

# **TAXREP 03/02**

## **DESIGNS FOR INNOVATION**

*Text of a memorandum submitted in January 2002 to the joint HM Treasury and  
Inland Revenue Consultation Paper published in December 2001*

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## DESIGNS FOR INNOVATION

- 1 We welcome the opportunity to respond to this consultation exercise.

### GENERAL COMMENT

- 2 We welcome the Government's decision to introduce a Research and Development (R & D) tax credit for larger companies. We welcome also the Government's decision to adopt a volume based credit rather than the incremental based credit which was the approach suggested in the previous consultation document issued in March 2001 and to which we responded as TAXREP 12/01.

### SPECIFIC COMMENTS ON CONSULTATION NOTE

#### Volume-based options

- 3 The document presents three volume based options. Whatever method is adopted, it is of course essential that the system is easy to understand and apply in practice. It is important to remember that the formulation of R & D claims, both under the old rules for scientific research (now R & D) allowances and also the new relief for R & D expenditure by small and medium sized enterprises (SMEs), is often far from straightforward. This is a particular problem under self assessment, because one year's claim often has to be made while there are still open issues from previous years. This practical problem will be compounded if companies are claiming an enhanced relief for R & D expenditure which has to be calculated by reference to R & D figures from earlier years. We would therefore prefer a simple volume based scheme such as that set out in Option One of the consultation note.
- 4 However, we understand the Government may wish to limit, or cap, R & D expenditure qualifying for this enhanced credit. The precise level of the cap is of course a policy question. If the Government decides on a cap, then we would prefer Option Two, i.e. the two tiered volume scheme.
- 5 We are not in favour of Option Three, the baseline volume scheme. This is because it introduces most of the same practical problems as the incrementally based scheme, as set out in paragraph three above and explained more fully in TAXREP 12/01, our response to the consultation document issued in March 2001. In summary, it appears to us that this option introduces unnecessary complexity and presents practical difficulties in respect of the application of the rules to groups of companies, thus increasing compliance costs.

#### Annex A

##### *R & D Definition*

- 6 We agree that the definition of R & D for the purposes of this relief should be the same as that for the R & D tax credit for small and medium sized enterprises.

However there are concerns with this existing R & D definition. We, and others, have argued that the existing definition is too narrow and that the Government should consider encouraging innovation in its broadest sense. So although we think it is important that the same definition should apply for all relevant purposes, which in the short term implies using the existing definition for the new relief, we welcome the Revenue's commitment to keep the issue of the R & D definition under review.

#### *Sub-contracted costs*

- 7 In general we disagree with the Government's conclusion to allow the company actually carrying out the work to claim the credit.
- 8 The underlying principle must be that relief should be available to the company which funded the research rather than the company which actually undertook the research. The latter is acting purely as a subcontractor for these purposes and does not bear the investment risk. The relief should be available for the company which bears the risk, namely the principal. Moreover, if the purpose of the relief is to act as an incentive, it should be given to the party who makes the relevant investment decisions, which again is the principal. We note that the Government proposes an exception where R & D is carried on in collaboration with universities etc, but we cannot see that the status of the subcontractor should determine whether or not relief is due to the principal.
- 9 However, we would agree with the Government's conclusion in the particular case mentioned in the consultative note (the fourth bullet point in paragraph 3.5); that is where the company financing the R & D and the company carrying it out are members of the same group. In a group context the identification of a particular company as the one which commissions or finances the R & D work will often involve a considerable degree of artificiality. In this case, we think that the relief should be given to the group company which actually does the work, and this approach should encourage multinational groups to carry out their R & D in the UK.

#### *Double credit*

- 10 We note the Government's proposal to deny relief for the credit where the company receives a similar foreign tax relief. On the assumption that the Government wishes to encourage R & D in the UK, we cannot see why the Government is too concerned about what tax relief, if any, will be available in another country. In fact, if the company is to be given an effective incentive to carry out R & D, the mechanism of double tax relief is such that it will normally have to be given an equivalent relief in both countries. It would be helpful if the Government explained in more detail its concerns on this point.

#### **Other points**

- 11 We would be grateful for confirmation that if the enhanced credit creates a loss, then loss relief will be available in the normal way.

## CONCLUSIONS

- 12 We welcome the decision to adopt a volume based credit, and we very much prefer the straightforward version set out in Option One. We agree that the definition of R & D should be the same as that for the R & D tax credit for small and medium sized enterprises, but we welcome the commitment to keep this definition under review. We disagree with the proposal to give the credit to the company carrying out the work rather than the company which financed the work, except where the principal and sub-contractor are in the same group. We do not see why relief should be denied if tax relief is available in another country but if the Government explained its concerns in more detail we would be happy to consider the point further.
- 13 If you have any questions, please let us know. We are happy to discuss in more detail any of the items raised in this response.

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FJH  
17 January 2002