TAXREP 12/01

INCREASING INNOVATION

Text of a memorandum submitted in June 2001 to the HM Treasury and the Inland Revenue in response to a Consultation Paper issued in March 2001

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INCREASING INNOVATION

GENERAL COMMENTS:

1 We welcome the opportunity to comment on this consultation exercise. Our comments below only relate to the tax aspects of the document.

2 We welcome the Government's proposal to provide an incentive for large companies to invest in Research and Development (R & D). We did not understand the logic of restricting the R & D tax credit introduced in the Finance Act 2000 to small and medium-sized companies. We said in our earlier representation (TAXREP 20/99) that:

We are not convinced that measures to encourage innovation in the UK should be limited solely to SMEs as defined in the Companies Act, subject to any necessary amendment so as to ensure that the definition complies with that adopted by the European Commission. We said in . . . TAX 20/98 that we would have thought that it is important to encourage innovation in its broadest sense. We do not see how innovation will be actively encouraged if the proposed new relief is targeted only at small and medium-sized enterprises. The proposed relief is potentially unfair to companies that do not satisfy the SME criteria, regardless of at what rate they pay corporation tax.

3 We are, therefore, pleased that the Government has now taken note of these concerns.

4 However, we have a number of concerns with the proposal outlined in this latest consultation document. Firstly, for reasons which we explain below, we do not favour a tax incentive based on incremental R&D expenditure. Secondly, we are particularly disappointed that, having discussed various methods whereby the tax incentives could be given, the incremental approach is then presented as the preferred choice and the rest of the document's questions are concerned to narrow down the consultation to that one method.

5 Given that each of the suggested methods for a tax incentive has advantages and disadvantages and that the Government is seeking (we presume) a wide selection of views, we do not think it is appropriate that the debate should be narrowed down in this way without first providing an opportunity to consider fully the other methods that have been put forward. The approach adopted is particularly surprising given the rigorous academic approach adopted at the start of the consultation. We do not think that the case for an incremental approach has as yet been sufficiently argued.

6 The result is that the consultation appears on the face of it to be a ‘done deal’ on the principle, with the consultation being confined to the details.

7 We are concerned that the approach adopted in this consultation merely invites criticism and devalues the consultation process. This is a pity as, in the light of, for

example, the double taxation relief consultation exercise, many of our members have lost confidence in the consultation process. Taxpayers will only have confidence in the consultation process if they think that their views have at least been listened to and considered. This is not achieved by publishing a wide ranging consultation which suggests a number of options, all but one of which are then rejected without taxpayers having the chance to make their views known on them.

Incremental basis approach

8 We appreciate the Revenue's reason for preferring an incremental basis, namely the supposed incentive effect. However, the purpose should not be merely to reward increased expenditure, but to incentivise expenditure which would not have occurred without the tax relief. An incremental relief is at best a very blunt instrument for that purpose. The incremental approach would reward companies with a historically low level of R&D spend and punish those companies with an already high level of R & D spend. The approach offers no incentive for a company which was planning to reduce its R&D expenditure to change its mind, and it rewards increases in expenditure which may have been planned to occur anyway.

9 The incremental basis is highly complicated in theory and difficult to apply in practice. The incremental basis is the reason why the more complicated aspects of the detailed proposal in Annex A of the consultation document are needed, particularly the debit bank and the double definition of groups. It will also cause severe practical complications because of the need to compute the relief for one year at a time when the qualifying R&D figure for the previous year (or years) is unlikely to have been agreed. There are still major difficulties in identifying what expenditure will qualify as R&D expenditure. It is likely to involve considerable compliance costs, not just for the taxpayer but also for the Revenue.

10 We would therefore prefer a relief based on total R&D expenditure. We appreciate that this may also be a fairly blunt instrument. However, it is much simpler than the incremental idea and will be easy to understand and apply in practice. If this method is not acceptable, an alternative method might be to base the incentive on the R&D spend over a defined percentage of turnover. However, even if this was based on sector averages, it does not appear any more satisfactory than a straightforward relief based on total expenditure.

11 If we have to have an incremental system, then we are not in favour of the proposal set out in Annex A. We suggest a system which sets the baseline once and for all, for example by reference to the average R&D spend for the two or three years prior to the commencement date for the new relief. Whilst this proposal has a number of problems, it appears to have less problems that the practical alternatives.

Tax credit versus super deduction

12 We have no particularly strong views on whether on the incentive should be by way of a tax credit or super-deduction. A tax credit is akin to a grant in some ways and would be more closely identified for management reporting purposes as a reduction in the actual R & D costs. The benefit of an enhanced deduction will depend more on the

company or group's tax position and will, therefore, be more difficult for the R & D managers to understand and assess. In addition, the tax credit, if payable in cash, may be more useful to a company in a loss-making and/or start-up position. However, in practice, these situations are unlikely. Each method has advantages and disadvantages. If we had to choose we would probably favour a tax credit.

