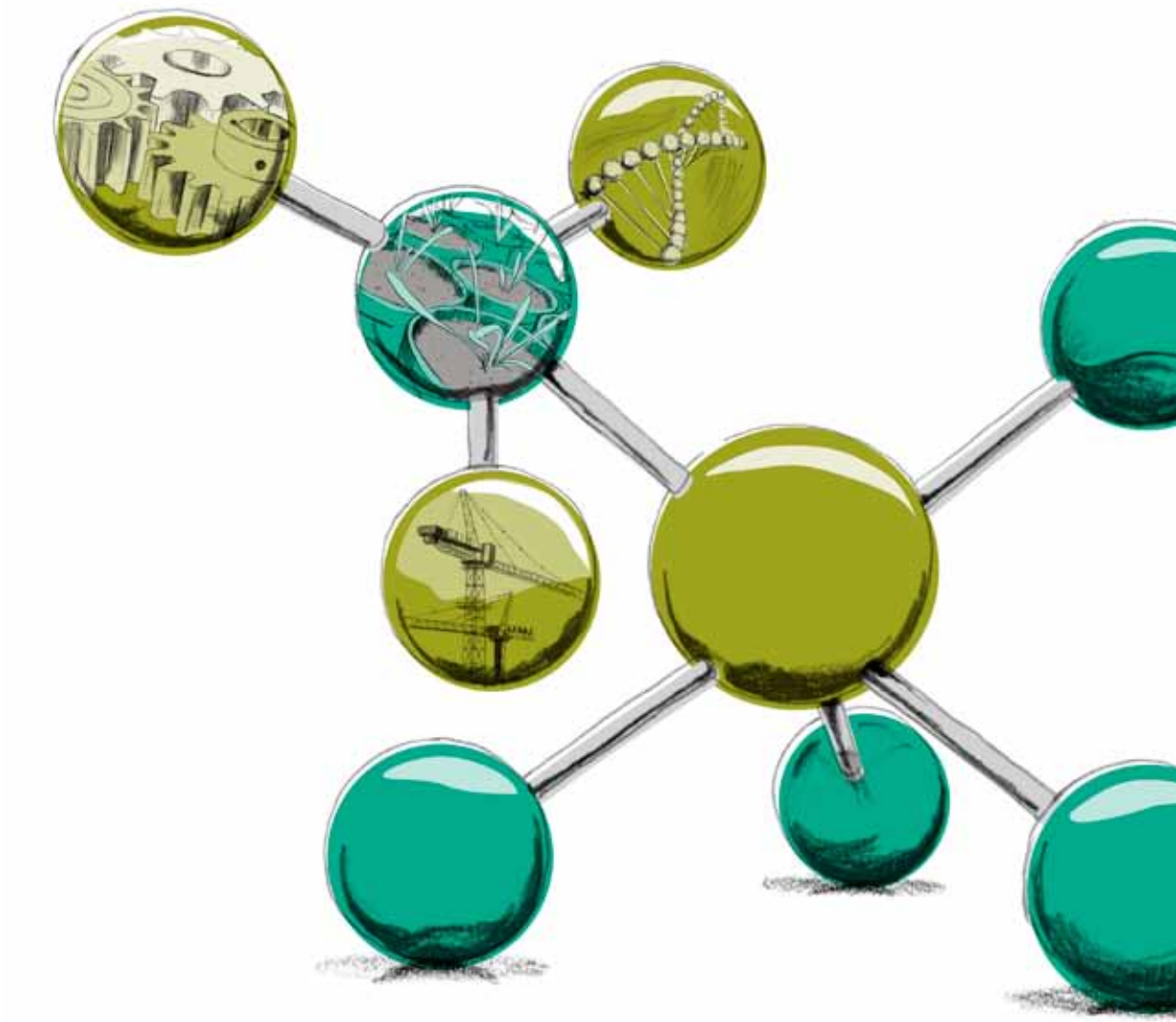
Grant Thornton

# The Dyson effect and the future: Tax incentives for research and development in the UK

**December** 2010



**Samantha Vanags**
Head of R&D Tax, Grant Thornton

"This tax relief provides a clear incentive for companies to invest in R&D activities, which are important to the UK economy - preserving the relief and making it more accessible to companies will help develop the UK as a centre for innovation and support general economic growth."

