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Submission to:

HM Treasury Consultation:

'Consultation on an 'above the line' credit for Research and Development (R&D)'

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From:

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This response is from AIRTO (The Association of Independent Research and Technology Organisations). AIRTO's members comprise representatives from:

- Public Sector Research Establishments (PSREs)
- Non-profit distributing member and non-member based research and technology organisations (RTOs),
- Privately held research and technology companies (including Contract Research Organisations - CROs)
- Universities (Enterprise/Technology Transfer Departments)
- R&D departments of industrial companies
- Business support (including Access to Finance) and early stage technology-based venture capital companies

AIRTO's members generally operate in the private sector but with varying degrees of interaction and financial involvement from the public sector. All are to a significant extent involved in aspects of the translation of ideas, research and technological advances into the commercial arena, for clients in both the private and public sectors.

AIRTO's response to the consultation is as follows:

Response to the new proposals

'Above the line' R&D Tax Credits

Feedback from AIRTO members in June 2012 has indicated that:

1. There is not an overwhelming case for an above the line "ATL" tax credit in place of the present Corporation Tax super-deduction ("Taxline Adjustment"). In particular, for non-quoted companies it is considered that the net cash flow after tax is likely to be the main consideration. For such companies it is doubtful that introduction of an ATL allowance *per se* would have much effect on the amount of R&D undertaken in the U.K.
2. The availability of a subsidy payment when no Corporation Tax is payable would be welcomed, but this would be more likely to increase the amount of R&D undertaken by "not for profit" organisations, (which would benefit from a cash inflow under the "ATL" proposals as set out) rather than for loss making profit distributing companies, who would be less likely to increase their expenditure on R&D.
3. Given State Aid Rules, it appears likely that current problems for RTOs funded by membership subscriptions would persist with the proposed new non-SME allowance/credit (see 10.1 below).
4. If a subsidy were payable, it could be most effectively administered by allowing it as a deduction from PAYE/NI, rather than as a separate payment from the Treasury.
5. Companies should be offered a choice between a Taxline Adjustment or an ATL allowance. This would mirror the current arrangements for the present SME-only R&D Tax Credit Scheme. In this way R&D Tax Credits would have the maximum impact in increasing the amount of R&D undertaken in the UK.

Observations on the operation of the current scheme and the impact of the new proposals

6. R&D tax credits are important to the Intermediate Research and Technology Sector because they provide a vital incentive to encourage innovation in the UK. They help offset risks, increase likelihoods of success and increase capacity for innovation.
7. However, with reference to the ATL Consultation document, feedback from AIRTO members challenges the assertion that the subsidy provided by the ATL allowance would increase the amount of R&D sub-contracted, particularly to private sector suppliers. Unless the concerns with the existing arrangements are addressed, the proposals could result in increased R&D being sub-contracted to universities and priority R&D being kept in-house rather than out-sourced, both at the possible expense of research work undertaken individually or collectively by RTOs. This would deny the expertise of RTOs being brought to bear on important R&D challenges for client companies.

This problem with the current R&D Tax Credit arrangements could be further exacerbated if the proposed ATL regime were to be effective in increasing the amount of R&D undertaken, increasingly placing RTOs undertaking R&D on behalf commercial companies at a relative disadvantage to universities and dis-incentivising the use of external suppliers to provide R&D services. The impact on capacity, flexibility and open innovation within the UK's R&D resource base could therefore be negative.

8. The above concerns are important for the UK as evidence exists which highlights the effectiveness of R&D carried out by RTOs when compared to the use of in-house facilities or research and development sub-contracted to Universities (*The contribution of research & technology organisations to innovation and Knowledge transfer; ESRC, 2006*). An R&D Tax Credit regime which gives equal benefit to RTOs and other organisations carrying out R&D would be most likely to result in increased R&D effectiveness and in turn increased R&D undertaken in the UK. AIRTO would therefore propose that legislative changes are introduced to address the issues in the present scheme and avoid further disincentives to R&D undertaken by RTOs on behalf of their clients. Some of the problematic features in the current arrangements are elaborated below.
9. The positioning of members on R&D tax credits varies considerably; however, issues variously identified with the current R&D Tax Credit regime by members include the following:
 - 9.1 In the present larger company R&D Tax Credit Scheme, a company cannot claim for R&D sub-contracted to another company but can claim for the costs of their own employees undertaking R&D. This provides a relative cost advantage to in-house R&D against work sub-contracted out to another company such as an RTO, even if that RTO is better placed and likely to be more effective in undertaking the research. This therefore operates to the detriment of RTOs, as previously noted.
 - 9.2 A commissioning company cannot claim an R&D Tax Credit on research contracted to a non "approved" RTO (see point 9.4 below) whereas it can claim R&D Tax Credit if the same research is sub-contracted to a University (by definition an approved body). This operates to the detriment of RTOs.
 - 9.3 Some AIRTO members have reported that because it is widely understood that some RTOs undertaking research funded by customers can claim R&D Tax Credits under the larger

company scheme, certain customers (usually a Government Department or Agency) demand a discount on the price. This is to the detriment of the RTO because not all project costs are allowable for R&D Tax Credit. Also, the tax credit provides no benefit to those RTOs who otherwise would not be paying Corporation Tax.

