

## **RESEARCH & DEVELOPMENT**

### **General description of the measure**

1. R&D tax credits for companies that are small or medium-sized enterprises (SMEs) were introduced in Finance Act 2000. After consultation, similar credits for large companies were introduced in Finance Act 2002.
2. Based on experience with the credits so far, the Government now proposes to make a number of changes to the qualifying rules. These will make it easier for companies, especially small companies, to qualify.
3. The Government has also announced that there will be consultation on the definition of R&D.

### **Operative date**

4. The changes to the rules will be included in the Finance Bill. For SMEs, they will then take effect as soon as approval has been received from the European Commission. These will therefore commence from a date yet to be announced.
5. The changes to those rules that apply to large companies will take effect from 9 April 2003.

### **Current rules and proposed changes**

6. Under general tax principles companies, of whatever size, can claim the whole cost of most of their current R&D expenditure against taxable income - a deduction of 100%. The R&D tax credits give SMEs a further deduction of 50% of their qualifying R&D expenditure, making 150% in all. Large companies are entitled to an additional 25% deduction, making 125%. SMEs which make losses can surrender the deduction to the Treasury in exchange for a payment (a credit) of 16% of the loss (equivalent to 24% of the original expenditure).

**£25,000 minimum expenditure**

7. Companies claiming the R&D tax credits are required to spend a minimum of £25,000 on qualifying R&D in an accounting period. It is now proposed to reduce this to £10,000. This will help small companies in particular to claim the relief.

**Staffing costs**

8. Qualifying expenditure consists of the R&D related costs of staff and of consumable stores (and also on certain costs of subcontracted R&D work).
9. The current definition of "staffing costs" focuses on staff employed by the company carrying out the R&D. It does not include workers paid through a third party and not taken on by the R&D company. The Government now proposes to include the costs of such workers.

**20%-80% rule**

10. Under the present rules, if an employee spends less than 20% of their time on R&D, the company cannot claim for their costs. For someone who spends more than 80% of their time on R&D, the company can claim 100% of the costs. To simplify the relief (and prevent small amounts of work from being disqualified) it is now proposed to abolish this rule and simply apportion staff costs.

**Extending the coverage of the large company scheme**

11. The SME tax credit is a state aid, approved by the European Commission. To avoid the amount of state aid that a company receives exceeding the maximum permitted, when an SME gets another state aid (usually a grant) for a project, it cannot claim the SME credit. This means that it receives no extra R&D relief.

12. A large company in the same situation would be able to claim the large company tax credit, as that is not a state aid. There are already limited circumstances in which an SME can claim the large company credit, and it is now proposed to extend these to include the situation described above.

### **Definition of Research and Development**

13. The definition of R&D currently used is set out in guidelines produced by the DTI, under S837A ICTA 1988. This definition was introduced, after consultation, in 2000 at the same time as the SME credit.
14. The SME tax credit has now been operating for nearly three years. In that time a number of SMEs have commented on areas where the definition could be clearer or more accurately encapsulate the innovative activities they undertake. The introduction of the large company credit has provided the opportunity for further useful dialogue between R&D companies, their representatives and Government.
15. The DTI and Treasury will shortly issue a formal consultation document, focusing in particular on such areas as: the development end of 'R&D'; innovative elements of design; the uniqueness of the R&D being undertaken; software development; and how best to define 'consumable stores'.
16. The Government looks forward to receiving responses which will help ensure that the R&D definition remains consistent with technological developments. Changes to the definition, to the extent that they increase the activities that qualify for the credit, will add to Exchequer costs, and it may be the case that a number of the changes will be more appropriate to SME credit scheme.

### **Software licences**

17. Many R&D companies are dependent in their work on short life, advanced software, the cost of which does not, at present, qualify for the R&D tax credits. The Government now proposes to extend the reliefs to cover this sort of software, subject to consultation with industry on a satisfactory definition for such software.

18. This will form part of the consultation on the R&D definition, and the consultation document will therefore also address the issue of software licences.