

CaSE response to R&D Tax Credits Consultation

2nd September 2011

This is CaSE's response to the HM Treasury consultation on R&D Tax Credits. We believe that the UK must become a knowledge-intensive economy if it is to be internationally competitive in the years to come, and it is therefore crucial that the tax system incentivises research and development activity in the private sector.

Government SET Statistics show that in 2008, 1.8% of UK GDP was spent on R&D. This compares to 3.4% in Japan, 2.8% in the USA, and 2.6% in Germany. Looking at R&D performed by business alone, the figures are 1.1% for the UK, 2.7% for Japan, 2% for the USA, and 1.3% for France. These figures underline the importance of incentivising R&D in the UK.

The responses to the questions below are the result of consultation with CaSE's member organisations who engage in industrial R&D.

We would further like to make the point that with the reduction in corporation tax from 28 per cent to 23 per cent, the relative benefit of the tax credit is reduced. We recommend that if the Government is seeking to maintain the same effective incentive for research and development, it should increase the rate of the tax credit.

Consultation question responses:

Q1. What difference, if any, to levels of R&D investment in the UK would a move from the current superdeduction to an 'above the line' credit against tax make, if the level of benefit to the company, in terms of reduced cost of R&D, remained broadly the same?

Given the aim of the R&D Tax Credit regime to modify behaviour by encouraging tax payers to undertake greater levels of R&D, and to locate greater levels of R&D in the UK, than would otherwise be the case, it is vital that the benefit to a business of the R&D tax credit is visible to and focused on those individuals in a business who make the decisions around R&D expenditure and project appraisal.

Our members consider that the present scheme is generally effective in encouraging greater levels of R&D, but that it is not as effective as it could be. This is due to the fact that with the present scheme it can be the case that as the credit is included in the tax line it may only be visible to the tax department, and not necessarily visible to those who make the decisions on whether to undertake R&D and where to locate that R&D. Our members agree with the comment in the consultation document that this can lead in some cases to the tax credit being disregarded in investment calculations.

A number of our members commented to us that although tax departments make efforts to communicate tax implications to the rest of their company, such communication can be imperfect, leading to sub-optimal effectiveness of the tax credit.

Those who make R&D decisions in large organisations, be they senior R&D management, procurement or the R&D finance function, will have a wide range of complicated factors to consider when making R&D decisions – tax will only be one factor in these and it is all too easy for those decision makers to view tax as a 'black box', rather than fully understanding the tax impact of those decision, which can be

somewhat complicated. This effect can be compounded by individuals typically being appraised based on pre-tax metrics.

In order for the full benefit of the R&D Tax Credit regime to be realised it is important that not only are the decision makers aware of the ramifications of the regime, but moreover that it is in the forefront of their mind when making decisions. If the credit was “above the line” and therefore included within the budgets of the decision makers, rather than just in the tax line, our members believe that this would lead to a greater focus, and ultimately we believe a more knowledge-intensive economy for the UK.

In an environment where budgetary constraints may restrict the ability to increase the absolute amount of the credit to encourage investment, any move to increase the impact of the regime through this greater visibility is especially important.

Q2. What tax treatment would allow loss-making companies to account for the credit above the line? Given the potential complexity of offsetting the tax credit against other taxes apart from CT, would loss-makers need the credit to be payable if there was insufficient CT cover?

We appreciate the importance of this question, especially as it affects small innovative companies yet to make a profit. Although we have no specific recommendations, we hope the Government can find a solution to this issue.

Q3. If a payable credit was introduced for loss-making companies, should the benefit be less than that available to profitable companies, to recognise the value to the loss-makers of being able to utilise the credit immediately?

One suggestion from our members has been that it would be preferable for companies to have the choice of claiming the lower repayment immediately or carrying forward the credit and offsetting the full amount in a future profitable period.

However, although we appreciate the point that such companies would value being able to utilise the credit immediately, they may also be in more urgent and more absolute need of such credit than profit-making companies. This should be considered when potentially penalising them with respect to reducing the benefit available.

Q4. Are there additional issues around added complexity to the schemes that should be considered?

Our members have commented that the complexity with R&D Tax Credits is around identifying qualifying expenditure. Against this background, we do not consider that any additional complexity around these potential changes should have a material impact.

Moreover, it is currently quite time consuming for tax departments/finance functions to keep the decision makers in the business informed and aware of the impact of the R&D Tax Credit system. If the move to an above the line system means that those decision makers are naturally more informed, this level of work is reduced and this should more than compensate for any additional complexity arising from the actual claim.

Q5. The majority of respondents in favour of the change were large companies. What separate compliance and complexity issues would arise if the SME scheme also moved to an ‘above the line’ credit system?

