Supporting growth in innovation: next steps for the R&D tax credit

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INTRODUCTION AND SUMMARY

1.1 In today's increasingly global markets, economic activity is shifting towards innovation and knowledge-driven industries in emerging and advanced economies. This changing economic environment presents both opportunities and challenges for the UK, highlighted in the HM Treasury paper *Globalisation and the UK: strength and opportunity to meet the economic challenge*. Increasingly in the global economy, the UK's future prosperity will depend on its capacity to expand knowledge through science, and translate this knowledge into innovative products and better services. Maintaining and growing science and innovation in the UK are therefore critical to its long-term prosperity.

1.2 The Government's *10-Year Science and Innovation Investment Framework* sets out its strategy for promoting science and innovation in the UK. High levels of Research and Development (R&D) are central to this. The benefits of R&D spill over across the whole economy and are an important driver of productivity growth; R&D supports innovation and opens up new markets through the creation of improved products, services and processes. The Government has therefore set the challenging goal that overall levels of R&D in the economy should reach 2.5 per cent of GDP by 2014, from the current level of 1.9 per cent. This target will only be reached if private sector growth in R&D at least matches that in Government investment. The R&D tax credit is a key part of the strategy to raise overall levels of business R&D in the UK.

1.3 The Government is grateful to all respondents for informing the discussion on the continued development of the R&D tax credit. In particular, the Government welcomes the contribution of the Cox Review of creativity in UK business.[2] The review's conclusions regarding the R&D tax credit accord with those of many other respondents. The Government has therefore sought to respond immediately to these recommendations where they fall within the scope of this discussion and to consider its wider conclusions in the longer term.

THE UK R&D TAX CREDIT

1.4 The R&D tax credit was first introduced in 2000, with a 150 per cent tax credit for Small and Medium-sized Enterprises (SMEs), including a generous payable 'cash' element worth up to 24 per cent of R&D spending for non-profit-makers. In 2002, the scheme was extended to all companies with the introduction of a 125 per cent tax credit for large companies. 18,500 claims have been made in total to date, with over 16,000 claims for the SME scheme and over 2,000 for the large company scheme. So far, £850 million of support has been claimed under the SME scheme and £530 million under the large company scheme; in total almost £1.4 billion of support has been claimed.

1.5 International evidence from other OECD countries strongly suggests that fiscal incentives, such as the R&D tax credit, are effective in generating additional R&D, although their full effects may not be felt immediately. An effective tax incentive should be visible and predictable, so that firms can build its level of support into their investment appraisal with certainty, and should offer sufficient value to influence those decisions.

[1] *Globalisation and the UK: strength and opportunity to meet the economic challenge*, HM Treasury, December 2005.
[2] *Cox Review of creativity in business: building on the UK's strengths*, December 2005.

1.6 The Government recognises the trade-off between providing simplicity and certainty against providing a stronger incentive for additional R&D spending, and has engaged in a constructive dialogue with business since the outset to ensure that this balance is right. In line with the international evidence, the strong message from business has been that simplicity, consistency and certainty are key. Thanks in part to this dialogue with business, the UK's R&D tax credit is now widely regarded as an example of best practice in the field.[3]

1.7 Continuing the process of engaging with business, in July HM Treasury, the Department of Trade and Industry (DTI) and HM Revenue & Customs (HMRC), published a discussion paper *Supporting growth in innovation: enhancing the R&D tax credit.*[4] The Government had two aims: to identify areas for further simplification and improvement in the delivery and administration of the tax credit, and to determine whether the incentives structure provided by the tax credit adequately supports the emergence of R&D-intensive firms with the potential to grow to become world-leading innovators. This paper summarises the responses to the discussion paper and sets out the Government's intentions.

1.8 The results from a quantitative survey of nearly 1,000 R&D performing companies on their early experiences and views of the R&D tax credit are also published today. This is the first part of the ongoing long-term evaluation of the R&D tax credit. The survey shows the positive impact that the R&D tax credit has had since its introduction. The Government remains committed to ongoing evaluation of the R&D tax credit and will continue to appraise its overall success as further evaluation results build up over time.