DETAILED COMMENTS ON ANNEX A

13 As mentioned above, we disagree with the proposed use of an incremental system. In order to be helpful, we have set out below our detailed responses to the questions raised in the Annex, but this should not be taken as meaning that we agree with the fundamental principle.

14 A1 We suspect that there are very few, if any, large unincorporated businesses which incur substantial R&D expenditure. However, in principle, we do not see why the relief should be confined to companies. This is perhaps of more serious concern now that Limited Liability Partnerships can be established and that the use of this vehicle may become quite common.

15 B1/2 In principle any relief should be allocated to the company which earns it, particularly bearing in mind the possibility of independent minority shareholdings. However, with an incrementally-based relief, there seems to be no fair way of identifying which company does earn the relief. This is yet another reason why we do not want such a system. Of the alternatives offered, allocation pro-rata to R&D expenditure is probably the least unsatisfactory.

16 C1 As above, we would prefer a permanently fixed baseline if we have to have an incremental system at all.

17 D1 We can see the need to calculate the initial baseline at the start of the new relief over a reasonably long period, and two years seems a reasonable compromise. However, if the idea of the debit bank is accepted that should absorb the effect of subsequent short-term fluctuations in R&D expenditure and we do not think it is necessary to continue using a rolling two-year average. On the other hand a (preferable) alternative would be to retain the idea of the two-year rolling base to blunt the effect of short-term fluctuations, but do away with the debit bank.

18 E1/2 The Retail Price Index (RPI) is an extremely rough and ready measure of the effect of inflation on R&D expenditure, particularly as the expenditure will include quite a high proportion of salary and related costs and this element will rise in line with earnings rather than the RPI. Although we do not have a better measure to suggest we wonder, however, whether such an adjustment is really necessary, given present levels of inflation.

19 F1 The principle is not unreasonable (given the assumption of an incremental system) but the idea is likely to be excessively complicated to operate in practice. It is not too difficult to understand and apply in a static group structure, but most substantial groups have companies leaving and joining at frequent intervals. The bank may remain in debit for years at a time, and adjusting the fluctuating balance for every

change in the group structure is likely to be a major task even if one could decide what form of adjustment is appropriate (see question J1).

20 I1 It seems broadly reasonable to operate the relief by reference to economic units (accepting once again, of course, that we have to have an incremental system at all) and the 'exclusive group definition' seems a reasonable way of identifying such units. However, we believe the proposed application of a second test depending on the 'inclusive definition' is neither practicable nor fair.

21 Applying the exclusive definition in the context of fluctuating group membership is going to be complicated enough. Applying a second definition in parallel is going to be much worse, particularly when one takes account of the difficulty in some cases of deciding whether a control test is actually satisfied. In any event, it is clearly unfair to deny the relief to company A, whose R&D spend has increased, just because it happens to have technical control over company B whose spend has decreased, if the two companies are managed independently: they have not in fact manipulated their R&D expenditure to maximise the relief, and A's economic interest in B is only 51% (or possibly less).

22 The operation of the two-tier grouping test is also unfair in that it is one-sided; the inclusive group being taken into account only to reduce the relief which would otherwise be available. For example, suppose A controls B; A's R&D expenditure increases while B's decreases. B's reduction would actually be taken into account twice over, once to cancel A's entitlement to relief via the inclusive group test, and again to reduce B's own future relief via the debit bank.

23 The document only says that companies *controlled by* a member of the exclusive group would be included in the inclusive group. However, it is also clearly the intention to bring in companies which *control* a member of the exclusive group (and probably also those which are under common control by a third person). This would further increase both the practical difficulty of applying the test and the range of circumstances in which unfair results would arise.

24 The usual 75% group definition test should be used. If it is considered necessary, then there should be an anti-avoidance rule to deal with any artificial arrangements whose purpose is to redistribute R&D expenditure within a wider 'group'.

25 I2 It is not clear what role it is suggested that an accounts-based test might perform. It might have some slight advantage as an alternative form of the inclusive definition (provided it only takes in group companies and not associates as well), since it avoids the need to carry out a separate exercise to identify the members of the wider group for tax purposes. Nevertheless, it does nothing at all to reduce the objections to using the inclusive definition. Neither would it be acceptable as a substitute for the exclusive definition. As already stated, a company's entitlement to the relief should not be affected by a reduction in the R&D expenditure of another company with which it has only a 51% relationship.

26 J1 It is obviously unreasonable to take into account only expenditure incurred while a company is a member of the group. That would mean, presumably, that if a

company happens to join a new group in a year in which its R&D expenditure increases substantially that increase will be completely ignored for the purposes of the new relief.

27 We believe the only reasonable approach appears to be to treat the company as bringing its R&D history with it when it joins. Conversely it will be necessary to rewrite the group's R&D history when a company leaves, as though it had never been there, and recreate a notional R&D history for the company on its own. This, of course, raises a number of complex problems which are difficult, if not impossible, to resolve.

