TAX REP 6/99

RESEARCH AND DEVELOPMENT: DEFINITION AND APPEALS

Text of a letter submitted to the Inland Revenue by the Tax Faculty in response to a request for comments issued in January 1999.

RESEARCH AND DEVELOPMENT: DEFINITION AND APPEALS

Introduction

1 We refer to your letter dated 14 January, addressed to Robert Maas, requesting comments on the above document which follows on from the consultation last year: *Innovating for the Future: Investing in R & D.* We welcome the opportunity to comment and set out our general views and particular points below.

2 In respect of scientific research allowances (SRAs), we are pleased to see that this consultative document picks up on many of the points raised in our response to the earlier consultation (we attach a copy of TAX 20/98), in particular paragraphs 17 to 29.

3 Subject to this, we welcome this consultative document, which we think will be of assistance to taxpayers and Revenue staff. We broadly agree with the main thrust of its objectives, and the proposed solutions.

Detailed comments

Chapter 3

Paragraph 3.6

4 We are broadly in agreement with the guidelines on the meaning of scientific research as outlined in Annex 2. We think it is important to ensure that expenditure on technological research into computer software should be given equal treatment (paragraph 12 of Annex 2). However, we expressed the view in our earlier note (paragraphs 27 to 30) that consideration should be given to more generous tax allowances on the acquisition or development of computer software, and we trust that this aspect will be addressed in the further consultative document which we understand is being prepared on the wider question of tax relief for expenditure on intellectual property.

Paragraph 3.11

5 We believe that the guidelines set out reproduce the essential ideas and boundary conditions as set out in the Frascati definition.

Paragraph 3.14

6 We appreciate that there will always be a difficulty in establishing whether some expenditure qualifies for SRA relief. One particular area of difficulty relates to expenditure incurred on identifying new uses for old technology. A typical example is the discovery of drugs that could not be exploited because of the limits of technological facilities and knowledge at the time. Technological advances then enable the drug to be developed and commercially exploited.

7 The position on whether such expenditure qualifies for SRA relief is unclear; on the one hand paragraph 13 of Annex 2 suggests that such expenditure may be excluded from the definition of SRAs because “it does not represent any departure from standard practice or any technological advance for the industry sector concerned.”

On the other hand it appears to be clearly covered by paragraph 1(b) of Annex 3, the draft expanded statutory definition of scientific research. Our view is that such expenditure should clearly be included within the definition, but we would be grateful for clarification that this is the case.

Paragraph 3.19

8 We are unsure as to what R & D undertaken in the fields of the humanities and social sciences would be relevant or important for the purposes of encouraging scientific based innovation. We believe it is sensible to continue to exclude such activities from the definition of research and development. We therefore think that the boundary drawn between research expenditure that qualifies for SRA allowances and that which does not is reasonable.

9 We agree with the comment made in paragraph 16 of Annex 2, that is that expenditure on research into man-machine interfaces where it forms part of an integral part of natural or applied R & D should be included. In any event, if the non-scientific research envisaged is more in the nature of, say, expenditure on market research, then we would have thought that in principle a revenue deduction might be available.

Chapter 4

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.

Paragraph 4.25 (Commercial Confidentiality)

15 In our view, the issue of commercial confidentiality may be overstated. Firstly, it is important to remember that it will in all probability take some time before expenditure incurred and claimed as SRA is disputed by the Revenue. It is likely that there will be a further interval of a few years, and possibly longer, before the dispute comes before the Special Commissioners. Most commercial developments will probably be well into their development cycle by the time an appeal reaches the Special Commissioners.

16 Secondly, public information may already be available if, for example, the process resulted in a patent application.

17 Thirdly, once a product becomes available commercially, competitors are likely to 'reverse engineer' the product and its processes.

18 Fourthly, if preserving secrecy in respect of its expenditure on R & D is so critical, in the event of any dispute the company concerned is more likely to seek a compromise with the Revenue or, failing that, will decide not to pursue an SRA claim disputed by the Revenue. If the expenditure is so sensitive commercially, the company may even decide that commercial considerations outweigh tax considerations, so that they decide not to claim SRAs.

Paragraph 4.27

19 We believe that decisions should be published in the normal way, and that if requested by the taxpayer and agreed by the Special Commissioners, that they should be published in anonymised form.

Chapter 5

Paragraph 5.4

20 We believe that the draft clause outlined in Annex 3 is helpful, and our reading is that the drafting of the clause is if anything more successful than the detailed guidance set out in Annex 2. Again, we believe that it reproduces the essential Frascati definition, whilst drawing the boundary between scientific/technological R & D and research in the social sciences and humanities. We are therefore in favour of the introduction of a clause along the lines of that set out in Annex 3.

21 Although we think that the new clause is written clearly, we nevertheless think that this presents an opportunity for the clause and the related SRA rules found in the Capital Allowances Act 1990 to be rewritten by the Tax Law Rewrite team.

No doubt they were planning to rewrite these clauses in the near future but, as a result of this consultation, we think that the team should rewrite these provisions, incorporating these changes, as a matter of priority.

22 Whether or not a new, expanded, definition of scientific research is introduced, we believe it is still essential that detailed guidance is published along the lines as set out in

Annex 2. We also think it would be helpful if this was published (to replace the long out of print CA4) and not merely reproduced in the Revenue Manuals.

Other points

23 We appreciate that this note concentrates on the narrow questions of the scope of SRAs and the appeal structure. However, as noted in the introduction, these questions are merely part of the wider question, which is "how should the UK tax system encourage innovation". We therefore believe it is appropriate to restate some of the concerns that we mentioned in TAX 20/98.

Development Expenditure

24 The technical note highlights, once again, the difficulty in drawing the boundary between scientific research and so-called development work. As we outlined in our earlier representation (see paragraphs 21 to 23), we believe that the scope of SRAs is narrow, and that the definition should be widened to encourage innovation in its broadest sense. It seems to us development work is of crucial importance in ensuring that the results of scientific research are brought to a successful commercial conclusion.

25 We believe that the boundary between tax deductible R & D expenditure (whether of a capital or revenue nature) and development expenditure, where the available allowances may be equally problematic, may discourage innovation. We think that consideration should be given to enhanced allowances for development necessary in order to bring expenditure on scientific research to a successful commercial conclusion.

Smaller businesses and start-ups

26 The 100% SRA allowance is clearly a valuable relief in that it enables a write-off of expenditure for tax purposes when it is incurred. We presume that the policy purpose behind encouraging R & D expenditure is to encourage innovation and to increase employment in the UK. Clearly, although SRAs will be advantageous to certain major corporates, for example companies in the chemical industry, there are many smaller "high-tech" companies and start-up situations that may be able to claim SRAs but where the benefit is more limited. This may be due to, for example, losses being incurred in the opening years.

27 If it is the Government's aim to encourage such companies, it needs to consider whether such companies require enhanced reliefs over and above that offered by SRAs.

We considered these points in paragraphs 34 to 40 of TAX 20/98, when we concluded that grants might be more beneficial to some high technology companies.

Conclusion

28 We welcome the draft clause and the detailed guidance, which in general we consider to be successful. We look forward to seeing the further proposals which are expected on tax relief for intellectual property and encouraging innovation by smaller companies.

29 If you wish to have a meeting to discuss any of these points, please let us know.

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