

Research and Development

Minutes of R&D Consultative Committee held on Friday 21 November 2008 at 1 Horse Guards Road

Present

HM Revenue & Customs

Peter Faherty (PF) (CT&VAT) (Chair)
Lynn Carroll (LC) (CT&VAT)
David Harris (DH) (CT&VAT)
Phil Gilbert (PG) (LBS)
Iain Rickerby (IR) (Cambridge R&D unit)
Colin Wood (CW) (Maidstone R&D unit)
Nalini Arora (CT&VAT) (minutes)

HMT: James Perry (JP)

Committee members

Sion Rayson (SR) (ICAEW & Ernst & Young)
Lawrence Bard (LB) (ICAE&W BTG & Tax (formerly Shaws))
Steven Levine (SL) (CIOT & Chantry Vellacott)
John Moore (JM) (ICAEW & Deloitte)
David Cobb (DC) (ICAEW & Deloitte)
David O'Keeffe (DOK) (CIOT & KPMG)
Diarmuid McDoughall (DM) (PWC)
Leslie Hill (LH) (PWC)
Stewart Wilson (SW) (PWC)
Ian Huddart (IH) (Johnson Matthey)

Apologies: Frank Buffone, Amanda Devonshire, Peter Shield and Tom Wills-Sandford.

Introductions

1. Peter Faherty (PF) welcomed everyone to the meeting and invited everyone to introduce themselves.

Matters arising from the previous minutes

Qualifying bodies

2. Still outstanding. The intention remained to list the qualifying bodies that have been approved by HM Revenue & Customs (HMRC) to date. However the team had been dealing with matters which had higher priority.

Externally provided workers

3. The guidance had now been updated in line with the draft circulated earlier in the year. While it was acknowledged that some members of the committee considered the legislation to be too restrictive, there were no current proposals to change the scope of the EPW provisions. As always, if anyone wished to make representations seeking changes to the rules, these would be considered in the normal way.

General update

4. David Harris (DH) said that three years of changes had finally come into force on 1 August 2008. A great deal of work had been put into getting state aid approval before those changes could take effect, and it had not yet been possible to update the guidance to reflect all the changes made. The guidance had however been updated to reflect the rate increase for mid-sized companies. Draft material on companies in difficulty had been prepared and was ready for publication. These updates were scheduled for 2 December on the HMRC website. The CIRDS manual was to be re-written to reflect changes to the underlying legislation made by Tax Law Re-write (TLR) - the revised legislation would be in force from 1 April 2009. The complete order of the manual will need to be changed to reflect the new legislation, which was organised differently from the current version. PF added that since the TLR team are just re-writing the language of the legislation, the re-write should not alter or change the meaning of the legislation as it stands. DH would confirm the timetable for the re-written guidance in due course. From the CT&VAT point of view there should now be some stability, allowing the operation of the schemes to be optimised and allowing a stable background for evaluation.

Operational update

LBS

5. Phil Gilbert (PG) explained that the expertise developed in the R&D units over the past few years had been increasingly recognised by the LBS and this had resulted in the R&D units being approached by the LBS with requests for technical support. It was decided to formalise the process and this gave rise to the development of an operational protocol which came into effect in July 2008. At the same time the LBS updated its practice note which has been published in the CIRDS manual.
6. John Moore (JM) asked how a large claim case was dealt with in practice. How did LBS work such cases and how are the units

involved? Was it compulsory for the units to be involved in all the cases?

7. PG responded that there was a considerable amount of R&D experience and knowledge within LBS. However, some sectors have sought to have the R&D units involved from the onset. A Client Relationship Manager (CRM) was in control of every case in LBS, delegating work within his team. If R&D experience was needed then the CRM would discuss the staffing requirements with the unit heads. However, the CRM remained in control of the overall case: For example if staff from the units made a visit to the company the CRM will normally attend.

