

TAXREP 20/99

RESEARCH & DEVELOPMENT: NEW TAX INCENTIVES FOR SMALL AND MEDIUM-SIZED COMPANIES

A representation submitted by the Tax Faculty to the Inland Revenue in response to a request for comments made in a Technical Note issued on 10 March 1999.

	Paragraph
INTRODUCTION	1
PREVIOUS CONSULTATIONS	2 – 5
GENERAL COMMENTS	6 –14
RESPONSES TO QUESTIONS	
Chapter 2	15 – 18
Chapter 3	19 – 24
Chapter 4	25
Chapter 5	26 – 29
Chapter 6	30 – 33
Chapter 7	34 – 38
CONCLUSIONS	39 – 41

RESEARCH & DEVELOPMENT: NEW TAX INCENTIVES FOR SMALL AND MEDIUM-SIZED COMPANIES

INTRODUCTION

- 1 We refer to the above Technical Note issued on 10 March 1999. We welcome the opportunity to comment on this Note and the proposal to introduce further incentives for research and development ('R & D'). This consultation follows up one particular aspect of the consultation document issued last year, entitled '*Innovating for the future, Investing in R & D*', namely the suggestion that further tax incentives might be required to encourage R & D.

PREVIOUS CONSULTATIONS

- 2 The question relevant to this exercise was posed at point d) in Chapter 4 of the earlier consultation document, namely '*Is there a role for further tax incentives to R & D?*' We commented on this earlier consultation document in our representation TAX 20/98, and we attach a copy of as Annex A. Our response to the particular question referred to above was set out in paragraphs 34 to 45 of TAX 20/98.
- 3 We also commented on the further consultation exercise on scientific research allowances (TAXREP 6/99), much of which is also relevant to this consultation exercise. We attach this document as Annex B.
- 4 We have responded under separate cover to the related consultation exercise on the proposed reform of intellectual property (TAXREP 19/99).
- 5 Where we think the points are still valid; we have incorporated extracts from our earlier responses in our reply to this consultation. For clarity, our earlier comments are set out in *italics*.

GENERAL COMMENTS

Limitation to small and medium sized companies

- 6 The companies that stand to receive the most benefit from this proposed new relief will be those companies which qualify as small and medium-sized enterprises ('SMEs') but which pay corporation tax at the marginal rate or the full rate. Companies in these categories will obtain tax relief on qualifying expenditure at 48³/₄ % or 45% respectively. We suspect, however, that the numbers of companies that fall into these categories, particularly the latter, will be small. Companies that satisfy the SME test but which pay corporation tax at the small companies' rate of 20% will obtain effective tax relief at 30%, i.e. tax relief equal to the full rate of corporation tax.
- 7 We are not convinced that measures to encourage innovation in the UK should be limited solely to SMEs as defined in the Companies Act, subject to any necessary

amendment so as to ensure that the definition complies with that adopted by the European Commission. We said in paragraph of TAX 20/98 that we would have thought that it is important to encourage innovation in its broadest sense. We do not see how innovation will be actively encouraged if the proposed new relief is targeted only at small and medium-sized enterprises. The proposed relief is potentially unfair to companies that do not satisfy the SME criteria, regardless of at what rate they pay corporation tax.

- 8 Further, as a quid pro quo for the introduction of this new relief, it is proposed in Chapter 6 that the type of expenditure that qualifies for relief under the scientific research allowances ('SRA') rules should be restricted. The restrictions will apply to all SRA claims, whether or not the taxpayer company qualifies as an SME. If SRAs are restricted in this way then many companies engaged in research which do not qualify as SMEs will now be disadvantaged. Companies that do not qualify as SMEs will find that, not only will they be unable to claim the new credit, but also their future SRA claims will be restricted.
- 9 We are not convinced that this relief is targeted correctly. We are also concerned that the if SRAs are restricted in the future, this may have the effect of reducing rather than increasing the UK research base. We will come back to this point in our review of Chapter 6. We believe that a detailed review should be undertaken to identify whether it would be more beneficial to provide enhanced allowances to all companies whether or not they satisfy the SME criteria.
- 10 We welcome the Government proposal that the European Commission will be consulted and their approval obtained before any measures are introduced. We recommended this course of action in paragraph 40 of TAX 20/98.

