

Summary: Intervention & Options

Department /Agency: HMT	Title: Impact Assessment of changes to R&D tax credits to ensure State aid compatibility	
Stage: Final proposal	Version: 1.0	Date: 12 March 2008
Related Publications:		

Available to view or download at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/ria/consult_ria_index.cfm

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What is the problem under consideration? Why is government intervention necessary?

Research and development (R&D) tax credits aim to encourage companies to spend more on R&D in order to promote investment in innovation. Three changes are needed to the R&D tax credit scheme for companies that are small and medium sized enterprises (SMEs) and the vaccine research relief (VRR) scheme. At Budget 2007, the Government announced changes to the schemes, notably to increase the rate of the relief given, and, as a consequence, the small changes described below are necessary to ensure that the revised, more generous, reliefs still fall within the European Commission's state aid guidelines.

What are the policy objectives and the intended effects?

The package is intended to ensure that the UK can obtain EC approval in respect of recently announced changes to the SME R&D and VRR schemes. Budget 2007 announced increases in the rate of the tax relief from 150% to 175%. The three changes described in this document will enable this Budget announcement to be activated and make additional relief available to companies.

What policy options have been considered? Please justify any preferred option.

1. Do nothing - in which case the EC guidelines would not be satisfied.
2. Continue operating a two-tier scheme complying with EU state aid rules, which requires:
 - A cap on relief available to any single R&D project at EUR 7.5m
 - That relief is not given to companies in difficulties
 - Large companies claiming under the Vaccine Research Relief scheme to declare that the relief has had an incentive effect.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A Compliance Cost Review is expected to be carried out once the policy has bedded in (typically between 1 and 3 years after implementation).

Ministerial Sign-off final proposal/implementation Impact Assessment:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Angela EagleDate: 4 March 2008

Summary: Analysis & Evidence

Policy Option:	Description: changes to R&D tax credits to ensure State aid compatibility
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COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' The estimated one-off cost almost all reflects companies familiarising themselves with changes and accounts for half of the total cost. The average annual cost is split between all companies checking they are a going concern, a few companies checking the cap and a few large companies declaring a VRR incentive.
	One-off (Transition) Yrs	5	
	£ 260k-630k		
	Average Annual Cost (excluding one-off)		
£ 60k		Total Cost (PV)	£ 490k-830k
Other key non-monetised costs by 'main affected groups'			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups'
	One-off Yrs		
	£		
	Average Annual Benefit (excluding one-off)		
£		Total Benefit (PV)	£
Other key non-monetised benefits by 'main affected groups'			
The main benefit from these changes is allowing companies to continue to claim support under the SME R&D tax credit and VRR schemes.			

Key Assumptions/Sensitivities/Risks Changes are assumed to enable companies to continue to claim support under the SME R&D tax credit and VRR schemes, with no significant Exchequer effect. Present value estimates assume a 3.5% discount rate.

Price Base Year 2008	Time Period Years 5	Net Benefit Range (NPV) £ 490k-830k (cost)	NET BENEFIT (NPV Best estimate) £ 660k (cost)
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What is the geographic coverage of the policy/option?	UK				
On what date will the policy be implemented?	to be decided				
Which organisation(s) will enforce the policy?	HMRC				
What is the total annual cost of enforcement for these organisations?	£				
Does enforcement comply with Hampton principles?	Yes/No				
Will implementation go beyond minimum EU requirements?	No				
What is the value of the proposed offsetting measure per year?	£ N/A				
What is the value of changes in greenhouse gas emissions?	£ N/A				
Will the proposal have a significant impact on competition?	No				
Annual cost (£-£) per organisation (excluding one-off)	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; background-color: #ffffcc;">Micro 10</td> <td style="width: 25%; background-color: #ffffcc;">Small 10</td> <td style="width: 25%; background-color: #ffffcc;">Medium 510</td> <td style="width: 25%; background-color: #ffffcc;">Large 2,400</td> </tr> </table>	Micro 10	Small 10	Medium 510	Large 2,400
Micro 10	Small 10	Medium 510	Large 2,400		
Are any of these organisations exempt?	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">N/A</td> <td style="width: 25%; text-align: center;">N/A</td> </tr> </table>	No	No	N/A	N/A
No	No	N/A	N/A		

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ 25k	Decrease of £	Net Impact £ 25k increase

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base

PROPOSED CHANGES

The research and development (R&D) tax credit scheme for companies that are small and medium-sized enterprises (SMEs) and the vaccines research relief (VRR) scheme are notified State aids and must comply with the European Commission's (EC) Research and Development and Innovation (R&D&I) guidelines published in 2006. In line with this, we are required to introduce three changes:

- a cap to limit the amount of relief available in respect of a single research project to EUR 7.5m;
- a restriction so that aid is not provided, under either scheme, to companies in difficulty. To achieve this we will be adding, as a condition of making a claim, a requirement that a company's accounts be prepared on a "going concern" basis; and
- a requirement that large companies claiming support through the VRR scheme must make a declaration that the aid received had an incentive effect.

