

### Main recommendation:

- The current HM Treasury review of R&D Tax Credits should consider changes (listed below) to increase its effect on smaller businesses.

### Further recommendation:

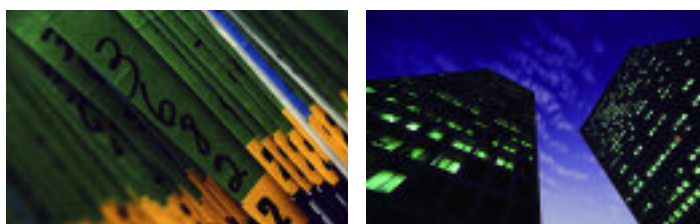
- The profile of creativity and design in business-support activities should be raised.

In terms of the general economic and regulatory climate in which SMEs operate, government has a major role to play; considerations of creativity cannot be divorced from other considerations in bringing about a more enterprising culture in the UK.

In terms of *direct* action to stimulate or support greater creativity and innovation within SMEs, government is in a more difficult position, both because of the limitations of international agreements in areas like tax, and because of the disinclination of companies to listen. Companies generally, and smaller businesses in particular, do not normally turn to government for guidance on what they should be doing. A survey by the Federation of Small Businesses (FSB) indicated that fewer than 23 per cent had used, or intended to use, any form of government support.

Nonetheless, there are some areas where useful things are being done and I believe that these could be made more effective – specifically, raising the profile of creativity and design in business-support activities, and providing incentives for UK companies to undertake more R&D and for multinational companies to do research in the UK.

**‘...Considerations of creativity cannot be divorced from other considerations in bringing about a more enterprising culture in the UK...’**



### Raise the profile of creativity and design in business-support activities

In the course of this review, I have looked at the range of existing business-support schemes, from diagnostics and advice, to grants. I believe that more could be done to emphasise the role and management of creativity and design in innovation. The Hay Group and *Fortune*, and the DTI Economics Paper both go to lengths to emphasise that innovation isn't something confined to a company's R&D unit. It's a mindset that needs to permeate the whole of a company's activities. This needs to be reflected in the various support schemes.

As an outcome of the discussions, several programmes have already agreed to raise the profile of creativity and design. UK Trade & Investment will provide information, awareness and advice to trade teams around the country. The Grant for R&D will include design and creativity in its guidance notes. The Leadership and Management Programme will cover design and creativity in its newsletters, as will the regular email to Business Link regional coordinators.

Further training for experienced managers is essential; that is true for business generally and especially so for those running organisations in the creative and cultural industries. I would like to see a scaling up of programmes such as the Centre for Creative Businesses' courses and the work being carried out by organisations such as the Clore Leadership Programme and the Cultural Leadership Fund.

## Provide incentives to undertake more R&D

This review also looked at the various areas of fiscal incentive that might be used to stimulate greater creativity. It considered various aspects of the tax system such as Enterprise Management Incentives, the Capital Allowances System and Venture Capital Trusts, but concluded that by far the most relevant was the system of R&D Tax Credits, which is highly relevant in that, in origin, it was largely focused on SMEs in the manufacturing sector.

Essentially, R&D Tax Credits should have two beneficial outcomes. One is to incentivise companies to carry out more research than they would otherwise do; the other is to induce multinational companies to get more of their research carried out in the UK. Discussions with accounting firms, business organisations, groups of SMEs, major international companies with multinational research activities, and Her Majesty's Revenue and Customs (HMRC) indicate that the scheme is considered by many to be a valuable tool. However, in terms of stimulating more small companies to undertake R&D, I do not believe that it is having the impact that it could have. Of more importance, it is not having the kind of impact that I believe is *necessary* in the context of my review.

In the period 2000/01 to 2004/05, over 16,000 claims were made for R&D Tax Credits. While this figure is above the original projection made by Inland Revenue, the real measure is the impact on the amount of R&D undertaken in the UK. It is difficult to assess the effect of the scheme because of the many other factors that influence the amount of R&D undertaken, but the problem remains that the UK continues to lag in international terms. Furthermore, the Confederation of British Industry (CBI) *Business Improvement Survey (Summer 2005)* indicated that limited use had been made of the R&D Tax Credits or other government support aimed at fostering design, creativity and innovation. This accords with similar views I have received from business. These findings illustrate the need to change the situation.

