



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Douglas Flint
Group Finance Director
HSBC Holdings plc
8 Canada Square
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16 July 2009

Dear Douglas,

I am writing to update you on the work that HM Treasury is conducting on tax and innovation ahead of the Pre-Budget Report. Budget 2009 announced that the Government would consider evidence for changes to the balance of taxation of innovative activity, to ensure the tax system encourages innovation and contributes to the competitiveness of the UK. This work has highlighted some emerging issues that I thought it would be helpful to set out at this early stage.

Following the June meeting of the Business-Government Forum on Tax and Globalisation, my officials have met with businesses across a wide range of sectors to gather evidence on innovation and the role of taxation. Businesses have highlighted that, across many innovative activities, the strength of the science and skills base is the primary driver of investment decisions. The UK is strong in these and other key factors, such as the regulatory and legal environment. But we also recognise that global competition is increasing, with skills and infrastructure improving in other countries.

The Government is committed to ensuring the UK remains an attractive location for investment in innovative activity. Taxation can play an



important role in investment decisions and a competitive rate of corporation tax, as well as a regime that provides certainty and minimizes complexity for all businesses is seen as increasingly important.

The tax system combines the lowest corporation tax rate in the G7 with generous incentives for innovative activity. Research and Development (R&D) tax credits, introduced in 2000, are of significant benefit in supporting innovation in the UK, providing around £800 million of support per annum to companies undertaking R&D activity and the regime for corporate intangible assets, introduced in 2002, allows companies additional relief against intangible assets including IP.

Scope and emerging views

The work is examining the role of business tax in encouraging investment in innovation, and the impact on jobs and productivity growth in the UK. It is also considering how the UK tax system compares to other regimes internationally, and the role that taxes play in decisions on where to locate innovative investment, including the location of dedicated R&D and manufacturing centres and patent development. This assessment will allow the Government to ensure that the tax system provides the appropriate conditions for investment in innovation and to drive productivity, growth and jobs.

The work is considering whether there is scope to improve or enhance the way the tax system encourages innovation. Many businesses have pointed to the attractiveness of countries offering low corporation tax rates, particularly where they are able to match the UK in providing a skilled workforce and business-friendly environment. Therefore the benefits of introducing or enhancing specific tax reliefs and incentives



will be set against the benefits of further reductions in the rate of corporation tax, which the Government continues to keep under review.

Investment in innovation occurs across a diverse range of activities and sectors. Our discussions are focusing on the entire innovation chain: the creation of value, including research and development; securing that value, such as through patents and other intellectual property; and unlocking value, including through production or licensing. This chain of activity is global: it can involve a range of actors around the world. The work is assessing the strength of links between these activities and the balance between tax and non-tax factors in driving investment decisions.

There is strong support among all businesses for the current R&D tax credits, particularly among small and medium sized enterprises (SMEs) where the credit is seen as critical in supporting cash flow. There is evidence to support the effectiveness of such incentives in increasing the level of R&D and the work is seeking to ensure the impact of the credits is maximised.

Some businesses have highlighted tax regimes introduced in some EU Member States in recent years that provide a preferential rate of tax on income earned from intellectual property – for example ‘patent boxes’. HM Treasury is exploring the extent to which such schemes could encourage intellectual property to be located in the UK and the impact this could have by way of additional and productive investment in the UK.



Framework for assessment

In evaluating proposals for change, evidence on the long-term impact on productivity and employment will be crucial. The potential impact on tax receipts in the short and long term will also be a key factor in the assessment. This will draw on analysis of the full costs of introducing any changes, taking into account any current pressures on the tax base. Any potential changes will also be considered alongside the Government's wider approach to business taxation, including providing certainty and stability and minimizing complexity, as well as meeting international commitments.

The evidence will be assessed over the summer and HM Treasury will set out its assessment and proposed approach before the 2009 Pre-Budget Report. If proposals can be developed that meet the considerations set out above, Government would consult widely with businesses before making any changes.

I hope that this letter provides a useful update on this important strand of work. I would also thank you for your assistance – many of the organizations involved in the forum have contributed significantly to this work and my officials are meeting again with the Forum 'sherpas' this week for a more detailed discussion.

*Yours ever,
Stephen*

Rt Hon Stephen Timms MP