



HM TREASURY

Research and Development tax credits:

response and further consultation



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June 2011



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Foreword

The Government's Plan for Growth emphasises the importance of creating the right conditions for businesses to succeed, removing barriers that are preventing them from performing to their full potential.

As part of this, the Government is committed to creating the most competitive tax system in the G20, in order to drive private sector growth. Since last May, the Government has set out a series of reductions in the main rate of corporation tax – bringing it down to just 23% by the end of this Parliament – as well as a substantial programme of corporate tax reforms as set out in last year's Corporate Tax Road Map. These reforms include:

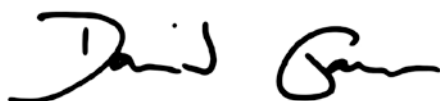
- significant changes to the UK's controlled foreign company regime, to better reflect the way that businesses now operate in a globalised economy,
- reforms to the Research and Development (R&D) tax credits regimes, to reinforce their importance in promoting innovation, and
- the Patent Box

The Government believes that high-growth, high-tech companies will be a key component of the private sector led recovery and has a commitment to make the UK the most attractive place to start and invest in innovative technology companies. The Government recognises the value of R&D tax credits to companies undertaking R&D in the UK - from start-ups with little more than a new idea to multinational groups deciding where to site major R&D facilities.

R&D tax credits provide nearly £1 billion of support, to over 6000 companies. The response to the November consultation reinforced the message of the importance of R&D tax credits in promoting innovation in the UK and in the March Budget the Government announced increases in the small and medium sized enterprise (SME) rate both for this year and next, together with a number of proposals to simplify the schemes.

The Government is now bringing forward further proposals, which will remove barriers to companies claiming the credit and provide greater certainty to small and start-up companies about what costs qualify for the credit. The Government would also like to explore further with industry the arguments put forward by a number of companies for moving from the current 'superdeduction' system for delivering the credits to an 'above the line' credit against tax.

I am pleased to publish the consultation paper and hope that businesses, representative bodies and others interested in promoting the growth of innovative companies in the UK will play a full part in the consultation process.



David Gauke

Exchequer Secretary

June 2011

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Introduction

Aim of the response and consultation

1.1 The aim of this document is to provide the Government response to the comments and proposals put forward by individuals, companies, representative bodies, professional bodies and others to the Research and Development (“R&D”) tax credits consultation published in November 2010.

1.2 In addition to providing its response, the Government also seeks further views on specific policy proposals.

Previous consultation process

1.3 R&D tax credits were introduced for small and medium sized enterprises (“SMEs”) in 2000 and for large companies in 2002. As part of the corporate tax reform process, the Government announced in June 2010 that it would consult with business to review the support R&D tax credits provide for innovation and the proposals of the Dyson Review.

1.4 The consultation commenced in November 2010 and six public forums were held in Cardiff, Glasgow, Manchester, Birmingham, Cambridge and London, with over 500 attendees. In addition to the feedback from these forums, over 80 written responses were received. The Government brought together a Working Group comprising R&D companies, accountants and representative bodies, all with a keen interest in R&D.

1.5 The Government is grateful to all who responded to this consultation. One of the key messages from respondents was that the schemes are generally well liked and seen as making a positive contribution to ensuring the UK is a place where high-growth, high-tech and innovative businesses can thrive. This consultation process, together with the Budget 2011 announcements, confirms the Government’s commitment to the future of tax support for R&D investment by UK companies.

Policy intention

1.6 The policy intention is to ensure that R&D tax credits are effective in supporting innovation in the UK both for large companies and for SMEs. The Government also recognises the importance of tax simplification and the reduction of compliance burdens on business, where possible.

Scope of the response and further consultation

1.7 Chapter 2 outlines the key proposals and comments put forward by companies and others to the questions outlined in the November consultation document, together with the Government response. In some instances the Government response was embodied in the R&D tax credits measures announced in Budget 2011; in others this document provides further details on the Government’s views on particular issues.

1.8 There are some areas where further discussion is required and these are considered in more detail in Chapter 3. Chapter 4 details the timetable for taking this work forward.

Stage of consultation

1.9 The proposals set out in this document are either at stage 1 (setting out objectives and identifying options) or stage 2 (determining the best option and developing a framework for implementation including detailed policy design) of the Government's framework for tax consultation. Annex A provides further details of the Code of Practice on Consultation.

