Consultation on an ‘Above the Line’ credit for Research and Development

Submission from ICAS to HM Treasury

26 June 2012
The Institute of Chartered Accountants of Scotland welcomes the opportunity to comment on the proposals for the introduction of an ‘above the line’ credit for research and development expenditure set out in the Consultation Paper issued in March 2012.

Our responses to the questions raised are set out below. In addition, Appendix A includes the accounting analysis we have prepared in relation to the proposals discussed, and which highlights the design issues requiring consideration. A key finding is that a contingency or linkage of the quantum of payable credit to the corporation tax liability of the claimant is likely to preclude the ‘above the line’ accounting treatment, and therefore deny the benefit the change seeks to deliver. Whilst prevention of tax leakage or the artificial exploitation of any payable credit regime is an understandable line for HM Treasury to take, how that is achieved whilst delivering a payable credit regime may need different considerations; some perspectives are set out in Appendix A.

**Question 1**

The criteria offered are reasonable and appropriate. In addition, whilst it is stated that a profitable company should receive the same support as it would under the current system, consideration should be given as to whether the rate for the credit should change in line with future changes to the corporation tax rate in order to maintain, rather than erode, the attractiveness of the value delivered from this favourable regime.

**Question 2**

The basic model of credit, as it applies to profit making companies, meets three of the criteria set out in Chapter 2. It is not clear that certain aspects of the current proposals, which relate the value of the research and development credit to the company’s corporation tax liability, will result in ‘above the line’ treatment and our detailed comments on this are set out in Appendix A.

Other concerns arise in relation to the “simple and straightforward to administer” criteria for large businesses, who may need to adjust their year-end accounts preparation processes regardless of whether ‘above the line’ treatment is their preferred accounting outcome. As the ‘above the line’ credit would be recorded in the statutory accounts, the time for identifying qualifying research and development projects and related costs may be accelerated from the position at present. This may depend on the relative materiality of the claim to the overall business expenditure and, whilst a timing issue only, is one that may accelerate work into an already busy time in the organisation’s financial year. IAS 20 requires that grants be recognised in the profit or loss on a systematic basis over the period in which the entity recognises the related costs i.e. there is an expectation that the costs and revenues are “matched”. However when draft tax computations are prepared to support the tax provisions shown in the same statutory accounts process, a prudent estimate of the claim may be used which reflects the fact that the additional tax relief is only one component of the tax computation which contributes to the overall charge. An estimated claim may have less impact on materiality considerations when accounted for below the line rather than above the line.

This particularly impacts because the filing deadline for statutory accounts is either 6 months or 9 months after the balance sheet date while the filing deadline for the corporation tax return is 12 months after the end of the accounting period. The qualifying costs for any qualifying research and development project are not simply extracted from figures disclosed within the statutory accounts or within one cost centre and so time may be needed to extract the necessary information from the accounting records of the company, or processes be adjusted. The consequential change to the accounting arrangements in relation to tax accounts – the below the line consequence – also need consideration.
It is likely therefore that the ‘above the line’ system would mean changes to the procedures and timing relating to the preparation and audit of the statutory accounts, including the possibility of requiring additional staff resources at a busy time.

Finally, HMRC have 24 months from the end of an accounting period to raise an enquiry in respect of a corporation tax return. It is not clear from the Consultation Paper that this would continue with the new methodology, but it is assumed. If an enquiry were to be raised in respect of an ‘above the line’ claim under the proposed new system it is possible that the final ‘above the line’ credit to be incorporated into the accounts would not be known for some years after the accounts have been signed. As noted above, if the change was material this may require the accounts to be restated and/or the contingency disclosed, potentially more so than a current tax system enquiry where the claim is part of a larger tax provision.

The overall balance of the benefit from the regime change when compared with the effort of changing processes will differ from organisation to organisation.

**Question 3**

We agree that the basic design principles, which build on existing definitions and legislative provisions, appear appropriate. Some points of detail do need clarified as set out below, and it is with these that concerns arise. It is welcome that changes from the existing system are minimised in order to avoid the costs and complexities than would arise if an entirely new regime were introduced. We consider that in order to maximise the credit to the income statement, which is the driver for the change, the ‘above the line’ credit should be taxable and a higher or gross amount.