IMPROVING THE EXPERIENCE OF CLAIMANT COMPANIES

1.9 The discussions with business and their representatives have confirmed the successful introduction of the R&D tax credit. Despite some early difficulties for both claimants and HMRC staff, respondents reported that the experience of claimants has steadily improved as companies, their tax advisers and HMRC staff have increased their familiarity with the scheme.

1.10 The first evaluation results on the scheme are further confirmation of this view. In general, as claimants have become more familiar with the scheme, they have found the process easier. Most claimants now understand the process well and intend to continue making use of the tax credit in the future.

1.11 Tempering this strong positive message was a general consensus among respondents that there were some areas where the administration and delivery of the scheme could still be improved, particularly for smaller firms. Specifically, respondents reported that the Government's aim of consistency has not yet been fully achieved. While the evidence shows that the majority of claims are handled well, there remain issues in a small minority of claims. A number of suggestions were made as to how the design of the scheme might be improved. Chapter 2 summarises the responses on these issues.

[3] See, for example, *Report submitted to CREST in the context of the Open Method of Co-ordination,* Expert Group of Fiscal Measures for Research, The Hague, 15 June 2004.
[4] *Supporting growth in innovation: enhancing the R&D tax credit*, HM Treasury, DTI and HMRC, July 2005.

1.12 The Government recognises the need to make further improvements to the delivery and administration of the R&D tax credit. It will therefore begin implementing a package of measures, including:

- the creation of dedicated R&D units within HMRC to ensure that all SME tax credit claims are dealt with by specialist HMRC staff, expanding on the recommendation of the Cox Review;
- an R&D tax credit statement of practice for SMEs, detailing how SMEs can expect HMRC to deal with their claims; and
- a package of legislative and operational simplifications, including expanding qualifying costs to include payments to clinical trial volunteers.

1.13 The Government is confident that these measures will improve the consistency with which claims are treated and ensure that the positive experience of most claimants is replicated for all – giving all companies the certainty they need to build the value of the R&D tax credit into their investment appraisal decisions.

ENHANCING THE CREDIT

1.14 The Government has noted the positive feedback from business on the fundamental aspects of the R&D tax credit's design. As detailed in Chapter 3, firms felt that the incentives structure provided by the tax credit is broadly correct. Almost all respondents cautioned against any fundamental change that might compromise the simplicity, stability or market-driven premise of the present structure. The Government has also noted the encouraging evidence of the tax credit's positive impact on R&D spending, from respondents and from the evaluation survey.

1.15 Evidence from the DTI's recently published 2005 R&D Scoreboard continues to highlight the emergence of new R&D-intensive firms outside the traditional R&D conducting sectors, particularly in service and technology-based sectors, such as software. However, respondents saw no strong rationale for targeting specific sectors and many strongly opposed it. Instead, the Institute for Fiscal Studies (IFS) and others have suggested that the Government's focus should be on increasing the UK's R&D intensity through growth in the numbers of R&D-performing firms across all sectors and company sizes.

1.16 The clear message from respondents was that, in preference to sector-targeted enhancements, additional support should be concentrated on smaller companies generally – boosting the growth of companies already performing R&D and encouraging R&D among those not currently innovating. The Government agrees with these views. In its existing structure, the R&D tax credit is a valuable incentive for small and growing companies; however, the Government would like to see wider take-up of the scheme. The Government therefore accepts the recommendation of the Cox Review: more can be done to raise businesses' awareness of the scheme and it will engage in further promotion of the tax credit with this aim.

1.17 Over the coming months the Government will also review whether there is a case to further enhance the support available through the SME tax credit, without compromising its key strengths. Any conclusions arising from these considerations will be announced at Budget 2006.

2 IMPROVING THE EXPERIENCE OF CLAIMANTS: SUMMARY OF RESPONSES AND GOVERNMENT PROPOSALS

2.1 *Supporting growth in innovation* highlighted the importance of maintaining high standards of delivery. The R&D tax credit must be visible to all potential claimants, who should have a clear understanding of the system and its rules. Companies who make a claim should be confident enough of its value to build it into their investment appraisal decisions.

2.2 The Government has set out three key delivery objectives: *simplicity, certainty and consistency.* Any changes to the system will be made within this framework.

