

Research and Development tax credits: response and further consultation

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to respond to HM Treasury's (HMT's) on-going consultation into research and development (R&D) tax credits and in particular the specific policy proposals as set out in the response and further consultation document of June 2011.

Following the original consultation document published in February 2011 and the responses from industry we welcome the changes to the scheme for small and medium-sized enterprises (the SME scheme) implemented in the latest Budget and the proposed changes to the large company scheme referred to in the most recent consultation document. It has been encouraging to us and our clients that the Government has listened to and acted on the feedback provided by industry and we are pleased to provide comment on behalf of our clients on the further questions raised. Following on from our last submission we have found an increased willingness on the part of our clients to provide further input into the process and a perception that HMT is genuinely engaged and interested in their views.

We particularly welcome the proposals to simplify the rules regarding agency workers which we hope will give credit for all staff working alongside one another on the same basis regardless of how they are paid. Our smaller clients have also confirmed that the proposed formal system of voluntary advance assurance will provide greater certainty for them and look forward to partaking in the pilot scheme as it becomes available.

Our general comments in respect of the further consultation document, along with some specific responses to certain questions raised within, are set out below.

Our clients' views

Our response to the consultation document has been prepared by reference to the views of our clients and other interested industry parties representing a broad cross section of companies undertaking R&D activity.

Following the publication of the consultation document in June we have held a live webinar attended by 115 persons. Participants were able to provide us with their views through interactive polls on the consultation document, its specific proposals and make suggestions as to which areas are of most importance to them. We also held one-to-one discussions with clients that we were able to meet with in person. From the webinar and these discussions, we have been able to identify common themes and changes for which there is popular support. Our clients have provided a great deal of positive and constructive feedback, and we hope that this will prove useful.

Before relating our clients' responses to the specific questions raised, we want first to reiterate the fact that R&D tax relief is something which is valued by the companies with which we spoke, and the current system is working well. While there are still areas in which some changes and improvements are suggested, the principle of providing support for innovative companies through the tax system remains fundamentally popular. Our larger clients commented that without this relief they would be less likely to maintain an R&D presence in the UK, while SME claimants indicated that the relief is vital in enabling them to maintain R&D investment in the current economic climate. They are acutely aware of the erosion of the effective rate of relief as corporation tax (CT) rates fall towards 23%. Already, the effective rate for large companies paying CT at the main rate has fallen from 8.4% to 7.8% and will eventually fall to 6.9%. This is a relative fall of nearly 18%. With increasing international competition to attract R&D activity, we

believe the Government should take measures to prevent this erosion of the R&D effective rate. The obvious way to do this would be to increase the rate of the enhancement.

Response to the consultation

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?

We have received a mixed response from clients with regard to the proposed 'above the line' system. While some large companies see this as a benefit allowing them to better incentivise their R&D teams, others see it as adding unnecessary complication to a system that is already working well.

Whether it would create more visibility of the impact of the relief within organisations seems to depend on whether they are UK or overseas parented. Those making the decisions about R&D investment in UK parented organisations are more likely to have a degree of familiarity with the relief, whereas it is currently ignored in some overseas parented organisations. Without an above the line credit the UK risks continuing to appear unattractive to the latter group. In response to this, the merits of an opt in to an above the line system or making above the line apply to large company claims only should be considered.

Some of our clients are concerned that, under an above the line structure, the quantum of relief would be more visible to their customers who may demand a share in the benefit. This is particularly true of companies who budget for projects based on hourly rates derived from above the line figures. Consequently, the benefit (and incentive to undertake R&D) could effectively be removed from the company undertaking the R&D.

At the webinar, attendees were split, with 51% believing that this would increase R&D in the UK, and 49% thinking that it would not.

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?

There has been strong support for making the relief more valuable for loss making companies, whether or not above the line is introduced. This would especially help loss making companies engaged in highly speculative R&D perhaps most in need of the relief. In our webinar, 79% of attendees believed that a payable credit for large companies would increase the level of R&D activity in the UK.

Given the operational objections by HM Revenue and Customs (HMRC) against a payroll taxes offset, this may mean that it would have to be a cash credit like the SME scheme. In terms of how the credit should be structured, the French system of making it payable after three consecutive years of losses has been suggested. However, an immediately payable credit would be preferred, providing more immediate mitigation of the risk associated with R&D investment.

There was broad acceptance of an above the line credit being taxable providing the gross rate is increased so that post tax, the credit is worth no less than it is now. This would give the Chancellor a good news announcement (rate of R&D tax relief increases) at no cost to HMT. It is important to clients that any R&D credit remains effectively tax free.

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?

