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Impact of the R&D tax credit

Adding value, reducing costs, investing for the future

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Innovation will be the key to business success as the economy reshapes during the downturn. For many companies this will require investment in research and development (R&D), even as finances become tighter. The government must build on the R&D tax credit and other measures to maintain business investment in R&D and position the UK as the best place for innovation and growth. A new CBI survey shows the tax credit is working well, but complacency now could drive high value jobs and new growth overseas.

Introduction

The R&D tax credit was introduced for small and medium-sized enterprises (SMEs) in 2000. The scheme was extended to large companies after extensive CBI and trade association lobbying in 2002. Since then, we have continued to seek ways to improve these schemes – making them as competitive as possible as business R&D becomes increasingly globalised. The combined schemes now benefit over 6,000 companies in the UK, at a total value of over £600m a year (**Exhibit 1, page 2**). We estimate that the large company scheme alone has been worth over £2bn since its inception.

It is important to understand the real impact of this investment by government, especially as the economic downturn begins to bite. R&D is a key component of innovation in many sectors and most companies agree that investment in innovation now is essential if they are to prosper when the upturn comes. In 2005 we conducted our first R&D tax credits survey,¹ allowing us to understand how companies perceive and use the tax credit, and what changes should be made. It provided evidence which underpinned our lobbying for a range of improvements to be

made. The latest survey focuses on progress made since then as the tax credit moves away from its 'bedding in' period, to one where it is an established part of the UK's R&D culture. The overwhelming message from business this time is positive: the UK R&D tax credit is well established and effective.

Key findings from the 2008 R&D tax credit survey

- Cost savings delivered by the R&D tax credit have doubled since our last survey – from a 4% reduction in R&D costs in 2005 to 8% on average in 2008
- Companies are now more positive about all aspects of the R&D tax credit
- The majority of companies have their claims met in full and 90% intend to claim the credit again
- HMRC has improved dramatically in terms of the advice it gives and how it handles claims, but costs incurred in making a claim remain a concern

In association with



- The tax credit has had an appreciable impact on R&D for 80% of companies claiming it, with many reporting a range of benefits:
 - 37% have already increased R&D as a result
 - 50% said it had directly helped maintain their R&D spend in the UK
 - 76% reported other indirect benefits that again helped maintain UK R&D spending.

What is the R&D tax credit?

Companies of any size can claim the whole cost of most of their current research and development spend against taxable income – a deduction of 100%. Following changes announced in the 2007 budget, R&D tax credits give SMEs a further deduction of 75% of their qualifying R&D expenditure, making 175% in all. Large companies are entitled to an additional 30% deduction, making 130%. Previously SMEs could claim 150%, and large companies 125%. The CBI calculates these changes should now reduce the cost of qualifying R&D for SMEs by a maximum of 15.75%, and by 8.4% for larger companies paying the standard rate of corporation tax. A special vaccine research relief is also available. SMEs not in profit can claim a payable credit of £24.50 for every £100 spent on R&D. HMRC paid out £670m across all its R&D schemes in 2006-07.

Background to the survey

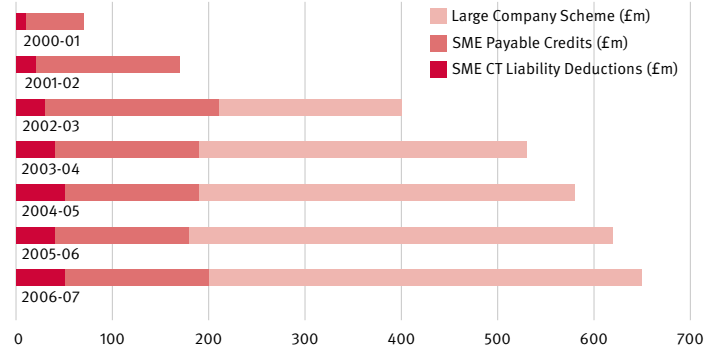
The survey was conducted in conjunction with partners from our trade association forum (including AIRTO, SBAC and Intellect)² and was emailed to members in November 2008. Seventy companies responded, of which 62 had claimed or were in the process of claiming the R&D tax credit.

