



Neutral Citation: [2024] UKFTT 1059 (TC)

Case Number: TC09358

**FIRST-TIER TRIBUNAL
TAX CHAMBER**

By remote video hearing

Appeal reference: TC/2022/00748

CORPORATION TAX – relief for expenditure on research and development – Part 13 Corporation Tax Act 2009 – whether “subsidised” expenditure – no – whether “carrying on activities which are contracted out” – no – discovery assessments – whether there was a discovery for each of the relevant years – no – was there a practice generally prevailing – yes – appeal allowed

Heard on: 20-22 November 2023
Judgment date: 25 November 2024

Before

**TRIBUNAL JUDGE ANNE SCOTT
MEMBER CHRISTOPHER JENKINS**

Between

STAGE ONE CREATIVE SERVICES LTD

Appellant

and

THE COMMISSIONERS FOR HIS MAJESTY’S REVENUE AND CUSTOMS

Respondents

Representation:

For the Appellant: Charles Bradley, of counsel, instructed by Clive Owen LLP

For the Respondents: Francis Fitzpatrick, KC and Sarah Black, of counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs

DECISION

INTRODUCTION

1. This appeal concerns the conditions for claiming additional corporation tax relief for expenditure on research and development (“R&D”) pursuant to the Rules in Chapter 2 Part 13 Corporation Tax Act 2009 (“Part 13”).
2. In broad terms, the appellant (“SOCS”) has appealed against the respondents’ (“HMRC’s”) refusal of its claims under the provisions of Part 13 for what is commonly referred to as “SME relief” or “enhanced research and development relief”. Those claims were made in respect of its accounting periods (“APs”) ending on 31 December 2017, 2018 and 2019 (“the Relevant Periods”).
3. In brief outline, SOCS argues that the R&D expenditure is qualifying expenditure and it is neither subsidised expenditure nor expenditure incurred in carrying out contracted R&D activities. HMRC argues that it is both subsidised and contracted out.
4. SOCS appeals the two Discovery Assessments issued by HMRC in respect of the APs ending on 31 December 2017 and 2018 and the Closure Notice relating to the AP ending 31 December 2019 amending SOCS’ corporation tax return for that period (“the 2019 Return”). The 2017 Discovery Assessment was raised under paragraph 41 of Schedule 18 Finance Act 1998 (“Schedule 18”) and the 2018 Discovery Assessment was raised under paragraph 52 of Schedule 18.

The Hearing

5. With the consent of the parties, the hearing was conducted by video link using the Tribunal's video hearing system. Prior notice of the hearing had been published on the gov.uk website, with information about how representatives of the media or members of the public could apply to join the hearing remotely in order to observe the proceedings. As such, the hearing was held in public.
6. We had the benefit of transcript writers. We had Skeleton Arguments for both parties. The documents to which we were referred comprised a Hearing Bundle consisting of 1,349 pages and an Authorities Bundle consisting of 997 pages. We were subsequently furnished with a copy of a missing email dated 9 October 2020 and a copy of “CIRD81900-R&D tax relief: conditions to be satisfied: DTI guidelines (2004)”.
7. The parties had lodged a helpful “Chronology and Dramatis Personae” and included in the Hearing Bundle there was a Statement of Agreed Facts and Issues extending to four pages.
8. This decision is late in being issued due to an extended period of sick leave following an accident.

The Agreed Issues

9. The legal issues in this appeal divide into issues relating to the substantive validity of SOCS’ claims for relief under Part 13 for the Relevant Periods (“the Substantive Issues”) and issues relating to the validity of the 2017 and 2018 Discovery Assessments (“the Discovery Issues”).

The Substantive Issues

10. The Substantive Issues are:

(1) “the Contracted Out Condition” - whether the material expenditure was incurred by SOCS “in carrying on activities which are contracted out to the company by any person” within the meaning of sections 1052(5) and 1053(4) Corporation Tax Act 2009 (“CTA 2009”); and

(2) “the Subsidy Condition” - whether the material expenditure was subsidised within the meaning of section 1138 CTA 2009.

To succeed on the Substantive Issues, SOCS must prove, on the balance of probabilities, that both issues (1) and (2) are answered in the negative.

The Discovery Issues

11. There are Discovery Issues only in respect of the 2017 and 2018 Discovery Assessments.

12. The Discovery Issues are:

(1) whether, at the time when an officer of HMRC ceased to be entitled to give notice of enquiry into SOCS’ company tax return for the 2017 and 2018 APs “...they could not have been reasonably expected, on the basis of the information made available to them before that time, to be aware of the situation mentioned in paragraph 41(1) ...” within the meaning of paragraph 44 of Schedule 18 and having regard to the circumstances in which information is regarded as being made available to an officer as per paragraph 44(2); and

(2) whether SOCS’ company tax returns for the 2017 and 2018 APs were each made in circumstances whereby there was an under-declaration of tax attributable to a mistake in the returns as to the basis on which SOCS’ “...liability ought to have been computed and the return[s were] in fact made on the basis or in accordance with the practice generally prevailing at the time when [they were] made” within the meaning of paragraph 45 of Schedule 18.

13. For SOCS to succeed on the Discovery Issues, either SOCS must prove issue (2) on the balance of probabilities or HMRC must fail to prove issue (1) on the balance of probabilities.

The Law

The Substantive Issues

The context

14. Here, as elsewhere in this decision, we refer to the legislation as amended and in force during the Relevant Periods, unless the contrary is stated. The original legislation was introduced in the Finance Act 2000 and the consolidated legislation is in CTA 2009.

15. Section 1041 CTA 2009 states that “research and development” has the meaning given in section 1138 Corporation Tax Act 2010 which defines the term by reference to GAAP but also provides that if something is R&D for the purposes of section 1006 Income Tax Act 2007 then it is such for the purposes of section 1138. Regulations were made under section 1006 prescribing certain activities as research and development, namely The Research and Development (Prescribed Activities) Regulations 2004/712.

16. Those Regulations state *inter alia* that R&D will qualify if it accords with the Guidelines on the Meaning of Research and Development for Tax Purposes issued by the Department for Business, Innovation & Skills on 5 March 2004 (with amendments that are not material on 6 December 2010). Those were known as the BIS Guidelines and latterly, following a merger

of Government departments, as the BEIS Guidelines. We annex relevant excerpts therefrom at Appendix 1. As can be seen from the Appendix those Guidelines have the force of law.

17. Part 13 includes provision for R&D relief for Small and Medium Size Enterprises (“SME”s); hence the descriptions the SME Scheme and SME relief. It is distinguished from the R&D Expenditure Credit (“RDEC”) Scheme.

18. The SME Scheme provides an extra deduction for the purposes of calculating a company’s R&D. For the Relevant Periods this was 130% of all qualifying expenditure, which is taken as an additional deduction in computing SOCS’ corporation tax profit so the total rate of relief is 230%, ie the ordinary trade deduction of 100% plus the additional 130% R&D relief.

19. The RDEC Scheme, which originally only related to large companies but which was later extended to SMEs in certain circumstances, is a more limited form of relief and provides entitlement to a payable tax credit which is a percentage of the qualifying expenditure on R&D. It was 11% for expenditure incurred from 1 April 2015, 12% on or after 1 January 2018 and 13% from and after 1 April 2020.

20. Companies cannot claim both SME relief and RDEC on the same R&D expenditure. Companies that are excluded from the more generous SME scheme because they do not meet the criteria can claim RDEC.

21. The SME Scheme was described by Mr Justice Henderson (as he then was) at paragraph 12 in *Gripple Ltd v HMRC* [2010] EWHC 1609 (CH) as follows:

“...the provisions form a detailed and meticulously drafted code, with a series of defined terms and composite expressions, and a large number of carefully delineated conditions, all of which have to be satisfied if the relief is to be available... It seems to me... that a detailed and prescriptive code of this nature leaves little room for a purposive construction, and there is no substitute for going through the detailed conditions, one by one, to see if, on a fair reading, they are satisfied. It also needs to be remembered, in this context, that the relief is a generous one, which grants a deduction for notional expenditure which has not actually been incurred.”

22. Of course that was in 2010, and in 2021 Lord Briggs, at paragraph 24, in the Supreme Court in *Balhousie Holdings Ltd v HMRC* [2012] UKSC 11 made it explicit that:

“The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.”

23. We agree that the statutory provisions must be interpreted in that context. Lord Hodge at paragraphs 31 and 29 respectively of *R (Project for the Registration of Children as British Citizens) v Secretary of State for the Home Department* [2023] AC 255 made it clear that:-

(a) that “...involves an objective assessment of the meaning which a reasonable legislature as a body would be seeking to convey in using the statutory words”, and

(b) “A phrase or passage must be read in the context of the section as a whole and in the wider context of a relevant group of sections”.

23. At paragraph 30 he said that “External aids to interpretation therefore must play a secondary role. Explanatory Notes, prepared under the authority of Parliament, may cast light on the meaning of particular statutory provisions...”. Whilst Lady Arden agreed with Lord Hodge, at paragraph 64, she referred to the use of external aids quoting with approval Lord Nicholls’ statement in another case that “To the extent that extraneous material assists in identifying the purpose of the legislation, it is a useful tool”.

24. What then is the purpose of the legislation? In explaining the history and purpose of sections 1052(5-6) and 1053 (4-5) CTA 20009, Officer Hamblin explained that those sections reflect three separate policy requirements, being avoiding market distortion in terms of ensuring the rules were compatible with the State Aid rules (and therefore obtaining European Commission notification), not discriminating between subsidised and unsubsidised taxpayers, and avoiding double claims. The first two go hand-in-hand. That was not challenged and we accept that. We find that the purpose of the legislation is to provide relief for R&D expenditure where the statutory requirements are met.

Extracts from the relevant legislation

25. Section 1039 in Chapter 1 of Part 13 CTA 2009 reads:

“1039 Overview of Part

(1) This Part provides for corporation tax relief for expenditure on research and development.

(2) Relief under this Part is in addition to any deduction given under section 87 for the expenditure.

(3) Relief under Chapter 2 is available to a company which is a small or medium-sized enterprise, in particular—

(a) Chapter 2 provides for relief where the cost of in-house direct research and development or contracted out research and development is incurred by the company.

...

(7) Chapter 2 also provides for the payment of tax credits (“R&D tax credits”) where a company which is a small or medium-sized enterprise—

(a) obtains relief under Chapter 2, and

(b) makes, or is treated as making, a trading loss.

...”.

26. Sections 1043 and 1044 in Chapter 2 read:

“1043 Overview of Chapter

(1) This Chapter provides for relief for companies which are small or medium-sized enterprises for expenditure on—

(a) in-house direct research and development, or

(b) contracted out research and development,

where the cost of the research and development is incurred by the company.

(2) The reliefs available are—

(a) an additional deduction under section 1044, or

(b) a deemed trading loss under section 1045.

(3) Sections 1046 to 1053 contain provision relevant to the reliefs available under this Chapter, namely—

...

(f) provision about when a company's expenditure is “qualifying Chapter 2 expenditure” for those purposes (see sections 1051 to 1053).

...”

and

“1044 Additional deduction in calculating profits of trade

(1) A company is entitled to corporation tax relief for an accounting period if it meets each of conditions A to D.

(2) Condition A is that the company is a small or medium-sized enterprise in the period

...

(3) [repealed]

(4) Condition C is that the company carries on a trade in the period.

(5) Condition D is that the company has qualifying Chapter 2 expenditure which is allowable as a deduction in calculating for corporation tax purposes the profits of the trade for the period ...

(7) The relief is an additional deduction in calculating the profits of the trade for the period.

(8) The amount of the additional deduction is 130% of the qualifying Chapter 2 expenditure...”.

27. Section 1051 provides that:

“1051 Qualifying Chapter 2 expenditure

For the purposes of this Part a company’s “qualifying Chapter 2 expenditure” means-

“(a) its qualifying expenditure on in-house direct research and development (see section 1052)

and

(b) its qualifying expenditure on contracted out research and development (see section 1053)”.

28. Section 1052 provides in so far as material:

“1052 Qualifying expenditure on in-house direct R&D

“(1) A company’s ‘qualifying expenditure on in-house direct research and development’ means expenditure incurred by it in relation to which each of conditions A, B, D and E is met.

- (2) Condition A is that the expenditure is—
 - (a) incurred on staffing costs (see section 1123),
 - (b) incurred on software or consumable items (see section 1125),
 - (c) qualifying expenditure on externally provided workers (see section 1127), or
 - (d) incurred on relevant payments to the subjects of a clinical trial (see section 1140).
 - (3) Condition B is that the expenditure is attributable to relevant research and development undertaken by the company itself ...
 - (4) [repealed]
 - (5) Condition D is that the expenditure is not incurred by the company in carrying on activities which are contracted out to the company by any person.
 - (6) Condition E is that the expenditure is not subsidised (see section 1138)
- ...”.

Only Conditions D and E are in dispute in this appeal.

29. Section 1053 provides in so far as material:

“1053 Qualifying expenditure on contracted out R&D

“(1) A company’s ‘qualifying expenditure on contracted out research and development’ means expenditure—

- (a) which is incurred by it in making the qualifying element of a subcontractor (sic) payment (see sections 1134 to 1136), and
 - (b) in relation to which each of conditions A, C and D is met.
- (2) Condition A is that the expenditure is attributable to relevant research and development undertaken on behalf of the company...
 - (3) [repealed]
 - (4) Condition C is that the expenditure is not incurred by the company in carrying on activities which are contracted out to the company by any person.
 - (5) Condition D is that the expenditure is not subsidised (see section 1138)...”.

30. Subcontractor payment, there spelt “sub-contractor payment” is defined in section 1133(1) as “... a payment made by a company to another person (‘the sub-contractor’) in respect of research and development contracted out by the company to that person”.

31. Section 1138(1) provides:

“1138 “Subsidised expenditure”

“(1) For the purposes of this Part a company’s expenditure is treated as subsidised—

(a) if a notified State aid is, or has been obtained in respect of—

(i) the whole or part of the expenditure, or

(ii) any other expenditure (whenever incurred) attributable to the same research and development project,

(b) to the extent that a grant or subsidy (other than a notified State aid) is obtained in respect of the expenditure,

(c) to the extent that it is otherwise met directly or indirectly by a person other than the company.”

32. In terms of section 1054 (which has subsequently been amended and the wrong version was in the Bundle) where an SME has a “surrenderable loss” in an AP it may claim an “R&D Tax Credit” where the loss included SME relief. The amount of the surrenderable loss is the lower of the trading loss as is unrelieved or 230% of the qualifying R&D expenditure. The amount of the credit during the Relevant Periods was 14.5%.

The Discovery Issues

The First Issue

33. There was no real dispute between the parties about the relevant legislative provisions. It is common ground that the assessments under both paragraphs 41 and 52 of Schedule 18 are subject to the provisions of paragraph 44 of Schedule 18. That paragraph provides protection for the taxpayer. As can be seen from the first Discovery Issue at paragraph 12 above, it says that if at a time when an officer ceased to be entitled to give a notice of enquiry into a return, then if they “could not have been reasonably expected, on the basis of the information made available to them before that time, to be aware” that an assessment of tax had become insufficient, then a discovery assessment can be raised.

34. However, paragraph 44(2) goes on to say that:-

“(2) For this purpose information is regarded as made available to [an officer of Revenue and Customs] if—

(a) it is contained in a relevant return by the company or in documents accompanying any such return, or

(b) it is contained in a relevant claim made by the company or in any accounts, statements or documents accompanying any such claim, or

(c) it is contained in any documents, accounts or information produced or provided by the company to [an officer of Revenue and Customs] for the purposes of an enquiry into any such return or claim, or

(d) it is information the existence of which, and the relevance of which as regards the situation mentioned in paragraph 41(1) or (2)—

(i) could reasonably be expected to be inferred by [an officer of Revenue and Customs] from information falling within paragraphs (a) to (c) above, or

(ii) are notified in writing to [an officer of Revenue and Customs] by the company or a person acting on its behalf.”