In this regard, we would note that the example at Table 3A is potentially confusing. The reported profit before tax would increase in the move to ‘above the line’ but the tax charge would correspondingly increase, leaving profit after tax unchanged. The corporation tax liability reported would be the increased amount of £125, it is only in cash flow terms it appears that it is proposed that the credit would be offset against the corporation tax liability. The lower right hand column description “tax saved” is inaccurate; the claimant benefits by a payable credit of 100, less tax thereon at 25 giving a net 75 benefit. It will be helpful for future communications if this could be set out more clearly to ensure readers fully understand the proposals. Similarly, the extended accounting treatment in relation to Tables 3B and 3C might usefully be expanded.

**Question 4**

Anything other than a gross fully payable credit increases the complexity of the scheme as both corporation tax withheld, and corporation tax carried forward for future offset or reclaim would have to be tracked. Consideration would then have to be given as to what, if any, tax benefit should be recognised in the statutory accounts and what additional disclosures would be required. Accordingly, the administrative burden would increase beyond that in the current regime for loss making companies.

The model for a reduced payable credit contingent on corporation tax liability, or any restriction on payment pending a corporation tax liability arising, is likely to prevent the accounting treatment to ‘above the line’ to the extent of the reduction or restriction. A contingency based on other financial performance measures than corporation tax liability may provide a similar safeguard without this effect.

A fully payable credit in a withholding tax regime could maintain ‘above the line’ treatment. The rationale for the accounting comments and impact on design principles are discussed fully in Appendix A.
**Question 5**

As set out above, the effectiveness of the design principles fail when the payable credit is linked to the corporation tax position, as the linked credit is then unlikely to be accounted for ‘above the line’. At a 20% level of reduced payment that may not be regarded as critical by businesses but it may be that it is an unnecessary complication.

**Question 6**

As set out in Appendix A, it may be worth exploring a model related to other financial criteria than the corporation tax position.

**Question 7**

As noted in the Consultation Paper, the proposal that businesses claim for the ‘above the line’ credit for accounting periods beginning after 1 April 2013 rather than expenditure incurred after that date (which may be over different accounting periods) is preferable in terms of reducing the complexity of any change.

However, as noted in response to Question 2 above, moving to an ‘above the line’ credit will mean that the research and development claims will have to be identified and quantified in time to be reflected in the statutory accounts. The filing deadline for statutory accounts is earlier than that for company tax returns and so the time to prepare the claim is reduced by 3 or, in some cases 6, months. We commented above in relation to the need to change the resource allocation as well as in year and year end accounting processes, in order to support the change in accounting treatment of the support on the relevant projects. The exact impact will depend on each organisation’s current accounting procedures. It might also be expected that communication with shareholders and stakeholders on the different accounting impact achieved and performance measures will be necessary. The form and detail of this will depend on individual organisations.

**Question 8**

Clear and accessible information on the HMRC website, an early prompt to existing claimants to raise awareness of the changes and articles/updates through the accounting and tax trade press, as well as trade bodies, would all help to communicate the procedural changes to the regime as well as any financial impacts. The legislative timetable for the Finance Act 2013 means the first affected accounting period may have commenced before the enactment of the legislation. Whilst the consultation has started early enough to permit proper discussion of the potential changes, it is important that the final decisions are made and announced, along with draft legislation, as soon as possible.

**Question 9**

If there were any uncertainty on the accounting treatment (which depends on the final proposals) as well as possible changes to the numbers reported in the statutory accounts and a reduced timescale to prepare a claim, then it is likely that some companies will wish to retain the existing scheme. Should any new scheme permit earlier cash flow benefits from the relief than at present, the position could well change, but the timing of payment of claims is not explored in particular detail in the Consultation Paper.

