Tax Representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

TAXREP 49/05

SUPPORTING GROWTH IN INNOVATION: ENHANCING THE R&D TAX CREDIT

Memorandum submitted in October2005 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a discussion paper issued in July 2005 by HM Treasury, HM Revenue & Customs and the Department of Trade and Industry

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INTRODUCTION

1. We welcome the opportunity to comment on the discussion paper **Supporting Growth in innovation: enhancing the R&D tax credit** http://www.hmrc.gov.uk/consult_new/rd-taxcredit.pdf

2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are in the Annex.

GENERAL COMMENTS

3. We are encouraged that the Government continues to seek to improve the system of R&D tax credits and we welcome the opportunity to contribute to the discussion as to how that can best be achieved.

4. We believe that the system of R&D tax credits can be improved and that more companies are entitled to make claims than are doing so at the present time. As is mentioned at paragraph 1.7 'there have been unintended difficulties for both companies making a claim and HM Revenue & Customs inspectors.' Our evidence is that larger companies have had much less difficulty dealing with the R&D tax credits regime than smaller companies.

5. A research project is currently being undertaken by Manchester Business School on behalf of ICAEW into the role of tax policy in R&D decisions by small and medium enterprises. The draft report indicates that the costs of preparing and administering claims prevents some companies from taking advantage of R&D tax credits.

6. Two examples are cited in the draft report and these are reproduced below:

> 'The first example is an R&D intensive medium size firm, capable of preparing the required documentation and making claims. For this successful firm, the R&D tax credit improves cash flow, and in this sense it helps the business function better. The company has grown substantially over the years and is not financially constrained, but the additional resources provided by the tax policy are welcome.
>
> The second example is a small R&D intensive company. It has problems maintaining adequate documentation of their R&D expenditure because they do not have adequate human resources and, as stated by the company director, the insufficient help they get from their tax advisor, possibly because the advisor is part of a small practice that lacks the capacity to deal with complex R&D claims. The incentives are there but the requirements are too demanding for this very small firm that is run by two scientists. If the R&D incentives could be assessed, they would be very helpful. In such circumstances, the administrative burden for smaller firms appears to offset the potential benefits of the incentives.'

7. R&D tax credits reduce the real cost of companies' investment in R&D (paragraph 2.10) but this is shown as a reduction in the tax charge rather than in the pre tax profit as it would be if the UK had a repayable tax credit for all companies. This does also have implications for people carrying out the R&D as their performance is more likely to be measured by reference to the pre-tax profit.

8. Our members have seen the draft SBS advice to SMEs. Feedback is not specifically sought in the discussion paper on this draft advice but our members' do have some reservations about the (draft) advice and we have already provided SBS with our members' specific comments. We understand that SBS have taken note of our comments, and those provided by others, and that the amended advice is to be published on the SBS website during the course of the current month.

SPECIFIC QUESTIONS

Have the tax credit rules introduced any unintended distortions, for example by favouring one type of expenditure over another, or by causing companies to alter their relationships with third parties?

9. There are potential distortions for large companies that outsource services to third parties such that the costs do not count towards the R&D tax credits even though the personnel costs would have counted if the people involved had been working in-house.

10. It seems arbitrary for HMRC to purport to exclude the costs of self-employed 'consultants' as neither employees, staff provided through agencies nor 'subcontractors'; this potentially produces distortions and may hinder a company's efforts to use the most efficient resource that is available. We know of no good policy reason for this, nor consider it merited by the legislation.

11. Although the legislation appears clear on this, we do not understand why connected party costs should be limited to staffing and consumable and software costs, and not their own subcontracted costs. This also potentially produces distortions and may hinder a group's efforts to use the available resources in the most efficient way.

12. We are also concerned that this provision may be in breach of Article 49 of the EU Treaty relating to the freedom to provide services. It is restricting the possibility of outsourcing services to businesses establishment in other EU countries.

Should scientific experts be used in the claims process?

13. This was an issue which was discussed extensively at a meeting on 31 August 2005 between Chris Stark and his team and representatives of the Tax Faculty. No absolute consensus emerged at the meeting.

14. There is clearly a problem because of insufficient understanding of what properly constitutes R&D. There is also a feeling that some of the problems might be alleviated over time by better guidance and better training. It is felt that it would be

worth exploring ways in which experts could be used not as an integral part of the 'normal' process for every claim but rather experts should be available if areas of dispute arise.

15. Our members have told us that they are aware of companies that have received conflicting advice from HMRC and DTI as to whether their activities are R&D.

Are there other ways of ensuring the timely payment of the repayable credit to eligible companies?

16. Our members felt that this was worth investigating further although we are not able to make any concrete suggestions as to how this could be achieved. There is often a large time lag between the expenditure being incurred and the tax credit being received, unlike the position with grants, which are often received in advance of the expenditure being incurred. However as the amounts involved with repayable tax credits are often relatively small it is likely to be overly expensive in terms of professional fees to make interim claims in respect of the R&D expenditure.

Do the emerging firms presented in the discussion paper represent the most effective target group for enhancement to the R&D tax credits?

17. There is evidence from our members that emerging firms are effective in carrying out R&D and it may be worth exploring further ways in which the system could assist them without making the system overcomplicated and burdensome.

Are we able to provide a fuller picture of the issues facing the emerging firms and the characteristics of these firms that are relevant for the R&D tax credits?

18. Such companies are likely to be in the range £1 to £10 million turnover (or costs) with little likelihood of coming into profit for a number of years. Finance is often the key issue for such businesses and R&D repayable tax credits can make a contribution to the finance issues.

Is it possible to target effectively additional support to the emerging firms within the tax credit system, without compromising the basic market-driven premise?

19. It is felt that to target specific groups of companies would complicate the scheme.

Can the questions raised in the discussion paper be better addressed with measures other than R&D tax credits?

20. The discussion paper is seeking evidence in relation to high level issues surrounding R&D tax credits (paragraph 6.4). This question is aimed to find other policy means of achieving the same objective and we do not have any evidence that the stated policy objectives could be better achieved by a different mechanism.

IKY
12.10.05

ANNEX

WHO WE ARE

The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.