Inaccuracy in terminology

- 11 We are concerned and disappointed that the Technical Note contains a fundamental inaccuracy in its terminology, in particular in paragraph 1.10, although it is repeated elsewhere. It states that '*....in addition to the existing special relief for R & D, which gives 100% relief for expenditure on R & D...*'. This statement, we presume, is referring to expenditure qualifying for scientific research allowances ('SRAs').
- 12 We think it is important to make it clear that development expenditure does not qualify for SRAs. In fact, tax relief for development expenditure is problematic. Thus, the implication that all such expenditure qualifies for 100% relief, and will therefore qualify for a further 50% relief under this new system, is incorrect and misleading.
- 13 We pointed out in our earlier response on the SRA consultation (TAXREP 6/99) the problems involved in identifying expenditure at the boundary of what may qualify for SRAs, as well as the need to provide further incentives to encourage innovation in its widest sense. The proposed allowances do nothing to address these problems.
- 14 We set out below our comments on the questions posed in the Technical Note, as summarised in Chapter Seven.

RESPONSES TO QUESTIONS

Chapter 2: Who would qualify for the proposed tax credit scheme

Views are sought on whether there are any significant drawbacks from limiting the scheme to companies?

- 15 In principle, we think that relief should be available to unincorporated businesses. There may be instances, for example, where R & D is undertaken by a partnership. We note that the rules for the re-introduced first year allowances include unincorporated businesses, and restricting this proposed R & D credit to companies would introduce another distortion to the UK tax system. Whilst we suspect that there is unlikely to be a major problem in practice, this is an important point of principle.

Views are sought on whether a de minimis limit of £50,000 is set at the right level.

- 16 We are not convinced that there should be a de minimis. In our view, this merely introduces a further complication into an already complicated tax system. Further, it appears to discriminate against smaller companies, which are the very types of companies that the Government is trying to encourage. There is no indication in the Note as to why the figure of £50,000 was chosen as the minimum amount. The setting of a relatively high threshold will merely encourage unproductive expenditure in order to ensure that the threshold is reached.
- 17 If there is to be a limit, we suggest that it is set at a modest threshold, but perhaps sufficient to discourage claims for insignificant amounts. We therefore suggest that the limit on the minimum expenditure required before a claim can be made should be £10,000. Thus, for a company that pays corporation tax at the small companies' rate, the minimum tax saved by the R & D tax credit is £1,000.

Views are sought on whether there is a pressing case for extending the scheme to joint ventures and if so how this would be done?

- 18 We suspect that there is not a pressing case for an extension of the scheme to include joint ventures. In the event that this was considered desirable, we are not convinced that the existing limits will be appropriate, because we suspect that there are very few joint ventures where both parties are SMEs, or which would meet the SME criteria in their own right.

Chapter 3: What expenditure would qualify for the proposed tax credit scheme?

We would welcome views on the proposals in this chapter on the definition and measure of qualifying expenditure for R & D tax credits.

- 19 We note that the proposed definition of qualifying expenditure will be expenditure that qualifies for scientific research allowances, but modified in order to restrict the relief to R & D performed in the UK and to exclude capital expenditure. The latter two restrictions appear reasonable for the proposed R & D tax credit.

- 20 However, we have stated in our previous representation (TAXREP 6/99) that the definition of scientific research for the purposes of SRA is too narrow and that the definition could usefully be relaxed to include product development. We have set out below the text of our earlier response on this matter.

