Research and Development Tax Credits

Institute of Physics submission to a Treasury consultation.

A full list of the Institute’s responses and submissions to consultations can be found at www.iop.org

22 February 2011
Dear Mr Crabtree

Research and Development Tax Credits

The Institute of Physics is a scientific charity devoted to increasing the practice, understanding and application of physics. It has a worldwide membership of around 40 000 and is a leading communicator of physics-related science to all audiences, from specialists through to government and the general public. Its publishing company, IOP Publishing, is a world leader in scientific publishing and the electronic dissemination of physics.

This submission was prepared in consultation with the Institute’s Business and Innovation Board, with input from members of the Institute members working in small and large businesses that depend on physics.

The Institute welcomes the opportunity to respond to the consultation of Research and Development Tax Credits. The attached annex highlights key issues of concern to the Institute.

If you need any further information on the points raised, please do not hesitate to contact me.

Yours sincerely,

Professor Stuart Palmer FREng CPhys FInstP
Honorary Secretary

John Brindley
Director, Membership and Business
Research and Development Tax Credits

Question 3E: The Government welcomes any further general views on the Patent Box.

The Patent Box may well be a positive addition to the UK system, providing an extra attractor for multinational companies seeking a base and perhaps also acting as an 'anchor' to those larger R&D-intensive companies already in the UK.

However, the introduction of the patent box system should not be at the expense of other aspects of the Research and Development (R&D) tax credits system, particularly the 'large company' scheme (which some have suggested should be cancelled). Both the large and small company R&D tax credit schemes have only been in a place for a relatively short time, and might still be regarded as ‘bedding in’. Even so, early surveys by the CBI\(^1\) have suggested that some benefits to UK companies were being already accrued, and that the schemes are having greater effect year on year as firms become used to them. We would caution against introducing unnecessary uncertainty into the future of the schemes.

Question 4A: 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?

As noted above, the R&D tax credit schemes have been seen to be beneficial to both large and small companies alike. Recently it has been suggested that the scheme be 'refocused' exclusively on smaller, high-tech and start-up companies, we would argue that the scheme should be open to companies of all sizes undertaking research and development, regardless of how much of their business is dedicated to R&D.

An issue related perhaps more to practice more than structure is the perception from some physics-based businesses applying to the scheme that the assessors often have limited specialist knowledge of the processes that are involved in such organisations. If the scheme is to fulfil its potential as a driver of R&D in physics-based companies, it is essential that these companies have confidence in the scheme and those who operate it. We recommend that the training programmes of assessors be reviewed. This is an area that could perhaps benefit from greater interaction with the network of government Chief Scientific Advisers.

\(^1\)Impact of the R&D tax credit, CBI 2009
Question 4B: Are there additional costs that should be eligible for relief under the schemes?

The criteria for eligibility of staff training under the schemes could be expanded. While there is some provision currently, this is drawn too tightly and training that could legitimately be seen as a necessary prerequisite for research and development is sometimes excluded.

Additionally, there is perhaps scope for increasing the options for recognition of companies working with universities or other public research centres. Such knowledge transfer work could include companies that provide student placements that are part of specific courses but cannot currently claim relief on the facilities and management overheads they provide.

Question 4C: Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?

The consultation document suggests that relief might be limited or removed from the development of 'internal use software'. Many companies currently regard the development of such software as central to their R&D activities. It might be that in some companies, such software is developed for human resources management and financial management. However, in physics-based businesses, internally developed non-commercial software is often an integral part of development and testing. To remove or limit relief for such work would have a significant detrimental effect on this important sector of the UK's innovative economy.

Question 4D: 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?

We would recommend reviewing the current definitions used in the Tax Credit scheme, and particularly their implementation in practice, against those of the OECD described in the Frascati Manual, which are used in several other European countries.

Question 4E: Would respondents welcome a statutory definition of production? If so, what should it include and exclude?

Flexibility may be more appropriate than identifying a definite transition from 'development' to 'production'. Consideration might be given to allowing tax credits to 'fade out' over this period, since some R&D is often still taking place. If there is a desire to tighten up the system, a clearer definition of R&D might be more beneficial.

Question 4F: 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?

We would agree that it is essential that the complexity or bureaucratic burden must be kept to a minimum across the scheme. However, we feel that there are several
areas where minor adjustments could be made, which would be beneficial to smaller companies:

- There are specific issues related to the upper limits for claims made by early-stage smaller companies. At present this upper limit is dependent on the amount of tax paid by the company. As such, in loss-making start-ups, this limit can be strongly dependent on the level of staff salaries. This can have the effect of skewing some decisions of very small companies. For example, while under neutral conditions, a founder may have forgone their salary in order to maximise resource. Under the current rules, the founder might be forced to take a salary, in order for the company to retain tax credits. Given the small sums associated with such companies, consideration might be given to lifting the PAYE cap for ‘micro’ companies or very early start-ups.

- In some specific cases, interaction with European grants has left companies worse off, since a prospective grant has forbidden retrospective tax credits of greater value.

- Collaborative research and development is also not easily accounted for under the current system, both in terms of companies working with universities, and, more particularly, consortia of smaller companies who can find themselves at a disadvantage.

The net effect of such issues can be a significant increase in the time and resource that smaller companies must invest in applications, often needing to employ specialist consultants to manage their applications to the scheme – so incurring further expense (none of which is eligible for relief).

**Question 4G:** 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?

This is an area that falls outside the Institute's expertise.

**Question 4H:** 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?**

We welcome the continued emphasis on reducing the burden on small companies claiming against the scheme. In this context, we believe that the introduction of external audits would introduce a layer too many of bureaucracy for smaller companies with limited resources.
The Institute of Physics is a scientific charity devoted to increasing the practice, understanding and application of physics. It has a worldwide membership of around 40 000 and is a leading communicator of physics-related science to all audiences, from specialists through to government and the general public. Its publishing company, IOP Publishing, is a world leader in scientific publishing and the electronic dissemination of physics.

IOP Institute of Physics
76 Portland Place
London W1B 1NT

Tel: +44 (0) 20 7470 4800
Fax: +44 (0) 20 7470 4848
Email: physics@iop.org
Website: www.iop.org
Registered Charity No. 293851