A number of alternative options were considered. The introduction of a cap was in preference to the alternative of companies individually notifying to the EC details of any projects for which they had received relief in excess of EUR 7.5m. The EC would then have the discretion to refuse all the relief, not just that above the cap. This would have added considerable complexity and uncertainty to the whole claims process.

The EC limits the amount of aid provided to companies in difficulty but its definition of such a company is not easily applicable and might have affected companies which are not actually in difficulties. The "going concern" test is a concept already familiar with UK companies and accountants.

The UK must be able to evidence an incentive effect arising as a result of large companies receiving VRR relief. The government had no other choice regarding this issue.

SUMMARY OF ESTIMATED IMPACTS

The proposed cap may affect around an estimated 25 companies out of the total 5,000 companies claiming the SME tax credit and VRR each year. HMRC are not aware of any companies that would be affected by the proposal for companies in difficulty and, if any companies are affected, the number is likely to be extremely small. The proposal for large companies to declare an incentive effect when claiming VRR is estimated to affect around 5 companies a year.

The total admin burdens for R&D tax credits are estimated to increase by around £25,000 a year as a result of these proposed changes. This increase is split between the effects of the proposed cap and the proposed declaration of a VRR incentive effect. In addition, the proposed changes are estimated to increase wider compliance costs, comprising a one-off cost in range of £260,000 to £630,000 and an ongoing cost of around £25,000 a year. Finally, the changes are estimated to involve an ongoing cost to HMRC of around £10,000 a year. **Overall, therefore, the proposed changes are estimated to involve a total one-off compliance cost in the range of £260,000 to £630,000 and a total ongoing cost of around £60,000 a year.**

In estimating the total cost, the one-off cost is summed with ongoing costs over an assumed five-year period and a present value total calculated using an assumed 3.5% discount rate. This shows **a total estimated cost over five years in the region of £490,000 to £830,000**. The central point of this range is taken to give **a best estimate of the net cost of £660,000 over five years** (at present value), equivalent to an annual average cost of around £130,000 over the period.

The proposed changes are not expected to have any adverse impacts on competition. Indeed, as the changes are required to ensure compatibility with State aid guidelines, they may involve a small positive effect on competition. Similarly, the proposed changes are not expected to have a disproportionate effect on small companies. Indeed, the effects of the proposed changes should either be similar across companies of all sizes or disproportionately affect larger companies.

DETAILED ASSESSMENT OF POTENTIAL IMPACTS

Number of businesses affected

EUR 7.5m cap per R&D project

This proposed change will mean that relief provided under the SME R&D tax credit or VRR schemes will be capped at EUR 7.5m per R&D project; any R&D in excess of the cap can only be claimed under the large company scheme. The value of the 7.5m euros cap in sterling will vary with the prevailing exchange rate but is likely to translate to a cap of around £5.5m.

Companies typically claim R&D tax credit support on annual basis rather than in terms of specific R&D projects. So far, claims made for the SME R&D tax credit are well below the £5.5m cap. Latest monitoring statistics for the SME scheme show that of the 15,000 or so claims made over the latest three years (2003-04 to 2005-06), only about 50 claims were for more than £1m of support, between 15 and 20 each year. Of these 15-20 claims each year, around 10-15 claims were for support of £1m to £1.5m, around 5 were for support of £1.5m to £2m and, in one of the three years, 1 claim was made for support of over £2m.

It is also not the same companies claiming the largest amounts of support each year. In 2005-06, for example, the top 20 claims were for support ranging from £0.97m up to £1.7m. Of these 20 claims, 8 had also claimed a similar amount in both of the two previous years (2003-04 and 2004-05), whilst a further 6 had claimed a similar amount in 2004-05 but not in 2003-04. The remaining 6 companies had not claimed a similar amount in either of the two previous years.

