



Faculty of Taxation

TAXREP 36/03

Defining innovation: A consultation on the definition of R&D for tax purposes

Memorandum submitted in October 2003 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Inland Revenue in response to Consultation Document

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Defining innovation: A consultation on the definition of R&D for tax purposes

INTRODUCTION

1. We welcome the opportunity to respond to the Consultation Document 'Defining Innovation: A consultation on the definition of R&D for tax purposes' issued in July 2003 which deals with the definition of R&D for Tax Purposes.

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 123,000 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.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) 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 (which includes taxation).
4. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions 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.

GENERAL COMMENTS

5. We believe that the most important objective is to have a readily understandable definition of R&D which does not give rise to uncertainty as to whether or not particular items of expenditure will or will not qualify and does not lay itself open to fruitless argument between taxpayers and individual Inspectors of Taxes as to the divide between qualifying and non qualifying expenditure.
6. The revised definition should make it clear that it will only be necessary to demonstrate on a project by project basis that the intention of the R&D is to produce a novel or improved product or process.

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ANSWERS TO SPECIFIC QUESTIONS

7 Innovation and R&D Tax Credits (Chapter 2)

2.1 *Assuming that any changes to the Guidelines to provide greater certainty and clarity within the current boundaries will apply to all companies, what are your views on any extensions beyond this applying only to SMEs?*

We feel it would be an unnecessary complication to have different rules.

2.2 *Are there any other factors (outside uncertainty around the meaning of the definition) which respondents feel add unnecessary complexity to the whole process of establishing which activities qualify for the credit and subsequently claiming the credit? What practical changes would simplify the process.*

We do not feel that making the actual claim is complicated. There is complexity in making the judgements necessary to make the claim and assembling the necessary information to support the claim.

We feel there is a need for a clearer definition and that improvements should be measured at the project level. In addition the use of examples and case studies will clarify the position.

8 Towards a Revised R&D Definition (Chapter 3)

3.1 *Are there any areas in which the UK's definition of R&D does not follow the Frascati definition, or is significantly less favourable than other countries? (Examples of any differences would be particularly helpful.)*

3.2 *Do you envisage any problems arising from a revised definition of R&D based on the concepts articulated in the current Guidelines and Commentary on the Guidelines?*

3.3 *In introducing a revised definition of R&D for tax purposes, which would be more important to you in providing clarity and certainty: continuity of language between old and new definitions (for example, retaining terms such as 'significantly improved') or the introduction of new language to reduce the scope for ambiguity? Would more examples or case studies be beneficial?*

We consider that improving the clarity and certainty of the definition is far more important than continuity of language. In fact we consider that the expression 'significantly improved' is positively unhelpful, and probably inconsistent with the Frascati definition, so we would like to see it removed. As we mentioned in our earlier representations we believe that the use of more examples and case studies is vital, and not just beneficial, in reducing the scope for uncertainty and increasing the clarity and certainty of the rules.

3.4 *Comments are invited on how to ensure design as part of the R&D process is fully reflected by the new Guidelines, while not extending the definition of R&D to cover design more generally.*

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In engineering businesses the design of a new product or component is an integral part of the R&D process. It is not a merely cosmetic 'add on'. The guidelines need to bring this point out.

- 3.5 *Comments are invited on how best to ensure the new Guidelines capture the essence of what constitutes R&D in and using software, and provided the UK with an internationally competitive definition of R&D in this field.*
- 3.6 *Do you think that the new Guidelines should include additional specific guidance on software?*

Software that is specifically related to the R&D process should qualify for the credit. This should be the case whether the software is internally generated or purchased.

If additional guidance is retained on R&D in software then it should be explicitly mentioned that software is to be treated in the same way as other items of R&D expenditure. We consider, however, that the guidelines themselves should say no more than that, and that any more specific guidance in relation to software R&D should be a matter for separate sectoral guidance.

9 The Boundary between R&D and Related Activities (Chapter 4)

- 4.1 *Would it be helpful in understanding what activities are R&D for tax purposes to have a more explicit definition of 'commercial development' activities that are not R&D? Should such a definition be along the lines set out in paragraphs 4.5 and 4.6?*

We believe the dividing line could be drawn with greater clarity and certainty between R&D and commercial development by the use of case studies. Attempting to produce a more specific definition in abstract terms is likely only to create more boundary issues.

- 4.2 *Do you agree that the Government should define 'novelty' along the lines set out in paragraphs 4.8-4.11?*

Overall we believe that the principles set out in paragraphs 4.10 and 4.11 are reasonable. As mentioned below we object to the use of the word 'substantially' in paragraph 4.8, and we note that paragraph 4.11 reverts to the preferable word 'appreciably'. However it should be recognised that in some industries a performance improvement of as little as 1% could legitimately be regarded as novel rather than the hypothetical 10% quoted in the first bullet point in paragraph 4.10. There should be a strong presumption that if the improvement is great enough that a company thinks it worthwhile to spend the money to achieve it then it is 'appreciable' enough to qualify as R&D; the improvement would of course also have to satisfy the qualitative requirement of being technological in nature rather than cosmetic.