It is suggested that the mechanism for payment of the tax credit would be by netting off against a corporation tax liability that might be expected to be payable either 9 months after the year end, or by quarterly instalments. Final proposals which permit clarity on the accounting treatment and the claim and payment process and timescales are likely to be factors that would reduce any requests for retention of the previous system.
**Question 10**

If the new regime were optional, then it is only to be expected that organisations will consider how a claim might be maximised, and if the claim choice is left to the organisation, this might become an annual, or project by project, assessment. This carries an administrative burden but would only be relevant if the design of the ‘above the line’ credit gave a different value or cash flow benefit when compared to the current regime. There would appear to be no difference intended in terms of identifying the qualifying projects and costs and so the only other differential would be in administrative effort around having two sets of accounting processes and accounting adjustments. Where the value and timing was unchanged, it might be anticipated that many would stick with what they currently know and have experience of with HMRC, unless of course the core driver for this change, the performance measure of the research and development activities, required the adjustment for that particular organisation. We cannot see why a company would operate two regimes which each offered the same value.

**Question 11**

No comment.

**Question 12**

No comment.

**Question 13**

At the moment, group relief allows value for research and development tax credits where there are profits within the UK group but the entity undertaking the research activity itself makes a tax loss. The new proposals could see groups disadvantaged if research and development projects were being carried out by companies with insufficient taxable profits and there was then discounting of the payable amount or a withholding of tax from the payable amount. We agree that the ability to surrender unused credit or withholding tax to other group companies should be included in the final legislation to take account of this and that this should mirror the arrangements for the surrender of group relief. We know of at least one group where the research and development activities are within a company which currently generates tax losses and which would be disadvantaged if less generous group offset rules were introduced with a new regime, or the option of the current regime was not available.

**Question 14**

No comment.

**Question 15**

The existing SME scheme is now well understood by businesses and receives specialist, focussed resources from HMRC, so the administrative change for no increase in value of the credit or timing or receipt of the cash flow benefit would be unwelcome for the majority of SMEs. We have not received any suggestion from SMEs that the accounting treatment ‘above the line’ is a business necessity.
**Question 16**

There are already cases where claims are made by an SME under both regimes. The different approach needed for the new large claims regime would give an administrative burden from the change to a new system to learn, unless it was to be optional. This burden would only affect some, rather than all, SME claimants. An alternative may be to consider changes to the SME regime for such cases (we note the subcontracting issue is still under review) either to include the possibility of an SME claim or permit an SME claim under a lower rate of relief where such cases arise.

**Question 17**

It appears the concern is that the provision of credit by means of a cash payment as opposed to corporation tax relief may make the regime attractive to a wider range of organisations than are considered necessary for encouraging the policy reason of genuine investment in research and development in the UK. This was presumably the concern behind the introduction of the previous SME cap in relation to NIC and PAYE, but the statistics showed this limited very few claims in practice and has been withdrawn. We have no information on the likelihood of this abuse arising, or the current profile of claimants, so have no information to comment on whether a cap related to NIC and PAYE could be an overly restrictive hurdle to meet. Where costs are primarily in research salaries liable to PAYE and NIC then the payment of a credit at 9.1% would be less likely to fail this restriction. Consideration of how any abuse of the system would be identified, as well as challenged, would be necessary for any anti-abuse rule to be meaningful or effective.

**Question 18**

If the new system takes account of the comments at Question 13 above, permitting the present group arrangements to continue to be available, albeit in a different form, it would not be logical to seek to prevent a UK group from arranging its affairs in a way that preserves its current entitlement. It would appear that any restrictions on group flexibility in this way could defeat the purpose of these proposals.

**Question 19**

No comment.

**Question 20**

If a UK branch of an overseas company is entitled to the ‘above the line’ relief rather than an enhanced tax deduction, then its tax consequences vary depending on the assumptions as to taxability. Using the figures in Table 3A of the Consultation Paper, and as noted in our response to Question 3 above, the UK corporation tax liability increases when compared to the current regime. If this is right, the effective tax rate on UK profits will increase to 25% with the withdrawal of the enhanced deduction, which reduces the effective tax rate in that example to 6.25%.

Depending on the rules of the parent jurisdiction, the increased UK tax offset may reduce the domestic tax payable by a corresponding amount with no overall effect, but if it is not wholly able to be offset, then the new method may be less attractive.