'Scope of SRAs

21 *The Faculty is also concerned that there is a perception that the Revenue/Government take a very narrow view as to what constitutes scientific research. We believe that the SRA definition should be widened to encourage innovation in its broadest sense.*

22 *It is not only expenditure on research that facilitates innovative practice. The invention of new processes and products is of no value unless businesses are prepared to spend the money necessary to bring about their implementation and production.*

23 *The Faculty believes that SRAs should be extended to cover areas such as development expenditure, whether of a revenue or capital nature, where existing allowances might not always be available.*

24 *We recognise that there might be problems in identifying expenditure which represented an innovative approach by the business concerned as compared to that which merely represented the maintenance or extension of existing practice.*

25 *As noted in paragraph 4.12 [of the Technical Note: research and Development, Definitions and Appeals], in certain areas, for example the SRA treatment of buildings, the treatment appears rather generous. Thus, the Faculty believes that it might be reasonable to extend the availability of SRAs to encompass innovation in its broadest sense, with a quid pro quo that SRAs on buildings be restricted.*

26 *However, we understand that the current treatment, that is allowing immediate write-off of capital expenditure on buildings for tax purposes, may help to encourage the establishment by international groups of research facilities in the UK. If this is correct, then clearly this has economic benefits to the UK which may exceed the overall cost to the Exchequer. Thus, we recommend that before any decisions are taken to restrict SRA relief in these circumstances, the economic impact must be examined.*

27 *An extension of SRAs might include, for example, expenditure on computer software. The tax treatment of expenditure on computer software continues to give rise to difficulties. Paragraph 4.05 [of the Technical Note], for example, states that, 'expenditure on developing computer software may occasionally be classified as capital for tax, even where it is written off immediately in the accounts'.*

28 *We believe that there is a case for a more generous tax allowance for expenditure on the acquisition or development of computer software. We believe it is*

important to recognise that expenditure on computer software may have a short real working life because, in order to achieve the significant gains in efficiency that modern software systems can deliver, it requires constant development and upgrading.

29 We suggest that relief for computer software costs is given by writing off the cost as an expense for the purposes of Schedule D Case I. We recognise that this may be more advantageous when compared to the accounts treatment, and that this view conflicts with the ‘radical approach’ described above. However, we believe that it is justified in view of the great importance of software to the growth in technology.’

- 21 We are still firmly of these views, and think that unless a broader approach is taken to providing tax relief for innovation, the likely benefits to the UK scientific base are likely to be limited.
- 22 Of more concern with this proposal is that we believe that few SMEs are likely to carry out any substantial scientific research in the narrow sense in which that expression is used in relation to SRA. If the intention is to encourage new and growing businesses in the hi-tech sector, what is needed is an incentive for innovation in the broad sense, rather than fundamental research.
- 23 We propose therefore that the relief should be given for expenditure on research and development as defined in SSAP 13. The SSAP 13 definition of ‘development’ seems to us to coincide closely with what we understand the government is seeking to encourage, and there would also be an advantage in terms of compliance costs in adopting the same definition for tax and accounts purposes.

We would welcome views on whether a certification procedure would be helpful for a UK R & D tax credit, for instance in reducing compliance and administrative costs by improving the quality and reliability of claims, and, if so, which professionals should be authorised to certify claims and how that would be regulated.

- 24 We do not think that a certification procedure will be particularly helpful, and we do not believe it is appropriate for tax professionals to ‘certify’ a claim to the enhanced R & D tax credit. It is apparent from the consultation exercise to date that the boundaries of what is scientific research are not clear cut, and ultimately these are questions that may need to be decided upon by the Special Commissioners, possibly acting on expert advice. We understand, for example, that the Canadian Tax authority may send out suitably qualified engineers and university professors to decide on similar issues when they audit a taxpayer's return. We do not think that a tax professional will be in a position to decide on specialised questions that require a high degree of scientific knowledge.

Chapter 4: The proposed tax credit scheme

We would welcome your views on the proposals in this chapter for the claim to be made and handled as part of the Corporation Tax Return subject to the same appeal procedure as SRA.

- 25 We agree that the claim should be made and handled as part of the corporation tax self assessment return. This issue was also considered in our representation TAXREP 6/99. We have set out again below the comments that we made in respect of the proposed SRA appeals system.

'Paragraph 4.14 (Appeals)

10 We stated in our representation last year to the initial consultation on encouraging R & D that SRA appeals should be subject to the normal appeals procedure. Our view was that due to the specialised nature of SRA appeals, it would be appropriate for them to be heard by the Special Commissioners. We are still of this view. Although we welcome the publication of the proposed new guidelines as one method whereby the lack of certainty might be clarified, in our view this is not a substitute for a formal appeal to an independent body.

