

## **Research & Development**

### **Minutes of R&D Consultative Committee on Monday 21 January 2008 at 1 Horse Guards Road**

#### **Present:**

Peter Faherty (PF) (HMRC – Chair)  
Jeremy Sherwood (JS) (HMRC)  
Lynn Carroll (LC) (HMRC)  
Alan Dickinson (ADi) (HMRC)  
Peter Stribblehill (PS) (HMRC)  
John Williams (JW) (HMRC)  
Phil Gilbert (PG) (HMRC)  
Dan York-Smith (DYS) (HMT)  
Alex Karsay (AK) (HMT)  
Frank Buffone (FB) (ICAEW & Ernst & Young)  
Laurence Bard (LB) (ICAEW & Shaws)  
Steven Levine (SL) (CIOT & Chantrey Vellacott)  
John Moore (JM) (ICAEW & Deloitte)  
David O'Keeffe (DOK)(CIOT & KPMG)  
Diarmuid MacDougall (DMc)(PWC)  
Amanda Devonshire (ADe) (Johnson & Johnson)  
Ian Huddart (IH) (Johnson Matthey)  
Tim Bramston (TB) (Kingston Smith)

#### **Introductions**

1. PF welcomed everyone to the meeting and this was followed by around the table introductions.

#### **Apologies**

2. Apologies had been received from Peter Shield and Mike Sufrin.

#### **Matters arising from the previous meeting**

3. There were no matters arising in respect of the previous minutes.

#### **Update on changes to the SME R&D scheme**

4. DYS introduced himself as the new HM Treasury Branch Head responsible for the R&D tax incentive schemes. He stressed the key role that the R&D tax relief played in the Government's general tax regime for companies as one of the most generous reliefs available. He complimented the Committee on the way that it worked to ensure the scheme continued to develop in close partnership between HMRC and business, and cited the example of the HMRC specialist units as a particularly helpful administrative change arising from the consultation process. The success of the R&D scheme depended on both sides working together to solve problems as they arose. In particular, the Government had introduced the scheme in the expectation that the relief would go towards the activities defined by the legislation. If attempts were

made to claim relief for expenditure that they would view as being explicitly excluded from receiving relief, for example commercial production, it would be a cause of considerable concern and would undermine the scheme.

5. DYS explained that the UK was in continuing discussions with the European Commission (EC) concerning the approval for the clinical trial and mid-sized company extension changes, and proposed rate changes, to the Small and Medium Enterprise (SME) and vaccine research relief schemes (VRR). He said that the EC had published Research & Development & Innovation Guidelines (2006/C323/01) in December 2006 and the SME and VRR schemes as a whole were being reviewed to ensure their compliance with the new Guidelines.
6. The UK was working closely with the EC and hoped that approval for the mid-sized company and relief rate increase would be approved shortly. However, no guidance could be given at this point as to the dates from which these changes would apply.

### **Progress report on approved bodies list under large company scheme**

7. JS apologised for the delay in the issue of the Statutory Instrument containing this list. He said that he had drawn up a list of all the bodies approved to date and so far they were all overseas universities. He asked whether Committee Members were aware of any other overseas bodies that had been subcontracted to do R&D work for companies claiming relief under the large company R&D scheme.
8. DOK said that he knew of some companies who had subcontracted work to bodies other than overseas universities. JS said that the general policy intention was to designate as qualifying bodies only those overseas bodies that were directly equivalent to the UK bodies in paragraph 18 (1)(a)-(d) of Schedule 12 to the Finance Act 2002. In practice, the only such bodies approved so far had been overseas universities, as the definitions of the other bodies were tightly drawn by UK legislation and case law, and no equivalent overseas bodies had yet been the subject of requests for approval. For example, it was difficult for HMRC to be clear whether a particular overseas body was equivalent to a UK charity, and the UK definition of Scientific Research Organisations was very restricted. There had been a few requests for approval for overseas commercial research organisations and private hospitals, but these had not been approved, as their UK equivalents would not come within paragraph 18.
9. JS said that he could either prepare a Statutory Instrument containing all the overseas bodies approved to date or try to come up with a generic definition of a qualifying body which was tight enough to ensure that relief was given in the appropriate circumstances. He asked that if any Committee Members had any comments or suggestions on this that they email him directly at [jeremy.d.sherwood@hmrc.gsi.gov.uk](mailto:jeremy.d.sherwood@hmrc.gsi.gov.uk). One view was that it might be best to wait until after the 31 March 2008 deadline for pre-2006 R&D claims, in case any other requests for designation were in the pipeline.

