A Capital Idea

Richard Lewis, of research and development tax relief specialists Pronovotech, argues the case for the extension of the relief to capital R&D projects

In December 2005 the Treasury published its proposals for taking the research and development (R&D) tax incentive forward in 'Supporting growth in innovation: next steps for the R&D tax credit'. This was a response to the consultation paper published earlier in the year seeking ways in which the system could be enhanced. An exciting suggestion in the December document was the possibility of extending the enhanced relief to certain R&D projects where the expenditure is treated as capital for tax purposes, in particular for small and medium-sized enterprises (SMEs). Under the current schemes, for both SMEs and large companies, only revenue expenditure qualifies, although capital R&D spend does benefit from a 100% current-year deduction in place of the usual capital allowances. The suggested amendments to the relief would not go as far as allowing expenditure on capital equipment or buildings but would be intended to allow costs such as staffing costs that would have been within the categories of qualifying expenditure for R&D relief, had they not been capital in nature. It might have been hoped that firm proposals for legislative change would have been made in this year's Budget but instead there was no announcement on the issue at all. Had the Treasury forgotten about it? Or had the proposals been quietly brushed under the carpet perhaps?

Fortunately the plans were still apparently under review but had hit potential snags, such as how the design of such an enhancement could meet with EC approval. As indicated in the document, any legislative changes would most likely be aimed at SMEs. For them, the problem of lack of R&D tax relief would be more acute than for large companies which, it has been suggested, can get around the problem by having a subsidiary company perform the software development on a sub-contract basis, subject to any restructuring not falling foul of the anti-avoidance provisions at FA 2002, Sch 12, para 16. The Government has always been very careful to avoid breaching EC State Aid rules in the design of the R&D tax relief for SMEs, so it is understandable that this would have an impact on progress but not to hear any positive messages on the subject was somewhat disappointing.

Why is this such a big issue? Well, consider two (fictional) software start-up companies, ShrinkWrap Solutions and ASP Solutions, which, like most developmental stage companies, are making substantial losses in their early years. Both companies employ highly-qualified computer scientists to carry out software development projects that meet the definition of R&D in ICTA 1988, s 837A. Both companies have adopted the same accounting treatment for the staff costs of the employees developing the software, by writing the expenditure off in their profit and loss accounts. The two companies have, however, chosen different methods to sell their software to the market. ShrinkWrap Solutions has opted to license copies of the software to its customers, who receive a CD containing the software program to install on and use in their own IT environment. ASP Solutions on the other hand has decided to go down a hosted service route, whereby customers pay a fee akin to a subscription giving them access to the software program over the Internet but do not actually purchase the software themselves. Such a business model is becoming more and more common amongst software providers, since it offers the advantage of a low up-front cost for the customer with the ability to deliver regular upgrades more easily.

The most important distinction for tax purposes is that in the latter case the software developer, in our case ASP Solutions, does not actually part with the software; it is installed on a server belonging to (or maybe leased by) the company, to be accessed by customers as and when needed. For ASP Solutions it is here that the problem starts from a tax point of view – tax law needs to ask the question whether the expenditure incurred in the development of the software is revenue or capital in nature. As is well known, the analysis of the tax position derives not from the accounting treatment but from decided case law. A large number of cases have considered the question of capital versus revenue, although an overarching principle can be said to be that established in *Atherton v British Insulated and Helsby Cables Ltd* [1925] 10TC155: expenditure is capital when it brings into existence an asset with an enduring benefit to the business.