Even allowing for projects that run over several years, it seems unlikely that the proposed cap will affect more than around 10 companies at most. For reasons of caution in estimating the impacts, however, we will assume that around 25 companies using the SME scheme may potentially be affected by the proposed cap and hence will need to consider it when claiming support.

No claims have been received under the VRR scheme for support of more £300,000, which suggests that it is extremely unlikely that any companies claiming VRR will be affected by the proposed cap, even allowing for projects to run over several years.

Companies in difficulty

This proposed change will mean that relief will not be provided under the SME R&D tax credit or VRR schemes to companies that are not a “going concern” according to their most recent accounts. Monitoring data for R&D tax credits does not contain information on whether or not a company is a “going concern”. However, HMRC are not aware of any companies claiming R&D tax credits that are not a “going concern” and it is expected that the number of any such companies would be extremely small (i.e. less than one per cent). Companies will already hold information on whether they are going concern and there should be no uncertainty surrounding this fact. Companies will not be required to submit any additional information to HMRC proving that they are a going concern, nor will they be required to keep additional records on this.

Declaration of VRR incentive effect

This proposed change will require large companies claiming VRR support to declare that there is an incentive effect from the relief. Monitoring statistics on R&D tax credits shows that around 10 companies claim VRR each year. This total comprises up to 5 large companies and between 5 and 10 SME companies claiming VRR each year. The proposed change is, therefore, assumed to affect up to 5 large companies each year. Each company would need to make a declaration in the computations filed with their CT return and to maintain background documentation backing this up.

Impact on admin burdens

Admin burdens, as measured by the Standard Cost Model, form a subset of overall compliance costs.

EUR 7.5m cap per R&D project

The proposed cap will not change the way that companies claim support through R&D tax credits and hence there is no change to the information obligations comprising the admin burdens for the SME scheme. However, the proposed cap will require some companies to undertake additional work in meeting those obligations and hence will result in an increase in admin burdens.

For the 25 companies assumed to be potentially affected by the proposed cap, there will be an ongoing burden to check whether or not the relief claimed for those projects reaches the cap or not. This will initially require some detailed familiarisation work to ensure that they understand the full implications of the cap and how it will affect them. These companies will also all need to spend some additional time each year to check that the relief claimed for each project does not exceed the cap.

The cost of this additional burden will vary between companies that use an agent and those undertaking the work themselves. For those carrying out the additional burden themselves, an assumption that the additional requirement would involve a day's work on average implies an additional burden of around £200 per company (assuming eight hours work at an average hourly wage of £25). Comparison with the 2005 admin burden database suggests that an additional £200 cost represents a 40% increase in the average burden of companies that don't use an agent. It seems extremely unlikely that the proposed cap would raise burdens to this extent and hence suggests that the assumed £200 cost is likely to be an over-estimate.

For companies that do use an agent, we would expect a higher cost from meeting the additional burden. The 2005 admin burden database shows that the average burden from R&D tax credits is roughly four times larger for companies using an agent compared to those not using an agent. Applying this ratio to the assumed £200 average cost per company not using an agent, therefore, suggests an average cost of £800 per company using an agent. Again, this represents a 40% increase in the 2005 admin burden baseline for companies using an agent, which most probably overstates the likely effects of the proposed cap.

Applying the average £200 cost per company not using agents to half of the 25 companies assumed to be affected suggests a burden of £2,500. Applying the average £800 cost per company using agents to the other half of the 25 companies affected suggests a burden of £10,000. Taking these together gives an additional annual burden of £12,500 in total for the 25 companies assumed to be affected.

Companies in difficulty

Companies that are not "normally efficient" are out of scope of the standard cost model for admin burdens and hence the effects of the proposed change on any companies that are "in difficulty" are assumed not to impact on admin burdens but count as wider compliance costs.

Declaration of VRR incentive effect

The 5 large companies assumed to be affected by this change would need to familiarise themselves with this change, incurring a small one-off cost. Familiarisation might involve someone at each company reviewing the change and understanding the implications for that company.

These 5 large companies would also be required to declare an incentive effect each time they make a claim for VRR following the change. The detailed process that would be required by this declaration is currently being negotiated with the Commission. However, it is anticipated that, for each VRR claim, the company would need to consider whether and how the relief has increased or changed the size, scope, speed or expenditure for that R&D. The nature of the impact would most likely need to be documented and a statement included in the company's CT computations. This process is not intended to represent too onerous a task and, since the company should already have the majority of this information, it is hoped that the work involved will be minimised.