**Francesca Lagerberg**
Head of Tax, Grant Thornton

"Creating the most competitive corporate tax regime in the G20 is one of the objectives of the coalition Government - expanding the current R&D tax relief must be a key part of this in order to provide an incentive for companies to choose the UK as a base for their R&D."

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# Foreword

"The CBI's Tax Taskforce recognised that while a low headline rate for corporation tax was a key policy objective, this needs to be supplemented by R&D tax credits to address genuine market failures in the investment profile of companies."

**Dyson Report, March 2010**

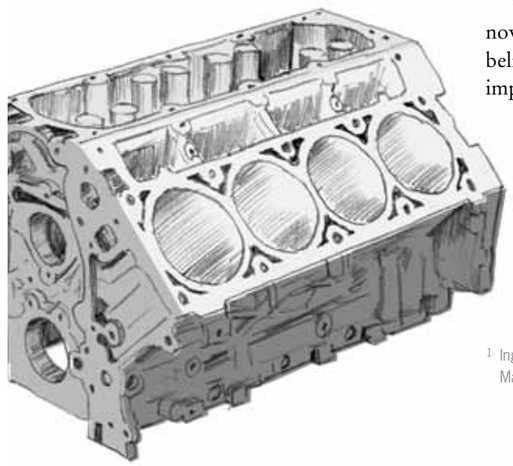
Sir James Dyson's Ingenious Britain report (Dyson Report)[1] is an important document for everyone involved in research and development (R&D) across the UK. Published in March 2010, it sets out recommendations for the Government to support this aspect of business through specific financial incentives. The Conservative party supported some of the recommendations during the election campaign, but now we have a coalition Government, will these ideas form the basis of future policy?

The Dyson Report suggests that the relief be refocused and directed towards high-tech companies, small companies and start-ups. This is on the basis that these companies face higher barriers to maintaining a sustained R&D programme. The report suggests that when the public finances allow, the rate of R&D tax relief should be increased to 200%. The report also recommends that the Government should improve the ease with which the R&D tax credit can be claimed.

With a Government consultation now underway, Grant Thornton believes it is vital to emphasise the importance of R&D tax relief and make our own recommendations based upon the Dyson Report. We act for over 500 companies who will be affected by this consultation. These companies are drawn from a wide range of sectors including automotive, manufacturing, IT, defence, bioscience and even food production. R&D tax relief has a positive effect on these businesses, and through them on the wider economy. Our recommendations suggest ways to safeguard those beneficial effects.

It has taken 10 years for these positive effects to become embedded in our economy, working their way into the running, planning and location of innovative companies. While it can be argued that investing more in this area will have an even greater benefit, we realise that this may not be realistic in the current financial climate. What we can do, however, is protect the progress we have made so far and continue to reap the rewards for years to come.

This document summarises the current global and UK context of R&D tax credits, and highlights the areas most at risk from change. It also provides clear recommendations for future legislation.



[1] Ingenious Britain: Making the UK the leading high tech exporter in Europe, March 2010, http://www.dyson.co.uk/insideDyson

# Our response in brief

We would like to highlight our three most important recommendations in response to the Dyson Report. They are:

**1. We support the continuation and enhancement of both small and medium enterprise (SME) and large company R&D tax relief schemes.**
These schemes have been effective in increasing investment in R&D. In a CBI survey in November 2008[2], 76% of respondents making an R&D claim said that the relief had helped to maintain their level of R&D spending. A further 37% had already increased R&D as a result of receiving the relief. This is clearly a key incentive for companies to invest in R&D.

**2. We do not agree that R&D tax relief should be restricted to 'high-tech' companies.**
Our clients' experiences show that R&D is pursued in a wide range of sectors, including – but in no way limited to – life sciences, manufacturing, engineering, and IT. Companies of every size in all of these sectors are investing in the UK's future income streams. Therefore, we believe that removing companies from the scheme by reference to their size or the proportion of their costs invested in R&D would negatively impact the economy.

**3. We think that more should be done to help early stage SMEs and start-ups.**
This can be more simply and economically achieved by increasing the rate of cash back offered when companies surrender losses for an R&D tax credit.

You can read our other recommendations on page 10.

