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Mike Crabtree
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Dear Mike

Consultation on R&D Tax Credits Reform
Our response

We are pleased to present our response to the Consultation Document "Corporate Tax Reform: delivering a more competitive system", in particular Section 4 regarding R&D Tax Relief.

As a firm providing specialist R&D tax services to companies making claims for the relief we welcome the opportunity to make representations to the Treasury. We are passionate supporters of the view that healthy technology-based industries, underpinned by a thriving science base and advanced manufacturing capabilities, are essential to the future prosperity of the UK economy as well as providing significant benefits to society as a whole. Maintaining a competitive position in a global marketplace requires constant innovation and the Government's R&D tax credit scheme is an important source of support for innovative projects.

Our responses below to the questions in the consultation are based on our own wide experience of making claims for companies in a variety of sectors including aerospace, IT and software, food and beverages, hi-tech and engineering.

Question 4A: Are there any changes to the structure of the schemes that would significantly improve their impact in stimulating investment in R&D by UK companies, in the context of the wider corporate tax reforms?

In our view, the structure of the R&D tax credit scheme overall serves its purpose very well. Compared to other countries with R&D tax incentives, the UK's system is simple in concept and in most practical scenarios avoids unnecessary bureaucracy and compliance cost. Companies have little difficulty in grasping the way the SME and large company reliefs work for straightforward R&D projects but find it harder to appreciate the more complex rules when considering inter-company R&D situations where, for example, subcontracting is involved.

Clients of ours are often daunted by the perceived complexity involved in making claims but once they have been through the process for the first time and realised the benefits of the relief tend to be much more positive about making future claims. The generally helpful attitude of the R&D specialist units has also contributed towards this.

We find that staff leading the R&D in SME companies who are involved in making claims are usually keen to participate in the process. In smaller companies the benefits of the relief are more visible particularly in start up companies where the senior technical personnel are often founders of the company. In large companies however it is often the case that technical staff are less keen to be involved, since they or their teams are not in a position to be rewarded for their effort either through increased remuneration or departmental budgets. There has been some discussion about whether the R&D tax relief could be accounted for "above the line", i.e. as a pre-tax item in the profit and loss account, which may go some way towards alleviating the problem by recognising the benefit as income rather than a reduced tax charge. Such a change should be considered in conjunction with the accounting standards bodies.

Question 4B: Are there additional costs that should be eligible for relief under the schemes?

When we explain to our clients which costs the relief can be claimed on, we encounter little disappointment that the range is not wider. Occasionally the question is asked as to why patent registration costs, for example, are not eligible, but since registration of any resulting IP does not contribute to resolving scientific or technological uncertainty there seems little case for the costs to be included.

Where we would strongly suggest that the cost base is ameliorated however is in relation to expenditure which on the face of it seems to be within the scope of the relief but for which is prevented from qualifying due to some of the stricter conditions attached under the legislation. A prime example of this is where a company pays the salary of a technical director and recharges all or part of the employment cost to another company in the same group, of which the individual is also a director. In this situation, the second company is prevented from claiming any relief at all on the cost it bears since firstly it cannot be treated as a staffing cost, the payment to the director being made by the first company, and secondly it is prevented from being treated as a payment for an externally provided worker since one of the conditions for relief under this head is that the worker is not an employee or director of both companies. Not only is it difficult to see what mischief this condition is intended to prevent, there have been actual situations where otherwise valid claims have been prevented from being made because of the condition, a notable example being the *Gripple* [1] tax case, where the Commissioners and Mr Justice Henderson sympathised with the company's plight but had no alternative but to find in favour of HMRC, who had denied the relief.

It is in situations like the above where the relief has often received a bad press, which must have had the effect of putting off potential claimants with perfectly valid claims, and where there is a strong case for the legislation to be revised. Of course, companies could organise their affairs in

[1] Gripple Ltd v Revenue and Customs [2010] EWHC 1609 (Ch)

such a way as to be within the legislation but it would seem an unnecessary burden to require them to disturb *bona fide* arrangements merely to satisfy a condition.