- 9.4 There is an allowance for larger companies making a contribution to an industry wide research project undertaken by an approved body. Approved bodies do include RTOs qualifying for the s508 exemptions and also charities (there are only about a dozen such approved RTOs), but the bulk of approved bodies are universities. Most RTOs are not approved bodies and payments to such unapproved bodies do not qualify for the tax credit, even when the RTO is undertaking an industry wide research project.
- 9.5 There is no such general provision for an SME to claim under the SME Scheme for a contribution to an industry wide research project. While an SME can claim for a proportion of sub-contracted research, the rules require the commissioning SME to acquire all the IPR in the work and also to use it within its own business. This deters SMEs from contracting-out research and in participating in collaborative research programmes.
- 9.6 Both s508 and charitable RTOs operate under restrictions which mean that the research they undertake cannot provide “an exclusive commercial benefit”. Universities however can undertake research which does provide such “an exclusive commercial benefit” to a single customer, provided that the academic content and credentials of the work are maintained (e.g. by making public a subsequent Ph.D. dissertation). S508 and charitable RTOs are required by legislation to disseminate all their research findings to the wider world within fixed and much shorter timescales. This is to the detriment of approved but non university qualifying bodies.

10. R&D Tax Credits Scheme for SME Companies

- 10.1 Regarding claims for R&D Tax Credits under the current SME arrangements, feedback from members has indicated that membership based research organisations may experience barriers to claiming due to present interpretation of legislation. Where membership subscriptions have been taken into consideration (despite there being no linkage to specific items of expenditure or R&D projects) the end result is that SME organisations which are funded in part by membership subscriptions are unable to claim SME R&D Tax Credits on generic research projects. The relevant sections of legislation are as follows:

Corporation Tax Act 2009 (c4)

1052 Qualifying expenditure on in-house direct R&D

(1) A company's “qualifying expenditure on in-house direct research and development” means expenditure incurred by it in relation to which each of conditions A to E is met.

...

(6) Condition E is that the expenditure is not subsidised (see section 1138)

...

1138 “Subsidised expenditure”

(1) ... a company's expenditure is treated as subsidised -

...

(c) to the extent that it is otherwise met directly or indirectly by a person other than the company.

...

(4) For the purposes of this Part a notified State aid, grant, subsidy or payment that is not allocated to particular expenditure is to be allocated to expenditure of the recipient on a just and reasonable basis.

10.2 Feedback from AIRTO members has identified an individual case where two separate HMRC Inspectors have rejected a recent SME's R&D Tax Credits claim on the basis that membership subscriptions paid to the company were directly or indirectly subsidising the R&D Projects which were the subject of the claim. This occurred despite there being no linkage between the item of expenditure, the R&D Project, and membership subscriptions. This is evidenced by the following facts:

- The Company's 'members' do not determine the R&D undertaken by the research organisation.
- The 'members' are unaware of the particular R&D projects undertaken until the results are published.
- 'Members' are given no indication of costs of an R&D project (whether spent, committed to, or allocated within budgets).
- There is no linkage between the expenditure on the R&D projects and any membership subscriptions (i.e., membership subscriptions are not varied if more or less is spent on an R&D project or on R&D projects generally).
- Membership subscriptions are set annually by reference to market factors which relate to the circumstance of the Member (i.e., how much they would pay) and the membership "product" offered by the Company and not to the R&D undertaken by the Company.
- The Company has always reported membership income as part of its trading income and assessed its liability to Corporation Tax including the subscriptions as income.

10.3 In this particular case HMRC maintains that membership subscriptions should be regarded as subsidising the R&D projects because:

- The members are aware that the amounts they pay will be applied, in part, to carrying out research and development on the industry's (and their) behalf.
- The membership subscriptions are set by an annual budgeting process that includes reference to the estimated costs of the research and development (as well as to other costs).
- If the company goes over budget, it has the capacity to increase membership subscriptions.
- The membership subscriptions are then applied, in part, to satisfying the costs of the R&D undertaken.

10.4 The consequence of this is that SME Research Associations which are funded in part by membership subscriptions would not be able to claim the SME R&D Tax Credits on their generic research projects (they are already precluded from claiming the SME R&D Tax Credit on the costs of client specific R&D). Consequently the additional credit given against Corporation Tax is reduced from 100% of the qualifying costs to 30% of (a more restricted range of) qualifying costs. The Association also loses the capacity to surrender unused R&D Tax Credits in return for a payment from the Exchequer if it is not paying Corporation Tax.

10.5 AIRTO recommends that, unless there are particular links present between a subscription and costs incurred or R&D projects undertaken, membership subscriptions in membership

organisations should not be regarded as subsidising the research undertaken by such organisations when assessing claims.

Declaration of interests

This submission is made by the Association of Independent Research and Technology Organisations (AIRTO). The organisation represents research organisations and technical consultants, operating in the space between the academic research of universities and the commercial needs of industry.

AIRTO members undertake applied research and development, and knowledge and technology transfer. AIRTO currently comprises organisations, employing more than 20,000 scientists and engineers, with a combined annual turnover in excess of £2billion. AIRTO Ltd. is a company limited by guarantee registered in England No. 1217006 Register office address: National Physical Laboratory, Hampton Road, Teddington, Middlesex, TW11 0LW. AIRTO is a not-for profit organisation funded by membership subscriptions, and managed under contact by NPL Management Ltd. The members of AIRTO currently are:

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University of Surrey
University of Greenwich

This submission does not necessarily represent the views of all individual member organisations but does represent an amalgamation of views from those expressing an interest in R&D Tax Credits.