THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

TAXREP 1/03

R&D TAX CREDITS

GUIDANCE ON AND POSSIBLE IMPROVEMENTS TO THE OPERATION OF THE EXISTING SYSTEM

Memorandum submitted in January 2003 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Inland Revenue in response to an invitation contained in the Pre Budget Report of November 2002 to help develop guidance and to suggest improvements to the existing system

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INTRODUCTION

1. We welcome the opportunity to respond to the request in the Pre Budget Report of November 2002 to help develop guidance on the R&D Tax Credit regime and to improve its operation.

2. Inland Revenue Policy Division, Business Tax, wrote in September 2002 to ICAEW and other representative bodies seeking their views on the draft Guidance which the Revenue proposed to include as part of the new manual, 'Corporate Intangibles and R&D'.

3. The Chancellor subsequently stated in his Pre Budget Report that the Government 'will continue to collaborate with business in developing guidance for the credits and considering options for changes to improve their operation.' (paragraph 3.73).

WHO WE ARE

4. 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.

5. 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).

6. 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 10,000 members of the ICAEW who pay an additional subscription.

GUIDANCE ON R&D TAX CREDITS

7. As noted in paragraph 2 above the Inland Revenue Policy Division, Business Tax wrote in September 2002 to the Tax Faculty and other representative bodies with a copy of draft guidance on the R&D Tax Credits. Representatives of the ICAEW Tax Faculty met with members of Inland Revenue Policy Division, Business Tax, on 18 December 2002 in response to this letter.

Definition of R&D

8. Members of the Business Tax Sub-Committee of the Tax Faculty have been involved working with the CBI in highlighting ambiguities in the existing DTI Guidance. The CBI has

also produced a number of detailed examples which we believe are extremely helpful in understanding the true nature of R&D expenditure.

9. Our members believe that agreeing what does, or does not, constitute qualifying expenditure is going to be one of the most difficult aspects of the R&D regime and anything which will make the Guidelines easier to interpret represents a very worthwhile improvement.

10. We strongly recommend that suitable examples should be published as part of the Guidelines.

Publication of special *Tax Bulletin*

11. Although it does not deal with the definition of R&D we welcome publication of the special *Tax Bulletin* issued in December 2002. This will do much to publicise the new relief as well as ensuring that taxpayers and their advisers are informed about the main parameters of the new system. We hope that the *Tax Bulletin* will be supplemented by published, detailed, examples of R&D expenditure when the new manual, Corporate Intangibles and R&D, is published.

POSSIBLE IMPROVEMENTS TO THE EXISTING SYSTEM

Outsourcing

12. It is now common for companies to outsource to other organisations, activities which would previously have been carried on internally. For instance IT work may be carried out by an outside organisation, and in some cases the contracts of the IT staff are transferred from the outsourcing company to this outside organisation. The existing R&D rules do not allow outsourcing costs relating to R&D to qualify for the enhanced relief, even though this would have been possible had the outsourced activities, e.g. IT, been carried out by the company's own staff.

13. We recommend that relief should be given for outsourcing costs in such circumstances.

Group Management companies

14. An equivalent problem also arises in groups of companies where all the staff are employed through a single management company. In such instances the staffing costs will not occur in the company actually carrying out the qualifying R&D. It is not clear that the provisions in FA 2002, Schedule 12 paragraph 14 provide relief in such situations.

15. We would ask either that the Revenue officially confirm that FA 2002, Schedule 12 paragraph 14 will be treated as applying in such circumstances or we would recommend that legislation be introduced to that effect.

Benefits in kind

16. The standard remuneration package for almost all employees will include some element of 'benefit in kind'.

17. We cannot see any policy reason why this legitimate part of the overall remuneration package should not rank for the R&D uplift to the extent those employees are involved with R&D.

18. Furthermore, in some organisations employees are given a choice as to how they take the agreed 'value' of their remuneration package which can, at the option of the employee, be split between salary and a range of different benefits in kind: the so-called 'cafeteria' system of employee remuneration.

19. To the extent that employees choose to take part of their remuneration package by way of benefit in kind such expenditure cannot, currently, rank for the R&D uplift.

20. We recommend that benefit in kind costs should rank for R&D tax credit relief to the extent that the other conditions for the relief are satisfied.

Staff who spend only part of their time on R&D – the 80:20 split

21. Under the present rules if an employee spends more than 80% of his or her time on R&D the whole cost qualifies.

22. Conversely, if an employee spends less than 20% of his or her time on R&D none of the cost qualifies.

23. Many companies' internal accounting procedures are not designed to allow them to determine in relation to individual employees the precise amount of time spent by each individual on different aspects of their work or on particular projects. A company's accounting records will usually be designed to capture the costs, including the appropriate element of labour costs, of major projects. There is therefore a risk that the credit may be denied even though the expenditure is on qualifying R&D and can be measured accurately in aggregate.

24. In order to ensure that relief is not denied in such cases we recommend that companies should be able to disregard the 80:20 split if their accounting records enable them to determine the precise amount of staffing costs which they incur on eligible R&D projects. If companies elected to calculate the credit using this method, then they would have to apply this method consistently. The credit would then be available by reference to the project and it would follow that any time charged to non-qualifying projects would not be eligible for the credit, i.e. even if a particular employee spent more than 80% of his or her time on qualifying R & D projects.

Overheads

25. No relief is currently given for overhead expenditure. We consider that appropriately allocated overhead expenditure is a legitimate cost of R&D activity and it should be included with other expenditure eligible for the R&D uplift.

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IKY
20 January 2003