[2] Impact of the R&D tax credit: Adding Value, reducing Costs, investing for the future, February 2010, http://www.cbi.org.uk/pdf/20090204-cbi-r&d-tax-credit-survey-report.pdf



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# The macroeconomic view

The UK cannot afford to lose the benefit of what it has already invested in R&D. The benefits we enjoy from the current system stimulate opportunity across nearly every sector of business, and as such represent an investment in our financial future.

Future income growth will come from the expansion of the knowledge economy. Traditional UK sectors are static or in decline: manufacturing is not on a growth curve; financial services are not yet poised to retake their position in the UK economy.

The incentives to stimulate this knowledge economy are already in place, and are already working. The Dyson Report points out that there is evidence that R&D tax credits have an impact on raising levels of R&D investment. The report contained many ideas for making the UK the leading high-tech exporter in Europe, and among these ideas were upward revisions to the current R&D tax relief scheme.

There are two significant factors influencing future revisions. Firstly, the financial situation of the UK Government is such that we are unlikely to see investment by other means. The Dyson Report states that tax credits are preferable to grants and provide the advantage that they help companies who are prepared to invest in R&D themselves. This therefore represents a cost-effective way Government can offer financial advantage to R&D in businesses.

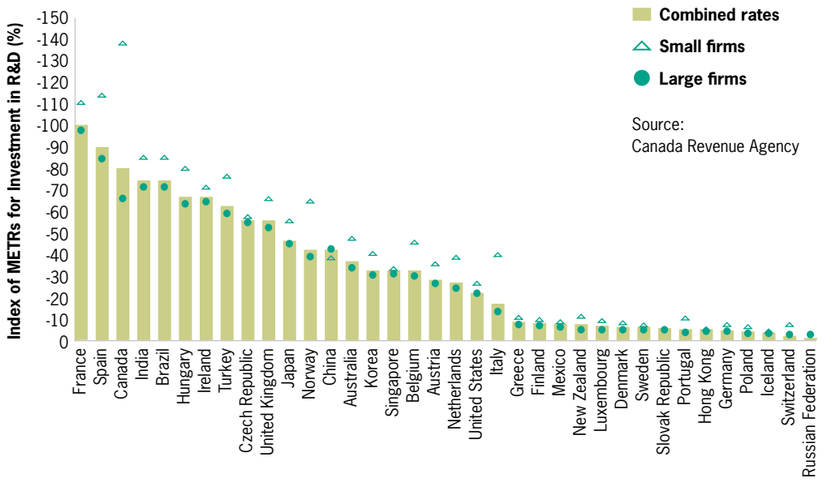
In addition, the current system has been in place for 10 years, and we are now seeing tangible benefits. This long period of increasing awareness and growing adoption of the relief has to be ongoing if we are to get good 'payback' from the investment made by the Government so far.

# How does the UK compare across the globe?

The UK is not alone in offering incentives for R&D. When we address changes to the UK's future relief scheme, we need to consider the benefits available elsewhere in the world.

Over half of the G20 countries offer some form of R&D tax relief. The Dyson Report places the UK 19th in terms of attractiveness of tax credits for R&D. Another study [Fig.1] of the Marginal Effective Tax Rate (METR) placed the UK schemes 10th most attractive globally for companies in R&D.

**Fig.1 Global attractiveness for investment in R&D**




Source:
Canada Revenue Agency

The Government's aim is to provide the most competitive corporate tax system in the G20

**From the consultation document issued December 2010 entitled 'Corporate Tax Reform: delivering a more competitive system'**

"Exports account for approximately 90% of our turnover and we regularly compete against countries such as Japan and China. The only way to remain competitive in the global marketplace is for us to maintain a high level of spend in R&D. The R&D tax credit allows us to invest more in R&D than we would otherwise be able to do; it acts as a force-multiplier meaning we can invest more money, earlier in the process which helps us to stay ahead of the competition."

**Jason Kingsley, CEO and Creative Director, Rebellion (SME company in the computer games industry)**





# UK rates of relief

### How the UK system works

The two existing UK schemes are offered to companies on the basis of their size. Companies which meet the definition of a 'small or medium sized enterprise' (SMEs) are entitled to a 'super deduction' of 175% of qualifying costs, while large companies are entitled to a 130% deduction. These super deductions directly decrease the companies' corporation tax liabilities.

SMEs can also reclaim cash from HM Revenue & Customs (HMRC) where they have made a loss for tax purposes. This 'R&D tax credit' can be worth up to 24.5p per £1 of qualifying expenditure, so can be very valuable to these companies.