How to respond

Please send comments, by 2 September 2011 to: Mike Crabtree or John Quinn, R&D Tax Credits Reform, Excise and Enterprise Tax Team, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ

Email: corporatetaxreform@hmtreasury.gsi.gov.uk; or
mike.crabtree@hmtreasury.gsi.gov.uk or john.quinn@hmtreasury.gsi.gov.uk

Telephone (Treasury switchboard) 020 7270 5000

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Summary of Responses

Structure and scope

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 wider corporate tax reforms?

2.1 This was a broad question and attracted a range of responses, many of which strayed into areas raised by other questions. However the two main themes were arguments for introducing an 'above the line' tax credit (a credit against the company's corporation tax bill rather than an enhanced deduction) and for an increase in the rate of relief.

2.2 By far the most significant response from large companies to the consultation was the proposal to move from the current superdeduction to a system which reduced the company's final tax liability rather than its taxable profits. This was commonly referred to as an 'above the line' tax credit system.

2.3 Those putting forward this proposal argued that it would deliver a better incentive effect for little additional cost. They pointed to the fact that the R&D incentive is currently reflected in the taxation line in most company accounts, so it is very often the case that "ownership" of the R&D tax claim sits within the finance or tax department and it is not possible for an R&D team to record the R&D benefit in the results for which they are responsible. This inability to book the R&D incentive within the R&D team can result in it being disregarded in investment calculations.

2.4 To be able to account for the credit 'above the line' the advice from HMRC accountants, and from those proposing the change, is that it has to be 'payable'. In other words, if a company did not have sufficient corporation tax payable to offset against the above the line credit, then it would either have to be able to offset the credit against other taxes or could 'cash in' the credit for a payable sum. This would give companies a fair degree of confidence about when the benefit of the credit would be received and how much it would be worth, allowing them to book it to the R&D cost centre in their accounts.

2.5 Under the current (superdeduction) arrangements, if a large company does not have enough profits to make use of the superdeduction immediately, it is carried forward as a corporation tax loss, and will be relieved when the company has sufficient taxable profits. A payable credit would therefore potentially deliver relief faster for some loss making companies, which increases the benefit to them but also has Exchequer cost implications.

2.6 There would be significant issues around introducing a payable credit. Some respondents suggested that the credit should be offset against other taxes where a company had insufficient corporation tax. Others suggested that the French system could be followed where an unrelieved tax credit is carried forward for a number of years against future profits before it becomes payable.

2.7 A few respondents focused more on the rate of the large company credit and suggested that in order to be internationally competitive it should be increased, to provide greater levels of

support for internationally mobile R&D. On the other hand, there were respondents to the consultation who were of the view that the current scheme was a good incentive for R&D investment and that further major reforms were not justified.

Government response

2.8 The Government recognises that a number of respondents have argued for a change to an ‘above the line’ credit and that a number of other countries, including Canada and France, offer such a system. However the Government is also aware that moving to such a system would be a major upheaval to what is already a successful scheme. It would require significant changes to systems, for example to provide certainty for loss-making companies, and could also have considerable cost implications at a time of fiscal consolidation.

2.9 In view of the support expressed for a move to an ‘above the line’ credit, the Government would like to explore further with stakeholders the evidence base and the extent to which it would stimulate additional R&D in the UK or make the UK more attractive for internationally mobile R&D. In addition the Government would like to discuss the design, complexity and compliance challenges that arise from introducing a new way of delivering the credit, including potential offset against corporation tax and other taxes, the treatment of loss-makers and the interaction with the SME scheme.

Subcontracting

2.10 Under the SME scheme, a company (“customer”) may claim relief for work that it subcontracts to another person (“subcontractor”). Whether or not the expenditure qualifies for relief depends on whether it is R&D for the customer – its status for the subcontractor is not an issue and companies cannot claim for work subcontracted to them.

2.11 Under the more general scheme that applies to large companies and to SMEs doing subcontract work for large companies, it is the subcontractor who claims, and a key issue in determining what expenditure qualifies is, then, whether the work is R&D for the subcontractor. In some circumstances, it may not be. Respondents to the consultation suggested that this distinction should be reconsidered.

Government response

2.12 The Government announced in the Budget that it would bring forward proposals to address this situation.

2.13 One way to achieve this would be to alter the relief for large companies to work in the same way as that for SMEs. Companies would be able to claim for payments to subcontractors, but the subcontractors would not themselves be able to claim.