The Second Issue

35. Paragraph 45 of Schedule 18 reads:

“No discovery assessment for an accounting period for which the company has delivered a company tax return, or discovery determination, may be made if—

(a) the situation mentioned in paragraph 41(1) or (2) is attributable to a mistake in the return as to the basis on which the company's liability ought to have been computed, and

(b) the return was in fact made on the basis or in accordance with the practice generally prevailing at the time when it was made.”

HMRC’s Corporate Intangibles Research and Development Manual (CIRD)

36. In correspondence and elsewhere, HMRC have relied on their published guidance which is included in this manual. CIRD81650 relates to subsidised expenditure and CIRD84250 relates to sub-contracted activities. Both were amended on 30 November 2021 and we annex at Appendix 2 extracts of the relevant sections showing both the old and the new versions. Of course, the amendments were made after the Relevant Periods.

The witnesses

37. For the appellant we heard firstly from Mr Tim Leigh, who has been employed by SOCS since 2013, initially as Sales and Marketing Director and since 2019 as Managing Director. We found him to be a credible and reliable witness whose evidence, both written and oral, was straightforward and he provided clear and straightforward explanations of both SOCS’ *modus operandi* and the detail of the three sample contracts.

38. We then heard from Mr Nigel Holmes, Director of Tax at Catax, which is a specialist tax relief organisation specialising *inter alia* in R&D tax relief claims. He was called to give evidence as to the “practice generally prevailing” (“PGP”) in the Relevant Periods.

39. Lastly, we heard from Ms Nicola Bellerby who was a tax partner in Clive Owen LLP. She spoke to earlier R&D claims which had been the subject matter of a previous enquiry by HMRC. She also spoke to PGP.

40. For HMRC we heard evidence firstly from HMRC Officer Mark Aspey who was the officer who issued the Closure Notice and the Discovery Assessments that are the subject matter of this appeal.

41. We also heard evidence from Officer Philip Hamblin, technical adviser, Research and Development Relief Policy Team of HMRC. He described the purpose of his evidence as being “...to provide some background information as to the various regimes relating to research and development expenditure and as to HMRC’s understanding of the purposes of the rules in issue in these proceedings”.

42. He was one of the authors of the new version of CRID issued in November 2021. He had also first been consulted on 17 September 2020 to advise in relation to the HMRC enquiry in this appeal.

The Facts

43. As we have indicated, the parties had lodged a Statement of Agreed Facts and Issues but we also had agreed facts in the Alternative Dispute Resolution Exit Document (“the ADR Exit”). The parties had consented to that being lodged in process and founded upon. It is not a “without prejudice” document. In the course of the hearing, it transpired that a number of other facts were also agreed. With one exception, there was no substantive challenge to the evidence of fact. We therefore narrate our findings in fact from all sources.

44. There was no dispute between the parties in relation to the factual background other than in the context of PGP.

Overview of SOCS and the Enquiry

45. SOCS is a UK incorporated limited company resident in the UK for corporation tax purposes. It is an SME.

46. SOCS’ business is the provision of engineering, construction and automation solutions for live events and installations. SOCS frequently accepted commissions to produce projects that had no precedent. It was a company that took on difficult, challenging projects; on occasion not being sure at the outset whether they would be able to deliver the result that was actually sought by the client.

47. SOCS have a proven track record for developing innovative solutions in the creative industries; their work would not be described as “routine”. Their client base is diverse and approximately 60% of their work is delivered outwith the UK.

48. The portfolio of projects that SOCS deliver is both broad and varied and that is reflected in the value of their contracts that range from a few hundred pounds to several million pounds. There is no typical project although they all start with a concept that may involve various stages of development. SOCS is routinely commissioned to produce projects that have no precedent. The creative agencies that commission SOCS are usually keen to do things that are novel.

49. There is no catalogue of products and there is usually an element of uniqueness, albeit SOCS may utilise ideas that have been used in the past and adapt them, although that would not be included in the R&D claim. Knowledge derived from R&D activity, and the intellectual property are retained by SOCS, and may subsequently be applied in later projects, perhaps with a different client.

50. As Mr Fitzpatrick conceded, the evidence is that under the contracts with their clients SOCS agrees to deliver a particular result and, to varying degrees, the clients are not concerned with exactly how that is achieved.

51. It is common ground that all of SOCS’ clients were unconnected and that all contracts were entered into at arm’s length.

52. Individual contracts have been as basic as a simple acceptance of standard Terms & Conditions (“T&Cs”) but some contracts extended to hundreds of pages with detailed scope of both work and performance criteria.

53. Clients come to SOCS with a concept and at the point of contract, it is not usual for the scope of work and performance specification to be comprehensively detailed. The financial risk lies with SOCS in that when it delivers a tender or quotation for delivery of the aesthetic vision transformed into physical form, in many cases it does not know the extent of R&D that will be required. Further the project itself may well evolve. The tender or quotation is usually a fixed price so that the client has a degree of certainty.

54. In the course of normal project delivery, SOCS may experience failure of an approach or methodology. This occurs to some degree across all projects. The risk and uncertainty are accommodated by SOCS and the additional cost of R&D activity to overcome this failure is not passed to the client.
55. The contract will usually reference a series of drawings, renders, or take the form of a narrative that describes the design intent. As the project progresses SOCS collaborates with the client to rationalise, refine and develop the project requirements further. In most cases, the clients will develop the specification and requirements after the contract has been agreed.
56. Where specification requirements are developed beyond the scope of the original contract, and where time allows, a contract variation notice may be entered into. However, where requirements are further refined but still fall within the scope of the original contract, the cost of that additional work will be borne by SOCS.
57. Where SOCS receives stage payments, if the project is not delivered those payments are repayable. Where a project is not entirely successful, the contract may provide for financial penalties. Some projects are loss making.
58. SOCS undertakes R&D both in the context of specific contracts but also in what Mr Fitzpatrick described as freestanding R&D where there is no client; the example given was “Blender Motion Mapping” in the 2018 R&D Report (documentation supporting the claim for SME relief). Mr Bradley described that project and eight others in that R&D Report as being “purely ‘internal’ R&D aimed at improving aspects of SOCS’ proprietary systems”. Mr Leigh’s evidence confirmed that.
59. Very occasionally, SOCS is asked to develop a specific technology, as for example for spider cams, and in those circumstances, it makes no claims for R&D because it views that as sub-contracted R&D.
60. Any intellectual property generated whilst working on contracts remains the property of SOCS. This applies equally to SOCS’ clients, and to the relationships with those who it engages to perform activities on its behalf.
61. The phrase “Research and Development” is not included in any contracts for projects for which SOCS is making a claim for R&D expenditure.
62. SOCS has been making claims for relief for R&D expenditure since the AP ending 31 December 2012. Those claims were made under the SME Scheme.
63. Their accountants prepared the R&D Reports for each accounting period and submitted those to HMRC together with the tax returns and accounts. Ms Bellerby assisted with the R&D Reports for the periods ended 31 December 2013 and 30 June 2014.
64. Her approach to the R&D Reports was to discuss the projects in detail, at a meeting, with the R&D director, who was also the materials engineer, and the finance director. The R&D Report was then prepared and included:
- (a) A summary of the relevant expenditure, up to the point where the technical uncertainty was finally overcome.
 - (b) A narrative of the company background.
 - (c) Detail of each of the individual projects, summarising what the project involved, highlighting the technical uncertainties and how they were overcome and an explanation under the heading “Why was the knowledge not readily deducible by a competent professional?”.
 - (d) A cost analysis.

(e) A breakdown of costs by project.

65. In or about 2016, HMRC opened an enquiry into R&D Reports for the APs ending 31 December 2013 and 30 June 2014. On 18 March 2016, Mr Leigh and three other directors of SOCS, accompanied by Ms Bellerby, attended a meeting with HMRC where those R&D Reports were discussed in detail.

66. At that meeting neither HMRC nor Clive Owen LLP raised the issue as to whether any part of the projects in question had been sub-contracted or subsidised. The meeting ended with HMRC authorising a substantial part repayment.

67. HMRC's case notes indicate that the primary focus of that enquiry appeared to have been to check whether the claimed activities constituted R&D as defined by the BIS Guidelines. Some other risks were addressed, including a concern that the R&D may have "belonged" to overseas group companies rather than to SOCS.

68. R&D Reports in the same format were lodged in each of the following years.

69. SOCS' tax return for the AP ending 31 December 2019 included a claim for relief for the R&D expenditure and a claim for a R&D tax credit payment. It was accompanied by an R&D Report. The 2019 Return was received by HMRC on 29 May 2020.

70. By a compliance check opening notice letter dated 28 July 2020, Officer Richardson of HMRC notified SOCS and Clive Owen LLP, that HMRC was going to check that 2019 Return. The letter specifically referred to HMRC's intention to review the figure shown for the R&D claim and in a Schedule requested specified information and documents relating to three of the 10 projects undertaken by SOCS during the 2019 AP and included in the R&D Report.

71. In particular, in respect of each of the three sample projects, the Schedule indicated that HMRC thought that it appeared that SOCS had undertaken the project on behalf of a third party.

72. Correspondence ensued and SOCS delivered files including the relevant contracts to HMRC. They later furnished further details in relation to the three sample projects on 9 October 2020 ("the October email").

73. On 30 October 2020, Officer Richardson wrote to SOCS setting out her conclusion that SME relief would not be available because Conditions D and E in section 1052, Part 13 were not met, ie the expenditure had been incurred in carrying out activities which were contracted out to SOCS and the expenditure was subsidised in terms of section 1138, Part 13.

74. She argued that:

(a) as SOCS had said in the October email, "The R&D activity was undertaken to put the company in a position to fulfil our contractual obligations" and was therefore part of the work that had been contracted, as without it the requirements of the contract would not have been met; the R&D activities formed an inherent part of the contract,

(b) because SOCS undertakes contracts to provide services for payment and in fulfilling those contracts had undertaken R&D there was a clear and direct link between the payments received and the R&D so section 1138 (1)(c), Part 13 applies,

(c) as R&D formed an inherent part of the contracts it would be expected that SOCS would have factored the cost of the R&D into any tender and thus the contracts; she referred to the iterations of cost in the Pearl project which she argued showed a clear link between the R&D and the payments, and

(d) reliance was placed on paragraph 303 in *Hadee Engineering Co Ltd V HMRC* [2020] UKFTT 497 (“Hadee”) because she argued that the facts bore a striking similarity to those in the three sample projects.

75. On 24 November 2020, Mr Leigh and others, accompanied by Ms Anderson of Clive Owen LLP met with Officer Richardson and Officer Patel via Teams. After discussion, as HMRC’s note of the meeting records, the HMRC officers indicated that (a) they did not consider that the R&D had been sub-contracted, and (b) the subsidy issue would be referred to HMRC’s policy division.

76. There was a brief discussion about the previous enquiry and SOCS’ note of the meeting records that Officer Patel said that the previous officers had “got it wrong”. HMRC’s note records that Officer Patel said that the previous enquiry had been “incorrect”.

77. Both notes record that Ms Anderson distinguished *Hadee* which she said had been based on lack of records and she had pointed out that, in any event it was not binding.

78. On 25 November 2020, Ms Anderson wrote to HMRC *inter alia* requesting confirmation that HMRC accepted that the R&D was not sub-contracted to SOCS by the clients.

79. On 18 December 2020, Officer Richardson responded stating that on further reflection, and after discussing matters with head office, she reiterated the views articulated in the letter of 30 October 2020, ie the R&D activities were both subsidised and sub-contracted.

80. She also suggested that the previous enquiry had simply not addressed the relevant issues; there had been no change in HMRC’s approach. She relied on CIRD84250 from November 2004, which she enclosed, and referenced by hyperlink the 2016 CIRD84250, arguing that they said the same thing.

81. Correspondence ensued in relation to both subsidy and sub-contracting. Officer Aspey conceded in cross-examination that no new facts were elicited as a result of that correspondence.

82. On 23 February 2021, Officer Davies of HMRC wrote to Clive Owen LLP stating that she planned to close the enquiry on the basis of the views already expressed, ie the letters of 30 October and 18 December 2020. Therefore, she intended to issue a Closure Notice and amend the 2019 Return on 26 March 2021 on the basis that SME relief was not available. Clive Owen LLP responded on 11 March 2021 disagreeing with HMRC. On 12 April 2021, HMRC responded stating that their view remained unchanged, and a Closure Notice would be issued on 14 May 2021. They indicated that they did not consider ADR to be of value in this case. On 28 April 2021, HMRC wrote stating that Discovery Assessments for 2017 and 2018 would be issued on 1 June 2021.

83. On 20 May 2021, HMRC sent SOCS details of ADR in response to an expression of interest in a letter of 11 March 2021. That interest appears to have been triggered by HMRC’s letter of 23 February 2021.

84. The compliance check was transferred to Officer Aspey on 24 August 2021 when the ADR process had started.

85. On 10 November 2021, the ADR Exit was signed establishing the points on which agreement had been reached and those where there was no agreement.

86. On 17 December 2021, using a MS Teams meeting, Ms Anderson of Clive Owen LLP and Mr Leigh (and others) met with Officer Aspey. The unchallenged notes of the meeting record that one of the topics of discussion was the decision of Judge Morgan in *Quinn v HMRC*

[2021] UKFTT 0437 (TC) (“Quinn”) which had been released on 27 October 2021 (the hearing had been on 10 and 11 June 2021 notwithstanding the dates shown on the face of the decision).

87. The notes stated:

“...TB [Officer Brown] read directly from the HMRC notes delivered to the RDCF (communications forum, name changed from consultative committee). These will be published shortly but of interest was the following:

1. HMRC not appealing Quinn but think Judge was wrong and HMRC not changing their view.
2. HMRC think their mistake was not litigating both contracted and subsidised in Quinn.”

88. Officers Aspey and Brown confirmed that to their knowledge SOCS was the most advanced case where HMRC intended to assess on the basis of both sub-contracted and subsidised. HMRC stated that the earlier concession in relation to sub-contracted was incorrect and they would now proceed to issue assessments.

89. On 24 December 2021, Officer Aspey, having consulted HMRC’s policy team whom he stated had “guided” him, issued a decision letter (“the Decision Letter”) which stated, amongst other things:

(a) It was agreed that during the 2019 AP expenditure totalling £3,600,829 had been incurred which constituted R&D expenditure for the purposes of corporation tax.

(b) HMRC’s view was that the whole of this expenditure was not eligible to be claimed for relief under the SME Scheme, due to its being both subsidised by SOCS’ clients, and further and or alternatively, had been incurred in relation to activities that had been contracted out to SOCS by its clients.

(c) In relation to subsidisation, HMRC found that SOCS had been engaged by its clients to complete a range of projects in return for a consideration and the R&D expenditure formed part of delivery of those projects.

(d) HMRC relied upon their guidance CIRD81650 and argued that the R&D expenditure incurred as part of the projects had a clear and direct link with the payments received.

(e) In relation to contracting of activity, HMRC took the view that the substance of the contracts included the R&D activities and agreed with the argument advanced for SOCS in the letter attached to the October email that “The R&D activity was undertaken to put the company in a position to fulfil [their] contractual obligations”. Accordingly, the R&D activity was performed because of the contracts to deliver goods and services and as a necessary part of fulfilling SOCS’ obligations under the contracts. Therefore section 1052(5) Part 13 applied.

(f) HMRC accepted that the contractual revisions made during two of the three projects did not necessarily directly relate to R&D but it had been noted that in some instances those occurred after R&D had commenced; accordingly at that point R&D was a known component of the contract.

(g) The protective claims in respect of the alternate RDEC claims, received and reviewed on 10 December 2021 with further clarifying detail provided on 14 December 2021, would be taken to replace the original SME Scheme claims subject to certain caveats.

90. HMRC issued the following assessments:

(a) On 24 December 2021, a Discovery Assessment under paragraph 52 Schedule 18 (“the 2018 Discovery Assessment”) for the AP ending 31 December 2018). This was stated to be in respect of an overpayment of R&D tax credits paid on 2 October 2019 in relation to the AP ending 31 December 2018. The amount payable was stated as £198,971.32.