One of the advantages of fiscal stimulus over subsidies is that companies are given greater certainty of their availability in advance and can plan accordingly.

The value of the tax losses is equivalent to 14% if a cash back claim is made. However, if the losses are carried forward and offset against future taxable profits instead, this can give relief of up to 29.75%.

**In order to provide relief when it is most needed, we would suggest that the rate of 14% is brought closer in line to the relief available to those companies already making profits.**

The timing of the R&D tax credit is also important. HMRC attempts to provide all R&D tax credit refunds within 28 days, although in our experience this is often faster if returns are filed online. To give greater certainty to companies it would be useful to provide a guarantee on how quickly the credit will be paid out.

### Relief is a proven stimulus to R&D

The R&D tax credit regime was introduced for SMEs in 2000. Since then, claims made by this group have increased by 255%, to 6,600 in 2009. Growth was 10% between 2008 and 2009, indicating that knowledge and take-up of the relief continues to expand. This could be higher: it should be the aim of Government to increase knowledge of the scheme across all sectors.

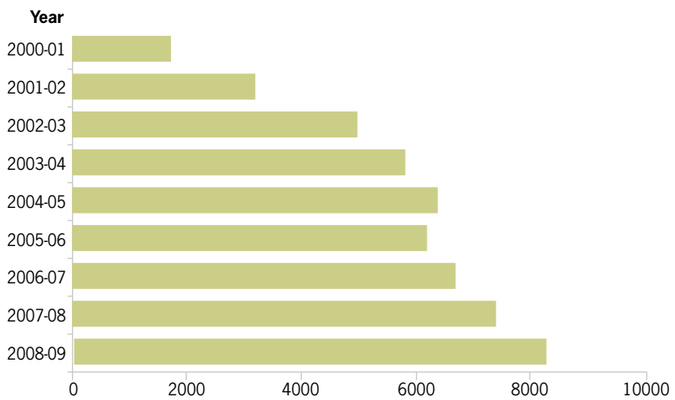
"The SME R&D tax relief has been very important in enabling Brady to continue to invest considerable resource in its development team, based at our headquarters in Cambridge. This investment in R&D is fundamental to the company's continuing growth and competitiveness and so also to the contribution it makes to the UK economy. We believe that this relief is too valuable to UK business to be limited to specific sectors or size of companies. We would also welcome greater clarity on the boundaries of eligible R&D and would be strongly in favour of an extension of the relief to reward more commercial development activity as this too benefits the UK economy as long as it takes place in the UK."

**Tony Ratcliffe, Finance Director, Brady Plc**

"The UK R&D tax relief scheme encourages investment in new technologies, however because of the current proposed consultation over the scheme and previous changes to the legislation it is difficult for companies to get long term certainty that the investments they make, or are planning to make, will qualify for R&D tax relief. To ensure UK companies continue to invest in R&D activities the Government should stand by R&D tax relief, and should also look to extend their current definition of what "R&D" is, to show that the UK continues to prioritise and promote R&D in all its forms."

**Louisa Evans, Head of Finance, Williams F1**

**Fig.2 Growth in claims of R&D tax credits across all companies in the UK**




Source:
HM Revenue & Customs

Fig.2 shows the increase in the number of companies making R&D claims from 2000 to 2009. The take-up clearly reflects a growing knowledge of the tax benefit since it was introduced.

The total cost to the Government of both SME and large company schemes was £980m in 2009, up from £810m in 2008. This represents an average cost of £39k per SME claimant in 2009 (£42k in 2008) and £329k per large company in 2009 (£276k in 2008). These schemes offer significant cash incentives to companies, without a significant administrative burden or cash spend for Government.

"The UK has a great tradition of science, engineering and invention . . . in the buildings and bridges of Wilkinson Eyre; Formula One cars of Williams and McLaren; the high-tech submarines of BAE; and the pharmaceutical breakthroughs made at GlaxoSmithKline and Astra Zeneca."