Another situation where relief is prevented under the externally provided worker rules is in relation to payments in respect of workers who are hired by an agency via their own company, a common scenario in some sectors, particularly IT. Here, relief is unavailable to the company paying for the agency worker's time since the legislation specifies a tripartite relationship between the payer (the R&D company), the agency, and the individual worker. The presence of the worker's limited company in between means the specified relationship does not occur and relief is not available for the payment. Again, this is a state of affairs that companies find hard to understand the reasoning behind, other than it is what the law requires. Anecdotal evidence suggests that this is a major issue for some large companies who are unable to take advantage of the relief for substantial amounts of their R&D expenditure.

Question 4C: Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?

We do not believe that any of the current areas of expenditure, including on internal use software, should be limited or excluded from the relief. Overall, the categories of cost that are currently included represent a reasonable range of the kinds of costs that are directly attributable to R&D and, as in our above answer, we feel that it should continue as it is.

The issue of internally-used software has been the subject of some discussion since the early days of the R&D relief. In some other countries of course, such as the US and Australia, restrictions already apply to software that is used internally. In the UK, no such statutory rule exists within the R&D legislation but HMRC has been known in the past to have challenged claims for such projects using the argument that the expenditure (notwithstanding the accounting treatment) is capital for tax purposes on the grounds that it represents the creation of an asset of enduring advantage. Such challenges did little to boost confidence in the effectiveness of the R&D tax relief scheme. The relief needs to be effective in stimulating the intensity of R&D activity in the UK through rewarding companies that are undertaking it. For this reason we believe that it should be applied as much as possible to projects that meet the criteria to be treated as R&D without regard to issues such as whether the expenditure is revenue or capital, or whether the resultant technology (whether software or anything else for that matter) is used internally by the business or intended to be sold or licensed as a product. The wider benefits to the economy arise through R&D no matter how the business makes use of it, and thus the reward delivered through the tax system should be applied neutrally.

Question 4D: Is the R&D definition contained in the guidelines issued by BIS an effective definition for recognising genuine R&D activity through the R&D tax credit schemes?

The 2004 definition, arrived at through consultation, represents a significant improvement over the original definition that proved troublesome to apply in practice. We find that companies invariably have little difficulty understanding the concepts of the 2004 Guidelines once explained to them. We would therefore not wish to see any changes to the definition, which has

proved to be effective since its introduction. One area that had caused confusion in the past was the reference to Qualifying Indirect Activities and we welcomed HMRC's change of interpretation that has resulted in these activities being included. However the exclusion for staff providing solely support activities (as opposed to those also carrying on direct R&D) remains a source of confusion for claimants and we would recommend that HMRC's guidance on this is improved.

We would question whether the additional test for expenditure to be capable of being treated as R&D under Generally Accepted Accounting Principles is necessary; in practice it is rarely in point and therefore a single statutory definition by reference to the 2004 Guidelines would introduce simplicity and certainty.

Question 4E: Would respondents welcome a statutory definition of production? If so, what should it include and exclude?

Production trials are an important aspect of R&D in the manufacturing sector; companies carry these out as part of the development of new manufacturing processes, to test the ability to scale up the manufacture of new products or to produce a significant number of items of a new product for further testing. We believe that whilst additional legislation to define production is unnecessary, there should be a distinction between activities that are carried out purely for the purpose of producing goods for sale and those that are performed in order to resolve scientific or technological uncertainty, even if the resulting product is, or may be, sold. In the latter, where there is an overriding R&D purpose, associated expenditure should be treated as capable of qualifying, but with an adjustment to restrict that expenditure by any proceeds received. Such a treatment would enable the R&D definition to encompass activities that are aimed at the resolution of uncertainty whilst recognising the dual nature of certain kinds of production activity.