Breakdown of companies in the survey:

- SMEs (companies with 1-249 employees) 36%
- Mid-sized (250 – 999 employees) 21%
- Larger companies (1,000+ employees) 43%

Half of the survey respondents were senior employees responsible for company tax or finance. A fifth were CEOs, managing directors or chairmen, 16% were R&D directors, technical directors or responsible for product development. A broad range of sectors were covered in the survey, including: aerospace, chemicals, consultancy, construction, defence, electronics, energy, engineering, food and drink, ICT, manufacturing, medical, pharmaceuticals, specialist R&D, telecommunications, water and utilities. Other more specific areas of communications, manufacturing and software development were also represented. Companies in the survey collectively spend over £5.2bn a

Exhibit 1 Value (£m) of tax credit claims – HMRC data



year on R&D in the UK. This represents over a third of the £14.5bn total business R&D investment in the UK in the period 2006-07.³

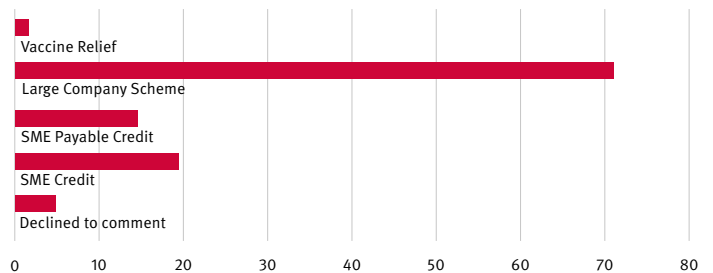
Use of the R&D tax credit

Eighty-nine percent of respondents had applied or were in the process of applying for the tax credit. Companies that had not claimed gave a variety of reasons. Some believed the claims process was too complex or that the tax credit was not relevant to them because of company governance or other factors. A number were also doubtful whether their work qualified as R&D activity.

Seventy percent of companies that had claimed the credit used the large company scheme, which was also used by a couple of smaller companies not meeting the criteria for the SME scheme.⁴ A number of SMEs applied for both the SME credit and the SME payable credit (**Exhibit 2**).

The majority of companies (56%) had their claims met in full – an increase from just 45% in 2005. Twenty percent said it was too early in the claims process to judge if they had been successful, but as in 2005, no claims had been rejected. As the proportion having their claims met in full has increased, the proportion with claims only partially accepted has fallen to just 20% – down from 51.5% in 2005.

Exhibit 2 Which R&D scheme used (%)



Experiences to date

As in 2005, the survey asked questions relating to companies' experiences so far and asked respondents to rate their answers on a four-point scale from 'unacceptable' to 'fully satisfied.' We repeated the same questions in our latest survey to provide a direct comparison covering three themes: technical aspects of the tax credit, advice and guidance, and the overall claim process.

Technical aspects of the tax credit

There are several criteria companies must meet before claiming the R&D tax credit. For example, there must be qualifying expenditure of at least £10,000 on R&D in the accounting period, and unless working with a university or similar organisation, companies must do the R&D themselves. R&D is defined by reference to DTI guidelines from March 2004, although not all R&D in this definition qualifies for the R&D tax credit. The CBI and some trade associations have lobbied for the full DTI definition to be used for qualifying R&D and for changes to the pre-claim criteria to make the tax credit align better with business needs.

Key improvements have been made since 2002 – for example, reducing the minimum qualifying expenditure, allowing assessment on the basis of overall R&D projects (rather than individual components of a project), and including some utility, software and other costs. Encouragingly, the majority of companies (86%) are now either satisfied or fully satisfied with the pre-claim criteria (up from 71% in 2005) and 80% are positive about HMRC's definition of R&D. Only 4% continue to find the R&D definition unacceptable – a marked improvement from the 16% in 2005.

