

Research and Development Tax Relief — Ongoing Consultation

Introduction

Historically, the U.K. spending on research and development has lagged behind that of other countries. As part of the government's move to improve innovation and therefore, increase productivity, measures have been introduced over the last ten years to encourage research and development activity.

The government believes that the U.K.'s research and development tax relief schemes are an important factor in determining the competitiveness of the U.K.'s corporate tax system. Since their introduction, the schemes have supported nearly £52 billion of research and development activity by U.K. companies, but the government is keen to ensure the schemes continue to be effective in encouraging innovation by U.K. companies.

Further to the 2010 consultation published as part of the tax reform agenda and the findings of the Dyson Report, further changes were announced in the 2011 Budget. The government has now responded to the issues raised in the consultation and it is likely that further proposals will be announced in the 2012 Budget. The key issues raised in the consultation are dealt with below, firstly those where further consultation is required.

Removal of PAYE/NIC cap

This is relevant to the small and medium sized enterprises (SME) scheme only. Currently there is a restriction on the amount of payable tax credit under the scheme, set to the amount of PAYE/NIC paid by a company. The Budget announced plans to remove this restriction from 1 April 2012, which will particularly help smaller start-ups and those with low staff bases. As the cap was initially introduced to deter fraudulent claims, further consultation will be based around making sure that its removal does not lead to companies being set up solely to generate payments from HM Revenue & Customs.

Qualifying indirect activities

Companies make claims in respect of certain qualifying indirect activities, but there is confusion as to what exactly can be claimed. The lack of clarity in this area also leads to additional HM Revenue & Customs enquiries, which lead to time and costs being incurred for companies, often over relatively small amounts. Generally, it is thought that determining what does and does not qualify under this heading is disproportionately complex and whilst excluding the costs narrows the relief, it is yet to be proved that their inclusion would really be effective in enhancing research and development investment. Further consultation will address the issue of whether this should be retained.

Sub-contracted research and development

In the Budget, the government announced it would consult on proposals to give research and development tax relief for routine activities by a sub-contractor. Currently, under the SME scheme, a customer, as opposed to the sub-contractor, may claim for work it sub-contracts, the key factor being whether the work is research and development for the customer. However, for large companies, or SMEs doing sub-contracted work for large companies, it is the sub-contractor who can make the claim. A key factor is whether the work is research and development for the sub-contractor, but this is sometimes not the case, it often amounts to routine work for them, for example testing.

The government would like the sub-contractor to be able to claim if the activity would be research and development as part of a larger research and development project. The difficulty they face is how to prove it relates to a qualifying research and development project, particularly if the customer cannot, or will not provide information on the wider project, perhaps for confidentiality reasons.

The main concerns here relate to the possible double claiming on the same expenditure and also how to share information on the projects between the customer, sub-contractor and HM Revenue & Customs. Further consultation will take place, but the government is unlikely to proceed with such an approach unless there is broad support and a general consensus that it can be effective.

Going concern basis

The SME scheme, due to it being European Union State Aid, has a requirement that the company must be a "going concern" to qualify. As this relates to whether the last published accounts were prepared on a going concern basis, it can be misrepresentative — as the last accounts may have been some time ago and the company's circumstances may have changed.

The suggestion is to use the European Union concept of a "company in difficulty" which would bring it in line with the definitions used for EIS and VCT relief and further consultation will take place to court views on this possible change.

Above the line credit

The initial consultation welcomed views on possible changes to the structure of the schemes that might stimulate investment in research and development by UK companies. The key suggestion was to make the large company relief into an above the line credit against tax, as opposed to a super-deduction. The hope was that this would deliver a more significant incentive effect, with little additional cost.

This would be of considerable benefit to loss making large companies who are not eligible to claim the cash back provided by the SME scheme and may not be able to obtain full benefit from the super-deduction if they have insufficient profits.

Whilst recognising that many countries operate schemes on this basis, for example Canada and France, the key issue with moving to such a system is that it would require a major upheaval to what is already a highly successful scheme. The government is, therefore, proposing further investigation into the potential design, complexity and compliance challenges this would pose and also the evidence base and the extent to which it would encourage further research and development in the U.K.

And they have concluded on...

The government also provided comments on the following consultation issues where they have concluded that no further consultation is required:

Qualifying costs and activities

Consultation also took place on what additional costs should be eligible for relief under the scheme and a wide range of additional classes of expenditure were suggested. Some costs were generic, for example including benefits in kind as part of staffing costs, but some were very sector specific, for example transport costs or some aspects of clinical trials.

The government's response is that the relief should focus on core research and development activities. Additional classes of qualifying expenditure would require additional rules and guidance and therefore, make the relief more complex.

Production issues

The consultation also looked at the issue of a definition for production in terms of what can and cannot qualify. The BIS guidelines refer to production and excludes the "production and distribution of goods and services" from being qualifying research and development. It has been unclear how far this extends to production in respect of research and development, for example, the production of a saleable prototype or the carrying out of trials in respect of processes. So far, claimants have relied on the degree to which the creation of these goods directly contributes to the advance, as opposed to being created with a view to a sale to customers.

The key issue is whether a definition could provide the clarity to aid claimants. It was concluded that it would prove too inflexible and therefore, no statutory definition should be introduced. It was felt, however, that further guidance on this area should be provided.

Removal of the de minimis limit

There is currently a limit of at least £10,000 expenditure on research and development in order for a company to be eligible to claim. This will be removed from 1 April 2012 and is generally welcomed to encourage start-up companies.

Externally provided workers

The rules relating to externally provided workers were introduced to allow relief for expenditure on staff who are not actually employees of the company making the claim, but who work alongside employees of the company and are treated as though they are employees. The general consensus provided by the consultation discussions was that the current rules relating to these workers are over restrictive.

Currently the legislation centres on the relationship between the company, the workers and the "staff provider" and can exclude workers employed by a group employment company, as opposed to the group company carrying out the research and development. It is clear that certain arrangements were intended to be covered, but due to the restrictions are not. New legislation will be announced this autumn for inclusion in the Finance Bill 2012.

Improving the claims process

Proposals for improving the claims process were welcomed, including views on a possible pre-clearance procedure with HM Revenue & Customs and external audits of claims.

HM Revenue & Customs currently have seven research and development units who already have capacity to provide pre-claim advice on what activities qualify and what documentation should be prepared and retained. The government would like to build on this by introducing a more formal system of voluntary advance assurances for smaller companies and start-ups. The proposal is that if assurance is received, a company would be able to rely on this assurance for a number of years.

HM Revenue & Customs will operate a pilot scheme from the autumn to see how best to offer pre-claim assurances and on what basis. The pilot schemes will operate for start-ups and small companies who have not yet made their first claim and will operate from one research and development unit in the first instance.

Summary

Research and development tax relief is still a valuable incentive. The consultation has already clarified some of the more complex areas of the relief and the further consultation process will provide the remaining conclusions soon.

If you have any queries on the consultation process or the issues raised in this briefing, please contact one of our specialists below. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>

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