- 4.3 *What evidence might companies reasonably be expected to have and produce to justify calling an activity 'novel' against the criteria outlined in paragraphs 4.12-4.16?*

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It should be sufficient for a company to be able to demonstrate at a project level that the expected outcome of the R&D activity is an appreciable improvement in the product or process or that an uncertainty is resolved. We do not believe there should be a requirement for a greater level of 'proof'. There should not be any prescriptive rules as to the form of evidence which is expected or required.

- 4.4 *Does 'appreciable improvement' (as contrasted with 'non-appreciable improvement') represent a more accurate and helpful term than 'substantial improvement' (as compared to 'incremental improvement')? Is there another term that would make this distinction better or more clearly?*
- 4.5 *What evidence might companies reasonably be expected to have and produce to justify calling something an appreciable improvement against the criteria set out in paragraphs 4.19-4.23?*

As we have noted in relation to question 4.1 in some industries small improvements can be novel, which is reflected in the discussion in paragraph 4.22, whereas the term 'substantial' would tend to suggest a quantitative measure which is not always appropriate. We believe that a term such as 'appreciable' would be better and if there were case studies to illustrate how this would operate in practice then this would reduce the, potentially, subjective impact of the term.

- 4.6 *Should the Government encourage the use of sectoral or technology-specific agreements to improve certainty as to the availability of R&D tax credits for particular types of activity?*
- 4.7 *Is the use of a 'core' definition of R&D for tax purposes plus ad-hoc sectoral or technology-specific agreements the best model for providing more detailed guidance to companies? Or would respondents prefer greater use of examples/case studies as a way of demonstrating the key elements of R&D in particular technologies/sectors?*

We believe that there should be a 'core' definition which in relation to individual sectors could be supplemented either by specific agreement and/or the use of examples and case studies. It would be a matter for particular industries or sectors to decide what format best suited the particular characteristics of their sector to provide the greatest clarity and certainty.

10 Consumable Stores (Chapter 5)

- 5.1 *What would be the most effective means of ensuring greater clarity on qualifying expenditure on consumable stores?*
- 5.2 *What types of expenditure should be included in 'consumable stores'?*
- 5.3 *Should the term consumable stores be replaced and the link with normal accounting practice be severed?*
- 5.4 *If the term is to be replaced, what should be put in its place?*
- 5.5 *Should the relief be extended to the costs of all materials used in the construction of prototypes?*

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This is an area where there has been significant confusion and uncertainty which any changes should seek to remove. In addition all physical goods, such as materials and components, which are used in the R&D process should qualify for the relief. In our view this should include the cost of material for making prototypes.

We are not clear why the cost of 'specially commissioned parts' would appear not to rank for the R&D credit. Our representatives, in their meetings with the Revenue, had been led to believe that the cost (including materials) of building prototypes would qualify, and we see no reason why this phrase should be understood as excluding 'specially commissioned parts'. So we are not clear why the CIR Manual, quoted at paragraph 5.4, states that 'specially commissioned parts are excluded'.

In addition if the opportunity is to be taken to extend the scope of the credit so as to more fairly reflect the actual cost of R&D, then all directly attributable overheads and support staff should be included.

11 Licence for Advanced Software (Chapter 6)

6.1 *Do you agree that 'bought in' advanced software should qualify for the R&D tax credit?*

We agree that the cost of advanced software bought in for use in R&D should qualify for the credit.

6.2 *How close to the R&D should software be to qualify for the credit?*

6.3 *What views do respondents have on defining 'advanced'? Alternatively, what examples can they suggest of the sort of 'advanced' software that might be included?*

In order to qualify for the credit the software should be clearly applicable to the R&D.

Examples would include:

- Computer aided design software
- Software that simulates operating conditions for testing
- Expert systems

6.4 *Is 'advanced' software invariably short lived – either in terms of the length of licence or number of times it can be run? Do respondents think that setting a clear time limit and/or number of uses limit is the best approach – or is there a more useful generic definition of such software that would provide the clarity that is necessary?*

6.5 *If respondents prefer definite time limits and/or limited number of uses, what would the appropriate limits be?*

We believe that all software used in the R&D process should qualify. We do not think it is necessary or appropriate to set a time limit or specify a limited number of uses.

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12 Subcontracted Work and Qualifying Bodies (Chapter 7)

7.1 *Are respondents aware of any foreign universities that carry on contract R&D for UK companies?*

Our members have reported details of these in their individual submissions

7.2 *Are respondents satisfied with the present procedure for designating particular institutions – or would they prefer a more general definition?*

7.3 *If respondents favour a general definition, what sorts of entities should be included? What should be excluded?*

7.4 *Which would respondents find more useful for determining whether a body was a PSRE for R&D tax credit purposes – a comprehensive list of PSREs or a generic term describing such organisations?*

We are aware that companies for which our members work procure research from a number of overseas universities and at least one overseas PSRE. There should be a generic definition for both Universities and PSREs which should include both UK and overseas bodies.

IKY

10.10.2003