Advice and guidance

Companies were asked about the guidance offered by HMRC in general (eg from their website and normal contacts) and also from HMRC's specialist tax credit centres. Over two thirds of companies (71%) said the general advice given by HMRC was satisfactory. Again, this is a major improvement on our previous survey when only 48% of companies were satisfied.

In November 2006, HMRC announced the creation of seven specialist R&D tax credit centres to handle all claims from companies outside the Large Business Service. The specialist centres are based across the country and staffed by specially trained officers with the aim of providing a more consistent service to applicants, while also raising awareness of the tax credit scheme.⁵ Three quarters of respondents were satisfied or fully satisfied with the service they received from these centres.

Most companies (62%) were also satisfied with the advice and help provided by other government business support services, but none were fully satisfied. In contrast, 91% of respondents were satisfied or fully satisfied with the advice provided by non-government sources.

Exhibit 3 Cost of preparing claim – balance +15%

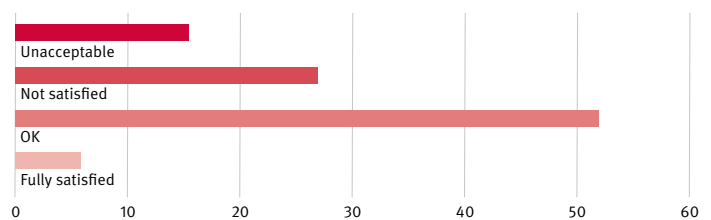
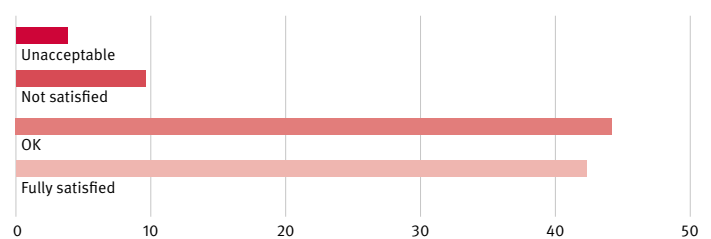


Exhibit 4 Overall value of tax credit – balance +72%



Claim process

A key problem highlighted by respondents in 2005 was the way claims were handled by the former Inland Revenue. For many companies making their first claim the experience may well have affected their decision to apply again. HMRC's performance on this important metric has improved considerably over the intervening three years. Over a quarter of companies (26%) now say they are fully satisfied with the claims process, and a further 57% are satisfied.

We welcome the steps taken by HMRC to improve its claim-handling performance. It is vital to the credit's integrity that companies have confidence in the scheme and that the claim process is consistent. Establishing the specialist centres, training staff and engaging directly with business to understand the R&D process has clearly paid off.

One key area that remains a concern is the cost of claiming. In tough economic conditions and with companies looking for radical cost control, this factor may well deter some companies from using the scheme. The majority (51%) were satisfied with the costs incurred, yet still too many (42%) were not satisfied or found the overall cost of preparing claims unacceptable (**Exhibit 3**). This is an area where HMRC should work with business to minimise the effort required in collecting data for tax credit claims. Ideally this should be done directly from reporting systems businesses already use for other purposes. Wider engagement by business with HMRC's specialist advice centres is also likely to help.

Costs are also incurred when consultants are involved in helping companies prepare claims, but we expect some of these costs to fall

as companies become more confident with the process after making claims over a number of years. As one large company told us, the cost of consultants to help with early R&D tax credit claims was ten times higher than it had ever paid for consultancy work before – although this did also bring a direct financial return which made it an effective investment.

Despite the costs, the survey shows companies certainly value the tax credit (**Exhibit 4, page 3**). Eighty-seven percent said they were either satisfied or fully satisfied with the overall value provided by the scheme, a rise of over 30 percentage points on 2005.