The availability of a payable credit to large, loss making companies **equal** in value to the relief available to profitable companies would be much simpler than that in operation under the SME scheme. As a single percentage of qualifying R&D spend (whether profitable or loss making), the calculation of the relief would be solely dependent on the quantum of R&D spend providing decision makers with a more predictable means of valuing the relief.

The implications of such a change to the Exchequer would largely be one of timing rather than cost - providing loss making companies with access to relief when they most need it rather than at some time in the future when they have returned to profitability.

The large company scheme is already discounted against the SME scheme and a further discount should not therefore be seen as necessary.

Although 56% of our webinar attendees thought that a discount should be applied to recognise the value to loss makers of being able to utilise a credit immediately it should be noted that a significant number of these were likely to be representing SMEs.

One client has expressed the opinion that if the benefit were to be less, it should be approximately 90% of the benefit available to profitable companies.

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

The schemes are well established and effective at promoting R&D investment in the UK. Not surprisingly therefore, many of our clients are concerned about any modifications to the scheme that result in extra complexity with no significant improvement.

Where the scheme is working as intended, promoting all the activities related to R&D, they would prefer that it remains in its current state. Where significant improvements can be achieved, in making the scheme fairer to both loss making and profitable companies, any necessary modifications should be implemented in as simple a form as possible. Where changes result in complexity with only minor benefits, our clients would choose simplicity over the potential benefit.

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?

Feedback from our SME clients has shown that in general they are comfortable with the structure of the existing scheme and would be reluctant to move to a new structure that they perceive will bring added complexity. In contrast with large companies, the finance and research departments of SMEs tend to be sufficiently close as to make the relief visible to all interested parties and decision makers of the company. Consequently, the advantages of an above the line system are less relevant to SMEs than they are to large companies.

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

Given that QIAs have only recently been introduced as qualifying expenditure, this question has come as a surprise to many of our clients who see indirect activities as integral to their R&D process.

For the clients we specifically advise on R&D tax relief we estimate that 70 - 80% include the costs of QIAs and feedback suggests that they provide a real, significant benefit to companies.

50% of attendees to the webinar believed that QIA relief is a benefit, and wish to retain it. The remaining 50% either do not currently claim, as they believe it does not provide sufficient value for the effort required or do claim, but believe it is not significant enough to justify retention. The latter group would benefit from clearer guidance as to make the claim simpler to quantify.

We would therefore recommend one of two solutions:

- Provision of additional clarity on what constitutes a QIA. Some companies, particularly SMEs, feel that the effort required to calculate the value QIAs is not worth the benefit that it provides. A clear definition of what activities are allowable and the methodologies by which they may be determined would simplify this process, and improve its value to SMEs. It is important that this definition covers all QIAs, and not solely staff costs

- Given the real benefit of QIAs to companies who do claim, our clients have suggested that if they were to be removed, then the rate of R&D relief ought to be commensurately increased in order to make the change cash neutral to claimant companies

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?

In our webinar, respondents favoured certification over joint election and is likely to reflect the reluctance of a principal to agree to potential obligations under the joint election process with no benefit to themselves.

However, respondents were actually in favour of a self-assessment approach over both certification and joint election. While we are aware of HMRC's concerns over confidentiality it is generally our experience that potential claimants have a good knowledge of their customers and would generally be able to provide evidence to support the activities as R&D in nature. We would suggest that where this is possible, and a claimant would not be in breach of any contractual confidentiality clauses it may make a claim without either of HMRC's proposed structures. Where this is not possible we would suggest a claimant company be able to fall-back on the certification process.

50% of attendees to the Grant Thornton webinar identified self-assessment as their preferred method. 23% favoured joint election and 27% certification.

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? The removal of the PAYE/NICs cap is welcomed by our clients, and is anticipated to simplify SME claims significantly.

Any foreseen abuses that might result from the removal of the PAYE/NIC cap not already captured by section 1112 of the Corporation Tax Act 2009 could be countered by the inclusion of further 'disqualifying purposes'.

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

Grant Thornton is of the view that the current definition used for whether a company is a 'going concern' is already fit for purpose. A change linking this definition to the EU 'company in difficulty' is likely to add unnecessary complexity to the process, and is likely to disadvantage some companies, particularly SMEs, without due cause. Clients have expressed the opinion that as the Financial Reporting Council (FRC) continues to require more disclosure in company accounts around going concern assumptions, diverging the accounting and tax definitions of 'going concern' is unhelpful.

A facility for SMEs to claim under the large company scheme, even when not considered a going concern, would also be welcome.

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

Where we have statistical or anecdotal evidence to support the assessments and their impact we have included them as appropriate under the specific questions raised.

Contacts

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