PROGRESS SO FAR

2.3 Informed by a constructive dialogue with business, the Government has continued to make improvements to the delivery and administration of the R&D tax credit since its introduction – including a new, clearer definition of qualifying R&D, a widening of qualifying costs, and clearer guidance for HMRC staff and companies.

New guidance for SMEs

2.4 In October, HMRC published new, simple guidance for SMEs and their advisers to use when making an R&D tax credit claim. This new format, developed in discussion with small businesses, comprises both easy to use guidance on the scheme and practical tools for companies to use when making their claim. It can be found at www.hmrc.gov.uk/randd.

2.5 Respondents to the discussion paper acknowledged that changes to date have improved the experience of companies claiming the credit. They also fully endorsed the Government's key delivery principles. Many made it clear that their suggestions were intended to improve what they already perceive to be a valuable and generally well-administered scheme.

2.6 These views are confirmed by the results of the first stage of the Government's evaluation of the R&D tax credit. This independent research, commissioned by HMRC and conducted by BMRB Social Research, is the first large-scale evaluation of the experience of R&D tax credit claimants and attitudes towards the R&D tax credit scheme. The headline results of the survey, also published today, are summarised in Box 2.1.[1]

[1] The survey report can be found at www.hmrc.gov.uk/research.

Box 2.1 The R&D tax credit: early evaluation evidence

Of the nearly 1,000 R&D performing companies surveyed, over 80 per cent of respondents were aware of the R&D tax credit. Most companies also said they had a good understanding of the scheme.

Around 70 per cent of respondents who were aware of the tax credit and thought they were eligible had made a claim, and almost 90 per cent of claimants were successful. Most companies who were aware of the tax credit but had not claimed thought it likely that they would claim in future, and almost three-quarters of those not aware said they were likely to investigate further.

Around three-quarters of claimants found the claims process very or fairly easy. A third thought claiming had got easier over time, largely through familiarity with the process. A fifth of claimants said their most recent claim had been subject to an enquiry, but the survey responses show that enquiries are not significantly deterring companies from claiming. Where the enquiry was complete, over 80 per cent of companies suggested it would either have no effect or would help with future claims.

External accountants and advisers play a key role in the R&D tax credit scheme. They were the most common source for companies' first information concerning the tax credit – 44 per cent of companies found out this way. Most companies also used external help when making a claim, with half using a mixture of internal and external work and a quarter relying entirely on external assistance.

The R&D tax credit is affecting R&D spending decisions. Of those companies who had made a successful claim, 55 per cent said the tax credit had had some impact on either their level of R&D spend and/or the type of R&D projects they undertook. A fifth of successful claimants said they took the expected value of the tax credit into account when setting their R&D budget, a third that the tax credit had allowed the company to conduct longer-term R&D projects and a quarter said it had allowed them to undertake riskier R&D projects.

The survey report is the first part of the long-term evaluation of the R&D tax credit. Other studies, such as an econometric project, are also planned and work has started on developing the necessary matched data. The results of this first survey give a positive indication of the early effects of the R&D tax credit; however, the R&D tax credit is a long-term policy and full appraisal of the scheme's success will only be possible as the evaluation results build up over time.

SUMMARY OF RESPONSES AND GOVERNMENT PROPOSALS

2.7 The positive message from respondents on the improved claimant experience was complemented by some consistent themes around areas for further improvement. In particular, the Government has noted a strong desire to see more consistency in the treatment of claims, particularly for small firms.

Use of experts

2.8 There has been some recent criticism of HMRC's handling of claims, questioning whether it is appropriate for tax officers who are not experts in science or technology to deal with R&D tax credit claims. The criticism has stemmed from a small number of difficult cases, but these cases have highlighted the need to consider measures to improve consistency across the handling of all claims. The discussion paper raised the possible use of scientific experts in the tax credit claims process to improve administration.

2.9 A large number of varied responses were received on the use of scientific experts. Some were in favour of the recruitment of experts across different scientific disciplines to work within HMRC; others favoured an external panel of scientific experts acting as an independent tribunal with formal procedures, akin to the General Commissioners of Income Tax.