Overall experience 2005-2008

Comparing the percentage balances (those satisfied or fully satisfied minus those not satisfied or reporting their experience as unacceptable) from 2005 with 2008, shows just how much real progress has been made (**Exhibit 5**).

Across every category, companies report a positive balance of experience and in some areas there has been a dramatic improvement. Improvements in the qualifying R&D definition and in pre-claim criteria, for example, reflect our efforts in lobbying for the scheme to be made more effective. The cost involved, while a concern, shows a small positive balance – disappointingly low at +15%, but still considerably better compared to a negative balance of over 30% in 2005.

The ease of claiming balance score is now +47%, having risen from zero in 2005, and the balance score for the overall value of the tax credit is up from +21% to +74%.

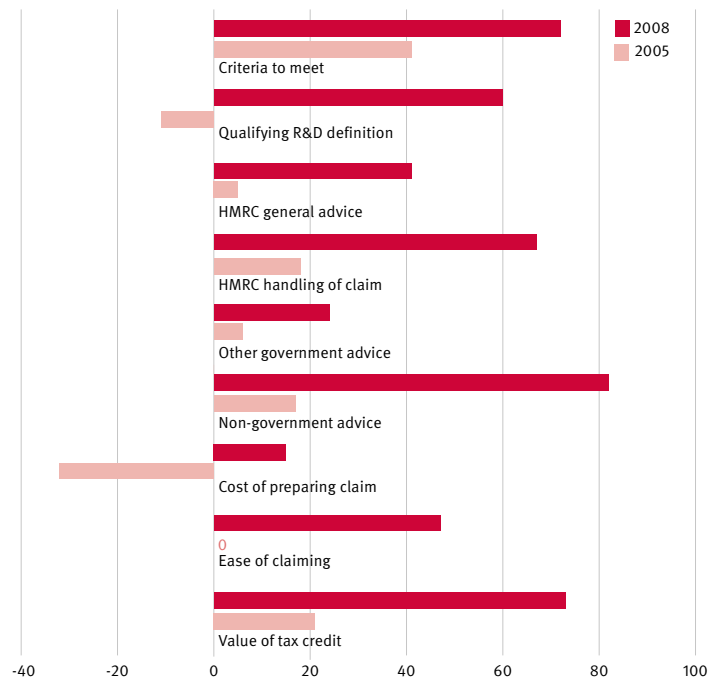
In terms of advice and claim handling, the government should be very pleased by the improvement shown for HMRC. The general advice balance score for HMRC has increased eightfold to +41% and the score for claim handling has more than trebled to nearly +70%. Further improvement could still be made though to match the balance score of over +80% achieved by the non-government providers of advice and guidance.

The overall experience pattern demonstrates the tax credit has now moved out of an early period of uncertainty, where business and government were both finding their feet, to a much more confident position. In 2005, the tax credit was still a relatively new addition to the R&D incentives on offer to business in the UK with many companies making claims for the first time. Equally, the Inland Revenue was unused to administering the credit in large numbers. A period of ‘bedding in’ was inevitable, but now it is well established.

Impact of the R&D tax credit

It is important that company experiences with the tax credit have improved, but the key issue for government and business is whether the credit is having the desired impact on R&D for the investment made.

Exhibit 5 Experiences 2005-2008 comparison (% balance)



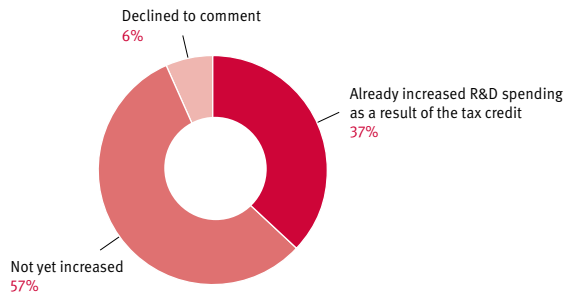
We asked companies to assess the impact on R&D spending after making an application and to consider the role of the tax credit in helping to either maintain or grow their R&D activities in the UK (**Exhibit 6**).