2.14 While this would simplify the R&D reliefs by removing a boundary issue and treating companies of all sizes the same, this would mean that UK companies carrying out work for overseas customers – including UK companies doing work for other group companies based abroad – could not claim. The Government does not propose to follow this approach.

2.15 Instead, the Government proposes to consider the subcontractor’s work as part of the customer’s project. To be able to claim, the subcontractor needs to be aware that the work it is doing for its customer is R&D and it needs to be able to give HMRC evidence, if necessary, that this is so. Relief should be given only once in respect of the same expenditure. This is considered in more detail in Chapter 3.

Qualifying costs and activities

Are there additional costs that should be eligible for relief under the schemes?

2.16 A wide range of additional classes of expenditure that could qualify were suggested. Some were generic, such as benefits in kind, rent or costs associated with obtaining patents, whilst others more closely reflected the concerns of particular sectors or companies, such as transport costs or some aspects of clinical trials that do not currently qualify. There were no costs that were raised consistently by most or all respondents, apart from the treatment of externally provided workers (EPWs).

Government response

2.17 The Government is keen to keep the schemes focused on supporting core R&D activities – in this way it is better focused, provides better value for money and is simpler to operate.

2.18 Additional categories of qualifying expenditure would require additional rules to define them and set the boundaries. Whilst it would be possible to add extra costs to the current list, this would add complexity to the rules and with the major elements of R&D expenditure already covered by the credits, adding more would generate limited additional benefit. **The Government does not, therefore, propose to extend the qualifying costs rules at this time beyond the EPW changes outlined below.**

Externally provided workers

2.19 A number of respondents were of the view that the rules defining EPWs (for example, agency staff) are over restrictive and could be relaxed.

2.20 These rules (which are in ss 1128 – 1132 CTA2009) were introduced to allow relief for expenditure on staff who are not actually employees of the company making the claim, but who work alongside the company's own employees and are, for day-to-day purposes, treated as though they were employees. Two particular examples which the legislation was intended to include were: staff who, within a group, are all employed by a single group company, whichever company they actually work for; and agency staff supplied to meet a particular need who remain employed by the agency rather than the company.

2.21 The rules therefore define expenditure on an externally provided worker in terms of there being certain arrangements between the company, the worker and a 'staff provider' (such as an agency). These are such that if a fourth party (such as the worker's personal services company or a second agency) is included, it is likely that the definition will fail to be met.

2.22 It is often the case that there is a lengthier chain where, for example, a company undertaking R&D sources EPWs through a staff provider which itself sources through another staff provider.

Government response

2.23 The Government accepts that the current EPW rules are over restrictive and will bring forward draft legislation in the Autumn retaining the essential features (that the worker is for day to day purposes performing similar functions to, and is subject to the same degree of control as, an employee) but allowing a wider range of circumstances to qualify.

Restricting costs

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

2.24 There were no strong recommendations for exclusions of any particular expenditure from the schemes, although a number of respondents questioned whether the benefit achieved from the relief available in respect of Qualifying Indirect Activities, was really effective in enhancing R&D investment,

Government response

2.25 The Government does not propose to restrict qualifying costs further, subject to the views on the relief available for qualifying indirect activities (QIAs) (see paragraph 3.2 Chapter 3). Given the importance of internal use software to a number of sectors, there are no proposals to change the existing treatment under the R&D rules. Any restrictions could hamper the effectiveness of the schemes and could also be complex and/ or impractical to deliver.

Definition

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?

2.26 Responses were generally positive. Although some respondents mentioned complexity and uncertainty, the general mood was that there would be no great benefit in a major upheaval as the current definition is well established and understood.

2.27 There were suggestions to make the definition clearer, including excluding qualifying indirect activities from qualifying for relief (on the grounds that it is very hard to define their limits) and improving guidance on what qualifies more generally.

Government response

2.28 The Government does not propose any changes to the BIS guidelines at the present time.

Production

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

2.29 The term “production” occurs in paragraph 28 of the BIS guidelines, which excludes the “production and distribution of goods and services” from being R&D. While this clearly encompasses routine, commercial production for supply to customers, uncertainty has arisen about the manufacture of goods in connection with an R&D project – for example, the operation of a manufacturing process either to test R&D which has been done to modify plant, or as part of the R&D itself.

2.30 The consultation sought views on whether a statutory definition would be helpful in providing clarity on this point, avoiding disputes between HMRC and claimant companies.