The timing is fortuitous. HM Treasury is currently carrying out an in-depth review of R&D Tax Credits. This will undoubtedly look far more widely at the issue, and take into account other concerns. My own concern is purely for stimulating more investment in R&D both by smaller companies and by the design units that serve international groups. Further, I would like to see more companies stimulated to get involved in R&D. Based on this investigation, I have submitted the following proposals to be considered by the HM Treasury review:



### Extend the range of eligible costs

The range of eligible costs should be extended to embrace all areas allowable under the OECD Frascati definition, including things like the cost of testing, to reflect more fully the true cost of undertaking R&D.

However, I do not recommend the extension of the system to allow for costs beyond this definition. A number of individuals whom I consulted advocated expanding the system to cover design expenditure, where the latter falls outside the current strict definition of R&D: essentially making it an 'R&D&D' scheme. The idea is not without merit in terms of encouraging more innovation in SMEs.

My reason for rejecting it is practicability not principle. Just as creativity needs to permeate the whole business, so too does design. It affects strategy, processes, systems, products, marketing and communication. It comes from both internal and external resources. To isolate the costs associated with 'design', to the accuracy necessary for a tax claim, would be a nightmare for all but accountants.



If, to keep it more manageable, it were constrained purely to product design, it would take the system into the area of government subsidy for specific products, which is not permissible under competition law. Those aspects of design that generally relate to the Frascati definition of R&D are already allowable under the current system.

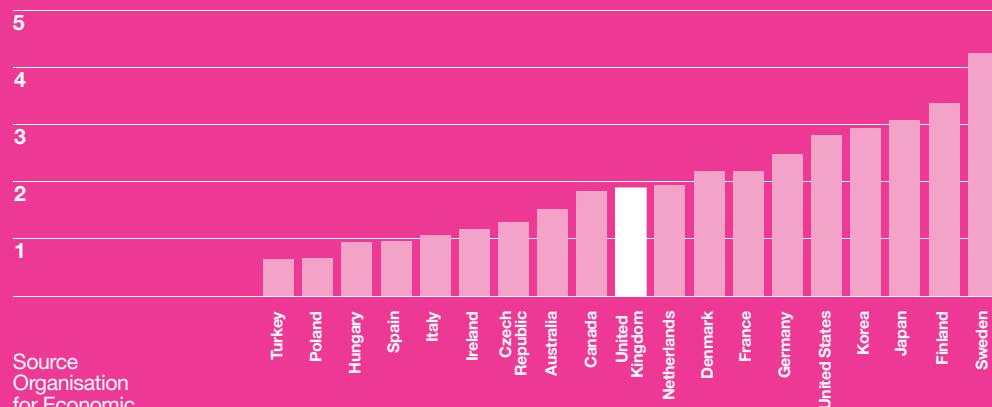
### Move to a partly incremental scheme

When R&D Tax Credits were introduced (in 2000/1 for SMEs and in 2002/3 for larger companies), consideration was given to an incremental scheme, which would reward additional research rather than research that was being undertaken anyway. At the time, it was felt that an incremental scheme would be unfair on those who were already generating the bulk of new knowledge and that it would, moreover, add further to the complexity of the tax system – a cause of continuing complaint, particularly from SMEs. A (relatively) simple system was therefore chosen, but with a greater level of expenditure that could be deducted for tax purposes by the smaller company.

I believe that, as a consequence, far too high a proportion of the cost of the scheme is incurred without providing sufficient incentive to undertake a greater level of research. For example, if the existing scheme were to stimulate a ten per cent increase in R&D, it would still mean that about 90 per cent of the cost to the taxpayer was being incurred for work that would have been undertaken anyway.