Thirty-seven percent said they had increased their UK R&D spending as a direct result of the R&D tax credit. This is double the proportion (18%) that reported an increase in the 2005 survey. An improvement had been expected as companies become more comfortable with the scheme and are able to factor in likely cost savings against future investment plans, but this level of increase in companies investing in additional R&D after just a few rounds of claiming is very promising. It should also give greater confidence that the tax credit will deliver for companies starting to make their first claims now.

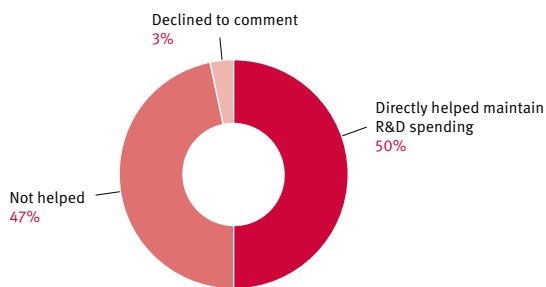
Given the rise in globalisation – with many opportunities to offshore R&D activities to lower cost centres and new markets – we were always more hopeful about the role of the tax credit in helping maintain R&D activity in the UK. Again, the survey response here is very encouraging. Over three quarters (76%) said the tax credit helped them indirectly to maintain UK R&D spending, and 50% said it had a more direct impact on maintaining UK R&D.

Exhibit 6 Tax credit influence on R&D spending in the UK

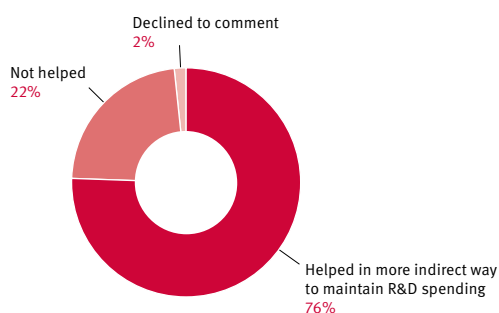
Increased



Maintained



Other indirect benefits



Indirectly, the tax credit is used by companies to offset the cost of other tax and regulatory burdens in the UK – for example, the large company scheme was introduced just as National Insurance Contributions increased – so the tax credit is seen as an important element in the overall business case for maintaining UK operations. More directly, the tax credit has helped to keep the UK competitive against other countries offering their own R&D incentives, often combined with lower costs – the salaries of skilled R&D staff being a major cost component. It is notable that the UK has a higher proportion of business R&D financed from

abroad than any other OECD country and inward investment remains high, suggesting that the UK is competing well for globally mobile R&D. And the tax credit is part of the offering that makes the UK attractive.

Overall, 80% of companies claiming the tax credit reported tangible direct or indirect benefits to their R&D activities in the UK as a result of the scheme. For the remaining companies, other benefits may have been realised that were not captured in this survey. However a couple of respondents noted that as this is a tax measure, rather than a direct R&D intervention, it had been difficult to link the benefit of the tax credit to actual R&D activity. Making this link more explicit could make the scheme even more effective.

The real value of the tax credit

The bottom line on value for companies is the amount by which their overall R&D costs are reduced when claiming the tax credit. This will always be less than the advertised tax credit rate as not all R&D-related activities are eligible – the key to creating a successful scheme is to ensure the value is enough to make an impact. Companies able to estimate a figure this time told us that the tax credit, on average, now saves them 8% of their R&D costs (**Exhibit 7, page 6**). This is a significant figure, representing a doubling of the costs saved in 2005 (4% mean) and evidence that claiming the credit has a real financial value.