28 For example, what do you do about the group's debit bank when a company leaves? The simple answer would be to leave the whole of the bank with the group, but that would not be logical if the company which leaves is the only one which actually does any R&D. Presumably, you would also have to divide the debit bank between the group and the departing company. Quite how this should be done we do not know. Recalculating the whole R&D history as if the company had always been independent, for as far back as the debit bank has existed, is not only extremely onerous, it will not necessarily produce the same figure in aggregate as the actual debit bank of the group at the time when it splits.

29 The complexity of these proposals makes them unworkable. The debit bank idea does not appear to be compatible with the principle of an incremental relief calculated on a group basis.

30 K1 We agree.

31 K2 This question depends how qualifying expenditure is defined. One probably does need rules to prevent the expenditure being inflated by the contractor's profit margin, and to identify the amount of staff and consumable costs (if that is to be the basis of the relief) attributable to a global fee for subcontract work. Strictly there is no reason why these rules need to be different for group companies and independent contractors. We believe a look-through approach seems to be the fairest method, and that cannot be made mandatory where the parties are unconnected. It, therefore, follows that the approach adopted should be the same as that in FA 2000; that is applying a look-through rule between connected parties and optionally in other cases.

32 L1/L2/L3/L4 Since section M deals with consortium companies, we assume that here 'joint venture' is intended to refer to contractual joint ventures with no corporate vehicle (but probably including partnerships, since they are not mentioned elsewhere).

33 The basic principle should be that each party treats the R&D expenditure which it actually bears as its own for the purpose of computing the relief. In answer to question L2, with the exception possibly for partnerships, this result should follow without the need for specific legislation or for a definition of 'joint venture'. We do not think it is fair or practicable to split the expenditure 'in proportion to the member's proportionate interest in the joint venture', as suggested in the document, if only because there will not necessarily be any one percentage figure that you can point to as being the member's interest in a joint venture.

34 Exceptionally in the case of partnerships, since the expenditure is as a matter of law incurred jointly, it probably is appropriate to divide it in the members' profit sharing ratio for the period in it is incurred.

35 Presumably L4 is concerned that the parties may organise their venture in such a way that the R&D expenditure is borne disproportionately by the member who is subject to tax and so is able to benefit from the relief. Opportunities for this sort of manipulation will be limited by commercial considerations (and by the fiduciary duties which bind most exempt organisations) particularly if, as suggested, the party who incurs the expenditure only gets the tax relief if he also gets the associated intellectual property rights. Together with an anti-avoidance rule of the sort mentioned above at I2, this should be sufficient protection for the Revenue.

36 M1 We suspect that most consortium companies are managed as independent entities and it follows that the relief should be given to the consortium company. Conversely even if (contrary to our recommendation) the proposal involving the inclusive group definition is adopted, a reduction in a bona fide consortium company's R&D expenditure should not be taken into account so as to limit the relief available to any of the consortium members, even if technically one or more of them controls it under the relevant statutory definition.

37 N1 Adoption of the same rules seems highly desirable.

38 O1 There is no 'issue of double dipping'. If a company is subject to tax on the same activities in two jurisdictions, and both offer a similar tax incentive for R&D, there is no justification for either jurisdiction to withhold the relief. Since the company effectively pays tax on the higher of the two measures of profit, withholding the relief in either of the two jurisdictions means that the company gets no effective benefit from it, despite having incurred the expenditure which both jurisdictions consider should qualify for the tax incentive.

39 P1 This is a policy issue, depending on what exactly the Government wants to encourage. However, the intention appears to be to encourage R&D expenditure by UK-based companies for the future benefit of their trades, rather than to stimulate employment in the R&D sector in the UK (where there is already a shortage of suitable skilled manpower). If that is so, a requirement of the sort mentioned here is not appropriate.

40 Q2 Yet again the problem only arises because of the incremental form of the relief. There is no difficulty in linking a relief based on absolute expenditure to the acquisition of intellectual property rights, as in FA 2000.

41 R1-6 By 'labour-based' we presume that it really means PAYE-linked. The basic version of the scheme is already labour-based, in that qualifying expenditure would be confined to wages and consumables, and could easily be confined to wages alone if policy so required.

42 Be that as it may, the type of scheme described in this section would be both more complicated and more distortive than the basic version. In other circumstances there might be policy reasons for skewing the scheme in favour of labour-intensive projects, but with the present shortage of suitable labour that appears to be undesirable. On this basis, we do not think it is sensible to answer the more detailed questions.

CONCLUSIONS

43 We welcome the Government's proposal to provide an incentive for large companies to invest in R & D. However, we favour a tax relief based upon a volume-based approach: we do not favour a tax incentive based on incremental R&D expenditure.

44 We are particularly disappointed that the incremental approach was presented as the preferred choice and the consultation exercise then concentrated on the details of this one method to the exclusion of the others. We think that a decision to adopt any particular method should only be taken after all responses have been received and the arguments for and against fully evaluated. If this is not done, this consultation exercise risks being devalued.

45 We would be happy to meet to discuss these points further, if that would be helpful and we would welcome any feedback from the responses to this consultation.

14-45-36
FJH
7 June 2001