2.10 A number of reservations were expressed. Concerns were raised over the extra bureaucracy and cost of in-house HMRC scientific experts. There were also concerns about the range of scientific experts required to cover adequately all types of UK R&D, particularly in extremely specialised areas, where the leading experts are likely to be employed by the claimant company. Perhaps the largest single concern was over the issue of confidentiality. Many respondents suggested they would be reluctant to make a claim if there were any risk of their technical information passing outside HMRC; one company said this step would stop them claiming the credit altogether.

Specialist R&D units

2.11 The Government has noted the pervading view from respondents – that the current self-assessment system works extremely well when it is well administered – and therefore agrees with the conclusion of the Cox Review that scientific experts do not offer the best solution to businesses' concerns. The Government nevertheless recognises that there is scope to improve the delivery of the scheme to ensure that R&D performing SMEs get the full value from the R&D tax credit. **HMRC will therefore improve the administration of the R&D tax credit, through the creation of specialist R&D units to deal with all SME R&D tax credit claims.**

2.12 The creation of specialist R&D units will ensure that all R&D tax credit claims outside the Large Business Service are dealt with by a smaller number of officers, specialising in R&D tax credit work. These proposals embrace the recommendation of the Cox review to set up a specialist R&D support unit in HMRC, but go further: *all SME claims* will be handled by an officer in a specialist R&D unit. These smaller teams of officers will develop specialised R&D expertise within HMRC, focusing on improving the consistency of claims treatment and easing the process, with a balanced focus on non-compliance. The units will also deliver further benefits for companies as clearly identified points of contact. The Government is confident that these steps will substantially improve the claims experience for SMEs.

2.13 The Government will also consider whether there is a need for further training of HMRC staff to better understand the processes of R&D generally, particularly in areas such as software and engineering where difficult issues can arise. HMRC will investigate whether there is scope to consult further with industry on training in these areas, working with the new units to develop expertise.

Improving the repayable credit

2.14 The discussion paper underlined the importance of prompt tax credit payments. Firms in receipt of payable credits often have significant cashflow problems and the R&D tax credit can play an important role in relieving these constraints. The discussion paper welcomed suggestions on ways to make these payments quicker.

2.15 The most frequent suggestion was to amend the scheme so there was some form of in-year offset against ongoing PAYE and National Insurance liabilities. This idea was first considered in detail with the introduction of the SME scheme. The Government has again considered this mechanism. However, its view remains that the additional upheaval and uncertainty for companies entailed in such a substantial change to the operation of the scheme would outweigh the benefits. Companies would receive payments before their final tax position had been calculated, increasing the likelihood of problems should any overpayments later be recovered by HMRC.

Statement of Practice for SME claims

2.16 The Government therefore intends to retain the current system, but to improve it to ensure that claims are dealt with promptly and consistently. The measures outlined at paragraph 2.11 will enable significant progress to be made towards this goal. Furthermore, following consistent praise for the statement of practice for R&D tax credit claims produced by HMRC's Large Business Service (LBS), **HMRC will also publish a corresponding statement of practice in 2006 outlining how claims from companies dealt with outside the LBS will be handled, particularly focusing on SME payable credit claims.**

2.17 The statement of practice will outline HMRC's approach to claims, setting out HMRC practice, in particular around prompt payment and requests for information. It will be developed alongside the creation of the specialist R&D units and support the move to this approach.

Unintended distortions

2.18 The discussion paper asked whether the R&D tax credit rules had introduced any unintended commercial distortions. The broad consensus from respondents was that the R&D tax credit had not led to unintended distortions to companies' behaviour. However, many respondents highlighted ways in which they thought the schemes could work better, through minor adjustments to the rules.

2.19 The Government is keen to implement improvements that will make the process more certain or simple. Subject to state aid approval, the following actions will be taken in response to representations:

- **an expansion of the range of qualifying costs to include payments made to clinical trial volunteers;**
- **consideration of what scope there may be to allow certain R&D projects which are capital for tax purposes to qualify for relief, particularly when conducted by SMEs;**[2]

[2] R&D expenditure that is revenue expenditure for tax purposes but appears on a company's balance sheet as an intangible asset is already eligible for relief. The change contemplated here is to allow certain capital expenditure associated with creating assets of continuing use to the business to qualify for relief, in addition to the existing qualifying revenue expenditure.