(b) On 30 December 2021, a Discovery Assessment under paragraph 41 Schedule 18 (“the 2017 Discovery Assessment”) for the AP ending 31 December 2017 showing an amount of tax payable of £248,100.67 plus interest in a total sum of £271,395.35. This reversed a claim under Part 13 CTA 2009 for R&D Expenditure made for this period.

91. SOCS appealed both Discovery Assessments by letters dated 10 January 2022 on the ground that “We do not believe this assessment is correct as we believe that the original claim for research and development tax credits is valid.”

92. On 11 January 2022, HMRC issued a notice of completion of enquiry into the 2019 Return amending that return in accordance with the conclusions reached in the Decision Letter (“the Closure Notice”).

93. The practical combined effect of the Closure Notice and the Discovery Assessments was that:

(1) In respect of the AP ending 31 December 2017, SOCS had set off the 130% SME relief against its trading profits so the assessment removed that and increased the trading profit.

(2) In respect of the AP ending 31 December 2018, SOCS had surrendered a loss (caused by the SME relief) and received a credit which had been paid on 2 October 2019 so the assessment reclaimed that credit.

(3) In respect of the AP ending 31 December 2019, SOCS had again surrendered a loss (caused by the SME relief) and claimed a credit but no credit had been paid. The effect of the Closure Notice was to confirm that no credit was payable or would be paid.

94. On 21 January 2022, SOCS submitted Notices of Appeal to the First-tier Tribunal (Tax Chamber) against the conclusions of the Decision Letter and the Discovery Assessments. The grounds for appeal were ‘We do not accept HMRC’s view that the R&D has been subcontracted to Stage One Creative Services Limited or subsidised by the customers’.

95. On 16 May 2022, the Tribunal consolidated the appeals.

The Sample Projects

96. The parties have agreed to approach this appeal on the basis that these three sample projects are, for all material purposes, representative of the other projects undertaken by SOCS during the 2019 AP. HMRC had reserved the right to challenge this position should contradictory evidence be produced but none was.

97. Whilst it is common ground that the sample projects were representative for the 2019 AP, the 2018 and 2017 Discovery Assessments for those APs were raised on the basis that they were made on the “presumption of continuity”. SOCS accepts that the material facts in respect of the 2017 and 2018 APs are similar to those in respect of the 2019 AP but there is a material difference. The R&D claim for the 2018 AP included 16 individual projects of which nine were not undertaken in order to fulfil commissions for particular clients but were instead purely internal R&D aimed at improving aspects of SOCS’ proprietary systems, ie what Mr Fitzpatrick referred to as “freestanding R&D”.

98. Mr Leigh is the managing director of SOCS and he explained the details of three projects as samples of the projects undertaken in relation to which the R & D Expenditure was incurred. Those projects were:

The Pearl

The Pavilion, and

The Parade.

99. In the first of these projects the client was the end-user and in the other two it was a creative agency that had won a pitch from the end-user and in each case the end-user had a particular aesthetic vision. As Mr Bradley put it, the task for SOCS was to translate that vision into physical reality and in doing so to surmount the complex technical issues.

The Pearl

100. Franco Dragone Trading (Beijing) LLC (“Franco”) was the counterparty in the contract dated 30 September 2019. The contractual relationship was conventional in that SOCS was the supplier and Franco was the end-user.

101. The contract is short and extends to only six pages in both Chinese and English. It is described as a contract for the sale of SOCS’ “commodities”. The contract then includes a table with details of “commodity, specifications, quality and unit price”. There then follows a table which is described as “Description of Goods” and those are all physical items and their prices. There is no mention of R&D.

102. Delivery was stipulated as being within two months. The value was stated as being US\$90,750.88 with payment of 45% “on signing and provision of technical drawings” and the balance in two tranches thereafter. An invoice for that 45% was attached stating that that payment was due on 30 September 2019 by return, that it was a supply of services per a quotation (which has not been produced) for a “Pearl & Straw Platform with Automation”.

103. As can be seen, there is very little detail in the contract but Mr Leigh confirmed that thereafter there would have been very lengthy discussions which might have involved emails, Zoom meetings, and face to face meetings.

104. Franco was a creative show production company and their only interest was in the elegance and aesthetic of the deliverable, rather than the process of researching and engineering the solution to produce that. The only specification made was the required speed of operation.

105. SOCS knew that the deliverable would require R&D activities and when entering the contract SOCS did so without the certainty that it was entirely feasible.

106. The project involved designing, manufacturing and installing a complex bespoke scenic design for a theatrical show comprising an automated pearl element that was flown through the theatre and opened to reveal a performer within it. There was also a Straw Platform which was a decorative piece.

107. At the outset, SOCS only had a render, a sketch and a visualisation of the Pearl, so the technical difficulties were only identified as the project evolved. The R&D Report identified five technical uncertainties and how the project was in fact delivered which included design development meetings and production of samples. The explanation as to why the knowledge was not readily deducible by a competent professional included the facts that the design was complex and novel, prototypes and a test build were required as the design was developed and it could only be fully tested and completed during installation.

108. When costing projects there is a high degree of uncertainty but the quotation is always a fixed price. As it evolved, with more information becoming known, requirements changing

and research conducted, this project involved 10 iterations of cost commencing at £95,322 and concluding at £159,830.

109. The eventual cost was greater than originally anticipated because of the additional man hours and the unexpected purchase of materials associated with developing a satisfactory working prototype. The additional man hours did not form part of the increase in the contract price.

110. The project was moderately profitable returning a gross profit of 9.66%. That is well below SOCS' objective of 35% before overheads. The reduced margin was the function of underestimating the hours required to solve the technical challenges during the development phase of the project. Typically, SOCS' overheads are approximately 25% of revenue. Accordingly, in this instance, SOCS made a loss on the R&D activities.

111. In the October email, SOCS confirmed to HMRC *inter alia* that:

“The R&D activity was undertaken to put the company in a position to fulfil our contractual obligations”.

“At the very outset of the project it was not known if [SOCS] could rely on its prior IP R&D knowledge with slight adaptations...It was known very early into the project that R&D would be required”.

The Pavilion

112. The client in this case was Aeorema Ltd trading as Cheerful Twentyfirst (“the Client”) and it is a creative agency that designs brand experiences. It had won a pitch to deliver a temporary exhibition stand for BBC Studios Distribution Limited (“BBC”) which was the end-user. That pitch was won on the strength of partially developed concepts and visualisations, ie the experience to be delivered was described in words supported by computer generated imagery which was an artist's impression.

113. On the basis of concepts shared with the BBC during the pitch, the project involved designing, fabricating, installing and uninstalling a large demountable and unique pavilion.

114. SOCS had complete autonomy in terms of delivery under the contract. The Client's concern was that the physical pavilion matched the description and computer generated image and was installed, and uninstalled, on the correct dates.

115. It was a considerable technical challenge and complicated to create. It involved months of research to develop the methodology.

116. The contract was “back to back” so the BBC contract (which was only produced in draft) flowed through the Client and then to SOCS albeit the main contract terms were apparently amended to SOCS' benefit through correspondence. The contract between SOCS and the Client was identified in correspondence which referred to and incorporated numerous documents. SOCS' own standard Terms and Conditions (“T&Cs”), which formed part of that, were amended to align with the BBC's T&Cs and a number of other items including the draft contract between the Client and BBC.

117. It suffices to say that in terms of the draft contract between the BBC and the Client:

(a) “Supplier Items” means the Services, Deliverables and Supplier Background IP (including the tools and materials used by the Client). There are very general definitions of “Deliverables” and “Services”.

(b) Clause 18 includes a general prohibition on sub-contracting or assignment with the exception of approved sub-contractors. SOCS was identified in the Schedule as the

approved sub-contractor for construction services. There were three other approved sub-contractors for creative direction, design services and facade sculpture.

(c) Schedule 1, which is entitled “Services and specification”, is lengthy and sets out detailed requirements in terms of the potential usage of the pavilion, but is very high level in terms of the concept *inter alia* stating, for example that:

“The new build should be pioneering, innovative and creative in structure, embracing the natural daylight and maximising both inside and outside space...

This space externally and internally should allow us the flexibility to showcase our brand and content in new, interesting and creative ways... Options should be investigated to find clever ways to change the format of the space at pace and with ease during the lifetime of the event...

Fully integrated technology led solutions should feature heavily in the design, supporting the need to display a range of content through smart, flexible branding opportunities e.g. could be a wall, could be a screen, could be an installation...

The design... Needs to be versatile in so many ways. As you step into the space you are greeted by a warm and friendly environment with a bold, British and creativeness of the brand speaks for itself.”

118. One of the documents that the email correspondence stated formed part of the contract was a “Cost Update v1.5”. The Executive Summary explained that it was the “...latest cost breakdown, including lines for items that were previously ‘TBC’”. The email explained that the base cost was “agreed as

- a. Design, fabricate test build, year 1 install – £833,143.05
- b. Year 2 install – £224,104.53 – if instructed
- c. Year 3 install – £224,104.53 – if instructed
- d. Total base order value – £1,281,352.11
- e. It is agreed that there will be a number of additional costs and free issue items procured by C21 [the Client] which are as described in these contract documents or otherwise agreed.”

119. Nowhere in the correspondence (and the documents) comprising the contract between SOCS and the Client is there reference to R&D. An example is one of the documents forming part of the contract which is called “Stage One Scope of Works & Specification”. Under the heading “Introduction” it states that “The purpose of this document is to maintain an explicit understanding of the agreed [supply to be made by SOCS] for this project and record substantive changes as they occur...”. That document is detailed and extends to 15 closely typed pages detailing what SOCS is contractually bound to provide. In summary, it specifies the provision of the particular physical items (and their cost) which are required to deliver a pavilion that meets that specification. It also includes provision for a test build off-site.

120. The original price that was quoted was £1.6 million. The project was then subject to value engineering and items falling out of scope giving a reduced price of £833,143. This was amended during development works because of further changes to scope and design. The final price of £938,279.38 was agreed for delivery of the Pavilion in 2019. The eventual cost, in terms of what was delivered, was much greater than originally anticipated at the point of quotation. That cost was incurred in the form of additional man hours incurred in the designing of the Pavilion’s construction methodology and elaborate opening façade. Additional costs associated with the installation crew on site were also incurred.

121. The R&D Report identified six technical uncertainties including “How to develop the architect’s concept design into a detailed design that could be manufactured in a demountable form, installed on site in the six days available and then dismantled and stored for reuse over successive years.” It went on to describe how the project was in fact delivered which included producing samples to establish finishes and details, producing mock-ups and prototypes of the complex facade, carrying out a test build and collaborating with the Client.

122. The explanation as to why the knowledge was not readily deducible by a competent professional included the facts that the concept design was highly innovative and complex, a test build was required to identify and resolve as many issues as possible ahead of delivering the project on site and it was only when it was erected on site (in a storm) that it was possible to resolve the uncertainties.

123. This contract was ultimately loss making and returned a gross profit of minus 13.66% because it required a great deal more R&D than had been anticipated at the outset.

124. In the October email, SOCS confirmed to HMRC *inter alia* that “The R&D activity was undertaken to put the company in a position to fulfil our contractual obligations”.

The Parade

125. The client in this case was Betty Productions Limited which is a London based production company which delivers some of the world’s largest ceremonies and events. They had been awarded the full production contract for delivery of the National Day show in Abu Dhabi.

126. The project for SOCS was the delivery of four key elements of the show including an automated aerial flying system for movement of scenery, a large stage with decorative face year, storage garages, hydraulic lifts, water pool and performer revolve, a skilled crew for installation, operation and removal and a scenic “weeping” dhow (“the Hero Water Boat”).

127. Their brief took the form of written descriptions of the required deliverables, some performance specifications in terms of weights and speed of movement and visual descriptions in the form of images for scenic elements. Those were detailed in the contracts.

128. Many components of R&D were required to successfully deliver this project. R&D, prototyping and experimentation were utilised to meet the creative objectives and design intent. One example is the automated flying system for the movement of scenic elements along a prescribed flight path which was achieved by bespoke software which was developed by SOCS.

129. The whole project was developed and manufactured by SOCS with the input of specialist sub-contractors. The prefabricated structures and equipment were shipped to Abu Dhabi and built on site by SOCS’ specialist team.

130. There is a separate contract for each of the four elements but they are in very similar form.

(a) The flying system contract is dated 14 August 2019 and is described as being for the provision of “technical services for an “Aerial Flying System”. “Deliverables” and “Services” are defined in very general terms and those are to be provided in terms of Schedule 1 which in turn refers to the Technical Specification at Annex B. That Annex is 12 pages of technical specification but makes no reference to R&D. SOCS’ contractual obligation is to meet that specification. Clause 8 of the contract provides that the charges to be paid to SOCS “...shall include all costs, charges and expenses arising and / or incurred by the Supplier and its Sub-contractors in the course of carrying out its

obligations under this agreement...”. The contract permits SOCS to utilise suitably qualified sub-contractors.

(b) The contract for the Stage, dated 14 August 2019, which is also described as being for the provision of technical services, is in the same format. Only the technical specification is different.

(c) The contract for the crew, which is dated 9 September 2019, is also in the same format but Schedule 1 specifies what is required in terms of crew, their numbers and the rates for their pay and expenses. There is no Annex B.

(d) The contract for the Hero Water Boat is dated 14 September 2019 and is described as being for provision of technical services for “a stand-alone scenic element in the Show” which SOCS was contracted to manufacture and provide. It is in a similar format but there is no Annex B. Instead, Schedule 1 sets out a relatively high level view of what is required and uses wording such as “Below is guidance on potential arrangements, but this is subject to further development and rehearsals...” and “The scenery could be constructed using any of the following individual methods or a combination of these methods, whichever is deemed most appropriate... The Supplier is encouraged to propose their preferred method of construction and materials to be used; this may or may not include any of the aforementioned methods”.

131. The Aerial Flying System and Stage contracts were amended by a Change Order dated 4 September 2019 (which included a further eight pages of technical specification). The latter was further amended by Change Orders dated 22 September, 22 October and 20 November 2019. Those Orders included provisions for additional charges payable as a result of further supplies. We observe that the Change Orders dated 4 September, 22 October and 20 November 2019 were all between Betty Productions Limited and a company called Stage One Limited. We drew that to the parties’ attention and Mr Bradley stated that Stage One Limited had always been dormant. We assume that those were drafting errors since the Orders were signed by Mr Leigh on behalf of SOCS.

132. The R&D Report identified nine technical difficulties and seven mechanisms by which those were resolved. One of those technical difficulties, being one upon which HMRC focussed in the course of their enquiry, was how to create a bespoke doughnut revolve “based on adapting the design principles of a ...previous design”. (HMRC had wanted evidence that R&D had been involved given that there was an existing design.) The R&D Report stated that knowledge was not readily deducible because it was the largest such revolve ever built and a one-off prototype had been built by adapting the design principles of a previous design.

133. In the October email, SOCS confirmed to HMRC *inter alia* that “The R&D activity was undertaken to put the company in a position to fulfil our contractual obligations”.

134. Betty Productions Ltd provided SOCS with designs and technical specifications but SOCS was autonomous in terms of designing a fabrication and technical methodology to meet the design brief. They were responsible for testing and commissioning the various components of the delivered goods.

135. The original price quoted for the project was £4,472,050. Subsequently there were 35 additional cost versions prepared for the project before getting to contract. The variation in costs were largely a function of elements coming in and out of scope. Ultimately, SOCS received £6,193,462. The expenditure incurred by SOCS had not changed from that initially projected.

Discussion

136. Mr Fitzpatrick rightly stated that the term “research and development” encapsulates a number of quite complex concepts. Some of those require specialist knowledge in order to decide whether it meets the relevant definition and ultimately whether it is R&D or not. Mr Bradley agreed.

137. We have included at Appendix 1 the relevant extracts from the BIS Guidelines, partly because they form part of the legal context, partly because both parties referred to them but also because the ADR Exit stated explicitly that it was agreed that “HMRC are not challenging whether the R&D meets the definition of R&D for tax purposes as set out in the BEIS guidelines.” We had observed that the Closure Notice stated that the enquiry had not focussed on whether the activities met the BIS definition of R&D and no decision had been made on that. However, HMRC had accepted, on a without prejudice basis, that the activities met the relevant criteria to the extent that that had been claimed.