Paragraphs 4.20 & 4.27

11 We think that there should be no difference between an SRA appeal and any other type of appeal made to the Special Commissioners. We are therefore in favour of the first option, that is all such appeals should be to the Special Commissioners who would be able to hear expert witnesses, including independent experts provided at the expense of the Exchequer.

12 We see no difference in principle between an appeal on SRAs and on, say, disputes about accounting treatment for the purposes of tax. We do not think that co-opting experts is satisfactory, as decisions need to be made by Commissioners based upon all of the evidence that they hear. We do not think that a new tribunal is necessary, and are not sure that there would be sufficient appeals to make its establishment worthwhile.

13 We believe that taxpayers should have the right to appeal to the High Court and beyond. However, we suspect that any decision at the Special Commissioners, being primarily one of fact, is unlikely to be overturned by a higher court unless there was an error of law in arriving at the decision.

14 We do not think that the perceived difficulties outlined in paragraph 4.19 should prove a problem in practice. We believe that taxpayers will welcome the opportunity to be heard and to put their side of the case. Clearly, there may be a difficulty in identifying suitable experts, and it may be that the taxpayer should have a limited right to reject a Revenue expert if, for example, he or she was a direct competitor, a problem recognised in paragraph 4.22.'

Chapter 5: Companies not in taxable profit

We would welcome views on the proposals in this chapter for a payment scheme based on the R & D tax credit.

- 26 We welcome the proposals for a payment scheme based on the R & D tax credit. This is an interesting and innovative development of the enhanced credit system and will provide, in effect, a cash grant. This appears administratively much more
- /opt/JQWA/WF/e17292e2-346b-453d-9ad9-ec77b7254330/7830c46e-6eec-48dc-8856-a12e53762a0e/downloaded-content/b4847748-9b6f-4ac7-8ede-223f6068fa26.odt

straightforward than the idea put forward by the Williams Group as set out in the Technical Note.

- 27 However, we believe that the idea of the discount is misconceived. We start from the position that this proposal is designed to help those most in need, and is akin to a cash grant. This also appears to be the Government thinking. Thus, we think it is reasonable to start from the position that the new system will not disadvantage taxpayers that cannot use the relief immediately to set against taxable profits as compared to those taxpayers that can use the relief. If this is the intention, we do not think that a discount is appropriate, as it discriminates against those companies that do not have taxable profits against which to set the allowance.
- 28 In a similar manner, we do not think that the relief should be restricted only to companies that are trading. This is for two reasons. Firstly, it appears to us that the companies that are not yet trading are likely to be most in need of any available tax credit. Secondly, if the repayment of unused credits is restricted only to trading companies, this will merely result in disputes between the taxpayer and the Revenue as to whether, and if so when, a company commenced trading. The company will have a clear incentive to satisfy the trading test as soon as possible, regardless of the underlying commercial position. A useful analogy is the VAT rules, where the ability to register for and reclaim VAT can be based upon an intention to make supplies in the future.
- 29 We appreciate that this proposed system could be abused. However we suspect that this is unlikely in practice, and it should be possible for adequate safeguards to be built in to the system.

Chapter 6: Scientific research allowance

Your comments on these suggestions are invited.

- 30 We note the comment in paragraph 6.2 that tightening the scope of SRA could help partly fund a tax credit scheme. The proposal to exclude remote purposes does not appear unreasonable, although we would have thought that the types of expenditure mentioned in paragraph 6.4 would not have qualified in any event.
- 31 However, we are very concerned at the proposal to restrict certain types of capital expenditure from qualifying for SRAs. Most of the comments that we made in our earlier representation TAXREP 6/99, as well as our comments on Chapter 3 of this Note, are relevant to this proposal. We have set out again below the paragraphs in TAXREP 6/99 that summarise our views on this proposal.