- **harmonisation of time limits and claims procedures across both the payable tax credit and enhanced relief, meaning claims for enhanced relief will need to be made in the same way as claims for payable tax credits, i.e. on a Corporation Tax return within the same timescale;**
- **amendment to the Treasury order which enacted the new definition of a SME effective from 2005 to correct minor errors; and**
- **naming of designated overseas universities as qualifying bodies for the purposes of the large company sub-contracting rules, rather than introduce a generic definition that may be susceptible to avoidance.**

Other issues raised

2.20 A number of respondents raised difficulties with the rules for large company sub-contracting. The Government has carefully considered these views. Its conclusion remains that these rules are necessary to prevent the possibility of relief being given to more than one company for the same R&D expenditure. Any change to the rules would be likely to increase their complexity, while delivering little or no benefits for most companies.

2.21 Various representations to expand the range of qualifying costs were made. The Government agrees that the exclusion of the cost of clinical trials volunteers is an anomaly and will therefore seek to legislate to amend this. However, in respect of an extension to other costs, including expenditure on protecting intellectual property, indirect R&D costs and the purchase of outsourced services by large companies, the Government's view, expressed in the discussion paper, remains unchanged. A review of qualifying costs was conducted in early 2004 and the Government wishes to see the new range of qualifying costs bed down before considering further substantive change through the introduction of new qualifying costs.

2.22 Some respondents to the consultation sought clarification on whether work to develop technical standards is R&D for tax purposes. The Government recognises the importance of such standards to innovation and to business. The key issues to consider are whether it is R&D for tax purposes and whether the loan of company R&D staff to standard setting bodies is relevant to that company's trade. HMRC will consider with DTI and standards bodies the extent to which this work is or could qualify as R&D for tax purposes, and seek to clarify the position through future guidance.

3 Enhancing the credit: summary of responses and Government intention

3.1 *Supporting growth in innovation* highlighted new trends in business R&D, with more R&D taking place outside the UK's established R&D-intensive industries. In particular, the paper noted strong growth in R&D activity in three broad and overlapping groups: the expansion in service sector R&D, the emergence of R&D-intensive technology-based firms, and the growth of smaller-firm innovation in the UK. These trends are set against a wider trend towards increasingly internationalised R&D.

Summary of responses

3.2 The discussion paper asked for views on whether the Government should focus support on these emerging groups, and whether this would be possible without compromising the simplicity and basic market-driven premise of the R&D tax credit. This chapter summarises the responses to these questions and sets out the Government's intentions for the development of the R&D tax credit.

New R&D activity outside established sectors

3.3 Respondents, including the Institute for Fiscal Studies,[1] agreed that the UK is seeing significant changes in the pattern of R&D investment. Their responses have provided some valuable evidence to complement and advance the Government's analysis.

3.4 The discussion paper identified service sector R&D and R&D-intensive technology based firms as major growth areas for innovation in the UK. The IFS report that UK service sector R&D has grown by 53 per cent in real terms in the five years between 1998 and 2003, going from 16 per cent to 21 per cent of all business R&D. Over half of this growth is accounted for by the 'computer and related activities' sector. This long-term trend reflects the growing strength of the UK software sector and the development of increased R&D intensity in the UK's IT hardware sector. Recent disappointing evidence from the 2004 Business Enterprise R&D statistics[2] shows a fall in R&D in the 'computer and related activities', reflecting both the cyclical and increasingly internationalised nature of R&D. More recent data, from the 2005 R&D Scoreboard, has shown renewed strength in these and other technology-orientated sectors in 2005; Box 3.1 presents some of these findings.

3.5 It remains clear that these are long-term upward trends, which present opportunities for the UK to boost its overall business R&D intensity by developing new R&D-intensive sectors and boosting R&D intensity in sectors that are lagging behind their peers. However, most respondents strongly cautioned against targeting enhancements specifically on these emerging sectors, at the expense of the tax credit's basic market-driven premise.