R&D units

8. Colin Wood (CW) gave an update on the R&D units' position.
 - These were now adequately staffed and able to cope with the allocation of work. The morale within the units was high and they were seen as desirable places to work.
 - Raising awareness of the R&D scheme had been a top priority for the first twelve months and this was very successful.
 - Companies were aware of where to seek advice on R&D.
 - Staff had more involvement with LBS cases and there was more consistency in cases dealt with by the units across the country.
 - The unit heads and LBS met recently at the national R&D conference to discuss best practice and share issues that have arisen, and this had proved very helpful.
 - There had so far been no generic problems in dealing with claims within the turnaround time of 28 days. However, CT processing was shortly to be centralised. The unit heads were making a very strong representation to ensure that the 28 day turnaround time was maintained.
9. Steven Levine (SL) said that a number of claims have been submitted to meet the deadline of 31 March 2008 which had not even been acknowledged let alone dealt with. These claims were not with specific units, they were across all the units.
10. CT&VAT asked that details of any outstanding claims be sent to them. This would then be addressed with the unit(s).
11. Sion Rayson (SR) asked whether the LBS offices or sectors were linked with units on postcode basis.
12. PF explained that while individual units were developing links with particular LBS offices, work was not strictly postcode linked. Cases were matched with whatever unit has staff capacity to get involved with the case.

13. JM asked whether it was a general requirement for all documents to be submitted at the same time as the return since some unit inspectors had been asking for this.
14. CW was unaware of this practice. HMRC had concluded in the past that it was too difficult to prescribe exactly what documents should be submitted, not least because of variations in different types of R&D.

Current issues

Production

15. PF set out the HMRC position on production activity. The advice from CT&VAT to LBS and the units was not to allow expenditure on production activity, and to open enquiries. Production activity (activity undertaken with a view to producing goods or services for supply customers) was outside the scope of R&D for tax purposes. (Paragraph 31 of the 2000 guidelines and paragraph 28(c) of the 2004 guidelines explicitly excluded production activity.)
16. The point here was that the nature of the 'activity' determined whether relief was allowable. While production activity was itself outside the scope of R&D for tax purposes, R&D could take place in a production environment and so other activities undertaken alongside production activity could, potentially, be R&D for tax purposes and qualify for relief. But even if there was such R&D the scheme distinguished between different types of activities, and excluded production activities altogether. So any expenditure on production activity should be excluded when computing R&D relief.
17. In the discussion that followed the following questions and issues were raised.
18. SR said that the 2000 guidelines said that production activity was not **normally** allowed, suggesting that it was allowable sometimes. PF responded that the guidelines did not say that.

(NOTE: The relevant text in the 2000 guidelines is:

'General commercial activities will not be R&D. These include:
.....the production and distribution of goods and services.'

[Guidelines on the meaning of Research and Development \(R&D\) for tax purposes](#)

Since the committee met it has come to light that HMRC's Corporate Intangibles and Research & Development manual did not reproduce the correct text of the 2000 guidelines. This was corrected on 19 January 2009.

- David O’Keeffe (DOK) asked if small number of products/prototypes were developed for the purposes of validating the R&D but then sold, did that mean that the costs were allowable? PF said no. Activity such as design, and testing to resolve uncertainties could be allowable (subject to satisfying other conditions) but expenditure on production activity (such as construction of a prototype that also constitutes goods for supply to a customer) was excluded. (Paragraph 27(a) of the 2004 guidelines covers construction of a prototype, which can only be R&D for tax purposes if the prototype is created solely for use in R&D.)
- Leslie Hill (LH) said that development and production costs were often inextricably linked. PF said that if there was an issue, companies could contact the units in advance before the work is undertaken, or before a claim is submitted, to discuss the basis for future claims.
- LH asked about a company constructing a prototype for R&D purposes that might be sold after testing. PF said that it was a matter of fact whether the prototype was created solely for use in R&D. The issue was the nature of the activity, rather than whether the activity leads to an actual sale. Though, if what was being produced was being sold to a customer, then the activity would be production activity. On the other hand, disposal by the company at some later stage of a prototype that the company created solely for use in R&D would not change the nature of the original activity of constructing the prototype (as being R&D).
- DOK asked whether HMRC’s position was, therefore, that if scale up trials fail and nothing is produced, that can be R&D but if it works and something is produced, that cannot be R&D? PF said neither would be R&D as the intention was that if anything was produced it would be sold, therefore the activity was production.
- DOK felt it was wrong that if something was sold then expenditure on producing it should be excluded from R&D relief. Good commercial practice was to try and recover value rather than just throwing the outcome of the research away. For example, if a company had produced a food product, rather than throwing it away it was only commercial sense to sell the product to a supermarket, if possible, to recover the costs incurred. DH said that if a food product were produced to be left, say, on a shelf for 6 months to test how well it kept, and then the product was thrown away (or sold cheaply for use as animal feed) then the expenditure could be allowable. If the product was produced with a view to supplying it to customers then the expenditure was excluded from the scheme. (Though, tax relief may still be available, at the normal rate, under ordinary tax rules.)