138. Mr Fitzpatrick very helpfully confirmed that the ADR Exit correctly stated HMRC’s position. That is not the same as accepting that it was R&D for tax purposes but we have proceeded on the basis that it was.

139. Shortly put, the issue between the parties is whether a company incurring R&D expenditure in meeting its contractual obligations is automatically both sub-contracted and subsidised?

140. Both the Contracted Out Condition and the Subsidy Condition (see paragraph 10 above), which are the substantive issues in this appeal, turn on statutory interpretation. There is no dispute between the parties about the applicable principles and we have set those out at paragraphs 22 to 24 above.

141. Mr Fitzpatrick argued that when considering the purpose of the statute it is derived from the words used by Parliament. One is not looking at the intention of Parliament but seeking the meaning of the words which have been used. We consider that to be fair comment.

142. Officer Hamblin narrated the history of the statutory provisions, the consultation process in 2013 and 2020 and HMRC’s view of the aims and purpose of the legislation.

143. He was very candid. He ultimately agreed that whatever HMRC may or may not have done in the course of enquiries into the affairs of various taxpayers, the only reported cases were *Hadee* and *Quinn*. Mr Bradley took him to the report of the meeting on 17 December 2021 (see paragraphs 86 to 88 above) which he described as being a précis. He did not accept that it would have been said that the Judge in *Quinn* was “wrong” but said that it was certainly the case that HMRC did not concur with Judge Morgan’s decision. He explained that no appeal had been made “Because we considered it appropriate to take a better worked case so we could have the matter heard...” and that that was a tactical decision because the sub-contract point had not been canvassed before the Tribunal in *Quinn*. In his opinion that was an error on the part of HMRC.

144. He went on to explain that in late 2019 he had become aware of an increasing number of SME claims where he thought that the Contracted Out and Subsidy Conditions were relevant and he was concerned about the possibility of what might have been either abuse or mistakes. He explained, for the avoidance of doubt, that he considered that SOCS did excellent work and if there was a problem it would be attributable to a mistake.

145. He said that HMRC had then been “on the lookout anyway for areas that we’d missed...”. The upshot of that was that this appeal and one other were listed for hearing and approximately 10 other appeals were stayed behind.

146. We propose to consider the Subsidy Condition first since it was litigated in *Quinn*.

The Subsidy Condition

147. SOCS has relied upon *Quinn* throughout having distinguished the decision in *Hadee*. Of course, neither decision is binding upon this Tribunal. We do not accept that Officer Richardson was correct to say (see paragraph 74 above) that the facts in this appeal bore a striking similarity to the facts in *Hadee*. The paragraph upon which she relied related to one project only and, in respect of at least two others, the Tribunal found as fact that the appellant had invoiced for, and was reimbursed for, design time. We take the view that SOCS is correct to distinguish *Hadee* saying, as Ms Anderson did (see paragraph 77 above) that the decision in *Hadee* had been based on lack of records. As Judge Dean and Mrs Christian said at paragraph 226:

“The difficulty for the appellant in this appeal is that no terms of engagement have been provided which may have clarified the nature of the activities forming part of the contract and whether, and if so to what extent, R&D was included”.

In this appeal, as can be seen, there is copious documentary evidence. Although in their Skeleton Argument, in a footnote, Mr Fitzpatrick and Ms Black state that *Hadee* supports their analysis of the legislation, Mr Fitzpatrick conceded that *Hadee* was “quite a difficult decision” because the underlying documentation was absent. We do not find that *Hadee* assists us in relation to the Substantive Issues.

The decision in Quinn

The submissions for SOCS

148. Mr Bradley relied on this decision and, in particular, adopted the arguments in Judge Morgan’s decision at paragraphs 47 and 50. He pointed out that Judge Morgan had rejected HMRC’s interpretation of section 1138(1)(c). He argued that the decision in *Quinn* had been expressly approved by the Upper Tribunal in *HMRC v Perenco (UK) Ltd* [2023] UKUT 169 (TCC) (“Perenco”).

149. By contrast, the Skeleton Argument for HMRC set out detailed submissions *inter alia* distinguishing paragraph 47 of *Quinn* so it is appropriate to quote that paragraph at this juncture but we take the view that it should be read in context and there are also other relevant paragraphs. For example, at paragraph 5 Judge Morgan said:

“5. In brief, HMRC said that it suffices for s 1138(1)(c) to apply that the relevant R&D was carried out by Quinn in the course of it providing construction and refurbishment services to its Clients for which it was entitled to payment from the Clients of a sufficient amount to cover the claimed expenditure and which was in due course paid. In their view, it follows that the Clients indirectly ‘met’ the claimed expenditure by paying Quinn for its services. Quinn argued that, on the contrary, it cannot be said that the claimed expenditure was ‘met’ by Clients who, under an entirely commercial arrangement, simply paid a price for a product, the finished building works.”

150. That is precisely the situation in this appeal and there is much else that is very similar to this appeal. In *Quinn* there were also three sample projects, and each of those projects generated new technological knowledge or capability which remained owned by Quinn and which Quinn was able to exploit or develop in other projects. The value for Quinn’s clients lay in the delivery of the project and the clients often had no knowledge of the detail of solutions developed by Quinn (paragraphs 8 and 9).

151. At paragraphs 43 and 46 Judge Morgan identified that the sole issue in that case was whether the R&D expenditure was subsidised because it was “met directly or indirectly” by

Quinn's clients in a situation where Quinn was undertaking ordinary commercial transactions in the course of its trade. They were paid an agreed price for a service or product provided using the relevant R&D. HMRC had argued that Quinn could use the payment to cover its expenditure on the R&D. She stated that:

"46.... Their analysis relies on the view that the interpretation of s 1138(1)(c) is not in any way to be constrained, coloured or shaped by reference to the scope of the preceding provisions in ss 1138(1)(a) or (b) or the fact that s 1052(6) refers to 'subsidised', expenditure seemingly as a generalised description of what is intended to be caught (as reflected in the heading to s 1138)."

152. Paragraph 47 reads:

"47. However, in my view, on the natural interpretation of these provisions as viewed in the overall context of the SME scheme, it is apparent that s 1138(1)(c) is not intended to apply in circumstances such as those in this case, in the absence of a clear link between the price paid by the client/customer and the expenditure on R&D:

(1) The reference in s 1138(1)(c) to a person other than the SME otherwise meeting the SME's expenditure, following on as it does from ss 1138(1)(a) and (b), is clearly based on the premise that 'notified State aid' or 'a grant or subsidy..' which is 'obtained...in respect of' the whole or part of the relevant expenditure (within the meaning of those preceding provisions) 'met' or meets that expenditure.

(2) It seems to me that the further implication of the 'otherwise' wording is that s 1138(1)(c) is intended to operate, in effect, as a form of sweep up provision to capture cases (a) where expenditure is not 'met' by 'notified State aid' or 'a grant or subsidy....' (under the preceding provisions in ss 1138(1)(a) or (b)) but (b) is 'met' in a similar sense to that in which expenditure may be said to be 'me' by 'a notified State aid' or 'a grant or subsidy'. In my view, that this is the correct interpretation is reinforced by the use of the term '*subsidised* expenditure' in s 1052(6). The use of that particular term indicates the scope of Condition E in general terms as then further explained in s 1138, albeit that the use of that term in the heading to that section does not control the operation of the substantive provisions in that section.

(3) I note that:

(a) Whilst it is difficult to postulate all the circumstances in which there may be 'a subsidy or grant', according to the normal meaning of those terms, like the provision of 'State aid', the making of 'a subsidy or grant' generally involves the provision of funds to a recipient who either provides nothing in return or provides something which, viewed from the perspective of parties acting on an arm's length basis, does not represent a commercial return commensurate with the value of the funds provided (albeit that in some cases, such as where a public or government body

provides the funds, that body may consider it is in the wider public interest to fund the relevant R&D).

(b) In ss 1138(1)(a) and (b) the requirement that the relevant funding must be ‘obtained ... in respect of’ the relevant expenditure reinforces that there must be a clear link between the funding and the use of the funds for the payment or discharge of the relevant R&D costs. I say reinforces as, in my view, the use of the word ‘met’ in s 1138(1)(c) of itself suggests that there must be such a link.

(4) Overall, it seems to me that the circumstances of this case are far removed from those which are intended to be captured by s 1138(1)(c) on a fair reading of it in the context of the whole of s 1138 and the overall SME scheme. I note that:

(a) The contractual bargain between Quinn and its Clients is for Quinn to provide specified ‘Works’ to the Client in return for payment of an agreed price for those Works from the Client, subject to the detailed terms and conditions set out in the construction contracts.

(b) For all the reasons set out in Mr Wells’ evidence (and as shown in the documents produced in the bundles) the price which is then agreed may or may not in fact be sufficient to cover the costs Quinn actual incurs in fulfilling the terms of the relevant contract. Quinn simply factors costs such as those relating to R&D into the price it wishes to charge in order to seek to achieve its desired commercial return.

(c) It is plain, therefore, that under the contracts, Clients do not agree to pay or reimburse Quinn for particular costs, such as the claimed expenditure, and Quinn does not agree to carry out the relevant R&D on being paid or reimbursed by the Client for doing so. In other words, the bargain made between the parties is not for Quinn to incur specific costs such as the claimed expenditure in return for the Clients agreeing to pay those specific costs.

(5) Moreover, it would be wholly out of kilter with the overall SME scheme, if an SME were to be denied enhanced R&D relief solely because, in doing what is envisaged by the legislation (namely, utilising the relevant R&D for the purposes of its trade), as is usual and to be expected of an entity carrying out a trade on a commercial basis, it seeks to recover some or all of the relevant costs of the R&D under its commercial contracts with its Clients entered into in the course of its ordinary trading activities. Indeed, if HMRC’s approach were to be adopted, the circumstances in which an SME could claim enhanced R&D relief would seem to be confined to those where it has no prospect of exploiting the R&D for commercial gain.”

153. Paragraph 50 reads:

“50. HMRC argued that their approach does not give rise to odd results on the basis that it does not follow from their analysis that s 1138(1)(c) applies where a taxpayer incurs

‘standalone’ R&D expenditure and seeks to recover the cost of that expenditure through its ordinary trading transactions at some later point in time as opposed to, as is the case here, under transactions which take place when the expenditure is incurred. However, I cannot see what basis HMRC have, on their own analysis, for drawing a distinction on the basis of the timing of the relevant ordinary trading transactions. In each case, the payments made by the customers or clients for the relevant services or products provided by the taxpayer could be used by the taxpayer to cover its expenditure on R&D which it uses for the purposes of that trading transaction. Moreover, from its terms, I can see no justification for the view that the application of s 1138(1)(c) is to be based on such fine and difficult distinctions.”

154. Lastly, we observe that at paragraph 51, as we do, Judge Morgan found that she did not find the decision in *Hadee* helpful given the different facts and lack of information about the contracts.

The submissions for HMRC

155. As we have indicated, the Skeleton Argument for HMRC set out detailed submissions on paragraph 47 of *Quinn* arguing, with the greatest of respect, that Judge Morgan had erred in law and that as follows:

“i. at [47(2)], the Tribunal stated that the word ‘otherwise’ is intended to operate ‘as a form of sweep up provision to capture cases (a) where expenditure is not ‘met’ [by (a) or (b)]...but (b) is ‘met’ in a similar sense to that in which expenditure may be said to be ‘met’ by ‘a notified State aid’ or ‘grant or subsidy...’. As above, HMRC submit that the use of the word ‘otherwise’ creates a new and separate category, and this is supported by *R v Uddin* [[2017] EWCA Crim 1072 at paragraph 34 (‘Uddin’)] and *BCM Cayman [LP and another v HMRC* [2022] STC 1586 at paragraph 93 (‘Cayman’)];

ii. at [47(2)] the Tribunal takes support for the incorrect analysis from the use of the term ‘subsidised expenditure’ in s.1052(6) and in the heading of s.1138. The Tribunal acknowledges that the heading cannot control the meaning of the substantive provision but seemingly does attribute significance to it. Whilst a heading can be considered, its function is merely to serve as a brief guide to the material to which it relates, and may not cover everything falling within the provision to which it relates [See *R v Schildkamp* [1971] AC 1 at 10 and *Naghshineh v Commissioners for HM Revenue and Customs* [2022] EWCA Civ 19 at [41]];

iii. at [47(3)], the Tribunal notes that there must be a ‘clear link’ between the funding and the use of the funds in s.1138(1)(a) and (b) because of the phrase ‘obtained in respect of’. However, the Tribunal then says this reinforces its conclusion on s.1138(1)(c) which uses the word ‘met’, seemingly in the Tribunal’s view to mean the same thing. With respect, that logic does not follow. If the draftsman intended to mean the same thing, they would have used the same wording. The fact that they chose to draft (c) differently should be respected in its interpretation. The ordinary meaning of ‘meet’ or ‘met’ in the Oxford English Dictionary encompasses being able to or sufficient to discharge or satisfy or fulfil a financial obligation. In the context of s.1138(1)(c) ‘met’ is equivalent to ‘discharged’ or ‘satisfied’ or ‘fulfilled’;

iv. at [47(4)], it is not clear from the Tribunal’s analysis what would fall within (c), and whether it must be something akin to a grant or subsidy (i.e. something given without full consideration being given in return but which is not a grant or subsidy, which is difficult to envisage), or whether all that is required is that there is a ‘clear link’ between that which

is given and that which is expended. A requirement of a ‘link’, which is a gloss on the statutory wording should be met in HMRC’s submission if R&D costs are incurred in delivering a project to a customer whose payments cover the R&D costs incurred for the project. Introducing a requirement that there is specific provision as to R&D in the contract would make it all too easy for taxpayers to get around this requirement and obtain the very generous relief. In any event, in each of the three projects before the Tribunal here, the price was increased to take account of the additional work that was required in order to deliver on the project. [Footnote: The Appellant has failed to adduce any evidence that would demonstrate these increases were attributable to anything other than R&D.]

v. at [47(5)] the Tribunal mischaracterises HMRC’s analysis. HMRC’s position does allow for exploitation of the R&D for commercial gain. If, for example, a taxpayer undertakes R&D in January and then in April is able to exploit the expenditure in the context of a commercial contract with a customer, that would qualify for relief on HMRC’s analysis. There is, in HMRC’s submission, a clear distinction between a trader who incurs R&D in the course of carrying out a contract, and the sums from the contract cover those costs – where it can naturally be said the customer has ‘met’ the costs of the expenditure; and the example above where it could not be said that the expenditure incurred in January is ‘met’ by the sums received from the contract in April.”

156. HMRC went on to argue that any support for Judge Morgan’s analysis in *Quinn* sought from *Perenco* is misplaced for four reasons, namely:

“First, *Perenco* concerned a completely different statutory regime. The material provision being considered by the UT, paragraph 8 of Schedule 3 Oil Taxation Act 1975 (‘OTA’), is structured differently to section 1138, and drafted differently. The UT’s comments on *Quinn* are clearly obiter and were without the benefit of full argument. The Appellant is, with respect, incorrect to state ‘the reasoning of the FTT in *Quinn* has now been expressly approved by the Upper Tribunal in [*Perenco*]... see at [75]’ (paragraph [32] Appellant’s Skeleton Argument). The UT merely noted that ‘Our approach to this point is very similar to that of the FTT in [*Quinn*]...’.

Second, there are little or no State Aid considerations underpinning the OTA and its drafting. The Witness Statement of Philip Hamblin ... explains in detail how important the State Aid considerations were in the context of Part 13.

Third, the policy incentives and drivers behind the two regimes are also very different. Paragraph 8 of Schedule 3 to the OTA is concerned with allowable expenditure. The Enhanced R&D Relief provisions on the other hand provide access to a very valuable, generous, and therefore carefully targeted, statutory regime that confers tax credits and relief.