[1] *Background facts and comments on "Supporting growth in innovation: enhancing the R&D tax credit"*, IFS, November 2005, available at http://www.ifs.org.uk

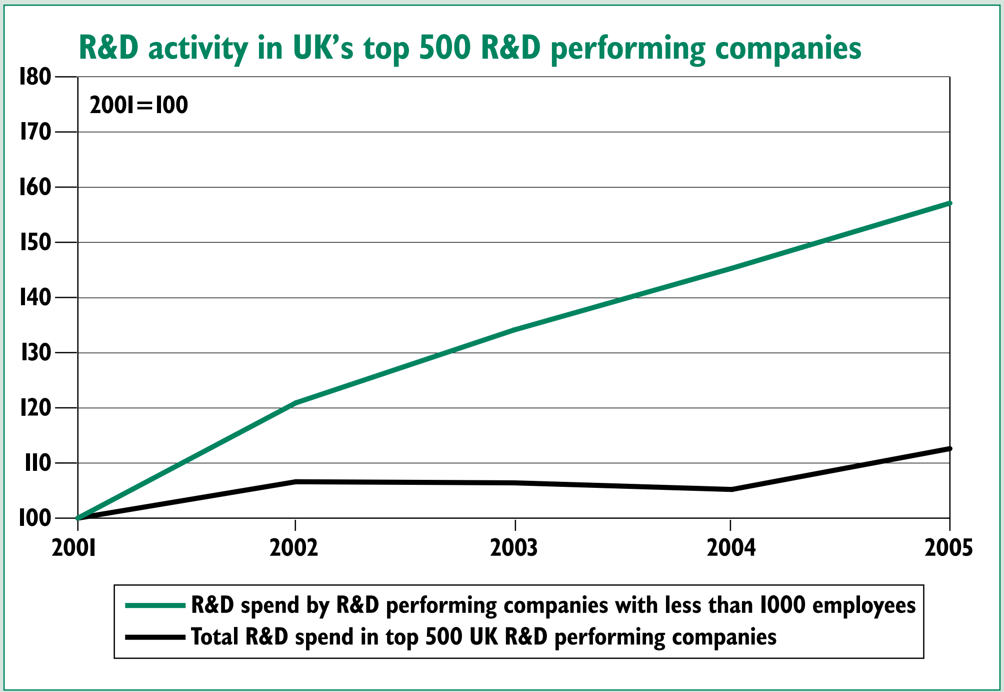
[2] Available at www.statistics.gov.uk

3.6 Having considered respondents' views, the Government agrees that there is no strong rationale for a sectoral approach to the structure of the tax credit. It has always recognised that a sector-targeted approach would introduce unnecessary complexity to the R&D tax credit. However, the Government wishes to ensure that firms in both established and emerging sectors are able to benefit fully from the tax credit. The improvements to delivery and administration outlined in Chapter 2 will bring significant improvements to all firms, and particularly those in emerging sectors where the R&D process can sometimes be less clear.

Box 3.1 Recent evidence on UK R&D

The ONS Business Enterprise R&D (BERD) 2004 evidence suggests that R&D spending by firms located in the UK decreased by 1 per cent in cash terms between 2003 and 2004. Part of this drop was due to a decrease in UK-funded R&D, but most of the decrease can be explained by a fall in R&D funded from overseas. This reflects the increasingly internationalised nature of R&D, and suggests that UK R&D has suffered from the global slowdown.

However, more recent evidence, from the DTI's R&D Scoreboard 2005, suggests that UK R&D has picked up again in 2005. The chart below shows R&D spending by the top 500 R&D performing companies in the UK. This chart shows that R&D in these companies increased in 2005, having dipped in 2004. It also highlights particularly strong growth in the R&D done by companies with less than 1,000 employees. There has been continued strong growth in R&D-intensive mid-sized companies in the UK as well; the number of very R&D-intensive, mid-sized UK-owned companies (R&D spending over £6.4 million, sales between £25 million and £500 million, and R&D intensity of over 10 per cent) increased by 77 per cent between the 2001 and 2005 Scoreboards.



The Scoreboard also highlighted strong growth in service sector and technology-based R&D, particularly in the software sector: the proportion of R&D in the UK Scoreboard done by software firms increased in 2005 to 5.2 per cent from 4.5 per cent in 2004. It also picks up levels of overseas R&D activity: 12 of the 17 biggest foreign-owned R&D spending companies in the UK now have higher R&D intensity than their overseas parents, investing a high proportion of their global R&D efforts in the UK.