**Dyson Report, March 2010**

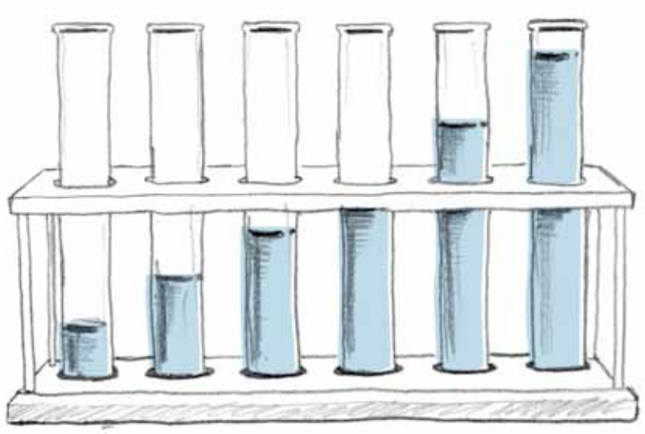
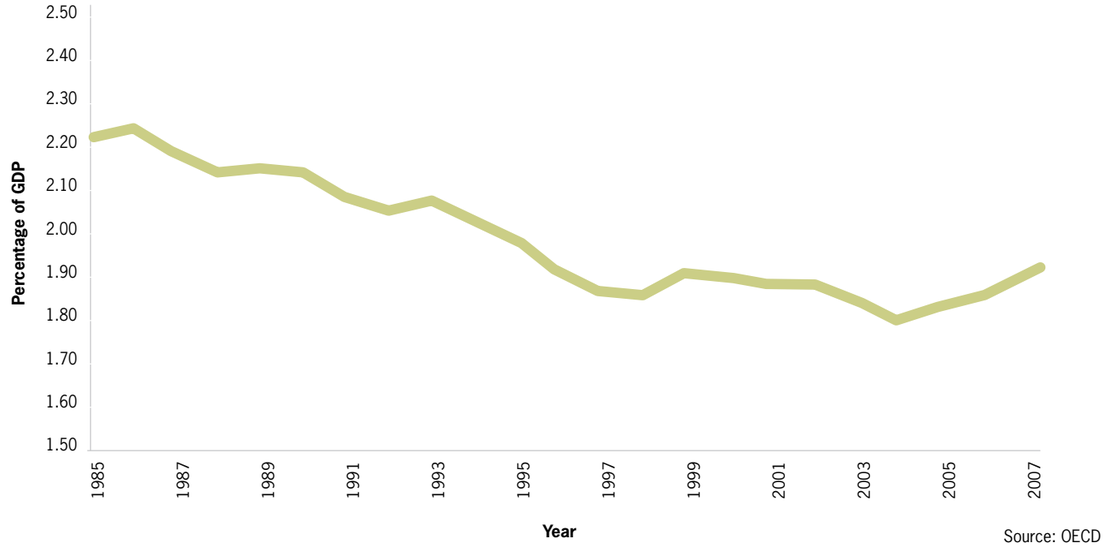






**Fig.3 Gross domestic expenditure on R&D as a percentage of GDP for the UK**




Source: OECD

"Dyson invests around £1 million a week in research and development. It is because of this investment that we were the second highest filer of patents in the UK after Rolls Royce last year. Such is the importance we attach to R&D that we are doubling our Wiltshire-based engineering team to 700. The tax credit helps us to develop patentable ideas and create goods to export from the UK to the rest of the world. To new companies and start-ups, its support can be essential to their survival."

**Sir James Dyson, letter to the Times 11 August 2010**

As Fig.3 shows, the percentage of gross domestic product (GDP) spent on R&D had been showing a decline for a number of years. In 2002 the Government widened the R&D tax relief scheme to include large companies, with claims being made from 2003. Since then the percentage of GDP spend on R&D has increased, reversing the decline.

### Who qualifies?

There are no restrictions on the type of company than can qualify for R&D tax relief. Activity will qualify as R&D if it meets two key criteria:

- it seeks to make a technological advance, and
- it seeks to resolve scientific or technological uncertainties.

This encourages all UK companies to undertake challenging and cutting-edge research activities. The criteria are drafted to reflect the fact that companies in many different markets undertake research and extend the overall offering of UK companies.

The Department for Business, Innovation and Skills (BIS) guidelines require that competent professionals determine the standard at which activities are regarded as R&D. This standard offers incentives for UK companies to make full use of their expertise to generate new ideas and value within their companies.

The Dyson Report says: "High-tech companies could be defined on the basis of their levels of R&D activity to ensure that companies across all sectors can benefit." Companies of different sizes across a wide range of sectors undertake R&D activity, which forms different proportions of overall spend.