Our respondents have been large companies, and we are not in a position to comment on this question.

Q6. Should the relief for Qualifying Indirect Activities be retained? Does it provide significant benefit to companies currently claiming QIA costs?

Our members believe that the relief for QIAs should be retained. Although all elements of a R&D claim involve a certain amount of work to prepare, this is clearly outweighed by the benefit. For example, one of our member companies claims tax benefit of £1.5m for QIA.

However, if QIA is abolished, then the rate of the tax credit should be proportionately increased, such that the overall effect upon companies is neutral. This is without prejudice to earlier comments about the need for an increased tax credit rate as a result of reductions in corporation tax.

Q7. Would either the certification process or joint election process (or an alternative process) be effective in delivering the intended certainty for both contractor and subcontractor to allow the subcontractor to claim the large company credit?

We agree with the comments in the consultation document that there can be an issue where the R&D tax credit is not available to either the contractor or subcontractor in certain circumstances.

However, with the proposed approach there are a number of issues which will need to be considered further:

- In practice the certification/joint election is likely to form part of the contract negotiation between the parties. Businesses are likely to face commercial issues where they represent that a project does qualify but this ultimately turns out to not be the case, say following further analysis before submitting a claim, or as a result of an enquiry by HMRC. The question would then arise as to whether the sub-contractor would seek a price adjustment from the contractor. This could result in a further significant administrative burden to the contractor and the sub-contractor, and potentially legal challenges.
- As discussed above, we believe that the key areas for improvement around the R&D Tax Credits regime should be focused on ensuring that the benefit is visible to the key R&D decision makers in a business, such that they are encouraged to undertake greater levels of R&D in the UK. If the credit is merely provided to the sub-contractor, the decision makers in the contractor entity will have little visibility and this may undermine the effectiveness of the regime.
- In a “perfect market”, it would be anticipated that sub-contractors would pass the benefit resulting from the R&D Tax Credit back to the contractor through reduced pricing. This reduced pricing would then encourage the contractor to undertake greater levels of R&D, benefitting the UK as a whole. However, clearly in the real world the market is less than perfect, and in some circumstances the sub-contractor may not pass on a significant amount of the saving – in which case the Exchequer is merely subsidising the sub-contractor’s profits with no increase in the level of R&D undertaken in the UK.
- The proposed election/certification process could result in a significant administrative burden on both the contractor and sub-contractor, but as the contractor may not see any direct benefit for this burden, they may be unwilling to undertake this effort, or unwilling to accept the risk of subsequent disputes.

Therefore, if a credit is to be granted to a subcontracting entity, our members consider that it is important that this is visible to the contractor such that it is factored into their decision making and project appraisal.

Such visibility would also ensure that the benefit of the credit is not merely to increase the profitability of the sub-contractor as it would then be factored in to the commercial negotiations and pricing.

Therefore, in order to maximise this visibility our members have suggested that the process should take the form of a joint election whereby the contractor and sub-contractor elect which party receives the credit.

This has the advantages that:

- The benefit of the credit forms part of the normal commercial negotiations around the contract, with both parties fully informed of the benefit.
- Decision makers in the contracting entity would have a clear view of the benefit of the credit and would be motivated by this to increase the levels of R&D which they commission.
- If there is a concern that the project may not ultimately qualify, an appropriate election could be made such that one party bears the risk on this – for example, the contractor could receive the full credit, such that they can handle any adjustments to the claim on the project as a whole, thus reducing the administrative burden of two parties having to adjust their claims and avoiding risks around contractual adjustments/legal challenges etc. The price agreed between the parties would obviously reflect which party receives the credit under the election.
- Where one party is loss making, and would otherwise be seeking a repayment in line with the comments above, the election could be used to give a more straightforward answer by electing the credit into the profitable entity, avoiding the need for repayments.
- This visibility would also help to eliminate any concerns around confidentiality, as both entities would be able to see the financial benefit of the credit, and could therefore weigh this benefit against any confidentiality concerns.

Overall, although our members are in favour of the expansion of the benefit available to sub-contractors, they do have concerns over the practicalities. As such, if there is budget for such a change, it may be that a more effective use of such a budget would be to simply increase the headline rate of the R&D tax credit, which is likely to have a greater impact on the level of R&D located in the UK, with a lower administrative burden.

Q9. Would companies welcome reform of the ‘going concern’ definition so that it more closely matched that used for the EIS/VCT schemes?

No response.

Q10. The Government would welcome comments or evidence to support the assessment of the impacts of the changes under consultation.

Individual companies are in a better position than we are to comment on this.