## UK R&D spend lags its main competitors...

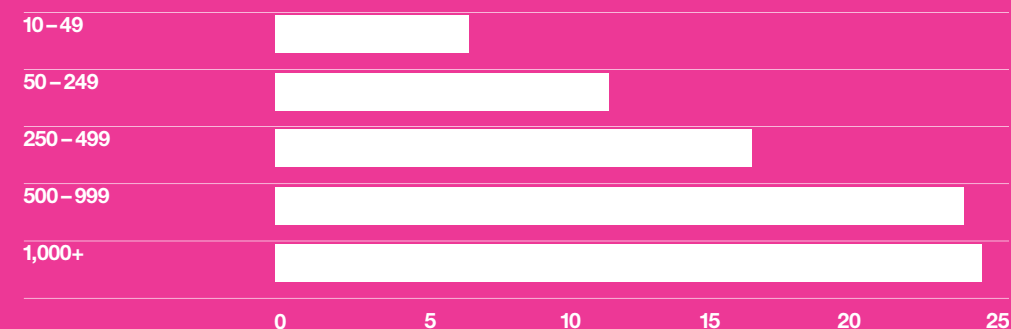
Proportion of gross domestic expenditure (latest available year) spent on R&D (%)



Source  
Organisation  
for Economic  
Co-operation  
& Development (OECD)

## Companies with fewer than 500 employees are less likely to invest in R&D...

Percentage of firms, by size, reporting internal expenditure on R&D (%)



Source  
Third Community  
Innovation Survey

**“The basic aim is to incentivise research and development above the level that would otherwise take place. At the moment our concern is that all too often the R&D tax credit rewards enterprises for activity that would have been undertaken anyway, whilst for SMEs the system largely passes them by.”**

**Graeme Leach, Chief Economist,  
Institute of Directors**

**Canada's system, which includes a specialist unit, is an interesting model...**

Canadian companies have been able to claim tax credits on their R&D since the mid-1980s. Having taken around 10 years to become fully effective, the Canadian Scientific Research and Experimental Development Program is now acknowledged to encourage investment in R&D from both domestic and international companies.

The Canadian system has a slightly wider definition of what is eligible for credits but the key to its success appears to be consistency and certainty, partly provided by its specialist unit. The credits have been consistently backed by government, so companies know that they are there for the long term.

They even have a ‘first time claimant’ service to help guide through new claimants of the credit. This service ensures that the correct level of credit is claimed, with specialists going into the businesses to help them make the claim.

I therefore suggest a change in the rules to give an *additional* allowance for *increased* levels of investment in R&D – in other words, a move to a *partly* incremental scheme. An incremental scheme would allow greater incentive to be introduced without simply scaling up the total payment for all R&D undertaken.

Under the proposal suggested here, there would be a higher rate of allowance for the volume of R&D undertaken above, say, the highest level in any of the past five years. I acknowledge that this would add to the complexity of the scheme, but it would provide a real incentive for companies to undertake *additional* research. As someone who has argued strongly for tax simplification in the past, I think this is one area where further complication is justified by the ends.

#### Raise the company size criterion for eligibility

The size of company eligible for the increased level of credit should be raised above the current 250 employee limit to double this figure. I recognise that extending additional support beyond the agreed definition of an SME would involve negotiation with the EU but I believe that the EU definition of what constitutes an SME is too restrictive in this instance. The *Third Community Innovation Survey* indicates that companies with up to 500 employees invest significantly less pro rata than their larger equivalents.

#### Set up a dedicated unit within HMRC to ensure consistent application

To ensure consistency of application, and confidence in the scheme, a dedicated unit should be set up within HMRC. Its mandate should be not only to rule on what is allowable but to ensure that full advantage is being taken of the scheme to increase the amount of research undertaken in the UK. Claims would be referred to this unit where a tax inspector felt a need for guidance, or where there was a dispute over the claim.

This need for consistent treatment – and confidence in such treatment – is paramount to the success of the scheme. A company's decision on new investment in R&D has to be taken on the basis of an assumption of what will qualify for allowance. Whether this assumption is correct is not proven until after the claim is made, which is sometime after the investment. Without confidence in the treatment by the authorities, the risk in the investment is compounded rather than reduced.