'25 As noted in paragraph 4.12, in certain areas, for example the SRA treatment of buildings, the treatment appears rather generous. Thus, the Faculty believes that it might be reasonable to extend the availability of SRAs to encompass innovation in its broadest sense, with a quid pro quo that SRAs on buildings be restricted.

26 However, we understand that the current treatment, that is allowing immediate write-off of capital expenditure on buildings for tax purposes, may help to encourage the establishment by international groups of research facilities in the UK.

If this is correct, then clearly this has economic benefits to the UK which may exceed the overall cost to the Exchequer. Thus, we recommend that before any decisions are taken to restrict SRA relief in these circumstances, the economic impact must be examined.'

- 32 Whilst we were happy to consider a possible restriction to SRAs in exchange for a wider relief for innovation, the proposal set out in this Note is not what we had in mind. We do not think that a general restriction in SRAs applying to all taxpayers should be introduced as a quid pro quo for the introduction of this proposed R & D credit for SMEs. The current generous SRA treatment of certain types of capital expenditure is likely to be of most benefit to companies which will not be able to take advantage of this proposed new credit, because they are unlikely to qualify as SMEs. Thus, they are potentially penalised by this proposal, with no corresponding benefit of an enhanced relief for revenue expenditure on SRAs.
- 33 We also believe that the concern we expressed previously that the existing system encourages UK based research facilities needs to be properly addressed before any action is taken to limit SRAs in this way.

Chapter 7: Further issues on which views are sought: feasibility and effectiveness

The Government is proposing two related schemes,

- 1 R & D tax credits giving 50% extra relief on R & D for SMEs, and*
- 2 payment of combined 150% relief on R & D to SMEs not in taxable profit.*

The Government would also welcome views on the feasibility of each scheme including in particular:

a) the compliance costs on business, and

- 34 We do not think that the compliance costs should be significant. It should be relatively straightforward to identify the expenditure that qualifies for the enhanced R & D tax credit because this information will need to be identified for an SRA claim.

b) the risk to the Exchequer through fraud and other abuses

- 35 We do not think that the risks to the Exchequer are any greater than any other existing reliefs. In effect, we are considering an enhanced SRA relief but only in circumstances where the taxable profit is likely to be relatively modest. It appears unlikely that the risks are greater than claims made for SRA by, say, oil companies or multinational companies with substantial research facilities.

It is estimated that the cost to the Exchequer, and the benefit to small and medium-sized businesses, is about £150 million a year. The Government would also welcome views on the cost effectiveness of each scheme including in particular:

a) the contribution it will make to improving the R & D performance of innovative SMEs and

36 We are not able to predict the cost effectiveness of the measure and whether it will contribute to improving the R & D performance of innovative SMEs. We would welcome clarification as to how the Government calculated a figure of £150 million a year, because we do not see how it is possible to predict the cost with any reasonable degree of accuracy.

37 We suggest that the Government gives the proposed scheme a try and then reviews the effectiveness after a reasonable period of time. We suspect that the review will require the input of suitably qualified professionals.

b) whether this will be a cost effective use of Government resources or whether the cost to the Exchequer could be deployed to improve R & D performance more effectively in different ways.

38 We do not think that this question can be answered until the scheme has been given a trial, although as we have already said we believe that a broader tax relief for innovation would be fairer. The proposal may encourage innovation where it might not be undertaken otherwise, but ultimately we think that investment in R & D should be a commercial decision and not unduly influenced by tax breaks. We think that wider measures, such as reducing the burdens on business, are more likely to assist in the long term to encourage innovation rather than the introduction of yet another complicated relief.

CONCLUSIONS

39 We appreciate the Government's desire to encourage innovation. However, whilst we welcome the Government's proposals, on balance we are not convinced that the proposed R & D tax credit is sufficiently attractive to encourage innovation in the UK.

40 Further, the proposed restriction on capital expenditure on buildings qualifying for SRAs could damage rather than enhance the UK's research base. In view of the current opportunity to consider the issues raised in this consultation, we think that a thorough review of this proposal should be undertaken before any decision is taken to restrict SRA relief.

41 We would be happy to discuss this further, if that would be helpful.

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FJH
16 July 1999