

Intellect Response to HMT Discussion Paper 'Supporting growth in innovation: enhancing the R&D tax credit'

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1. Introduction

Intellect is the trade association for the UK hi-tech industry. Our members comprise organisations both large and small from the UK's information technology, telecommunications and electronics sectors.

Intellect is the body UK hi-tech companies must be active in to:

- Influence Policy
- Improve Markets
- Enhance Business Performance

Intellect welcomes the opportunity to comment on the July 2005 discussion paper ['Supporting growth in innovation: enhancing the R&D tax credit'](#). Intellect notes the number of consultations and discussion papers there have been on this key topic, and applauds the government's determination to address the issues.

Intellect would like to thank HM Treasury and HMRC for the valuable meeting we held on September 15, 2005. The comments in this response should be read in the context of that meeting.

2. Effective rates

Our broad overall view, stated many times, is that **with the notable exceptions below**, we welcome the R&D Tax Credit Scheme and believe it has been particularly effective for many SME's. However for large companies the effective rate is between 3.75% and 5% and the tax credit is in the

noise level. It will play little or no role in attracting R&D from multi-national companies who can choose where to carry out their R&D.

We note that in paragraphs 5.18 and 5.19 HMT have ruled out both broadening the scope and changes to the large company rate. In 5.21 HMT state that the tax credit will continue to offer a competitive rate for large companies. We agree that the net cost of performing R&D in UK is one key factor out of several, but nevertheless believe that at some point HMT are going to have to accept that the effective tax credit rate, which is as low as 3.75%, is in the noise level for large companies. HMT's 2014 goal will become unreachable as we will not attract R&D from outside UK.

3 Response to Question 6.2 – Improving the experience of claiming the credit

3.1. Software R&D

We believe that the tax credits rules and the way they have been applied by HMRC have introduced significant distortions for the Software R&D industry.

HMT, at the policy level, clearly recognise the importance of software as a major potential contributor to R&D. Here are a few extracts from the paper:

*5.13 Furthermore, R&D in technology-based firms, such as information technology, **software** and electronics is also giving an important boost to UK R&D.*

*Page 15 Nonlinear Dynamics Case study, which is entirely based on **software***

*5.7 The Institute for Fiscal Studies, amongst others, has highlighted the importance of the service sector in closing the productivity gap with the US. Recently, in common with other OECD countries, the proportion of total R&D in services in the UK has been steadily increasing, rising by 23% between 1998 and 2003. There are three main reasons for this trend. Firstly, it is driven by organic growth in in-house R&D amongst service sector firms, for example in **software**.....*

*5.8 The emergence of R&D in technology-based firms, such as IT, **software** and electronics, is also an important boost to UK R&D.*

*5.18 Two-thirds of 'vigorous' firms in 2004 have become so in the last five years. In particular, mid-range companies in high tech sectors such as IT hardware and **software** have shown the strongest signs of increased vigour.*

Given this policy recognition of the importance of Software R&D, it is therefore unacceptable to the industry that some tax inspectors seem to believe that innovative Software R&D cannot qualify for the tax credit. HMT and HMRC heard a number of quotes at the meeting including, for instance, the belief that Software R&D cannot be innovative if the software is written in an existing language. Above all, tax inspectors' approaches are patchy. 'Experts' (an HMRC description) were introduced to some claimants but appeared not to have any greater understanding. It is believed that one of the reasons the problems occur is that the output of an innovative Software R&D project is not visible to the inspector. If this is the case, it is important that tax inspectors understand that in many cases software can be implemented in hardware and it is an implementation decision. In other cases systems complexity is so great that it leads to technology uncertainty and therefore qualification for the tax credit

Some of these reported comments show that some tax inspectors do not understand the difference between R&D into Software (part of computer science) and innovative R&D, which uses software as the implementation vehicle.

Another example is that of inspectors, quoting Frascati¹, who have said that you cannot claim for innovative work associated with the building of a Graphical User Interface (GUI) for Financial Trading Systems. A major factor in gaining competitive advantage in Trading Systems is delivered via the GUI. Patents have been granted for Trading Systems GUIs, and so there is little doubt about the need for innovation. Inspectors must realise that R&D, as is now clear in the definition, is not just science. Old attitudes take some time to change!

Much R&D, including design of microchips and drug research uses basic building blocks. Innovative Software R&D did not stop after the development of the first computer language, nor did the development of GUIs stop after the invention of the mouse, just as jet engine R&D did not stop once Frank Whittle had invented the jet engine.

¹ Inspectors regularly refer to the Frascati definition of R&D. The UK definition must stand alone. The Frascati definition is very orientated towards science. The scientific orientation of the original UK definition of R&D was one of the first matters Intellect or its predecessors commented on. As a result of our comments (and others) the definition was changed.



It was agreed at the meeting (at least by the industry side) that HMRC should establish a centre of expertise for difficult technology issues and particularly in relation to software. There must be a more open approach by tax inspectors so that if a claimant feels blocked by an inspector who does not understand software, discussion can be opened with others – in the centre or elsewhere. (This addresses bullet 2 of 6.2)

After some discussion at the HMT meeting it was agreed that, in addition to the centre referred to above, the tax inspectors need a better 'knowledge of how the industry works'. Intellect has consistently offered to arrange suitable training for the Revenue. We remain happy to arrange an industry briefing or anything more technical.