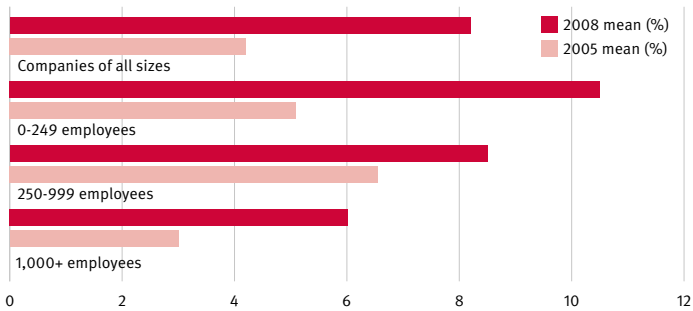
SMEs made the highest cost savings of 10.5% on average (up from 5.1% in 2005). Medium-large companies reduced their costs by 8.5% (up from 6.3%) and, encouragingly, even large companies are now able to reduce their costs appreciably – by 6% on average, compared to just under 3% in 2005.

This is an important milestone to reach, particularly for larger companies. A key CBI concern during development of the tax credit was it should seek to influence R&D decision-makers. Our recommendation was for the credit to be set at a level able to reduce overall R&D costs by 10%, but at the very least the tax credit value had to exceed the general ‘noise level’ for investment decisions. Companies estimated the noise level to be anything less than 5-6% of costs.

Having now reached this level of value, the R&D tax credit should begin to have an even greater impact. It should start, more clearly, to influence investment decisions and ought to feature more prominently on the radar screens of all companies undertaking R&D in the UK, even if they have dismissed the tax credit previously. But the government must accept there is still some way to go before our 10% target value is reached for all companies and it should look again at improving the scheme.

As one company currently only able to realise a 2% reduction in R&D costs told us, the tax credit still represents an add-on benefit rather than acting as a catalyst for new activity.

Exhibit 7 Percentage of R&D costs saved as a result of claiming the R&D tax credit (by company size)



How to improve the R&D tax credit

In the 2005 survey, respondents identified two specific ways to improve the tax credit: increase the range of eligible costs (ie widening the scope of the tax credit and the definition of R&D) and increase the rate of the tax credit. In 2008, these factors were again seen as key to enhancing the credit and companies cited both in equal measure.

As in 2005, one of the main criticisms of the scheme is that overhead costs on R&D projects are not included. It would make a significant difference if all infrastructure, maintenance, security and ancillary staff costs associated with R&D programmes could be included. This would be a major step towards realising the 10% cost reduction target discussed on page 5.

Suggestions for further improvements include:

- Continued simplification of the claims process and how to calculate claims
- A greater variety of incentives to encourage investment, with possibly even higher rates for certain areas of R&D
- Widening the range to include the development of business systems
- Payments to other companies to be covered when licensing-in technologies and IP.

There was also a call for the experience built up in the specialist HMRC centres to be replicated for the Large Business Service, which is now under-skilled by comparison and yet has to handle some very large claims.

Some trade bodies and individual companies have been actively involved in helping change the culture in HMRC – for example, Intellect ran a one-day training course on software for 50 tax inspectors at HMRC's residential training centre – and it's likely that other sectors could benefit from similar engagement.

Significantly, companies also called for long-term commitment by government to maintaining the R&D tax credit and the standard 100% allowance.

Future investment

Ninety percent of applicants said they would apply for the R&D tax credit again, with only 3% reporting they would not claim again having already done so – seven percent declined to comment, perhaps reflecting uncertainty over investment plans in the current economic climate.

Had the R&D tax credit not been available, nearly 60% of companies said their UK R&D activities would have been affected. Thirty percent said they would have done less R&D, 15% that they would have moved some R&D overseas, while a number would have sought other ways to offset the extra costs – perhaps impacting on wider business investment. If the tax credit ceased to be available in the near future a similar picture could be expected, but even more companies (20%) said they would actively relocate R&D overseas.