The cost of these requirements will vary depending both on amount of effort a company makes to demonstrate an incentive effect as well as whether or not the company uses an external agent in claiming VRR. Given this uncertainty, we assume a variety of effects in order to ensure the range of potential outcomes are reasonably represented.

Where a company either does the work internally or commissions a relatively simple report from an agent, we might assume a relatively low average cost of, say, £1,000. Where a company either undertakes a comprehensive internal assessment of the incentive effect or commissions a more substantial report from an agent, we might assume a slightly higher average cost of, say, £2,500. Finally, a company may opt to commission a detailed and extensive report from an agent, with an assumed cost of £5,000. Finally, assuming that two of the five affected companies incur the lower cost of £1,000 each, a further two incur the central cost of £2,500 each and the final company pays £5,000, would produce a total annual burden of £12,000. These assumptions are based on the figures which exist in the admin burdens baseline.

It should be noted that this proposed change will not affect small and medium sized companies as only large companies are required to declare an incentive effect of VRR support.

Summary

Overall, therefore, the proposed changes are estimated to have an admin burden increase of almost £25,000 a year. Half of this estimated burden arises from the proposed cap and half from the VRR incentive declaration. In order for these total costs to exceed what would normally be considered as negligible, the fees charged by agents would need to be of a completely different order of magnitude. This is considered to be unlikely and unnecessary, given the existence of the HMRC R&D tax credit units.

Impact on wider compliance costs

Familiarisation

In total, around 5,000 companies each year are estimated to claim the SME R&D tax credit, including the mid-size extension, and/or the VRR scheme. All of these companies will need to familiarise themselves with the proposed new EUR 7.5m cap and the rule around companies in difficulties. As the vast majority of companies are extremely unlikely to be affected by either change, they will simply need to spend a small amount of time to understand the proposed changes and satisfy themselves that they will be unaffected.

This familiarisation might be expected to take a few hours at most. If it took between two and five hours at an average hourly wage of £25, the average cost per company would be £50 to £125. This would represent a total one-off cost of between £250,000 and £625,000 for all 5,000 companies.

There seems to be little reason why the average cost of familiarisation will vary between small and medium-sized companies. Although larger SMEs and mid-size companies are likely to spend more on R&D and hence may need to take a little more time to understand the change and ensure they will not be affected, it seems unlikely that this will involve substantially larger familiarisation costs given that only a very small number of companies are likely to have sufficiently large R&D projects that may approach the cap. On the changes for companies in difficulty, all companies should be aware of whether they are a "going concern" and so there does not appear to be any strong reason why familiarisation of this change should vary substantially between different sized companies.

One-off IT costs

To comply with the proposed cap, the 25 companies assumed to be affected may well need to ensure that their internal accounting systems are able to track the R&D spending and relief claimed for each individual R&D project. Some companies may already use such systems, some may need to make small adjustments to existing accounts software, whilst others may need to make substantial improvements or purchase new software. These adjustments and improvements represent a one-off compliance cost.

Given the small numbers of companies likely to be affected by this change, we assume that 10 companies already track R&D projects, a further 10 companies need to make small adjustments to existing software, and a further 5 companies will require more substantial improvements. This will involve additional one-off costs for those companies needing to adjust existing software or to improve their systems.

Assuming an average cost of £250 for adjusting software would give a total burden of £2,500 for the 10 companies affected. Assuming a higher £1,000 average cost for improving systems would give a total burden of £5,000 for the five companies affected. Together, this suggests an additional one-off burden of around £7,500.

These costs are particularly uncertain as the standard of companies' existing accounts systems are unknown and the cost of adjusting or improving systems are likely to vary. However, the very small number of companies affects makes it very unlikely that the total cost will be substantial.

Companies in difficulty

The change relating to companies in difficulty will require a company to consider whether it is a going concern every time it claims relief under the SME R&D tax credit scheme. As the judgement of whether a company is a going concern is included in its accounts, which are required to support a claim, this check should take only a few minutes. Assuming 10 mins on average per company at an average hourly rate of £25 would imply a total ongoing cost of £25,000 per year for the 5,000 claims. As noted above, there does not seem to be any strong reason why this average cost should vary substantially between different sized companies.