Smaller firms and non-innovators

3.7 The challenge of encouraging firms to innovate goes much wider than stimulating R&D. At its heart, innovation is the successful exploitation of new ideas, and this covers new ways of working and the people and processes behind them as well as the technology behind products and services. Such innovation enables firms to compete successfully and profitably in today's fast-changing marketplace. The Government supports this activity in a number of ways through the DTI[3], which provides a range of solutions that offer practical support and encouragement at the different stages of the innovation process, including help for business growth via the DTI-backed national Business Link portal (www.businesslink.gov.uk).

3.8 The economic evidence indicates that where UK firms undertake R&D they are generally no less R&D-intensive than their similar-sized counterparts in France and Germany.[4] Instead, it suggests that the reason for the UK's lower overall business R&D intensity is the lack of an equivalent number of innovative firms, although other evidence points more towards the UK's different industrial mix as an explanation for its performance. Nevertheless, there are opportunities for the UK to catch up with its peers by lowering barriers to growth and increasing the number of innovative firms at all sizes conducting R&D. Broadly, there are two channels through which this can be achieved:

- helping R&D performing firms overcome barriers to their growth, so that there are more R&D performing mid-sized and large firms; and
- encouraging R&D among firms, particularly SMEs, who are non-innovators or whose innovation does not currently involve or identify R&D.

Smaller firm innovation

3.9 The discussion paper highlighted the substantial growth in smaller firm innovation in the UK. Respondents generally agreed that smaller firm innovation plays a fundamental role in the wider UK R&D environment, partly due to the strong links between SMEs and larger firms. The evidence described in Box 3.1 continues to show the trend towards increased R&D activity among smaller firms, and an increase in the number of R&D-intensive mid-sized firms.

3.10 The Government accepts the view of the majority of respondents that support for the growth in the number of successful R&D-intensive firms is best provided by a general focus on smaller firms, in preference to attempts to provide a more targeted mechanism focused solely on emerging R&D-intensive firms.

3.11 The discussions with business have further strengthened the Government's understanding of the importance of the payable credit for SMEs. This is a crucial aid to cashflow where a firm's development process entails long gestation periods prior to sustained profitability. In common with a number of respondents, the Cox Review recommended raising the threshold for the SME scheme to allow larger companies to benefit from the higher enhanced relief and payable credit. The Government will continue to consider this evidence, recognising the possible constraints of EU state aid rules in this area.

[3] www.dti.gov.uk/innovate and www.innovation.gov.uk

[4] IFS analysis using the Third Community Innovation Survey

"Non-innovators" **3.12** Many respondents also suggested that more effort should be focused on the second channel: encouraging R&D among firms that are currently not innovators in science and technology. A key challenge for the UK identified by the Cox Review is making more companies aware of the benefits of creativity and innovation. The Government accepts the Review's recommendation that, where companies are unaware of the R&D tax credit, it should be more vigorous in the promotion of its benefits.

3.13 Not all firms innovate through R&D, but in many cases R&D is vital. It is important for these firms to understand the potential value and impact of the R&D tax credit on their innovation if UK R&D is to grow faster. The evaluation survey found that four-fifths of R&D-performing companies were aware of the R&D tax credit and that the majority of these companies felt they had a good understanding of the scheme. There is still scope, therefore, to raise awareness and comprehension of the scheme further, not only among existing R&D performers but also among companies not currently doing or recognising R&D. Discussions with business have highlighted particular concerns over awareness among the smallest firms and firms outside the traditionally R&D-intensive industries and these findings are supported by the evaluation evidence.

3.14 The evaluation survey also showed that tax professionals and financial advisers were the main source of advice for businesses on the R&D tax credit. The Government will pursue further opportunities to promote and raise firms' awareness of the tax credit through these organisations. The importance of R&D in the regions is also a key feature of the Government's wider science strategy. The Government will work with business and business bodies, Regional Development Agencies and others to raise the visibility of the tax credit and improve comprehension of the scheme throughout the UK.