2.31 The consensus of respondents to the consultation was that there should not be a statutory definition of the term. This was seen as potentially inflexible. Instead, it was suggested that HMRC take a pragmatic approach to interpreting “production”, backed up by better guidance.

Government response

2.32 The Government agrees that there should not, at the present time, be a statutory definition of “production”.

2.33 Over the past year, HMRC has been working closely with companies to settle current claims. The central principle that has been applied is that set out in paragraphs 3 and 4 of the BIS Guidelines, that R&D takes place when a project seeks to achieve an advance in science or technology, and that activities which directly contribute to the advance, by resolving scientific or technological uncertainty, are R&D.

2.34 The question to be considered in cases where goods are created is therefore the degree to which their creation directly contributed to an advance by resolving scientific or technological uncertainty (as distinct from other sorts of uncertainty, for example commercial uncertainty), rather than simply whether they were created with a view to supply to customers.

2.35 HMRC will develop improved guidance setting out this “uncertainty” principle illustrating how it may be applied in a number of different situations. Draft guidance will be published shortly. After stakeholders have had an opportunity to contribute their views, it will be included in the HMRC Corporate Intangibles and R&D Manual, which contains the formal HMRC guidance on R&D, replacing the current material on production.

Refocusing

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?

2.36 A wide range of responses were received to this question. Smaller companies will usually not have in-house tax departments and their own tax advisers may have limited knowledge of the operation of the R&D schemes. To reflect this, a number of the suggestions were aimed at making it simpler for smaller companies to understand, claim and comply with the schemes.

2.37 Suggestions included removing the existing cap on the amount of the payable credit (by reference to the level of PAYE/NICs paid by the company) and providing an earlier or more regular payment of the credit, to improve cash flow. Others mentioned issues around the definition of an SME for the purposes of claiming the credits, when the company had substantial venture capital funding causing it to be linked to other larger enterprises. The interplay of R&D tax credits and R&D grants was also raised, with some respondents arguing further clarification was needed to explain how and when the receipt of a grant might impact the ability to claim tax credits in respect of the same project

2.38 The main point consistently raised was the value of the relief and arguments in support of raising the rate, as the single most important change Government could introduce to increase the level of R&D undertaken by smaller companies.

Government response

2.39 Budget 2011 announced a number of changes that will be of greatest benefit to SMEs and often to the smallest companies claiming the credits.

- The SME rate was increased from 175% to 200% from April 2011 and to 225% from April 2012 (subject to State aid clearance).
- The current cap on the amount of payable credit to loss making SMEs (based on the amount of PAYE/NICs paid by the company) will be removed. **Chapter 3 seeks views on any factors that should be taken into account, particularly in terms of risk mitigation, when introducing this change.**
- Companies must currently spend at least £10,000 per annum on qualifying R&D to qualify for the credit. That minimum amount will be removed for all the schemes.

Claims process

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?

2.40 External auditing had mixed responses, as did pre-approvals. Whilst some responses were positive, citing issues such as increased certainty, there were concerns over an increased compliance burden and the potential high cost of external auditing. There was a consensus that any such scheme should not be compulsory.

Government response

2.41 HMRC already operates seven specialist units overseeing claims to R&D relief. The Units already discuss claims before the event with companies, addressing not only the fundamental question of what is R&D but also matters such as what costs qualify, and what records need to be kept to substantiate a claim.

2.42 Based on the consultation responses, the R&D Units are well regarded by those who are aware of and use them, although it was clear (especially in the seminars held with companies and accountants) that awareness of them could be improved.

2.43 The Government wishes to build on a system that is working well - rather than replacing or radically changing it - by introducing a more formal system of voluntary advance assurances for smaller companies and for new start-ups. The intention is that companies applying for and receiving such an assurance would be able, unless their business substantially changes, to rely on it in making their claims for several years

2.44 Introducing such a system raises issues including exactly what information would need to be provided to obtain an assurance, and what the likely volume and uptake would be. **HMRC will therefore operate a pilot scheme, to commence in the Autumn to determine how best to make this work without, for example, introducing disproportionate new information requirements. One of the issues that will be addressed is whether the assurances should be a project or company based requirement.**

2.45 The pilot will also seek to establish which companies will most benefit from advance assurances, i.e. new, immature business or established companies.