Moreover, smaller companies made it clear that they don't want the prospect of the expense or the distraction of a prolonged dispute with HMRC. Business organisations, accountants and businesses themselves all complain of inconsistent treatment. The IoD told me that its members have reported that Tax Offices often interpret R&D Tax Credits in different ways.



Tax inspectors need to recognise that this is an incentive scheme to be encouraged, not an avoidance scheme to be policed. To be fair, many tax inspectors accept this and approach the matter in a pragmatic manner, but that is far from universal. Companies cannot be expected to increase their R&D investment in the hope that they will encounter an enlightened tax inspector. As Deloitte put it, “If all inspectors approached their review of claims with a consistently open mind, the relief would be much more favourably received, giving companies the certainty and confidence to make the additional investment”.



The current system is one of self-assessment, requiring the company to submit what it considers to be eligible R&D costs. There is thus a reliance on the company, its external advisors (many of which are, themselves, small firms with limited understanding of R&D or experience of the scheme) and the tax inspectors all understanding and applying the same logic and rules. Given the level of judgement/interpretation involved, this has led to a high degree of misfiling and subsequent queries. The problem is that ruling on what qualifies as R&D is a decision that requires not only a comprehensive knowledge of the definition for tax purposes but also an insight into the nature of ‘research’ – a judgement that is all the more difficult to make if it is not being called upon regularly.

***‘...Tax inspectors need to recognise that this is an incentive scheme to be encouraged, not an avoidance scheme to be policed...’***

I also found that confidence in the application of the system has a significant effect on the decisions of international companies. Several countries now compete by way of tax incentives to attract international research. Although my review concentrated on the threat from the developing economies, competition also comes from the other Western economies. Indeed, some multinationals still prefer their research to be done in these countries because of concerns about protection of IPR. In Europe, Austria and Spain are particularly attractive in terms of the current allowances, with France (which allows overheads to be taken into account) not far behind. Interestingly, Germany has yet to introduce an equivalent scheme successfully. The opinion of everyone consulted is that the competition is likely to intensify.

According to the international organisations to whom I spoke, the tax regime plays a significant part in their decision about where to site a research programme, or, more important, a research facility. However, it is not a simple matter of who offers the most generous allowances. An important consideration is the clarity of the scheme, along with its ease of application and the confidence of the projected claims being allowed. Another factor is the stability of the scheme, which is important when a company is making a long-term decision on where to site a facility. It is not so much the attractiveness of ‘this week’s offer’, more a case of having confidence in dealing with the taxation authority in the longer term.

### Promote the R&D Tax Credits System far more vigorously

The scheme should be promoted far more vigorously, through business organisations, RDAs and the accounting profession.

The scheme has several attractive aspects, not always widely understood. For example, for SMEs, it is a tax *credit* scheme rather a tax *allowance* scheme. That means that a company does not have to be making profits in order to take advantage of it – indeed, the majority of existing SME claims are made on this basis. The cash payment can thus help significantly not just with the cost, but with the funding, of R&D.

I am aware that the Small Business Service has developed guidance for SMEs in response to a perceived failing of companies to file their claims properly. The new guidance has been trialed and will be rolled out in the autumn. That's a welcome start. However, it will not, of itself, solve the problem of either lack of awareness or lack of enthusiasm for the scheme among SMEs. HMRC needs to promote the scheme far more actively, using channels other than the internet. Websites can help to meet the needs of the inquisitive; they don't reach the unaware or the uninterested. A promotional role may be relatively new for HMRC but is well within its capabilities. The success of the scheme, and of HMRC, must be measured in terms of the increase in R&D carried out in the UK.

***'... The tax regime plays a significant part in their decision about where to site a research programme or, more important, a research facility...'***

The professional bodies should be approached to ensure that knowledge of the scheme is included in accountants' training and continuing professional development. The relevant business organisations, such as the IoD, CBI, Chambers of Commerce and EEF, should also play a more active role in promoting the system to SMEs – who listen to them far more than they would to government communications.