Fourth, the suggestion in [73] that, if HMRC’s analysis is correct, the draftsman could have drafted the provision in simpler terms is not an appropriate approach to the statutory construction here. As noted above, Part 13 is a meticulously drafted and highly prescriptive regime [*Gripple*]. In drafting these provisions, Parliament had to ensure there was no additional State Aid (as explained in the Witness Statement of Philip Hamblin...), and had to do so in express and emphatic terms. The purpose, therefore, of s.1138(1)(a) and (b) is to inform the reader in clear terms of specific exclusions; and then (c) is an additional category to cover other expenditure met by third parties. Further, (a) works differently from (b) and (c): (a) prevents all expenditure incurred from benefiting from Enhanced R&D Relief; (b) and (c) do not exclude expenditure on

the same project which is outside their scope. The fact that Parliament could potentially have achieved the same result with a differently drafted (c) does not mean it has no purpose. Even if there were a degree of surplusage, there are good reasons for it given the State Aid considerations. As Nourse LJ said in *Omar Parks Ltd v Elkington* [1992] 1 WLR 1270:

‘It is perfectly true...that if that is the only function of the words...they could just as well have been omitted. If a long experience of legislative drafting had brought with it a conviction that an Act of Parliament never included words of surplusage, that would no doubt have been a persuasive point. But that is not our experience and I for one do not complain of it. An emphasis of the obvious, unnecessary to a judge who has had the benefit of argument, may yet be welcome to a busy practitioner who has not.’ [The footnote cites other cases to which we were not referred.]’

157. In summary, HMRC argues that the Tribunal is not bound by either *Quinn* or *Perenco* and should consider the Subsidy Condition afresh. That is correct and we have done so.

Conclusion on the Subsidy Condition

158. The first point to make is that although neither *Quinn* nor *Perenco* is binding on this Tribunal both are potentially persuasive. Of course, *Perenco* was concerned with a different statutory regime, in that there were little or no State Aid considerations to consider and the policy incentives and drivers behind the regimes were different.

159. HMRC are correct to say that the Upper Tribunal said, at paragraph 75, that their approach was similar to that of the FTT in *Quinn*. Indeed, Mr Bradley explicitly drew our attention to that quotation, amongst others. However, the rest of that paragraph neatly summarises *Quinn* and, in particular, approved, and quoted from, Judge Morgan’s reasoning at paragraph 47(3) of *Quinn*.

160. It is clear from paragraph 75 that the Upper Tribunal was well aware that the cases involved different statutory regimes. Further, that paragraph followed on from a discussion of the *obiter* comments of Harman J in *Stokes (Inspector of Taxes) v Costain Property Investments Ltd* [1983] STC 405 (“*Stokes*”) which was a case relating to capital allowances. The statutory provisions in *Stokes* were similar to those in both *Quinn* and *Perenco*. We make that observation since Judge Morgan also considered *Stokes* and also said at paragraph 44 of *Quinn* that those comments were both “informative and helpful”.

161. We are not persuaded by HMRC’s fourth submission which implies that in taking the same approach as Judge Morgan, the Upper Tribunal did not take an “appropriate approach” to statutory construction.

162. For these reasons, we find that the Upper Tribunal’s comments on *Quinn* and its own findings in relation to materially similar wording are “highly persuasive” as Mr Bradley argues.

163. We have carefully considered paragraph 47 of *Quinn* and HMRC’s submissions. As far as the facts are concerned, as we have indicated at paragraph 150 above, we have found that there are numerous similarities between the factual matrix in this appeal and that in *Quinn*.

164. Quite apart from the facts that we have already identified, we find that both appeals concerned projects where the appellants contracted with the clients to provide a specified end product, and or service, in return for payment of an agreed price, subject to the detailed T&Cs set out in most or all of the contracts. That price might, and clearly sometimes did, change but it also might not suffice to cover the costs incurred when fulfilling the contract; in this appeal the Pavilion is a case in point.

165. When agreeing a price, in order to attain its preferred profit margin, SOCS will have factored into the quotations or tenders its estimates for costs such as labour, materials and expenditure on R&D. Those estimates can be incorrectly costed or the scale of the technical difficulties or complexities underestimated. Where SOCS is responsible for design it is responsible for any flaws in the design. In all of the projects SOCS takes responsibility for materials and workmanship. It is a fixed cost and SOCS do not agree to carry out R&D *per se*. The clients will not necessarily know if R&D is required or, if it is, the extent or cost thereof. In his witness statement, Mr Leigh gave a colourful analogy that the client wanted the “picture on the jigsaw box, but has no interest in putting the puzzle together”. The clients did not instruct SOCS as to the order in which the pieces go together and SOCS is not rewarded for the way in which the puzzle is solved. SOCS is simply “rewarded for delivering a completed puzzle that matches the picture on the box”. Mr Leigh’s evidence was very clear to the effect that “...its only often when you are in the belly of the project that you realise the level of technical challenge that you face”. We accept that.

166. SOCS do not agree to carry out R&D or seek reimbursement of those costs. Any such expenditure is simply an incidental part of the delivery of a project and the clients did not undertake to reimburse such expenditure for which there was no specific provision in any contract.

167. Therefore, we not only find *Quinn* persuasive but we adopt the same approach as Judge Morgan in *Quinn*.

168. We agree with Judge Morgan’s interpretation of the word “otherwise” as a “form of sweep up” not only because we do not accept HMRC’s argument based on *Uddin* but also because the Upper Tribunal at paragraph 75 of *Perenco* utilised that wording when commenting on the decision in *Quinn*. The Criminal Court in *Uddin* was dealing with a completely different statutory provision. In that case it was considering the words “or otherwise” which followed the words “physical or mental disability or illness, through old age”. That is not analogous with the wording here which is “to the extent that it is otherwise met directly or indirectly...”. For similar reasons, paragraph 93 of *Cayman* does not assist either. It too is dealing with legislation where the word “otherwise” follows three special situations that have been identified.

169. As far as the argument on the heading is concerned, we do not accept that Judge Morgan attributed significance to it. She clearly stated:

“The use of that particular term indicates the scope of Condition E in general terms as then further explained in s1138, albeit that the use of that term in the heading to that section does not control the operation of the substantive provisions in that section.”

HMRC are correct to say that the function of a heading is merely to serve as a brief guide to the section but we can discern nothing in this quotation from *Quinn* to suggest anything beyond that. We agree with Judge Morgan’s reasoning.

170. As far as paragraph 47(3) is concerned, we accept HMRC’s submission that the meaning of the word “met” encompasses fulfilment of a financial obligation. However, we are somewhat bemused by the argument that Judge Morgan’s logic was flawed, because on finding that sub-paragraphs (a) and (b) require a clear link between the funding and the expenditure, she stated that it reinforced her view that sub-paragraph (c) also requires such a link. HMRC argue that the legislation uses the word “met” in sub-paragraph (c) whereas the words “obtained in respect of” are used in the two preceding paragraphs so the requirement for a clear link in the first two sub-paragraphs cannot be extrapolated to the third.

171. That flies in the face of the new version of CRID81650 which records that in relation to meeting expenditure directly or indirectly (ie sub-paragraph (c)), since at least October 2013

HMRC's view has been that "there needed to be a clear and direct link between the payment received and the qualifying expenditure". We agree with Judge Morgan's reasoning.

172. That also impacts on the fourth submission by HMRC and for that reason we reject the argument that the requirement for a link is a "gloss on the statutory wording". Judge Morgan did not state that there was a requirement that there was a specific provision as to R&D in the contracts. Her decision was far more nuanced than that. She had three sub-paragraphs in paragraph 47(4) explaining why, on the facts, which are similar to those in this appeal, and for the reasons given, the expenditure was incurred for delivery of a specific project and may not even cover the R&D costs.

173. In this appeal, although he made the point that R&D was not mentioned in the contracts, Mr Bradley confirmed that he agreed with Mr Fitzpatrick that given the rather complex and diffuse definition of R&D in the BIS Guideline, it was very unlikely that one would ever have a contractual obligation to carry out "R&D as defined in the [BIS or] BEIS Guidelines". We agree. He also argued that it was no part of his case that Condition D can be determined solely by analysis of the contractual documents. Again, we agree and we would say the same of Condition E.

174. At paragraph 47(2) Judge Morgan had already made it clear that sub-paragraph (c) is designed to "sweep up" and capture cases not falling into sub-paragraphs (a) or (b). She did not argue that the cases falling into sub-paragraph (c) must be akin to State Aid, a grant or subsidy but rather that the expenditure is "met" in a "similar sense" to the way expenditure on the categories in sub-paragraphs (a) and (b) are met. That is a different thing.

175. In relation to the final sentence and the footnote in HMRC's fourth submission whilst we accept that there were price increases in each of the three sample projects, we do not accept the suggestion that those were attributable to R&D. Although, undoubtedly, as SOCS has always stated, "The R&D activity was undertaken to put the company in a position to fulfil our contractual obligations", that does not mean that that was the cause of price increases. Further, as can be seen from paragraph 89(f) above, Officer Aspey had accepted that the variations in the contracts were not necessarily directly related to R&D.

176. As can be seen in relation to the Pearl, the additional man hours, which presumably relate to R&D, did not form part of the price increase. As far as the Pavilion was concerned the price was amended due to changes in scope and design. Similarly, as we record in relation to the Parade the price increases were largely attributable to elements coming in and out of scope.

177. We note the terms of the fifth submission but for all the reasons given we agree with and adopt all but the final sentence of paragraph 47(5).

178. Our caveat in relation to the final sentence is that, as the Upper Tribunal pointed out at paragraph 67 of *Perenco* there must clearly be some limit to the meaning of "met directly or indirectly" because generally businesses finance their expenditure from their sales. If HMRC's approach in this appeal were to be adopted no expenditure on R&D that is incurred in the course of delivering on a contract of any sort would be eligible for SME relief.

179. HMRC have asked us to accept that their interpretation of section 1138(c) gives purpose and function to that sub-section which would otherwise be redundant. On the contrary, we find that in substance their interpretation of the legislation is very narrow. It, and for the reasons given, is not in accord with the plain meaning and, indeed the grammar of the legislation.

180. The only relief that would be available would be such as in the cases of the nine of the 16 projects identified in the 2018 R&D Report, where no clients were involved (see paragraph 97 above) (the "freestanding projects"). Clearly those could have been exploited for commercial gain and it seems that they were. That is analogous with HMRC's January and

April argument. Had the final sentence read: “We find that if HMRC’s approach were to be adopted, the circumstances in which an SME could claim SME relief would seem to be confined to a very limited set of circumstances” we would have adopted it.

181. In summary, we do not accept that there was an error of law in *Quinn*. In fact, we agree with and, with that one minor exception, we adopt the reasoning in *Quinn*.

182. Specifically, we find that the R&D expenditure was not subsidised within the meaning of section 1138 CTA 2009.

183. Accordingly, the appeal succeeds in regard to the second Substantive Issue.

The Contracted Out Condition and our Conclusion thereon

184. The freestanding projects in 2018 were obviously not sub-contracted (or subsidised).

185. Mr Fitzpatrick argued that that only became apparent when the Skeleton Argument for SOCS was lodged. It certainly does appear that neither HMRC nor SOCS had made that point before that, and the 2018 Discovery Assessment was based on the presumption of continuity. We do not accept the argument that that demonstrates the difficulty in identifying what is at issue from the R&D Reports. On reading the 2018 R&D Report it is very clear to us that the freestanding projects had no client. Many related to SOCS’ proprietary motion control system, QMotion. Another described “creating a new product”. We had no difficulty in identifying which projects were “in-house” and which were not. Clearly, that was simply an oversight when applying the presumption of continuity.

186. Mr Fitzpatrick argued that HMRC’s position is that the legislation is, and always has been, supposed to apply only to freestanding R&D. Regardless of our decision on the sample projects, the appeal succeeds in relation to these freestanding projects.

187. The key words in section 1052(4) and (5) are “...incurred by the company in carrying on activities which are contracted out to the company by any person”.

188. The words “activities” and “contracted out” are not defined. We must therefore first look at what activities were involved, whether the expenditure was incurred in carrying out those activities and then at whether those activities were contracted out.

189. HMRC’s argument is that it is common ground that the R&D expenditure was incurred to fulfil the contractual obligations under each contract. It was, but where the parties differ is that Mr Bradley argues that the R&D activity on which SOCS incurred expenditure and the activity that was contracted out, are not the same thing.

190. HMRC disagree in that they argue that in order to design, develop, manufacture or otherwise provide the deliverables provided for in the contracts, SOCS had to incur expenditure some of which fell within the definition of R&D expenditure. Had the contracts not been in place SOCS would not have incurred the expenditure. As Mr Fitzpatrick put it, developing the concept was part and parcel of the contractual obligations.

191. Of course, we must look at, and we have, the contracts. SOCS have argued throughout that there is no mention of R&D anywhere in the contracts and it was not a contractual obligation that was incumbent upon them. HMRC say that R&D is inherent in the contracts and there is no need to mention it specifically. As we have indicated, the fact that it is not mentioned in the contracts is not a defining factor, although it would have been, had it been identified as an obligation or cost for payment, as was the case in at least two projects in *Hadee*.

192. Mr Bradley argues that SOCS’ obligation in terms of the contracts is to deliver the specified end product but not to solve any identified technical challenge or conduct any particular R&D. It is uncontroversial that from time-to-time SOCS is contracted to do R&D

but it makes no claims in that regard. In general, the client does not know or care what, if any, R&D is required to deliver the end product. Although they might or might not be aware that R&D was required that was, as we have indicated elsewhere, only an incidental matter.

193. SOCS argue that they complied with the guidance in CIR84520 in force in the Relevant Periods. As can be seen from our findings in fact, we accept that SOCS has complete autonomy as to how, and if, it carries out any R&D. It owns the intellectual property. It bears the financial risk of undertaking R&D having given a quotation to a client for delivering the end product.

194. As we have indicated, although there are sometimes variations to the contracts there is no evidence that those are attributable to R&D; we have already considered, and disposed of HMRC's arguments about R&D being the cause of variations in the contracts at paragraphs 175 and 176 above.

195. Although the parties only referred to a few paragraphs in *Perenco* we did read all of the decision. Of course, it is dealing with different legislative provisions but another aspect that the Upper Tribunal considered was the phrase "consideration...in respect of...". We noted that in that context at paragraph 50 they said:-

"50] ...The FTT correctly noted at [80] that a contractual payment may be consideration in respect of particular obligations even if it is not described as such in the contract. As Lewison J explained in *AI Lofts Ltd v Revenue and Customs Comrs* [2009] EWHC 2694 (Ch), [2010] STC 214 (at [40]):

'... the *identification* of the parties' obligations is a matter of contract. But once their obligations have been identified, the *nature* or *classification* of those obligations, and in particular whether they answer a particular statutory description, is not necessarily concluded by the contract ... The court is often called upon to decide whether a written contract falls within a particular legal description. In so doing the court will identify the rights and obligations of the parties as a matter of construction of the written agreement; but it will then go on to consider whether those obligations fall within the relevant legal description.'

196. That is consistent with the approach by both parties that the question posed by the statute is not answered by simply looking at the words used in the contract. Rather the contract must be used to establish the parties' obligations and duties and the statute is then applied to those facts viewed realistically.

197. We have set out our findings in fact at considerable length and analysed the implications of those facts in the context of the Subsidy Condition. We have pointed out the striking similarities with the facts in *Quinn*. We have agreed with, and adopted, the reasoning in *Quinn*.

198. Like Judge Morgan at paragraph 47(4) of *Quinn*, we find that the contractual obligation for SOCS was to deliver a specified project in return for an agreed price for that project subject to the sometimes very detailed terms and conditions set out in the contracts.

199. We accepted Mr Leigh's evidence (and the inferences from the documentation that we have seen) that the price which is ultimately agreed may or may not be sufficient to cover the costs actually incurred in fulfilling the terms of the relevant contract. In particular we accept Mr Leigh's evidence that the cost for additional man hours, which we assume related to R&D were not billed to the clients. We find as fact that although, of course, SOCS will factor costs such as those relating to R&D into the price it quotes in order to achieve its desired commercial return, quite apart from the fact that those costs may not be recouped, often the extent of those costs are not known, even in "ball park" terms, when the price is negotiated.