Wider business R&D trends

3.15 Respondents agreed that R&D is becoming increasingly internationalised. IFS analysis suggests that the internationalisation of R&D is particularly pronounced for the UK relative to other major economies; the UK is a significant exporter of R&D and has a higher share of business R&D financed from abroad than our G7 competitors. However, this increasing internationalisation, combined with the cyclical nature of R&D spending, means that UK R&D is particularly susceptible to fluctuations in global economic activity. In the ONS's Business Enterprise R&D survey, a 6 per cent fall in overseas funding of R&D was a major contributing factor behind the 1 per cent fall in expenditure on UK business R&D in 2004, in cash terms.

3.16 The IFS also find that UK multinationals are increasing the amount of R&D they undertake abroad, particularly in the US. Evidence from the US Bureau of Economic Analysis suggests that in 2000 UK majority-owned firms carried out $5 billion of R&D in the US, equivalent to about 28 per cent of all R&D performed in the UK. This is clear evidence of the strong performance of UK innovative firms worldwide – although it is not fully captured in the data on domestic R&D activity.

3.17 The IFS stress the productivity benefits for the UK flowing from this R&D activity. Multinationals play a vital role in enabling technology transfer between economies. Through locating R&D activity in other major economies, UK multinationals are able to transfer cutting-edge technologies back to the UK that might not otherwise be available through purely domestic R&D activity. At the same time, there are considerable benefits to be gained from R&D locating in the UK. Encouraging worldwide R&D investment in the UK is an important part of the Government's strategy to raise business R&D levels.

3.18 Encouragingly, some respondents indicated that the UK R&D tax credit can be an influencing factor in global decisions on the location of R&D. A number of respondents urged the Government to consider a higher large company R&D tax credit rate to raise the profile of the UK tax credit even further. However, the Government continues to believe that it is too early at this stage to draw conclusions on the effect of the large company scheme and is not therefore considering a change to the large company rate at this time. It is clear, however, that understanding of the implications of the increasing international mobility of R&D is still evolving, and the Government will continue to monitor this issue over time.

ENHANCING THE CREDIT

3.19 The Government is encouraged by the general message from respondents that the current structure of the R&D tax credit is effective and popular. It is also encouraged that the tax credit is beginning to have a positive impact on R&D spending. This anecdotal evidence has now been backed up by the first stage of the evaluation of the R&D tax credit, showing that 55 per cent of successful claimants had undertaken more R&D, or longer or riskier projects because of the R&D tax credit.

Framework for policy development

3.20 In line with the discussion paper, the Government is continuing to consider enhancements to the SME R&D tax credit. Having considered respondents' comments and the international evidence on R&D fiscal incentives, the Government is convinced that the key features of the R&D tax credit should be:

- simplicity, consistency and certainty in the tax credit claims process, to ensure that firms claim the tax credit and habitually build its value in to their investment decisions;
- a sufficient, visible and predictable incentive so that, where firms have certainty as to the value of the tax credit, they significantly boost their R&D spending; and
- a continuous and constructive dialogue between Government and business on the ongoing development of the R&D tax credit.

3.21 The simplicity of the UK's R&D tax credit, its improving consistency in delivery, and the growing stability around it as companies become accustomed to the scheme, are major strengths that will increasingly enable firms to build the value of the tax credit into their investment appraisal decisions. The Government will not at this time consider any changes to the SME scheme that might compromise these key strengths.

3.22 However, it remains clear that the trends in the changing business R&D environment present opportunities to help the UK achieve its targets for growth in business R&D. In particular, a key priority is to maintain and boost the growth of R&D performing firms throughout the SME population, and to encourage firms not currently involved in technological innovation to consider the benefits of undertaking or commissioning R&D.

3.23 The Government has reflected on the conclusions of the Cox Review regarding the structure of the R&D tax credit: specifically, an increase in the thresholds for the SME tax credit and the introduction of an incremental element to the scheme. The discussions with business have reinforced the Government's view that the volume-based structure is most effective; nevertheless, the Government will continue to consider the evidence presented by the Cox Review, including on the difficulties facing companies as they make the transition from SME to large company.

3.24 Over the coming months the Government will therefore review whether there are options that provide cost-effective enhancement to the existing incentives structure provided by the SME R&D tax credit. Any conclusions arising from these considerations will be announced at Budget 2006.

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