### **Update on guidance and HMRC website**

10. JS said that the HMRC Corporate Intangibles Research & Development (CIRD) manual needed updating in a number of areas. However he had been delaying this pending the EC approval to the proposed changes to the SME and VRR schemes. He said that there were also a few areas - capital/revenue, venture capital and control, and the SME definition – on which he had been liaising with other specialist colleagues. He wanted to ensure that any R&D guidance was consistent with that given in other areas.
11. In recent months JS had become aware of the need to improve the guidance concerning externally provided workers. The current CIRD manual merely reproduced the legislation and this was not very helpful (see AOB for further discussion on externally provided workers).
12. HMRC issued a Revenue and Customs Brief in November which covered the change in claim time limits and the approaching 31 March 2008 deadline. JS said that the information contained within the Brief would be incorporated into the CIRD in due course.
13. DOK asked whether the guidance in the CIRD could be relied upon in all circumstances. JS said that the R&D and VRR schemes were still relatively new and were continuing to evolve. The CIRD guidance needed to develop in line with this in order to provide consistency for inspectors and certainty for companies. The introduction to the manual made clear that it should not be assumed that the manual was comprehensive nor that it would provide a definitive answer in every case. Situations may therefore come to light which were not envisaged, or of concern, at the time a particular piece of CIRD guidance was written. The guidance would not necessarily apply in cases where HMRC considered there to be avoidance of tax. And in cases where litigation was likely, HMRC would have to be guided by their lawyers on the correct interpretation of the law. For example, the first stage of any litigation on R&D would be to consider the precise legal relationship set out in Section 837A ICTA 1988 between generally accepted accounting principles (GAAP) and the DTI guidelines. The current statements about this relationship in the CIRD were capable of differing interpretations, and the issue was currently being discussed with the HMRC Solicitor. When a clear view was established, the CIRD would be updated as appropriate. In the meantime, the CIRD instructions could normally be relied upon by companies and inspectors, subject to the provisos above.
14. SL asked how many R&D cases were currently being litigated but JS said he could not disclose that information. The only occasion so far where the Courts had considered R&D tax relief had been in the case of B E Studios Ltd v Smith & Williamson Ltd, [2005] EWHC 1506 (Ch), which was not a tax case but concerned an unsuccessful claim for professional negligence. In general JS expected there to be some litigation on R&D in the next few years as HMRC were starting to see claims for substantial expenditure that would not normally be considered R&D, for example the costs of commercial production. HMRC considered the definition of R&D set by GAAP and the DTI Guidelines to be clear on this point, and the costs of production of goods or materials did not qualify for relief. This was the Government intention reflected in statements around the introduction of the relief and in the consultation documents introducing the DTI guidelines. The aim of the relief was to target it at the more risky R&D stages of a project, rather than at commercial development.