Inquiry costs

If the proposed EUR 7.5m cap leads to one or more businesses being subject to an HMRC enquiry when otherwise they would not (see below), those businesses would incur additional compliance costs as a result (assuming they were found to be compliant). This might include costs of providing information to HMRC as well as more intangible costs associated with the enquiry procedure in general (e.g. uncertainty).

Summary

Overall, therefore, the proposed changes are estimated to have wider compliance costs comprising a one-off cost in the range of £260,000 to £630,000, mainly driven by familiarisation costs, and an ongoing cost of £25,000 per year from companies checking they are a going concern.

Impact on HMRC

EUR 7.5m cap per R&D project

In addition to costs incurred by companies, the change will also involve costs to HMRC. Companies' tax computations do not show the relief claimed by individual projects and so HMRC could only check this by opening an enquiry. Therefore, HMRC are most likely to identify companies that have claimed £4-5m of relief over a few years (and so may have a project approaching the cap) and explore whether they would need to open an enquiry to explore whether that company may be nearing the cap.

As it is only likely to be a small number of companies claiming this amount of relief, this check is unlikely to involve substantial resources. This might involve a total of five days a year at a total ongoing cost of £500 per year. If this work led to one additional enquiry being opened, this might involve a further £500 cost per year, implying a total ongoing cost of around £1,000 per year.

Companies in difficulty

In addition to costs incurred by companies, the change will also involve costs to HMRC. HMRC will need to check that each claim for relief is by a company that is a going concern. As this will simply mean checking the company accounts, which are easily accessible, the cost will be very small – perhaps an average of five minutes for each of the 5,000 claims per year, suggesting a total annual cost of £7,500.

Declaration of VRR incentive effect

In addition to costs incurred by companies, the change will also involve costs to HMRC. HMRC will need to check that each claim for VRR includes a declaration of the incentive effect. As this will simply mean

checking that the declaration has been made in the company's CT computations, the cost will be very small – perhaps an average of 10 minutes for each of the five claims, suggesting a total annual cost of less than £50.

Summary

Overall, therefore, the proposed changes are estimated to generate an additional ongoing cost of around £9,000 a year, mainly comprising that all companies claiming the SME R&D tax credit are a “going concern”.

Risk analysis

There would appear to be a number of potential risks relating to the accuracy of these compliance cost estimates. These include:

- more companies may exceed the 7.5m cap than assumed – past claims figures would suggest that this is a low risk;
- more companies than expected are subject to HMRC enquiries in relation to breaching the 7.5m cap or in relation to the VRR incentive effect declaration – again, past claims figures would suggest that this is likely to be a low risk;
- agent fees are higher than expected – this may be a possible risk, given some reported agent behaviour in the R&D tax credit field, and fees would also depend upon nature of each case; and
- IT costs are higher than assumed – again, a possible risk, but this would imply that existing company IT and management systems are weak and perhaps in line for an upgrade soon anyway.

SPECIFIC IMPACT TESTS

Competition assessment

The proposed changes are not expected to have any adverse impacts on competition.

The changes are required to ensure compatibility with State aid guidelines so that companies can continue to claim support under the SME R&D tax credit and VRR schemes. The SME R&D tax credit scheme is available to all small and medium-sized companies carrying out eligible R&D and the VRR scheme is available to all companies (of any size) carrying out eligible R&D into specified diseases. As such, the policies should not:

- directly limit the number or range of suppliers;
- indirectly limit the number or range of suppliers;
- limit the ability of suppliers to compete; nor
- reduce suppliers' incentives to compete vigorously.

Overall, the R&D tax credit and VRR schemes provide incentives for companies generally to spend more on R&D, leaving market forces to determine which companies undertake R&D and thus benefit from the support. The proposed changes simply aim to maintain the incentives provided by these schemes. By promoting business R&D generally, with additional support provided for SMEs, the schemes may involve a small positive effect on competition.

Small firms impact test

The proposed changes to VRR claims do not apply to small companies - SMEs claiming VRR would be excluded from making the declaration of incentive effect so would not suffer any increased costs.

The proposed cap on claims applies to the SME R&D tax credit scheme and so potentially affects all small and medium-sized companies claiming support under this scheme. However since the cap is set at 7.5m EURO (approx £5.5m) the threshold is thought to be substantial enough to exclude SMEs from any adverse impact.

The proposed restriction on companies in difficulty is answered by requiring companies to have their accounts prepared on a going concern basis. This is a widely understood term and should impose no extra costs on any compliant business and the cost to SMEs is not likely to be proportionately greater than the cost to larger enterprises.

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No