**Even if R&D forms only a small part of their activities, so long as it aims to bring technological solutions into the UK marketplace we believe it is worthwhile.**

We support the Dyson Report's recommendation that the SME rate be increased to 200%, further enhancing the incentive to smaller companies.

# What are Grant Thornton's other recommendations?

### 1. A simpler definition of a SME

The definition of a SME is determined by the assets, turnover and employee numbers of a group. However, the rules surrounding which group companies should be included, or included on a proportional basis, are complex. This is an area where our clients often have to seek specific advice.

Start-ups and small companies often seek a variety of different finance options – for example, the issue of different classes of shares and convertible loans. Each of these must be examined to determine the effect for R&D purposes.

A simpler definition of a SME would be welcomed. We suggest that the removal of any aggregation of partner enterprises would be a useful step.

### 2. Wider categories of qualifying cost

Current legislation defines qualifying categories of costs in great detail. Some of our clients find these categories confusing. For example, telephone costs incurred in R&D activities cannot be claimed, but light, heat and power costs qualify. This confusion makes compiling an accurate claim more burdensome.

We suggest widening the current categories of costs to allow: self-employed consultants, recruitment costs, travel necessary for R&D, benefits in kind paid to employees, other costs incurred in undertaking R&D activities and costs incurred in employing and incentivising key staff involved with R&D.

We also recommend that complicated rules for externally provided workers be amended so that any type of supply of external workers involved in R&D also qualifies for relief.

### 3. R&D in the production process should qualify

HMRC's current interpretation of the BIS guidelines means that activities qualifying for R&D tax relief cannot have duality of purpose, so activities cannot be carried out for both R&D and production purposes. This discourages R&D during a production process, such as the new high-speed rail network mentioned in the Dyson Report; the overall objective of the relief ought to encourage all R&D activities.

### 4. Rethink the going concern rule

If a company becomes reliant on their R&D tax credit, so that without this support they would cease to be a going concern, the credit becomes unavailable to them. Such withdrawal of support contributes to the failure of small companies, rather than assisting in their survival. We suggest that in these cases R&D tax credits should be used against outstanding Pay As You Earn (PAYE) and National Insurance Contributions (NIC) liabilities and are carried forward against future liabilities to the extent they cannot be used.

### 5. An introductory tax credit

The French R&D tax relief system offers higher relief rates for companies making R&D claims for the first time. We advocate a similar enhanced scheme for newly created SMEs in their first 2-5 years.

Reducing the availability of R&D capital allowances for start-up companies can offset this. Currently, these offer a 100% tax deduction for capital expenditure on R&D equipment or facilities in the year of expenditure. These are useful for tax-paying companies, but do not contribute significantly to the tax position of SMEs. A reduction in capital allowances could help fund our suggested increase in introductory tax credits for new SMEs.

### 6. HMRC pre-agreement of claims

The creation of specialist HMRC units has made the process of claiming R&D tax relief more efficient, but companies are still uncertain whether their claims will be subject to compliance checks, enquiries, etc. It would be useful if HMRC could pre-approve claims to give more certainty over the amounts of relief and cash credits available to companies. This could be subject to parameters to be set by HMRC, such as R&D spend in future periods.



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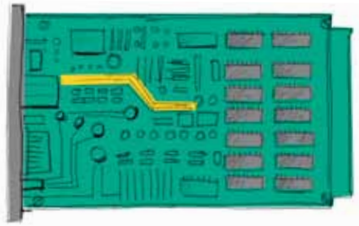
# Questions for you to consider



These are some of the specific questions raised in the consultation document. We would like to include feedback from our clients and claimant companies in our response to the consultation document. We would therefore be very happy to receive your feedback.

**Please email your comments to samantha.j.vanags@uk.gt.com**

### R&D tax credits

- Do they enhance the competitiveness of the UK corporate tax regime as a location for businesses to develop, hold and exploit Intellectual Property (IP)?
- Do they represent value for money for the taxpayer, and are they affordable within the wider Government priority of addressing the deficit?
- 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?
- Are there additional costs that should be eligible for relief under the schemes?
- Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?
- 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?
- Would respondents welcome a statutory definition of production? If so, what should it include and exclude?
- 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?
- 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?

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