gov.uk) stating: *"To qualify for relief, expenditure must not be linked to activities that have been contracted out to the company, subsidised by another party, or attributable to an exempt foreign permanent establishment. Condition A makes an exemption for activities that have been contracted out to the company when the other person is not a UK Corporation Taxpayer (e.g. is an overseas company.)"*

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[5] HMRC's approach to Research and Development tax reliefs

[6] Autumn Statement 2022

[7] Autumn Statement 2022

The construction sector supports efforts to eliminate abuse within the scheme and to avoid multiple organisations claiming for the same costs associated with R&D activity. However, it is important that such measures do not have the unintended consequence of limiting the ability of construction businesses to invest in innovation.

Contracted R&D

The proposed legislation contains a widely drafted clause which introduced restrictions to contracted out activities and raised significant concerns for construction companies.
It largely comes down to a question explored during the consultation: Should the UK government reward and incentivise the performer of the R&D, or the customer?

Current drafting would create the scenario where a customer engages a tier one contractor to build a building with no specific demands or instructions around R&D, the contract is to build a specific design of building within a certain time frame and cost, and the customer has no technical expertise or knowledge in the field of R&D. The contractor and others in the supply chain undertake the R&D activities as part of the build but the customer is awarded the tax credit. This creates a mismatch with the payment of the credit to the entity which does not take the economic and technical risk of R&D and does not employ the resource to have the technical expertise in the field or make use of the lessons learnt from the construction innovation.

The R&D Incentives scheme is rightly designed for companies across a variety of different fields of science and technology. While there is a valid concern for abuse of the scheme and a welcome focus on compliance, the impacts of the proposed changes would be materially and unfairly detrimental to the construction sector. The clause therefore undermines the success of R&D Tax Credits to date and is at odds with the government's key commitment in the 2019 Construction Sector Deal: "to increase the capacity of the sector to innovate."

Subsidised R&D

The draft legislation also includes a condition that R&D cannot be subsidised in square brackets, with the explanatory note stating *"[The subsidy provision is in square brackets because it is still under consideration]."* This clause is, however, still under consideration, according to the accompanying Explanatory Notes. Given the nature of specific contractual arrangements in construction, Fixed Price, CM, NEC it is unclear if how the "subsidised" term may also apply

in our circumstances. Simply because the nature of a contract is "Fixed Price" there is concern that this clause would deem any construction activities to be subsidised and therefore ineligible for R&D.

It is not clear what the purpose of such a restriction would be. RDEC has no equivalent provision; the source of a company's funding for its R&D projects being irrelevant to the eligibility of the claim. The current SME scheme does have similar wording and HMRC has attempted to use this clause to reject a number of claims. One such rejection was overturned at the First Tier Tribunal in the case of *Quinn (London) Ltd v HMRC*[8], with commentary from Judge Harriet Morgan that HMRC's argument was *"out of kilter with the overall R&D scheme"*[9]. This decision was further referenced in *HMRC v Perenco UK Ltd*[10], similarly examining the definition of subsidy, albeit in relation to Petroleum Revenue Tax.

Given the potential confusion over the circumstances in which this clause might apply, and the open question over the purpose of restricting relief in this way, we recommend that it be removed.

Conclusions

It is acknowledged that HMRC needs to take measures to tackle abuse and improve compliance across the R&D tax regime. The additional information form, for example, is a welcome introduction to improve the accuracy of R&D tax claims. However, the current draft legislation is set to severely damage the level of R&D investment across the construction industry thereby leading to job losses and reduced productivity.

Any reforms to the rules on contracted R&D and subsidised R&D should be rightly designed to avoid duplication of claims, and to mitigate against error and fraud. But it should align the credit with the entity that performs the R&D, takes the financial and technological risk on R&D and can best utilise the R&D lessons learnt to continuously innovate.

Clients often expect their construction contractors to lead on innovation and take the risk and the construction industry should not be denied the credit which encourages and rewards the risk taking. In addition, in order that the construction industry can meet government targets around digitalisation, productivity and net zero the legislation must preserve the flow of valuable tax credits to construction.

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[8] [2021] UKFTT 0437 (TC)
[9] Ibid, p47(5)
[10] [2023] UKUT 00169 (TCC)

Specific recommendations:

- **Amend Section 1042C from the draft legislation published 18th July 2023 to specify it refers to "subcontracting R&D" with further guidance offered to clarify how this is identified, and remove reference to subsidised.**
- **Work with industry to ensure this does not reduce the level of R&D investment across the construction sector.**
- **Delay the merged scheme beyond 1 April 2024 to allow appropriate time for further consultation with the industry to ensure no adverse effect of the merged scheme.**