- David Cobb (DC) suggested that the primary purpose of the activity was relevant, as indicated in 2000 guidelines. PF said that he did not agree. The reference to 'prime purpose' in the 2000 guidelines was only in the context of distinguishing between different non-production activities. The 2000 and 2004 guidelines specifically exclude production activity, and so the only issue is the nature of the activity - if it is production activity it is excluded whatever its prime purpose.
- SL made a number of points. He said this approach looked to be an attack on the engineering sector. In particular, a first of class will always be more expensive to build, even though it is delivered to the customer for use. He felt that HMRC were giving paragraph 28(c) of the 2004 guidelines priority over paragraph 39. PF said that paragraph 39 was only part of the commentary (section of the guidelines) and not part of the guidelines on the definition of R&D for tax purposes. (So, if there was any conflict then paragraph 28(c) would take precedence.) However, there was no inconsistency between paragraph 28(c) and paragraph 39 - which was simply commenting that often the construction of a prototype can fall within the definition of R&D for tax purposes. HMRC was not saying that all costs relating to developing a prototype were excluded from the scope of R&D for tax purposes, just production activity. Other activity, such as design and development work, could be R&D for tax purposes (subject to satisfying other conditions). The exclusion of production activity applied across all sectors and engineering was not being singled out in challenging claims.
- DC asked whether PF was suggesting primacy of paragraph 28 over paragraph 27? PF said there was no conflict between paragraphs 27 and 28. Paragraph 27(a) related to creation of materials or equipment created solely for use in R&D - this clearly excluded production activity, as the materials or equipment were not created solely for use in R&D but also with a view to supply to customers. Paragraph 27(c) allowed for scientific testing and analysis activity (eg setting up and monitoring scientific instruments and analysing the data) undertaken around production activity. This was perfectly consistent with the effect of paragraph 28(c) in excluding production activity itself from the scope of R&D for tax purposes.
- DOK asked the unit heads about the practicality of distinguishing production activity. CW replied that it was clear when dealing with claims what was production activity from the facts of a case.
- DOK asked for clarification of PF's earlier comments that if costs could be recovered then R&D relief was not given because the activity was a production activity. This meant that whatever the intention or activities, if the product was R&D relief could not be claimed. This amounted to re-writing the legislation. PF said that

HMRC was simply applying the legislation and the guidelines as they were. Expenditure on production activity was excluded from R&D relief. There could still be R&D for tax purposes alongside (though separate from) the production activity. (It was not whether costs could be recovered that was the distinguishing feature, but the nature of the activity. If activity was undertaken with a view to producing goods or services for supply to customers, the expenditure on that production activity was excluded, whether or not it was recovered through actual sales. Though, if what was being produced was being sold, then that indicated that production activity is taking place.)

- DOK pointed out that all processes involved scale up. PF said that scale up in itself was not R&D, though acknowledged that if it was necessary to make an advance in science or technology in order to scale up a process there might be some R&D. In any event, production activity undertaken in the course of scaling up a process was excluded from the scope of R&D for tax purposes.
- DC asked whether HMRC had received advice from counsel on the interpretation of the legislation being advanced in relation to production activity. PF said no. (Though, since the committee met, there has been occasion to confirm the interpretation with counsel in relation to particular cases.)
- SL asked why HMRC was changing its interpretation of the legislation. PF said that this was not a change. As far as he was aware HMRC had never regarded the scheme as covering production expenditure. The issue had arisen because some claims had been submitted covering such expenditure, not because of any change by HMRC.