International competition to attract R&D investment is fierce, with France currently proclaiming itself the best place in Europe to invest, with its advertised 50% research tax credit rate, and the US recently making a renewed commitment to its own R&D scheme. All of our major competitor countries now have R&D tax reliefs in some form and the UK must not become complacent.

There is also heightened concern over the possible severity of the downturn, which will become a major factor influencing business investment decisions of all types – and in particular new R&D activity where the benefits of spending may not be realised for some considerable time. Many companies are also anticipating severe reductions in profit over the coming year. This is likely to mean some medium and larger companies will be unable to benefit from the tax credit schemes as currently devised.

Now, more than ever, it is vital for companies making long-term investment decisions to have the confidence that incentives such as the R&D tax credit will continue, and indeed improve in value with time. We encourage the government to commit to the future of the R&D tax credit and provide further incentives for companies to claim. Any suggestion of doubt over the tax credit may well act as a disincentive to companies' future R&D activity in the UK at a time when all business investment decisions are under the closest scrutiny.

Summary and recommendations

The R&D tax credit enhances the UK's image as a destination for high value investment and jobs. Our 2008 survey demonstrates companies see real benefits from the tax credit. It makes a valuable contribution to maintaining and growing R&D investment in the UK and is now a well-established part of the UK's innovation ecosystem. While the scheme can be improved further through continued engagement with business to ensure its needs are being met, substantial progress has been made since the 2005 survey. The tax credit is now factored into investment decisions on where R&D operations are established and maintained, and it has contributed to creating a competitive environment for R&D and innovation in the UK.

Over the last three years, R&D cost savings through the tax credit have doubled on average to 8%. The majority of claims are now met in full and almost all the companies that claimed intend to do so again. The credit is directly responsible for over a third of claimants increasing their R&D spending, 76% say it has helped to maintain R&D activity in the UK and 80% have realised R&D-related benefits in some form.

The role of HMRC has improved significantly in terms of the advice provided and how claims are handled, but costs associated with making a claim remain a concern.

As the scheme matures and grows, the government should guard against complacency, given the incentives on offer from other countries and concerns over the economic downturn, and should take action to improve the R&D tax credit further.

We recommend the following government action:

- Commit to the future of the tax credit
- Continue to extend the rate and range of the credit to allow more companies to apply for the scheme and for the tax credit to cover additional R&D overheads
- Work with business to identify where costs can be reduced when making a claim
- Compare the incentives on offer in the UK with those from our international competitors to ensure UK support of business R&D remains competitive
- Focus on further embedding the tax credit as part of the UK's R&D culture.

A scheme of such size and magnitude needs time to be judged effective. We believe good progress has been made so far and this survey shows business confidence in the R&D tax credits has grown dramatically over a relatively short time. It is important this process continues, allowing companies to take advantage of tax credits, and ensuring further growth and investment in the UK's R&D base in future.

Acknowledgements

The CBI expresses its grateful thanks to all those who contributed to the R&D tax credit survey. In particular we acknowledge the help and support provided by our trade association partners.

Footnotes

- 1 *The R&D tax credit: performance & value* – CBI, July 2005.
- 2 Association of Independent Research & Technology Organisations, Society of British Aerospace Companies, and Intellect – the trade association for the UK technology industry.
- 3 *OECD Main Science & Technological Indicators 2008/Volume 1*. Note that this figure is less than recorded in the government's R&D Scoreboard as the Scoreboard also includes overseas R&D spending by UK companies.
- 4 HMRC uses the European Commission's definition of an SME – ie a company with fewer than 250 employees, and either an annual turnover not exceeding €50m or a balance sheet totalling €43m, and which is not part of a larger enterprise that would fail these tests.
- 5 The specialist R&D tax credit centres are located in Cambridge, Croydon, Leicester, Maidstone, Manchester, Southampton, and Cardiff (covering Wales, Scotland and Northern Ireland).