15. JS asked whether anyone was aware of any areas where the guidance could be improved. Suggestions received from those present included the issue of consumable and transformable items and the interaction of GAAP and the R&D rules.
16. PF said that in a move to improve clarity HMRC was looking at ways of releasing draft guidance for comment and consultation. It is possible that in the future draft guidance may be posted on the HMRC website prior to it becoming formally incorporated within the CIR D.
17. LC provided an update concerning the HMRC R&D web pages. She apologised for the fact that the R&D calculator template had not been amended and said that this together with updates to the small and medium company guidance was pending. On a wider note she advised that HMRC was looking to improve its overall website. This would include improvements to the navigation tools and search engines. It was therefore very unlikely that any work, other than that mentioned above to correct obvious problems, would be done on the R&D pages in advance of the total HMRC review.
18. LC asked those present to let her know if they were aware of any particular problems with the R&D pages such as broken links etc, to which early attention could be given. Her email address is [lynn.carroll@hmrc.gsi.gov.uk](mailto:lynn.carroll@hmrc.gsi.gov.uk)

## **Operational issues**

### **Specialist R&D Units**

19. ADi provided an update on the R&D Units. He said that the Units were continuing to develop experience and expertise in dealing with R&D claims. Consistency in the treatment of claims was maintained by good communication between the Units and the regular Unit Head meetings at which both the Large Business Service and the Head Office specialists were represented.
20. The Units worked hard to make the claims process easier and clearer for companies and generally there were very few areas of dispute between them and the claimant companies.
21. Recent publicity recognised the good work and successes of the Units to date and this was something the Units were keen to build upon. Going forward the Units were developing links with the Large Business Service (LBS) within HMRC with a view to improving consistency in the review of R&D claims.

### **Large Business Service**

22. PG circulated a draft copy of an updated LBS practice note he had been working on. He explained that it was not a wholesale rewrite, more of a refresh, of the existing LBS R&D practice note at CIR D 85100. He said that the note stressed the benefit of HMRC inspectors having access to, and speaking to, the company's technical and scientific specialists, the people on the front line of the R&D work. This cut down the potential for misunderstandings and enabled any queries to be resolved effectively and efficiently.

23. The draft included new comments on the HMRC approach to sampling and on the developing working protocols with the Specialist Units. PG asked that any comments on the draft practice note be emailed to him at phil.gilbert@hmrc.gsi.gov.uk

## **AOB**

24. JS said that issues had recently emerged surrounding the definition of externally provided workers (EPWs) in paragraphs 8A and 8B of Schedule 20 to Finance Act 2000. The Explanatory Note covering the introduction of the EPW legislation envisaged a basic tripartite relationship consisting of the worker, the staff provider and the R&D company. However, recent correspondence between HMRC and two firms of advisers concerned situations where there were two or more steps between the worker and the company carrying out the R&D work.
25. JS said that in such circumstances HMRC did not consider the conditions of the legislation to have been met and expenditure so incurred would not attract relief. This view should be applied consistently by HMRC across the R&D specialist units and the LBS where they came across the issue, but it was not an area that was currently being deliberately targeted for enquiry. He asked whether any other Committee Members had experienced any problems with respect to the operation of the EPW rule, but it appeared to be limited to a small number of cases, and was probably more prevalent in particular sectors.
26. There then followed a discussion around the possible situations which could give rise to more than three parties being involved in the provision of EPWs. Some Committee Members felt that the tripartite rule was an incorrect interpretation of the legislation, and that it put an undue burden on companies who would need to find out the precise contractual relationship between the worker and the staff provider. Another Committee Member felt that the EPW rule was clear and if a company could not be satisfied that a tripartite relationship existed then it should not make a claim in respect of the cost of that EPW.
27. JS said that under the self assessment system, if companies disagreed with the HMRC view of the legislation then they were entitled to submit a claim or return based on their understanding of the law. But they should be prepared for HMRC to enquire into the claim under their risk-based enquiry approach, and if the case warranted it under their litigation strategy, HMRC would proceed to litigation on the point.
28. SL mentioned one other situation which gave rise to difficulties in practice. If the EPW was a director or employee of both the staff provider and the R&D company then he or she would not qualify as an EPW at all. This could arise in group situations where some employees were typically directors of several group companies. JS said he would consider the point as it had not arisen before, but this seemed to be a clear consequence of the legislation, in which case it would be a policy issue for HM Treasury to consider.
29. PF said that there was a need for improved guidance on this issue and that HMRC and HMT would continue to monitor the operation of the EPW rule.