Consumables

19. PF said that there were further issues in relation to the treatment of consumables. Because production activity was excluded, then expenditure on consumables used in production activity was excluded. However, in addition, production inputs, such as raw materials, were distinct from consumables. Such inputs are not used up but result in a product. Expenditure on them could not qualify for relief in any event.
20. Members of the committee were invited to send further questions and scenarios relating to production activity to CT&VAT to consider. The intention was to publish some Q&A material on this issue to supplement the CIRD manual. HMRC would distribute a draft of such material to members of the committee for comment, before it is published.

SSAP 13

21. DOK referred to CIR99050 which he suggested indicated that the guidelines had primacy over accountancy. DH said that the Guidelines themselves rested on SSAP13. HMRC's view was that expenditure had to satisfy the guidelines and to be capable of satisfying SSAP13 - whether or not a disclosure was actually made.
22. PF added that the DTI guidelines did not extend the SSAP13 definition in any way, and only operated to narrow the scope for tax purposes. While no accounting disclosure was required, the absence of a disclosure could be a theoretical risk factor.
23. LH asked whether companies must therefore incur additional expenditure to get disclosure? CW said that in practice the specialist units had not found the absence of an accounting disclosure to be a useful risk indicator for operational purposes. There would be no point in companies making an accounting disclosure when they would not otherwise do so, if this would increase their costs.

SME change of status - HMRC change of practice

24. LC explained that Revenue & Customs Brief 55/08 set out a change to HMRC's view of SME status, to make it consistent with the legislation. As a result, where a SME was taken over by a large company, the change was taken as applying to the entire year, rather than the SME continuing in that status until the end of the year.
[Revenue & Customs Brief 55/08 - Change of SME \(Small and Medium Enterprise\) status for companies making claims under the Research & Development \(R&D\) and Vaccine Research Relief \(VRR\) schemes](#)
25. DOK said that the text of the brief may inadvertently prevent some companies from claiming relief by virtue of Qualification I. After further discussion DOK said that he would contact LC separately to discuss the issue. LC subsequently clarified that the purpose of the brief was to notify R&D companies and their advisors of a change of HMRC interpretation which came into effect from 1 December 2008. Its aim was to give a broad overview of the change and explain how it differed from the interpretation in place prior to that date. The brief was not meant to replace the SME R&D legislation or the 2003 EC SME recommendation, which together determine whether or not a company is a SME.

Any other business

Relationship with Corporation Tax Operational Consultative Committee (CTOCC)

26. DH explained that the present group was the primary forum for R&D issues, but that did not mean that CT&VAT would not provide helpful information in other for a (of which there were many), when this made sense. DOK added that, formally, the R&D Consultative committee was constituted a sub group of CTOCC.

Purchase of software for development

27. A query was made by Lawrence Bard (LB) about software purchased for further development; it is the main object of research and so there was a question about whether it is 'directly employed in' it. Was the cost allowable?

28. PF said that in terms of policy it would not make sense to provide enhanced relief for such expenditure under the R&D scheme. HMRC's starting point would be to treat software that was the object of the R&D as not being employed in the R&D, so that the cost would be excluded from the scope of R&D relief. However, if this was an issue in an actual case then HMRC would be prepared to explore the interpretation of the legislation in greater depth.

Intellectual Property (IP)

29. SL asked whether there were any policy reasons for the IP condition in the SME scheme but not in the large company scheme. Micro companies were driven by confidentiality, and might be unable to fulfil the condition.

30. PF said that the small company scheme provided a higher level of relief, and so it was appropriate to provide greater protection of the UK tax base by requiring the claimant company to have rights to the IP. JM suggested that the condition only required the company to have rights to part of the IP. PF said that this wasn't the case - rights to all the IP created must vest with the claimant company.

31. To emphasise this, material on the point would be included in the draft Q&A material.

32. PF suggested that small companies unable to meet the condition may be able to claim under the large company scheme instead. Though DOK correctly pointed out that small companies were only able to make a claim under the large company scheme in limited circumstances which did not include this scenario.

33. The meeting finished at 16.00.