The argument for capital treatment, when applied to circumstances such as ASP Solutions, is that the company's development team has created an asset – the hosted software system – that performs a function in the company's business in the same way as a substantial physical asset such as plant and

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machinery and thus will provide such an enduring benefit. The fact that the company may have – correctly – written off the salaries of the development staff in its profit and loss account carries little weight, since case law has held that accountancy evidence is not conclusive in the tax analysis. Here is where a number of number of real R&D tax credit claimants, expecting to simply follow the accounts, have had their expectations dashed on CTSA enquiry. Losing a revenue tax deduction when a company has substantial losses may not be too great a hardship if it is merely a timing difference that can be recouped via capital allowances. However, if the company had anticipated the receipt of a cash credit of 24% of the expenditure, losing out on this is a lot more painful. Meanwhile, ShrinkWrap Solutions suffers no challenge on capital-versus-revenue grounds, since the completed software does not function as a piece of intangible internal machinery – and has its R&D tax credit paid, even though both companies' R&D projects were equally meritorious in terms of technological advance.

Evidence based on the types of actual CTSA enquiries seen suggests that challenges from HMRC on capital-versus-revenue grounds have been on the increase in the last couple of years. In fact, even some software companies with a business model similar to ShrinkWrap Solutions have had claims for revenue deductions resisted. If there has indeed been a trend, this may be a result of the reference in the Corporate Intangible Research & Development (CIRD) Manual, published late in 2004, to guidance on in-house software development expenditure, pre-dating the R&D tax relief system, in the Revenue's Business Income Manual (BIM) at 35000 onwards. The guidance to Inspectors makes the case for expenditure on internal use software to be capital in certain situations, setting out a number of factors that would indicate such a classification: for example, the importance the piece of software has in the business as a whole, its longevity and its cost relative to the size of business. At the time of its release in the mid-1990s, the BIM guidance was aimed at the large financial institutions that were spending large sums on the development of massive IT systems and infrastructure. For them, the denial of a revenue tax deduction meant a significant acceleration of tax liabilities and thus this was potentially a fruitful area for the then Inland Revenue to pursue. Now we see the same guidance being brought out for a different purpose, to attack claims for a tax incentive aimed at stimulating innovation, particularly by smaller companies for which receipt of an R&D tax credit can mean the difference between survival and business failure.

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The capital-versus-revenue distinction, however, is nearly always far from clear-cut, a fact acknowledged by HMRC's guidance itself. This is of course often the case generally but for the types of company involved it becomes more complex. In an early-stage, R&D-intensive company, does the technical uncertainty surrounding the project go against the 'enduring benefit' argument? What about work on developmental iterations and prototypes that were never intended to survive long enough for operational use? Whilst decided case law can provide some guidance, there can be difficulties applying precedents that pre-date modern software development methodologies and, more recently, the explosion in web-based technology. The idea that the recurring cost of software development staff, employed to continually update, improve or replace software, represents the creation of an asset with a long-term advantage may not always be correct. Nevertheless, SMEs can be particularly vulnerable to attack where the software system forms the core of the company's business and it seems HMRC has been using this argument in a number of cases recently and, even more worryingly, threatening to reopen prior years on 'discovery' grounds, resulting in companies facing the prospect of having to repay tax credits received for earlier years. Stories of such challenges can only have the potential to do harm to UK business' confidence in the R&D tax incentive.

For software development companies like ASP Solutions, then, there are arguments both for and against capital treatment and the dividing line is never clear. Currently, therefore, many of these claimants can expect to be involved in protracted and costly correspondence with their inspectors over the issue. At the same time the Government has stated that its aims for improving the R&D tax credit claims experience are simplicity, certainty and consistency. Given that the R&D tax credits system is after all supposed to be an enabling piece of legislation, rewarding companies seeking to achieve technological advance, surely it would be better to avoid the need for the argument in the first place and provide a level playing field by removing the revenue requirement that currently provides no incentive to real-life companies in the same boat as ASP Solutions. Not only would the adoption of such a reform remove a distortion in the industry but it would also put the UK on a par with other jurisdictions with R&D tax incentives, such as the US and Canada, where capital expenditure is as eligible as revenue.

Studies suggest that take up of R&D tax credits falls a long way short of what it could be; removing barriers such as the revenue expenditure condition would help give non-claiming companies the confidence to participate. Let's hope for some good news in the Pre-Budget Report later this year.