2.46 The pilot will be operated by one of the R&D units, and will apply to small start-up companies and other small companies which have yet to make their first claim. Participation will be voluntary. Those companies taking part will be asked to provide specified information about

their company and R&D project, which the R&D unit may then discuss with them. The aim will be for the company and HMRC to agree a basis for future claims for a specified number of years.

Vaccine Research Relief

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?

2.47 There were only a few responses on the effectiveness of VRR, reflecting the very limited use of the relief, although most were in favour of its continuation.

Government response

2.48 VRR will be reduced for SMEs and then abolished, to ensure they can obtain the full benefit of the SME rate increases. The Government recognises that VRR can still be a valuable incentive for large companies so it is maintained for them

3

Further Consultation

3.1 The Government will consult in the autumn on draft legislation to implement further changes to the R&D schemes. Prior to that it would welcome views on the questions set out below. The questions relate to:

- Above the line credit
- The benefits of the current relief for Qualifying Indirect Activities
- Subcontracted R&D – giving the relief for ‘routine’ activities by subcontractors which would qualify as part of the customer’s project
- Removal of PAYE/NICs cap – need for revenue protection measures
- ‘Going concern’ definition – alignment with EIS/VCT definition

Above the line credit

3.2 The Government wishes to explore further with businesses the case for moving from the current superdeduction to an ‘above the line’ credit against tax. A number of companies argued for such a move but there remain a number of issues, around impact, complexity, design and cost/rate that require further consideration.

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?

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?

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?

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

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?

Qualifying Indirect Activities

3.3 Companies make claims in respect of Qualifying Indirect Activities, but there is uncertainty over what costs can be claimed and this would appear to result in companies incurring time and financial costs in attempting to decide which costs qualify, often over relatively small amounts.

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

Subcontracted R&D

3.4 The Government announced in the Budget that it would consult on proposals to give R&D tax relief for 'routine' activities by a subcontractor. Under the R&D tax relief for large companies and SMEs doing subcontract work for large companies, it is the subcontractor who claims. A key issue in determining what expenditure qualifies is whether the work is R&D for the subcontractor. In some circumstances, it may not be. See the example below.

Example

S is a subcontractor, whose business is testing the purity of pharmaceuticals. It carries on testing work for a number of customers, including pharmaceutical and bioscience companies, but also for police forces. The tests are identical. Some will have been commissioned as part of R&D projects, and some for other reasons.

These are routine tests and the work is not, in isolation, R&D for S, regardless of the reason for which the customers commission it. If the work were carried on directly by the customers themselves, some might be R&D, if done as part of a larger R&D project.

Thus, a subcontractor may not be entitled to claim relief even though the principal could have done so, if it had done the work itself in-house. So no relief is available to any company for this work.

3.5 The Government announced in the Budget that it would consult on proposals to address this situation. Essentially, this means considering the subcontractor's work as part of the customer's project. To be able to claim, the subcontractor needs to be aware that the work it is doing for its customer is R&D and it needs to be able to give HMRC evidence, if necessary, that this is so.

3.6 In the example, to know what relief it can claim, S needs to know the purpose of the tests. Some customers may however be unwilling to provide this information to S as it is commercially sensitive or simply because collating it is too burdensome for them.

3.7 One approach might be for HMRC to use information it already has to settle the issue. S could make a claim, based on its best knowledge about its customers (and naming which customers commissioned what work) and HMRC would then accept or reject the claim based on its knowledge of the customers' wider R&D claims.

3.8 However, there are problems with this approach. Apart from the burden on S recording and supplying the information, and on HMRC matching it up with all the customers' records, HMRC simply might not have information about customers' R&D because they are not claiming – for example, they may be based abroad. The customers themselves may be entitled to relief but not have claimed it, or may not have claimed yet. This would make the claims process very uncertain since entitlement would depend on the availability or not of information.

3.9 More fundamentally, even if it had the information, HMRC's duty of confidentiality means though that it probably cannot use it in this way because that would almost certainly mean S being told, or being able to infer, the purpose of the customers' work.

3.10 Government considers that this approach would be too burdensome and uncertain for all concerned, and that the problem can only be overcome when the customer is willing to share information with the subcontractor.

3.11 For example, the customer could, at the time of commissioning any work that is part of an R&D project, give the subcontractor a certificate stating that the work is R&D. The subcontractor would use this to back a claim, making HMRC aware that the work is R&D. The certificate would authorise HMRC to share information with the subcontractor if necessary. If, for example, HMRC concluded, in examining the customer's tax affairs, that the work was not part of an R&D project, then HMRC could go back to the subcontractor and withdraw relief.