200. We do not accept that, in terms of the contracts, SOCS' clients have an obligation to pay or reimburse SOCS for expenditure on R&D. Indeed, many clients do not know what, if any, R&D is needed and at the outset of many contracts nor does SOCS know that. SOCS does not agree to carry out the R&D on the basis that it will be paid or reimbursed for it; it simply undertakes to deliver the project for a price.

201. As far as the old version of CRID84250 is concerned, we have found that, at all times, SOCS owned the intellectual property and it bore the economic risk. Even where there were detailed technical specifications, it had autonomy in deciding how to deliver a project.

202. We have set out at paragraph 24 above the purpose of the legislative provisions. Officer Hamblin talked about that purpose in relation to both sections 1052 and 1053 CTA 2009 and we agree with him that the two should be read together. In the same vein, Mr Bradley argued that section 1053 is the flipside of section 1052 which is fair. Section 1052 CTA 2009 is the provision that deals with expenditure that is not contracted out and section 1053 CTA 2009 defines a company's qualifying expenditure on contracted out R&D.

203. Both parties agreed that Condition D is designed to prevent double relief for the same R&D and indeed that is what paragraph 18 of the Explanatory Notes to the Finance Bill 2000 (the predecessor provisions) states. It reads:

“Sub-paragraph (6) requires that the expenditure is not incurred by the company in carrying out activities contracted to it by another person. This complements the rules relating to sub-contracted R&D in paragraphs 9 to 12, which allow the principal to claim R&D tax relief where R&D is contracted out, and prevents double relief for the same R&D.”

204. Since we have found that SOCS' clients did not know the detail of any R&D or the extent, if any, of R&D there could not be competing claims for R&D.

205. In circumstances where SOCS owned the intellectual property at all times, we heard no evidence as to how a client could claim for R&D in that regard. Further, since SOCS had autonomy in terms of deciding what, if any, R&D should be done, we do not accept that the fact that there is a contract means that the R&D activity is sub-contracted.

206. In any event, Officer Aspey, said firstly, that notwithstanding the detailed R&D Reports, HMRC were not aware that R&D was required in order to fulfil the contracts until they received the October email and secondly that he could not say whether or not the mere fact of the existence of a contract is definitive of whether or not section 1052(5) would apply, ie Condition D.

207. We therefore have difficulty with HMRC's argument that the legislation encompasses only freestanding R&D and do not accept that argument.

208. We have looked objectively at the meaning of “contracted out” in the context of all of the legislative provisions and the purpose of that legislation. We find that it would mean that the SME relief would not be available in circumstances where R&D is carried out on behalf of someone else. Looking at the sample projects and, for the reasons given, we find that the obligations in term of the contracts did not encompass R&D. The R&D was a means to an end, enured to the benefit of SOCS, because the intellectual property was owned by it, and was an incidental part of delivery of the projects.

209. For all these reasons we find that the R&D expenditure was not contracted out within the meaning of section 1052 CTA 2009. Accordingly, the appeal succeeds on the First Substantive Issue.

The Discovery Issues

210. If we are wrong on the Substantive Issues then we must consider the Discovery Issues.

211. As far as the first issue is concerned there is no dispute that for 2017 the enquiry window closed on 9 August 2019 because the return had been filed on 10 August 2018. The window for 2018 closed on 17 September 2020 as the return was filed on 18 September 2019. Accordingly, only discovery assessments could be raised.

212. Both paragraph 41 (the 2017 Discovery Assessment) and paragraph 52 (the 2018 Discovery Assessment) require an officer to discover, as regarding the AP of SOCS, that an assessment of taxes has become insufficient. If so, the issue is whether paragraph 44, which provides protection for the taxpayer, is engaged.

213. It was common ground that *Hargreaves v HMRC* [2022] UKUT 34 (TCC) (“Hargreaves”) and *HMRC v Hicks* [2020] UKUT 254 (“Hicks”) support a number of propositions that are very well settled in law. Those are:

(a) Firstly, it is well settled that one is looking at a hypothetical officer and the awareness referred to is of an actual insufficiency in the amount of tax assessed in a return.

(b) Secondly, a mere awareness that HMRC should prudently ask further questions is not enough to constitute awareness of an actual insufficiency.

(c) Thirdly, the purpose of the information condition is to test the adequacy or otherwise of the taxpayer’s disclosure. It is not concerned with delineating the circumstances that would justify the actual HMRC officer in exercising a power to make a discovery assessment.

(d) Lastly, adequate disclosure may require more than pure factual disclosure.

214. The last of these is derived from paragraph 199 of *Hicks* which reads:

“[199] Plainly, the greater the level of disclosure, the greater the officer’s awareness can reasonably be expected to be. If a disclosure on a tax return includes all material facts and, in complex cases, an adequate explanation of the technical issues raised by those facts and the position taken in relation to those issues, it would be reasonable to expect an officer to be aware of an insufficiency. What constitutes reasonable awareness is linked to the fullness and adequacy of the disclosure – the expertise of the hypothetical officer remains that of general competence, knowledge or skill which includes a reasonable knowledge and understanding of the law.”

215. It is also common ground that the material information provided to HMRC was the tax returns and the R&D Reports.

216. Therefore, in the first instance, the key issue is whether on looking at the R&D Reports for 2017 and 2018, which accompanied the returns for those years, a hypothetical officer could not have been reasonably expected to have been aware that the assessments for tax for those years had become insufficient on the basis of the information made available.

217. It is not disputed that the R&D Reports did not give details of the contractual arrangements or identify the contracting parties. Mr Fitzpatrick argues that the R&D Reports were focused on providing a basis for the conclusion that the expenditure in question was R&D by reference to the BIS guidance, and whilst the descriptions of the projects was interesting and described what had been done, there is a lack of detail and it is not clear which of the

projects were freestanding. There is no explanation as to why the projects were neither sub-contracted nor subsidised; the tax issues were not identified.

218. We have already found that it was clear which projects were freestanding projects. That should have been obvious had the 2018 R&D Report been analysed even superficially. Clearly it was not.

219. Mr Bradley argued that the lengthy R&D reports which accompanied the tax returns for the APs for 2017 and 2018 provided a narrative description of each project in respect of which the R&D expenditure had been incurred. It was plain from those descriptions, or at the minimum it could reasonably be inferred, that the R&D expenditure had been incurred in the course of fulfilling the obligations to deliver particular projects for particular clients.

220. He also argued that on the basis that HMRC assert that they have always believed that (a) expenditure is “contracted out” where it is incurred in order to fulfil the taxpayer’s contractual obligations, and (b) it is “subsidised” where the customer pays for the services in respect of which the expenditure is incurred, that information should have been sufficient for the hypothetical officer to conclude that there was a loss of tax.

221. We address this latter argument first since it is really the “elephant in the room” as far as the Discovery Assessments are concerned.

222. On the one hand, HMRC are arguing that it has always been the case that only freestanding R&D can qualify for SME relief and, on the other hand, SOCS are arguing that the PGP was as outlined in the old version of CRID as amplified by the minutes of the Research & Development Consultative Committee (“RDCC”) meeting in October 2013. If there was such a PGP then the hypothetical officer would have been aware of that.

223. Accordingly, the two Discovery issues not only overlap but are inextricably interlinked so we turn to the second Discovery issue first.

224. It is common ground that paragraph 61 of *Hargreaves* is in point, and it reads:

“61. The FTT directed itself, at [24] of the Decision, as to what constituted a PGP for the purposes of s 29(2) of TMA. In doing so, it drew on another decision of the FTT in *Boyer Allen Investment Services Ltd v HMRC* [2012] UKFTT 558 (TC). Neither party argues that this self-direction was wrong in law. Importantly for present purposes, the FTT concluded that:

- (1) The practice has to be one adopted by taxpayers and HMRC alike ([24(1)]).
- (2) A practice will not be generally prevailing if it is not agreed, or respected, as a whole, either by HMRC failing to apply every element of the practice in every case where it should be applied, or by taxpayers adopting only those parts that are favourable to them, but disputing others ([24(5)]).
- (3) ‘Mere inactivity’ can, in appropriate circumstances, give rise to a practice. However, such an omission must be capable of articulation in the same way as a positive act so as to have both clarity and substance. Its parameters must be clearly defined so that the general acceptance amounts to the same unequivocal understanding ([24(8)].”

225. As Mr Bradley put it, “the centrepiece of our case” was “a radical change in HMRC’s published guidance” that took place in November 2021 which is after the Relevant Periods. The guidance is relevant because at paragraph 49 of *Boyer Allan*, Judge Berner and Mr Marsh

said that: “The natural starting point is to look at the material published by HMRC in this area.” We agree.

226. The full text is at Appendix 2 and, in relation to the Contracted Out Condition, prior to 30 November 2021, CIR84250 under a heading “Subcontracted R&D activities” *inter alia* stated that “A contract to provide services rather than to undertake a specific part of the activities is not subcontracted R&D...”. It went on to say that there is a wide variety of possible contractual arrangements and gave some examples but specifically it said that:

“But each case will need to be judged on its particular facts. As part of any examination it may be useful to examine the degree of autonomy enjoyed by the person engaged, the ownership of intellectual property, and the economic risk in any arrangements.”.

The only other heading related to the differences in the rules for SMEs and large companies.

227. As can be seen from Appendix 2, the post November 2021 version looked rather different with two headings namely “SME Scheme, Activities contracted to the SME...” and “SME Scheme, Activities contracted out by the SME...”. The passage from the old version that we have quoted referring to a multifactorial analysis of the facts had been deleted and the text under the first heading now included the sentence: “Any activities carried out in order to fulfil the terms of a contract are considered to have been contracted to the company”.

228. As far as the Subsidy Condition is concerned, CIR81650 covered State Aid, grants and subsidies but said nothing as to HMRC’s view of what might fall within section 1138(1)(c). The only evidence of any published HMRC guidance in the Relevant Periods is to be found in the minutes of the meeting of the RDCC on 17 October 2013. The RDCC is a meeting of HMRC and professional advisors. At that meeting an HMRC officer called Neil Smillie said:

“NS agreed that the guidance required further review to give an indication of where the boundary lay between subsidised and nonsubsidised expenditure. The meaning of “subsidised” referred to expenditure being met directly or indirectly which was not particularly helpful as all expenditure is met indirectly in some way or other.

Currently HMRC took the view that there needed to be a clear and direct link between the payment received and the qualifying expenditure.”

229. As can be seen from Appendix 2, the post November 2021 version included that quotation but went on to say:

“What is considered to be a clear and direct link will depend on the facts in each case. However:

- payment received for undertaking a contract will be considered to meet expenditure incurred in undertaking that contract....”.

230. We were also provided with minutes of another meeting of the RDCC dated 14 July 2020 where HMRC raised the issues of sub-contracted and subsidised expenditure. Our attention was drawn to the facts that:

(a) HMRC stated that there had been a lot of attention in the last 12 months to Conditions D and E and HMRC’s view was that expenditure incurred by a SME company in carrying out activities contracted to it did not qualify for SME relief.

(b) In pointing out that the effect of Condition D was to prevent double relief and reference was made to paragraph 18 of the Explanatory Notes to the Finance Bill 2000. That was quoted and the relevant portion is “[the rules] allow the principal to claim R&D Tax Relief where R&D is contracted out, and prevents double relief for the same R&D.” HMRC said that it had been suggested that Condition D did not apply unless the R&D

formed a project in itself and “on occasion” it had been suggested that the contract must stipulate that the activities are an R&D project but that neither view was correct. HMRC’s view was that the Condition referred to “activities” rather than to R&D to ensure that the effect was wider than that and expenditure incurred by a company carrying out activities contracted to it by a third party would not qualify.

(c) In a discussion about section 1138 and, in particular, subsection (c) it was recorded that Officer Smillie had

“...said that HMRC would be looking for a clear and direct link before arguing that subsection c was in point. Again, it’s been argued that this means there must be a document in which the payer specifically states that the payment is to meet that expenditure. This isn’t the case.... I’d also add that a Tribunal could well rule that HMRC’s application of the legislation is too wide...”

(d) “PH [Phil Hamblin] was asked six questions as follows:

Q1: Does HMRC agree with our opinion that the subsidisation clause catches scenarios where the end client of the SME (who is filing the claim) pays the company for its time in undertaking the R&D/delivery of services. We believe it clearly does. Do you expect taxpayers and agents to review relevant documentation to check this?

A1: Yes, I do agree, and have discussed the matter with several agents. All bar a tiny amount – less than a handful – are content with HMRC’s interpretation. And yes, HMRC does expect agents to review all relevant documents and transactions in order to establish whether s1138(1)(c) applies to a claim... HMRC has, since the SME scheme was introduced, considered that what is now s1138(c) (sic) is specifically there to stop a company claiming R&D Tax Relief on R&D paid for by someone else....”.

231. Officer Hamblin went on to refer to paragraph 19 of the Explanatory Notes to the Finance Bill 2000 and then stated:

“...This means that the coverage is far wider than just a contract which specifies that R&D must be carried out, and to assist claimants my predecessor Neil Smiley (sic) provided an explanation as to how HMRC interpret this provision (perhaps a bit less widely than it could be interpreted) when the RDCC met on 17 October 2013...”.

He then said that if the courts found that HMRC’s interpretation was too generous then HMRC may have to revisit the “arguably ‘looser’ interpretation” from 2013.

232. We were not taken to it but we observe that the third question put to Officer Hamblin was whether all R&D tax claims should be submitted with the project narrative(s) and a breakdown of the qualifying costs. The answer was:

“I agree that it is good practice to provide these details, and I agree that as the question implies such documents and information are not a requirement. However, I think good practice is what HMRC will expect without requirement. Indeed, not providing details may be a sign that the claim should be considered for enquiry.”

233. Incidentally, we observe that one of the topics of discussion was “ambulance chasing” practitioners which was a cause for concern.

234. The onus of proof in relation to PGP rests with SOCS and, as we have indicated, Mr Bradley led the evidence of Mr Holmes and Ms Bellerby.

235. In summary, Mr Holmes’ evidence was that prior to 2020 he had never seen any R&D enquiry, including those where the claim was in respect of R&D expenditure undertaken in the course of work for a specific customer, raise the issue of whether the expenditure had been

“contracted out”. He conceded that other advisers may have had a different experience. He told Mr Fitzpatrick that as far as professional advisers were concerned, it was the RDCC meeting in 2020 and the subsequent revisions to CIRD in November 2011 that changed their practice because of the perceived change in HMRC’s interpretation of the legislation.

236. In cross-examination, Mr Holmes accepted that the minutes of the RDCC from 2013 could be read as demonstrating that, quite apart from the Subsidy Condition where it is clear that there was a lack of clarity, the Contracted Out Condition was a difficult area and that in each case the specific facts had to be considered in order to decide whether SME Relief could be due.

237. Mr Fitzpatrick took Mr Holmes to a number of press articles. The first was one from the Tax Journal in May 2022 reporting on the decision in *Hadee* and it was put to Mr Holmes that the writer had not expressed surprise at the outcome. We are not surprised since the writer said that the decision turned on the “evidence submitted” and as we have pointed out there was a paucity of evidence.

238. What was not put to him was that the writer went on to discuss *Quinn* where she referred to paragraph 47 and said:

“Note that HMRC has recently rewritten the relevant part of its guidance for the SME scheme (CIRD84250). Previously, the guidance said that in deciding whether subcontracting had taken place, it was important to consider who owned the resulting IP from the R&D work, who took on the risk for the R&D project's success, and what level of autonomy the SME had in carrying out the project. These factors are no longer referred to in the guidance, which now focuses on the contractual relationship of the parties: where an SME is contractually engaged to deliver a product or project, HMRC will regard that as subcontracting from an R&D perspective.”

We take the view that the writer was inferring that there had been a change.

239. The next report was dated 11 November 2022 and was from John Cullinane, CIOT Public Policy Director, who had commented that:

“We fully support the Treasury and HMRC in trying to get better value for money from these reliefs and in combatting fraud and boundary-pushing. Reducing the generosity of the SME scheme may well reduce the level of fraud, though it will impact on honest claims as well.