We are puzzled and concerned that HMRC have let this software issue build up, as we are aware that others – not just the trade body for the industry – have expressed concern. Now is the time for HMRC to act!

We request a specific response, at the conclusion of the consultation, from HMT or HMRC or DTI regarding our offer to assist HMRC in achieving a better understanding of the industry.

Canada has had sector guidance available for a number of years, including a comprehensive version on software. HMRC are aware of it and in fact copied some of the statements out of it verbatim for the superseded Commentary on the previous Guidelines. If HMRC are not prepared to engage with the industry for some kind of guidance of the sort Intellect are offering, then perhaps a formal acknowledgement of the Canadian software guidance would be appropriate.

3.2 Capital vs Revenue Expenditure

Another market distortion introduced by the tax credit concerns the above. This is becoming more and more of an issue, especially for software claims.

Capital expenditure does not qualify for the relief (other than the 100% capital allowance) by statute. This is not consistent with the treatment in the US and Canada, where capital expenditure qualifies for the same benefits as revenue costs. It has been made clear that there is no desire to widen the R&D cost base, but given that there is a form of R&D capital relief at the moment then shifting capital expenditure, so that it is within the scope of the tax credit instead, is not broadening the scope of costs. Doing so would also be consistent with the policy aim that has been expressed, of

allowing the relief on "true" R&D costs i.e. those that would not have been incurred were it not for the R&D.

The impact of not allowing the tax credit on capital expenditure is particularly well demonstrated where companies treat in-house development costs as capital. If the aim of the system is to target R&D activity so that companies are encouraged to do more of it then there would appear to be no rationale for placing such companies at a disadvantage simply because of the way the cost is classified for tax purposes.

This is an issue affecting companies developing internal software and IT systems such as those in the financial services sector, together with a number of start up companies which spend their early years building software around which their business is based.

It has been reported that HMRC are targeting companies that have treated such costs as revenue and are claiming tax credits, where the Inspectors are arguing that in fact the costs are capital even though they have been classed as revenue in the accounts and tax computations. Sometimes this argument has been introduced late in the day, which gives the impression the Inspector is looking for any reason to try to disallow the claim if he or she feels they are on shaky ground on whether the work is R&D or not. In one recent case, a company was developing software which, if successful, would be licenced out to customers. This is a normal business model for software development houses yet the Inspector was arguing that the development costs are capital.

3.3 Distortions for all sectors of the hi-tech industry

On a wider front and not just related to software, our industry seeks the widest possible adherence to these principles:

Consistency
Certainty
Simplicity

Reported comments by tax inspectors at the HMT meeting included:

- You are an £11m company so you can't be doing R&D
- You haven't changed the laws of physics
- Most software claims fail

These comments do not add to our confidence in consistency and certainty. If doubt creeps into the system then there will be a cumulative loss of confidence.

Hi tech companies not in the software business also find that tax inspectors' approaches can be inconsistent and patchy and that a more open approach with access to other knowledgeable people in HMRC is required.

4. Response to Question 6.3 – Enhancing the credit & emerging winners

We applaud the government's determination to reach the target of 2.5% of GDP by 2014.

The discussion paper sends a strong message of the need to 'pick winners'. We do not understand how this can be done without compromising the basic market driven mechanisms.

We note HMT's expectation that 'enhancing the R&D tax credit' implies new money.

We face a challenge in putting forward suggestions which do not compromise market mechanisms. It is important to preserve simplicity. If simplicity is taken as a key driver, then it may be possible to define criteria in which the enhanced tax credit could be claimed, such as:

- Turnover (with an upper limit and possibly a lower limit)
- R&D spend (also with limits)
- R&D as a percentage of turnover in the last financial year.

Large R&D Grants were discussed but the disadvantages are clear and with one exception need not be repeated here. Large grants are often made for collaborative R&D projects and we do not believe this meets the original needs of the R&D tax credit scheme.

Another possible approach is to introduce an element of incremental incentive. Intellect opposed the original proposal that the whole of the tax credit for large companies should be based on an incremental approach. If it was decided to introduce a partially incremental approach to incentivise the 'emerging winners', Intellect reserves its position until we see the detailed proposals. As HMT mentioned, it has the obvious disadvantage of losing simplicity and no doubt certainty because of doubts during the financial year as to whether the R&D performance will go over a given threshold.



It might well incentivise companies emerging out of the SME band to have an element of incremental incentive – possibly a new band.

A further possible approach, which has been suggested, is for an additional incentive based on 'added value', certified by an auditor. However we have not had time to develop this concept further.

5. Conclusion

We believe that at some point HMT must accept that the effective rate for large companies must be raised above the 'noise level', even though HMT have ruled it out in this paper.

We believe that for Software R&D, in particular, implementation of the Tax Credit by HMRC must catch up with HMT's policy objectives. Elsewhere there are some patches where tax inspectors have not yet come to terms with their new role. The issue of tax inspectors' knowledge and understanding of practical R&D in our sector, and of software in particular, is still alive and really must be addressed. We request a specific response from HMT or HMRC or DTI regarding our offer to assist HMRC in achieving a better understanding of the industry.

We welcome HMT's desire to enhance the credit and will be delighted to discuss further practical suggestions. We oppose any market distortion mechanisms. However, we believe there are limited ways of identifying and rewarding emerging winners, without distorting the market.

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