3.12 Alternatively, both customer and subcontractor could make a joint election stating that for the purpose (only) of determining whether any work is R&D they would be treated as part of the same group¹, and allowing HMRC to request or disclose information as necessary for determining this.

3.13 Either option could require the customer to supply HMRC with information to validate a claim made by another company, which it might or might not be willing to do. Either option would therefore have to be voluntary and revocable. This places some additional burden on claimants, and also on customer companies (which may not themselves be claimants).

3.14 The Government would only wish to proceed with such an approach if there were broad support for it and general agreement that it would be effective.

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?

Removal of PAYE/NICS cap

3.15 Budget 2011 announced that the PAYE/NICs cap will be removed for the payable credit under the SME scheme. This will have the effect that companies with R&D claims in excess of their staff PAYE/NICs costs will be able to access greater levels of payable credit.

3.16 This will benefit a number of companies, especially start-ups, that are R&D rather than labour intensive, or where much of the labour costs are incurred on EPWs.

3.17 HMRC will ensure that mechanisms are in place to ensure that companies genuinely undertaking R&D are able to access repayments, while preventing companies from being set up solely for the purposes of generating payments from the Government.

Q8. Are there any particular safeguards that companies think would be effective but not add significantly to compliance burdens to ensure the removal of the PAYE/NICs cap on the payable credit is not abused?

Going concern definition

3.18 In addition, the Government would welcome views on whether it would be beneficial if the definition of 'going concern', which a company has to be to qualify under the State Aid rules

¹ There is already a provision that for companies in the same group, if work would be R&D for the customer, it is treated as if it was R&D for the subcontractor.

governing the SME scheme, should be reformed. This proposal would be to bring them in line with those currently operating for the EIS/VCT schemes.

3.19 Under the current definition, the key issue is whether the last published accounts were prepared on a “going concern” basis. The problem is that the last published accounts may relate to a period some time ago, and the company’s circumstances may have changed – for better or worse – since that time.

3.20 When a similar condition needed to be introduced to the Enterprise Investment and Venture Capital Trust schemes, rather than adopting a “going concern” test, the rule was linked directly to the EU concept of a “company in difficulty” (see the European Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (2004/C244/02)).

3.21 HMRC guidance concerning the application of this concept to the EIS and VCTs schemes is at

<http://www.hmrc.gov.uk/manuals/vcmmanual/VCM15015.htm>

and – with the caveat that points of detail may differ slightly between R&D relief, which is concerned with companies incurring expenditure, and venture capital, which addresses companies raising money – the overall interpretation would be similar.

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

Impact assessment

3.22 An impact assessment of the effect of the changes announced at the Budget, focusing primarily on the SME rate changes, was published in the Tax Impact and Information Note alongside the Budget (Page A49 of the Overview of Tax Legislation and Rates).

3.23 This section of the consultation document seeks feedback on the impact of the simplification proposals and for some of the proposals, the exact form in which they may be introduced will determine the impact. Overall, the Government believes that the simplification proposals set out here are deregulatory, but would welcome any feedback to inform the impact assessment that will be published with draft Finance Bill clauses in the Autumn. The main impacts are considered to be on companies within the SME scheme and these are outlined below. Other impacts are expected to be small and are summarised in the table below.

Administrative burdens/impact

3.24 Around 6,500 SME companies claim R&D tax relief each year, with a cost to the Exchequer of £230 million. The large company scheme benefits around 2,200 companies each year with an Exchequer cost of around £700 million.

Removing relief for expenditure on qualifying indirect activities

3.25 The Government’s view is that determining what does and does not qualify under this heading is disproportionately complex, so that while excluding these costs will narrow the scope of the relief slightly, overall the effect will be positive. The Government would welcome feedback from companies making claims for QIAs as to the proportion of their qualifying expenditure that comes from QIA costs.

Claims by subcontractors

3.26 The Government's view is that a system where claims by the subcontractor are facilitated by information from the customer can only work if the customer's participation is voluntary. The suggested change therefore increases the scope of the relief without imposing an undue burden on customer companies, since they will have the option not to participate. Again, the Government would welcome any evidence from companies about the amount of expenditure which they have been unable to claim relief on, because of the operation of the existing subcontractor rules, which may qualify under the proposed changes.