Question 4F: What further enhancements would be most effective in promoting additional investment in R&D by the smallest companies, taking into account the risk of adding additional complexity to the schemes?

As stated earlier, most companies find the relief relatively straightforward to claim and introducing additional complexity to the scheme would be unwelcome. There are however some areas where existing complexity could be removed. The problem referred to in our answer to Question 4B on the externally provided workers rules and recharges of directors' staff costs is one unnecessarily complex aspect of the legislation, that tends to hit small and medium sized businesses that have organised themselves in particular ways. A similar problem applies where an SME has structured itself into a group of companies with one company employing staff and recharging the costs to another company which carries out R&D. Here, the R&D company will not have paid any PAYE or national insurance contributions itself and is therefore unable to make a claim for the payable R&D tax credit if it has a surrenderable loss. Like the externally provided workers anomaly there seems no reason why the R&D company should not be able to

access the PAYE and NIC payment history of its fellow group member; they form part of the same economic unit.

Question 4G: Is VRR an effective intervention for incentivising research into drugs and vaccines for the prevention and treatment of disease prevalent in less-developed countries, or would it be more effective to deliver the support through other mechanisms?

Since we have not been involved in any of the very small number of claims that have been made for VRR this is not a question we are in a position to answer.

Question 4H: Are there improvements to the claims process that would make it more streamlined and certain for companies, particularly smaller companies with limited resources? Would there be significant benefits from an external auditing process for claims or a more formal pre-clearance procedure of R&D projects with HMRC?

The setting up of the specialist R&D units in November 2006, coupled with the training programmes for Inspectors, brought in a significant improvement in the handling of R&D tax relief claims, with more consistency and a better understanding of issues relevant to sectors such as software and IT. In addition, the processing of claims became much swifter, with most claims being dealt with within the timescale set out in the Practice Note issued in December 2006. Since the more recent centralisation of corporation tax return processing in Cardiff however, there has been a noticeable degradation in the response time in some cases. In order to allow the specialist units to deliver on the timescales set out in the Practice Note it would be better if returns containing R&D claims were submitted direct to the units rather than Cardiff (in fact, the Practice Note set out on the HMRC website still states that this is what should be done).

Despite the improvement in consistency, it is still the case that companies can never be completely sure that their claim will not be enquired into until the expiry of the enquiry time limit, even if payment of a tax credit has been made, and it can therefore come as a surprise when it is explained that receipt of the cash payment does not imply acceptance of the claim. Since that time can sometimes be almost two years away (for claims made promptly after the year end) companies are faced with a great deal of uncertainty. We recognise the right HMRC has to enquire into a return under the Corporation Tax Self Assessment system but feel that there would be a benefit in the ability to receive a more definite response, so that claimant companies can have confidence that the cash benefit received is unlikely to be scrutinised again at a later date.

Of course, the specialist units have been providing a useful facility to companies by offering to meet to discuss a potential claim in advance, albeit in an informal manner. In our experience companies do gain a measure of certainty from this process, and the absence of formality has been welcome. In view of this we feel that a formal pre-clearance procedure is not needed.

We would also not wish to see the introduction of an external auditing process, which we presume would be intended to examine the technical credibility of claims. This would introduce a further layer of complexity and potential dispute to the process, as well as additional timescales in handling claims, which businesses would not welcome. There would be issues such as what the qualifications of the firm or individuals carrying out the auditing should be, whether they had suitable expertise in the particular field of technology involved and the need for an appeals process. As well as this, the cost to the public purse of hiring highly-qualified staff would be considerable and difficult to justify particularly at a time of cuts in Government spending.

Once again we are grateful for the opportunity to respond to the consultation and we hope that our responses to the questions are of interest to the R&D Tax Credits Reform team. We would be pleased to discuss any issues arising.

Yours sincerely

Richard Lewis
Director, Pronovotech Ltd