However we are concerned that new interpretations of ‘subsidised’ and ‘subcontracted’ expenditure will divert HMRC and honest taxpayers’ and advisers’ resources from the struggle against fraud; and actually damage the effectiveness of these reliefs.

HMRC have in recent times been changing their interpretation of the existing rules of the more generous SME scheme in ways that are capable of acting almost as ‘catch-all’ provisions to deny relief. They have challenged claims that would have been legitimate under traditional interpretations, but have avoided bringing their new interpretations to a court or tribunal which could set a precedent against them. This has increased uncertainty and impaired the effectiveness of the relief.

Now that the government has signalled that it intends to align the support for SMEs with the less generous arrangements for larger firms, there seems no further purpose in harrying SME claimants in this way.”

240. The second footnote to that article read:

“2. SME relief is unavailable where expenditure on R&D is either ‘subsidised’ or ‘subcontracted’. The new interpretations treat as ‘subsidised’ anything which is done pursuant to an arms’ length profitable contract, and suggests that a business customer can ‘subcontract’ R&D work unknowingly. These interpretations move relief away from the companies who make the decision to undertake R&D, so reducing the effectiveness of the relief.”

241. Mr Fitzpatrick put it to Mr Holmes that that article was not articulating that HMRC had changed an almost universal practice. Mr Holmes disagreed. He accepted that the original guidance was not prescriptive and did not cover all possible situations, since it gave only a few examples. However, the guidance to look at the facts in the light of autonomy, ownership of intellectual property and economic risk were valuable “pointers” giving clarity to taxpayers as to whether something was sub-contracted or not. He said that in his experience, including reading technical journals, attending training courses and talking to peers, HMRC had changed their interpretation of the legislation.

242. We agree with Mr Fitzpatrick that the article does not, in terms, say that HMRC had changed an almost universal practice but, in our view, the sentence “They have challenged claims that would have been legitimate under traditional interpretations, but have avoided bringing their new interpretations to a court or tribunal...” is a clear indication that the previously widely understood practice had changed.

243. The timeline in this case is instructive and worthy of review in this context.

244. SME relief has been available since 2000 and CTA 2009 is the most recent legislation applicable to the Relevant Periods. We do not have a date for the publication of the old version of CIRD but it was clearly in existence when Officer Smillie agreed in October 2013 that it required review. That was when he said that HMRC took the view that there needed to be a clear and direct link between payment and expenditure. He did not say, as the new version did in 2021, that payment for undertaking a contract would be a clear and direct link.

245. The evidence from Ms Bellerby in relation to the 2013 and 2014 R&D Reports was that she did not consider that the payments from the clients could be a subsidy because it was not analogous to a grant or similar payment and it was a business transaction. Ms Bellerby believed that there was no sub-contracting because the contracts were contracts to provide services and not for a specific part of the activity; that was the same as a large project in the earlier enquiry which had involved manufacturing, testing and installing dynamic structures and HMRC had been content.

246. In relation to the HMRC enquiry in 2016, Ms Bellerby’s evidence was to the effect that the HMRC officers had gone through the projects in the years under enquiry in detail and had not raised the issues of sub-contracting and subsidy. Indeed, they had told her to make a claim. She had been told that the expenditure then incurred (on projects that were not dissimilar in scope to the sample projects in 2019) was R&D and the claims were valid.

247. She had not raised sub-contracting or subsidy with HMRC because she had reason to believe that they were not in contention. We accept that.

248. In April 2018, Officer Hamblin became aware that *Hadee* was progressing towards the Tribunal (he had had an involvement advising during the enquiry).

249. Officer Hamblin’s witness statement stated that in July 2019, having provided advice to the relevant HMRC officers, Officer Hamblin attended a meeting with a taxpayer involved in

an HMRC enquiry and that taxpayer accepted that their R&D claim was invalid. Apparently, the taxpayer said that other agents were submitting similar claims.

250. A couple of months later two agents contacted Officer Hamblin complaining that some specialist agents were submitting SME relief claims for the callers' clients and they were concerned that they might not be valid because of sub-contracting and subsidy rules.

251. A routine monthly meeting with HMRC Inspectors indicated that there seemed to be an increasing problem with incorrect SME claims.

252. We accept what the Officer says but it does not assist us because firstly, we know nothing about any of the SME claims to which he refers and secondly, in many areas of tax law "specialist" firms offer to make claims that are not well founded on behalf of taxpayers who are either unrepresented or represented by other firms. As can be seen from paragraph 233 above it was a concern that was more widely identified in the sector but it is not relevant to SOCS.

253. On 25 and 26 November 2019, *Hadee* was heard in the Tribunal. At paragraphs 147 and 149 of the decision it is recorded that HMRC submitted that in relation to sub-contracting that

"...If the Appellant was commissioned to design bespoke products and the design of those products is R&D, then that commission to provide a solution for the customer has been contracted out by the customer. In all projects save the marine gears project the description was that the work was subcontracted."

and in relation to "subsidised" that:

"...HMRC submitted that this includes payment for a bespoke product including R&D..."

254. That was the first time we see written evidence of what is HMRC's current stance. However, we observe that in addition to the quotation that we have included at paragraph 147 above, at paragraph 226 of *Hadee* the Tribunal went on to say that the lack of clarity because of the failure to produce documentation meant that "...there is no reason why any payments made could not be for the product, the R&D or both". Similarly, in regard to subsidisation the Tribunal found that the wording of section 1138 Part 13 meant that "In our view this could include R&D". The Tribunal noted that they proceeded to reach their conclusions on the basis of the (limited) material before them drawing inferences where they could do so.

255. We have highlighted the word "could" because if HMRC's submissions had been accepted then, because in all the other projects there were contracts, then the Tribunal would have used the word "would" instead of "could".

256. On 29 May 2020. SOCS' tax return and SME relief claim were received by HMRC.

257. On 14 July 2020, the RDCC met (see paragraph 230 above) and that is a forum where HMRC gives a presentation and takes the opportunity to draw attention to what they perceive as live issues. In Mr Holmes' words it was at that meeting that HMRC "flagged the topic", ie Conditions D and E to the profession.

258. The HMRC enquiry in this appeal was opened on 28 July 2020.

259. On 10 October 2020, the decision in *Hadee* was published, and, as we have indicated, that was the first explicit publication of HMRC's stance that no SME relief was available where there was a contract for a project that involved R&D; albeit, as we have indicated, the Tribunal does not appear to have accepted it.

260. On 4 November 2020, the Chartered Institute of Taxation ("CIOT"), having received a copy of *Hadee* from Officer Hamblin, wrote to him, referring to that, to the RDCC meeting in July and to the fact that HMRC had recently been questioning SME claims. They said:

“... These developments lead us to conclude that there is a disconnect between what advisers understand subsidised expenditure to be in some cases and HMRC’s apparent view of what is subsidised expenditure. I note that your view is that HMRC’s position is clear and well known, but our concern is that the evidence from our members suggest that this may not be the case.... It would be helpful for all taxpayers and their advisers if HMRC’s policy and view was properly understood and publicised”.

261. On 24 November 2020, HMRC argued that the officers involved in the earlier HMRC enquiry had “got it wrong” or that the enquiry had been “incorrect” (see paragraph 76 above). At that meeting, *Hadee* was discussed. The HMRC officers conceded that SOCS had not been sub-contracted in the sample projects.

262. On 25 November 2020, Officer Hamblin wrote at some length to CIOT stating, as he did in this hearing, that HMRC’s view had not changed since 2000. He referred to three articles in Taxation magazine which discussed “ambulance chasing” tactics in the R&D advice market. He said that HMRC would be looking at updating their guidance but it would be updating and “not a change in any way of HMRC’s long held interpretation of the legislation.”

263. None of the Taxation articles shed any light on either the profession’s or HMRC’s stance on what would be a valid SME relief claim.

264. Officer Hamblin having been consulted, on 18 December 2020, Officer Richardson withdrew the concession made on 24 November 2020.

265. On 10 and 11 June 2021, *Quinn* was heard.

266. On 27 October 2021, the decision in *Quinn* was published.

267. On 30 November 2021, the CIRD was amended.

268. On 7 December 2021, Taxation magazine included an article on *Quinn*. Mr Holmes had referenced that in his witness statement but was not cross-examined in that regard. It said, accurately, that Quinn’s R&D projects were typically carried out in delivering work for clients and the Tribunal had decided that there was no subsidy involved. That had provided clarity because “HMRC’s narrowing of its approach to subsidised research and development (R&D) expenditure has been a cause for concern for tax advisers dealing with research and development (R&D) tax relief.” The writer went on to discuss the “ambulance chasers” and fraud and argued that urgent action was required because HMRC’s “narrowed approach” would severely undermine Parliament’s intent when drafting the legislation, as Judge Morgan had noted. The writer asked for better guidance from HMRC since the uncertainty caused by the current guidance and the “narrowed approach” encouraged “rogue agents”.

269. On 20 May 2022, Tax Journal published the article to which we refer at paragraphs 237 and 238 above and which identified the changes in the CIRD.

270. Lastly, there was the CIOT article to which we have referred at paragraphs 239 to 242 above.

Conclusion on PGP and therefore the second Discovery Issue

271. Officer Hamblin argued that the changes that were made in November 2021 simply improved CIRD and did not change HMRC’s interpretation. For a number of reasons, we have difficulty in accepting the argument that the new version of CIRD simply expanded upon the old version and that HMRC’s views had never changed.

272. As far as the old version of CIRD84250 is concerned, two of the examples in the bullet points deal with scenarios involving the identity of the owner of intellectual property. In our view, the crucial wording is the paragraph stating that the examples given are not exhaustive,

each case must be judged on its particular facts and it may be useful to examine the degree of autonomy, the ownership of intellectual property, and the economic risk. As Mr Bradley observed, it was a question of fact and degree in every case. Those factors matter where one is trying to identify whether it is R&D that has been contracted out or something else such as delivery of a project. None of that would be necessary if only freestanding R&D could qualify.

273. In terms of the old version there could be SME relief where there was a commercial contract and R&D was needed in order to deliver under the contract. The new version removed those factors and made it clear that only freestanding R&D could qualify.

274. As far as the Subsidy Condition is concerned, the old version simply said that one had to look at the facts but HMRC and the profession knew that, as Officer Smillie said, there had to be a clear and direct link. It was only in the new version that it said that payment under a contract would be such a link.

275. Whilst we accept, as he did, that Mr Holmes could only speak from his own experience, his evidence was entirely credible and supported by the various articles in the taxation press.

276. We have described the timeline at length because that makes it clear that HMRC's approach changed in the latter part of 2019.

277. Mr Fitzpatrick was correct to say, as Mr Bradley acknowledged, that in a sense it did not matter whether or not there was a change since SOCS had to prove that there was a PGP. We accept Mr Bradley's argument that whether or not there was a change was relevant for two reasons, namely (a) because HMRC's case, both pleaded and in evidence, was that there had been no change, and (b) because the old versions, read with the 2013 explanation about a clear and direct link, indicate the understanding between HMRC and the profession during the Relevant Periods.

278. We do not accept that the two officers involved in the earlier enquiry were incorrect or got it wrong. HMRC's Notes of the Meeting and the correspondence are detailed and they clearly considered the activities involved in detail. They noted both freestanding projects and contracts for clients where R&D was involved. They looked at the costing of R&D in the sample projects and asked for a list of staff giving the percentage of time spent on R&D and their job titles.

279. As far as the enquiry in this appeal is concerned, when Officer Richardson wrote her letter of 30 October 2020 stating that SME relief would not be available, she had had the benefit of reading *Hadee* and quoted it. She will have seen HMRC's submissions (see paragraphs 253 and 254 above). Officer Hamblin had presumably been consulted. She implemented HMRC's revised view of the legislation.

280. However, the Notes of the Meeting of 24 November 2020, whether those drafted by Clive Owen LLP or HMRC, record that the factors in the old version of CIRD for sub-contracting were canvassed. HMRC had already seen the contracts. There would have been no point in exploring, for example, ownership of the intellectual property if it sufficed to know that there was a contract. Officer Richardson stated that HMRC accepted that there was no sub-contract. That suggests to us that HMRC were following the old version of the CIRD. They did say that they wished to refer the issue of subsidy to policy ie Officer Hamblin. It was at that point that it was decided that HMRC would revert to the terms of the letter of 30 October 2020.

281. It is trite law that the decision on PGP is "on the balance of probabilities". We accept that Officer Hamblin genuinely believes that there had been no change in HMRC's stance but the totality of the other evidence, looked at objectively, suggests that HMRC, on the ground as it were, and the profession had a different perspective during the Relevant Periods.

282. We find that there was a PGP based on the old version of CIRD. That recognised that it was possible for an SME company to satisfy Condition D where, for example, it had autonomy, bore the risks and retained ownership of the intellectual property. Those were not the only factors that might be relevant; each project had to be examined on its own merits. The need for a “clear and direct link” in relation to condition E was certainly a vague specification, but we find that the evidence that the new version of CIRD81650 was a change, and a significant change, is an indication that the PGP before 2019 was to look for such a link with R&D and not with incidental expenditure incurred in delivering a contract.

283. We find that not only was there a PGP but that SOCS’ tax returns were submitted in accordance therewith.

Conclusion on the Second Discovery Issue

284. For all these reasons the appeal succeeds on the Second Discovery Issue

The First Discovery Issue

285. HMRC bear the burden of proof in relation to this issue.

286. As far as Mr Fitzpatrick’s argument that it was necessary for the R&D Reports to include contractual details is concerned, we find that given that in two of the three sample projects the contracts were both lengthy and complex, we were not persuaded. It was obvious from the face of the R&D Reports both that there were contracts and that R&D was necessary.

287. This is a self-assessment system and paragraphs 196 and 197 of *Hicks* are in point and they read:

“[196] It seems to us that s 29(5) focuses primarily on the adequacy of the disclosure by the taxpayer. What constitutes adequate disclosure for the purposes of s 29(5) will vary from case to case. It depends on the nature and tax implications of the arrangements concerned and not on the assumed knowledge (or lack of knowledge) of the hypothetical officer. The obligation is on the taxpayer to make the appropriate level of disclosure as befits a self-assessment system.

[197] In a relatively simple case, where the legal principles are clear, it would be sufficient for a taxpayer simply to give a full disclosure of the factual position. The return must also make clear what position the taxpayer is adopting in relation to the factual position (eg whether a receipt was not taxable or whether a claim for relief was being made).

288. We certainly accept that, based on paragraph 41(2) of *Hargeaves*, the fact that the R&D Reports might or ought to have made a hypothetical officer ask questions, would not be enough to constitute awareness of an actual insufficiency.

289. We understand that the R&D Reports were in the format that they were because, effectively, SOCS had been given a “clean bill of health” following the earlier HMRC enquiry.

290. Ms Bellerby had carefully analysed the projects in question (see paragraph 64 above) before submitting the R&D Reports and since they were in the same format for the Relevant Periods, albeit not prepared by her, we find that the same process will have been followed. The technical uncertainties were identified and the heading “Why was the knowledge not readily deducible by a competent professional”, was a very clear reference to the BIS Guidelines.

291. Having said that however, we had regard to paragraph 198 of *Hicks* which reads:

“[198] But there may be other cases where the law and the facts (and/or the relationship between the law and the facts) are so complex that adequate disclosure may require more than pure factual disclosure: namely some adequate explanation of the main tax law issues raised by the facts and the position taken in respect of those issues.”

292. The Contracted Out and Subsidy Conditions are clearly the main tax law issues and Mr Fitzpatrick argued that those should have been addressed by SOCS.

293. Part 13 and R&D in general are not straightforward. However, we find that by making the claims and including the information that they did in the R&D Reports, SOCS inferred that they did not believe that the Contracted Out and Subsidy Conditions were an issue. The question is whether that sufficed as adequate disclosure?

294. As we have indicated at paragraph 232 above, Officer Hamblin had clearly indicated to the profession what HMRC would have considered to be best practice in terms of disclosure. He did not suggest that the tax law issues required to be addressed. SOCS’ R&D Reports were compliant with that guidance from HMRC, albeit that guidance was given after the Relevant Periods.