Removal of PAYE/NICs cap

3.27 The Government's view is that the compliance burden will be reduced for those SMEs that currently have to limit their claims by reference to the PAYE/NICs paid in a particular period. Removal of the PAYE/NICs cap takes away the requirement that the availability of a Corporation Tax relief is predicated on the amount of payroll tax paid under PAYE/NICs.

3.28 Annually around 70 claims are limited by the PAYE/NICs cap (not including those companies with no PAYE/NICs at all). Such claims predominantly come from the smallest companies: over 70 per cent have turnover levels below £2m.

Going concern

3.29 Replacing the current accounts-based test for whether a company is a going concern, for the purposes of the SME scheme, with one based on the EU concept of a "company in difficulty" will require companies and agents to master a new definition. However, this will allow the judgement to be based on more relevant circumstances, giving a better result.

Advance assurances

3.30 The pilot of these is based on the assumption that the assurances, providing early certainty about the company's eligibility for relief, can only be helpful for smaller companies, which are the target of the pilot. If there are fundamental difficulties in practice such that the assurances provide little or no overall benefit compared with present practice, then Government would not proceed with wider implementation of the idea.

Impact on the third sector

3.31 This is a corporate tax measure and will only impact on businesses which are liable to corporation tax in the UK. It is therefore not expected to have any impact on the third sector.

Summary of other impacts

Table 3.A: Summary of other impacts

Impact on individuals and households	This is a corporate tax measure so will not impact on individuals.
Equalities impact	This is a corporate tax measure. No impacts on race, equality, gender, disability or other equalities are anticipated.
Wider environmental impact	By encouraging research and development in high-tech industries, R&D tax credits are expected to contribute to the development of low carbon technology and technology to reduce carbon emissions but we cannot quantify actual impacts at this stage.
Health impact	By encouraging research and development in high-tech industries such as pharmaceuticals, R&D tax credits are expected to have a beneficial effect on health areas although these benefits have not been quantified at this stage.
Competition	R&D tax credits are not sector specific and support all companies with qualifying R&D spend.

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

Summary of questions

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?

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?

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?

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

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?

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

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?

Q8. Are there any particular safeguards that companies think would be effective but not add significantly to compliance burdens to ensure the removal of the PAYE/NICs cap on the payable credit is not abused?

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

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

4

Timetable for further consultation and implementation

4.1 The timetable for further consultation and implementation is as follows:

Table 4.A: Timetable for further consultation and implementation

June 2011	HMRC publication of draft guidance on production.
Finance Bill 2011	Increase in SME rate to 200%; reduction in number used to calculate payable credit; reduction in VRR for SMEs.
31 August 2011	End of further consultation period.
Autumn 2011	Publication of draft Finance Bill: including removal of PAYE/NICs cap; abolition of minimum spending requirement; increase in SME rate to 225%; removal of VRR for SMEs. Following consultation responses, potentially subcontracting; EPWs; QIAs; companies in difficulty. The Government will consider the responses to the questions on a potential move from a superdeduction to an 'above the line' credit. HMRC finalising guidance of production and amending manual. HMRC pilot of advance assurances.
Budget 2012	Confirmation of legislative changes to be enacted in Finance Bill 2012.
Finance Bill 2012	Legislation.

How to respond

Please send comments, by 2nd September 2011 to: Mike Crabtree or John Quinn, R&D Tax Credits Reform, Excise and Enterprise Tax Team, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ

Email: corporatetaxreform@hmtreasury.gsi.gov.uk; or
mike.crabtree@hmtreasury.gsi.gov.uk or john.quinn@hmtreasury.gsi.gov.uk

Telephone (Treasury switchboard) 020 7270 5000

Confidentiality

4.2 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOI), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

4.3 If you want the information that you provide to be treated as confidential, please be aware that, under the FOI, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury (HMT) and HM Revenue and Customs (HMRC).

HMT and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A

The Code of Practice on Consultation

About the consultation process

A.1 This consultation is being conducted in accordance with the Code of Practice on Consultation.

The consultation criteria

1. When to consult - Formal consultation should take place at a stage when there is scope to influence the policy outcome.
2. Duration of consultation exercises - Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Clarity of scope and impact - Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Accessibility of consultation exercise - Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. The burden of consultation - Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Responsiveness of consultation exercises - Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Capacity to consult - Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

A.2 If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Consultation Coordinator, Better Regulation and Policy Team, H M Revenue & Customs, Room 3E13, 100 Parliament Street, London, SWA 2BQ

020 7147 0062 or e-mail hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

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