295. Furthermore, and crucially, since HMRC’s pleaded case, both before and during the hearing, was that only freestanding R&D was eligible for relief, and that had always been their stance, then it would have been obvious from the R&D Reports that there was a potential loss of tax. For the same reason, we do not accept Officer Aspey’s evidence to the effect that HMRC did not know that there was R&D involved in the contracts until receipt of the October email.

296. The detailed information in the R&D Reports would have sufficed to enable the hypothetical officer to conclude that the expenditure was both contracted out and subsidised.

Conclusion on the First Discovery Issue

297. For these reasons we find that the appeal on the First Discovery Issue succeeds.

Footnote to the First Discovery Issue

298. As can be seen from our decision on PGP we do not think that HMRC’s argument about the generally understood position in the Relevant Periods was correct. Had we been asked to decide the First Discovery Issue by reference to our findings on the PGP, the position would be rather different.

299. SOCS believed that there had been adequate disclosure and had spent time and money in ensuring that the R&D Reports were detailed. Based on the PGP, Mr Holmes believed that there had been adequate disclosure. Were they correct?

300. If that insufficiency could only be identified by looking at the contracts and identifying SOCS’ *modus operandi* (ie autonomy, risk and intellectual property etc) then the R&D Reports alone would not suffice to constitute awareness of an insufficiency.

301. If we are correct on PGP, then there was a discovery after the November 2020 meeting when the *modus operandi* was discussed.

Conclusion

302. For all these reasons the appeal succeeds.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

303. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent

to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

**ANNE SCOTT
TRIBUNAL JUDGE**

BIS Guidelines

The Department for Business, Innovation and Skills issued Guidelines on the Meaning of Research and Development for Tax Purposes on 5 March 2004 and which were updated on 6 December 2010. The BIS Guidelines have the force of law by virtue of s1006 ITA 2007, s837 ICTA 1988 and s1138 CTA 2010 and the pertinent parts provide as follows:

1. “These Guidelines are issued by the Secretary of State for Trade and Industry for the purposes of Section 837A Income and Corporation Taxes Act 1988. They replace the previous Guidelines issued on 28 July 2000.

1. Research and development (‘R&D’) is defined for tax purposes in Section 837A Income and Corporation Taxes Act 1988. This says the definition of R&D for tax purposes follows generally accepted accounting practice. SSAP 13 Accounting for research and development is the Statement of Standard Accounting Practice which defines R&D. The accountancy definition is then modified for tax purposes by these Guidelines, which are given legal force by Parliamentary Regulations. These Guidelines explain what is meant by R&D for a variety of tax purposes, but the rules of particular tax schemes may restrict the qualifying expenditure.

2. ...

The Definition of Research & Development

3. R&D for tax purposes takes place when a **project** seeks to achieve an **advance in science or technology**.

4. The activities which **directly contribute** to achieving this advance in science or technology through the resolution of **scientific or technological uncertainty** are R&D.

5. Certain **qualifying indirect activities** relating to the project are also R&D. Activities other than qualifying indirect activities which do not directly contribute to the resolution of the project’s scientific or technological uncertainty are not R&D.

Advance in Science or Technology

6. An advance in science or technology means an advance in **overall knowledge or capability** in a field of **science or technology** (not a company’s own state of knowledge or capability alone). This includes the adaptation of knowledge or capability from another field of science or technology in order to make such an advance where this adaptation was not readily deducible.

7. An advance in science or technology may have tangible consequences (such as a new or more efficient cleaning product, or a process which generates less waste) or more intangible outcomes (new knowledge or cost improvements, for example).

8. A process, material, device, product, service or source of knowledge does not become an advance in science or technology simply because science or technology is

used in its creation. Work which uses science or technology but which does not advance scientific or technological capability as a whole is not an advance in science or technology.

9. A project which seeks to, for example,
 - (a) extend overall knowledge or capability in a field of science or technology; or
 - (b) create a process, material, device, product or service which incorporates or represents an increase in overall knowledge or capability in a field of science or technology; or
 - (c) make an **appreciable improvement** to an existing process, material, device, product or service through scientific or technological changes; or
 - (d) use science or technology to duplicate the effect of an existing process, material, device, product or service in a new or appreciably improved way (e.g. a product which has exactly the same performance characteristics as existing models, but is built in a fundamentally different manner)

will therefore be R&D.

10. Even if the advance in science or technology sought by a project is not achieved or not fully realised, R&D still takes place.

11. If a particular advance in science or technology has already been made or attempted but details are not readily available (for example, if it is a trade secret), work to achieve such an advance can still be an advance in science or technology.

12. However, the routine analysis, copying or adaptation of an existing product, process, service or material, will not be an advance in science or technology.

Scientific or Technological Uncertainty

13. Scientific or technological uncertainty exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, is not readily available or deducible by a competent professional working in the field. This includes **system uncertainty**. Scientific or technological uncertainty will often arise from turning something that has already been established as scientifically feasible into a cost-effective, reliable and reproducible process, material, device, product or service.

14. Uncertainties that can readily be resolved by a competent professional working in the field are not scientific or technological uncertainties. Similarly, improvements, optimisations and fine-tuning which do not materially affect the underlying science or technology do not constitute work to resolve scientific or technological uncertainty.”

2. In the Definitions section:

“Project” is defined as:

“19. A project consists of a number of activities conducted to a method or plan in order to achieve an advance in science or technology. It is important to get the boundaries of the project correct. It should encompass all the activities which collectively serve to resolve the scientific or technological uncertainty associated with achieving the advance, so it could include a number of different sub-projects. A project may itself be part of a larger commercial project, but that does not make the parts of the commercial project that do not address scientific or technological uncertainty into R&D.”

“Overall knowledge or capability” is defined as:

“20. Overall knowledge or capability in a field of science or technology means the knowledge or capability in the field which is publicly available or is readily deducible from the publicly available knowledge or capability by a competent professional working in the field. Work which seeks an advance relative to this overall knowledge or capability is R&D.”

“Appreciable improvement” is defined as:

“23. Appreciable improvement means to change or adapt the scientific or technological characteristics of something to the point where it is ‘better’ than the original. The improvement should be more than a minor or routine upgrading, and should represent something that would generally be acknowledged by a competent professional working in the field as a genuine and non-trivial improvement. Improvements arising from the adaptation of knowledge or capability from another field of science or technology are appreciable improvements if they would generally be acknowledged by a competent professional working in the field as a genuine and non-trivial improvement.

24. Improvements which arise from taking existing science or technology and deploying it in a new context (e.g. a different trade) with only minor or routine changes are not appreciable improvements. A process, material, device, product or service will not be appreciably improved if it simply brings a company into line with overall knowledge or capability in science or technology, even though it may be completely new to the company or the company’s trade.

25. The question of what scale of advance would constitute an appreciable improvement will differ between fields of science and technology and will depend on what a competent professional working in the field would regard as a genuine and non-trivial improvement.”

3. The “commentary on particular questions which arise” includes:-

“Start and end of R&D

33. R&D begins when work to resolve the scientific or technological uncertainty starts, and ends when that uncertainty is resolved or work to resolve it ceases. This means that work to identify the requirements for the process, material, device, product or service, where no scientific or technological questions are at issue, is not R&D.

34. R&D ends when knowledge is codified in a form usable by a competent professional working in the field, or when a prototype or pilot plant with all the functional characteristics of the final process, material, device, product or service is produced.

35. Although the R&D for a process, material, device, product or service may have ended, new problems which involve scientific or technological uncertainty may emerge after it has been turned over to production or put into use. The resolution of these problems may require new R&D to be carried out. But there is a distinction to be drawn between such problems and routine fault fixing.

4. “Examples/Illustrations” includes:-

A The R&D process

A1. A company conducts extensive market research to learn what technical and design characteristics a new DVD player should have in order to be an appealing product. This work is not R&D (paragraph 37). However, it does identify a potential project to create a DVD player incorporating a number of technological improvements which the company’s R&D staff (who are competent professionals) regard as genuine and nontrivial. This project would be seeking to develop an appreciably improved DVD player (paragraphs 23-25) and would therefore be seeking to achieve an advance in science or technology (paragraph 9(c)).

...

A4. Several copies of this prototype are made (not R&D; paragraphs 4-5 and 26-28) and distributed to a group of consumers to test their reactions (not R&D; paragraph 28((a))). Some of these consumers report concerns about the noise level of the DVD 8 player in operation. Additional work is done to resolve this problem. If this involves a routine adjustment of the existing prototype (i.e. no scientific or technological uncertainty) then it will not be R&D (paragraph 14); if it involves more substantial changes (i.e. there is scientific or technological uncertainty to resolve) then it will be R&D.

G Testing as part of R&D

G1. Scientific or technological testing and analysis which directly contributes to the resolution of scientific or technological uncertainty is R&D (paragraph 26). So for example if testing work is carried out as part of the development of a pilot plant, this would be R&D, but once the design of the ‘final’ pilot plant had been finalised and tested, any further testing would not be R&D (paragraph 39). However, if flaws in the design became apparent later on, then work to remedy them would be R&D if they could not readily be resolved by a competent professional working in the field (in other words, if there was scientific or technological uncertainty around how to fix the problem; paragraph 14).

J Project, prototype and end of R&D

J1. A company develops new spark plugs for use in an existing petrol engine. The scientific or technological uncertainty associated with this work is resolved once prototype plugs have been fully tested in the engine. The activities directly contributing

to this work, including the construction of prototypes and their testing in the engine, would be R&D.

J2. The same company decides to design a new engine to incorporate the new spark plugs, involving a new combustion chamber design, lighter materials and other improvements such that the overall engine is appreciably improved (it uses less petrol to achieve slightly greater power output performance, and generates less pollution than current models). The activities directly contributing to this work, including the design of the separate components (not all of which need be different from those used in previous models) and their integration into a new engine, are R&D. The uncertainty associated with this work is resolved, and R&D is complete. once a functionally final prototype has been tested.”

Extracts from HMRC's Corporate Intangibles Research and Development Manual

'Old' CIRD81650 wording:

Subsidised expenditure

Where a project has received any funding which is a notified State Aid (CIRD81670) then no expenditure on that project can qualify for the R&D tax relief under the SME scheme.

If a grant or subsidy is received other than by way of notified State Aid, the expenditure is subsidised to the extent that it does not exceed the subsidy. This may result in the expenditure qualifying for R&D tax relief partly under the SME scheme and partly under the large company scheme.

A notified State Aid, grant, subsidy or payment that is not allocated to particular expenditure should be allocated according to the underlying facts.

'New' CIRD81650 wording (inserted 30.11.21):

Subsidised expenditure

Where a project has received any funding which is a notified State Aid (CIRD81670) then no expenditure on that project can qualify for the R&D tax relief under the SME scheme. The legislation defining "subsidised expenditure" provides that if a grant or subsidy is received which is not notified State Aid, the expenditure is subsidised to the extent that it does not exceed the subsidy. This may result in the expenditure qualifying for R&D tax relief partly under the SME scheme and partly under the large company scheme for RDEC.

A notified State Aid, grant, subsidy or payment that is not provided for particular expenditure should be allocated according to the underlying facts.

The legislation separately provides that expenditure is also subsidised to the extent that it has been met, directly or indirectly by any other person. So expenditure may be "subsidised expenditure" even though the payments are not, for example, a grant or subsidy paid by a public body.

HMRC recognises the wide scope of the legislation and provided the following view to a meeting of the Research & Development Consultative Committee in October 2013:

NS agreed that the guidance required further review to give an indication of where the boundary lay between subsidised and non-subsidised expenditure. The meaning of 'subsidised' (CTA 2009 S1138) referred to expenditure being met directly or indirectly which was not particularly helpful as all expenditure is met indirectly in some way or other.

Currently HMRC took the view that there needed to be a clear and direct link between the payment received and the qualifying expenditure.

Link to the public document which, incorrectly, refers to section 1308.

What is considered to be a “clear and direct link” will depend on the facts in each case. However:-

- Payment received for undertaking a contract will be considered to meet expenditure incurred in undertaking that contract.
- Where a company carried out R&D on its own account and subsequently sells goods or services developed as a result of that R&D, receipts from those sales will not be considered to meet the expenditure incurred on the R&D.
- Where a company carries out R&D on its own account, receipts from the sale of goods or services which existed prior to the R&D being undertaken will not be considered to meet expenditure incurred on the R&D.

‘Old’ CIRD84250:

[CIRD84250] R&D tax relief: categories of qualifying expenditure: subcontracted activities – meaning of subcontracted

Subcontracted R&D activities

Where there is a contract between persons for R&D activities to be carried out by one for the other, then the R&D activities have been subcontracted. A contract to provide services rather than to undertake a specific part of the activities is not subcontracted R&D. Nor is a contract of personal employment.

There are obviously a considerable variety of possible contractual arrangements. Some examples are:

- Where a company carried out R&D on its own account (retaining use of the intellectual property in the work) and simply receives a subsidy from another entity, this is not subcontracting – it is subsidised expenditure.
- Where two companies are both carrying out R&D on the same subject they may decide to pursue the R&D jointly with each making a contribution and each free to enjoy any fruits of the R&D. This is collaborative research and each company would potentially be eligible for R&D relief on its share of the qualifying expenditure.
- Where one company carrying out R&D pays another company for the provision of workers, or materials this is not subcontracting of the R&D.
- Where one company engages another company to carry out R&D activity on the first company’s behalf in exchange for payment, with the first company having rights to the intellectual property resulting from the R&D then that is subcontracting of the R&D to the second company.

The above examples illustrate a range of situations. But each case will need to be judged on its particular facts. As part of any examination it may be useful to examine the degree of autonomy enjoyed by the person engaged, the ownership of intellectual property, and the economic risk in any arrangements. Where for example a consultant simply provides expert advice and charges for his time that does not amount to subcontracting of the R&D.

Subcontracting – differences in rules for SMEs and large companies

The rules in regard to qualifying expenditure for subcontracted R&D (CIRD84200) differ under the SME scheme and the large company scheme. Before considering mounting any arguments you should consider the appropriate tax treatment, so as to better focus attention on those areas where tax is at risk.

‘New’ CIRD84250 (inserted 30.11.21):

CIRD84250 – R&D tax relief: categories of qualifying expenditure: subcontracted activities – meaning of subcontracted SME Scheme, Activities contracted to the SME – ss 1052(5) & 1053(4) CTA09

Expenditure incurred by a company in carrying out activities contracted to it by another person is not qualifying expenditure. This is intended to prevent both parties to a contract from claiming relief for the same activities.

Whether the activities were contracted to the company is a question of fact and each case should be looked at individually. Any activities carried out in order to fulfil the terms of a contract are considered to have been contracted to the company. However, where a company continues to conduct relevant R&D after the contract has been fulfilled, those post-contract activities will not be considered to have been contracted to the company.

SME Scheme, Activities contracted out by the SME 1053 CTA09

Where there is a contract between persons for activities to be carried out by one for the other, and those activities form the whole of an R&D project or are part of a wider R&D project, then R&D activities have been subcontracted. A contract to provide services other than a specific part of those activities is not subcontracted R&D. Nor is a contract of personal employment.

There are obviously a considerable variety of possible contractual arrangements. The following examples illustrate a range of situations, but they are not exhaustive and each case will need to be judged on its particular merits.

- Where a company carries out R&D on its own account and simply receives a subsidy from another entity, this is not subcontracting – it is subsidised expenditure.
- Where two companies are both carrying out R&D on the same subject they may decide to pursue the R&D jointly with each making a contribution and each free to enjoy any fruits of the R&D. This is collaborative research and each company would potentially be eligible for R&D relief on its share of the qualifying expenditure.
- Where one company carrying out R&D pays another company for the provision of workers or materials this is not subcontracting of the R&D.
- Where one company engages another company to carry out R&D activity on the first company’s behalf in exchange for payment then that is subcontracting of the R&D to the second company.
- Where, for example, a consultant simply provides expert advice and charges for their time, that does not amount to subcontracting of R&D.