If the new regime credit is not taxable, and paid at a lower rate to reflect this, then the effective tax rate would increase but by a lower amount, to around 21%. An optional rather than mandatory regime would address this potential issue. We have no evidence of businesses that might be affected in this way.
The current R&D tax regime – ‘below the line’

The current regime for R&D tax credits in the UK provides for relief to be given by an additional corporation tax deduction. In some circumstances a resulting loss can be ‘cashed in’ rather than offset against future taxable profits.

The accounting treatment of the R&D tax credits under UK GAAP is determined by FRS 16 “Current tax”. For these purposes, current tax is defined as “the amount of tax estimated to be payable or recoverable in respect of the taxable profit or loss for a period”. It is the provision of R&D tax credits in a way that affects the taxable profit or loss for a period that means that the benefit of the R&D tax credit is accounted for as part of the tax charge for the period, ‘below the line’.

The corresponding provisions under IFRS are IAS 12; such is the similarity of provision that there is in practice no difference in approach from UK GAAP as regards R&D tax credits.

Most UK groups will apply UK GAAP to operating subsidiaries and, if appropriate, use IFRS for listed company and/or consolidated accounts only, albeit this may change in the future. It is worth bearing in mind that UK taxable profits are based on the individual entity level accounts, regardless of whether IFRS is adopted on consolidation. The accounting treatment under each set of standards therefore needs consideration as each can be the basis for a UK corporation tax computation.

There are changes to UK GAAP under consideration, in a draft FRS 102. Whilst these are not finalised, it does not appear the underlying definitions or principles of the treatments above will change.

Proposed ‘Above the line’ R&D credit

It is proposed that the R&D tax credit regime should be amended so that these can be accounted for ‘above the line’ ie in arriving at profits before tax. This is primarily because of the performance measures used by entities lobbying for this change and the government’s attempt to make the support as effective as possible in achieving the policy intent. The accounting treatment could be under UK GAAP or IFRS, so both are addressed below.

The proposal is that the substance of the current R&D tax credit would become, effectively, an ‘R&D credit’, akin to a government grant, payable at 9.1% of revenue expenditure. The current regime of offering an enhanced corporation tax deduction would cease to apply. However, it is presumed that the current definitions of qualifying entities and expenditure etc would continue to apply to the new regime, for ease of taxpayer use. For the purposes of the rest of this paper, the new regime will be called an R&D credit; the old regime an R&D tax credit.

This paper considers the nature of an R&D credit regime that may be accounted for ‘above the line’. It aims to identify the key changes that would be required to the existing tax legislation in order for the accounting treatment to be revised and to consider the treatment of the options proposed in the Consultation Paper. The paragraph references below are to that paper.
'Above the Line' under UK GAAP

A government grant under SSAP 4, “Accounting for Government Grants”, is defined as “assistance by government in the form of cash or transfers of assets to an enterprise in return for past or future compliance with certain conditions relating to the operating activities of the enterprise”. It would be expected that SSAP 4 would apply to the proposed R&D credit, so that the amount receivable would be included in ‘other operating income’ in the profit and loss account, matched to the period in which the entitlement arose, probably in which the related expenditure was incurred.

A number of points arise:

1. The capital/revenue distinction is relevant; R&D tax credits will have to continue to be related to revenue expenditure to achieve direct credit ‘above the line’.

2. Recognition of income in the accounts under SSAP 4 will arise when the conditions for the receipt have been complied with and there is reasonable assurance as to certainty of receipt. The detailed design principles around claiming for and paying the R&D credit need careful consideration in terms of the timing of recognition of the R&D credit, rather than the principle.

3. Should any R&D credit become repayable, SSAP 4 requires that it is charged to the profit and loss account immediately it becomes repayable.

4. Any contingency to repay R&D tax credits should be treated in accordance with FRS 12 “Provisions, contingent liabilities and contingent assets”; the contingency to repay should only be provided for to the extent that repayment is probable. It is not obvious from the consultation document and design principles available how this would apply, but again detailed design principles will need to be considered.

5. It is also envisaged under one design option, at para 3.10, that there would be a fully payable credit, but it would be paid net of tax. What appears to be envisaged is that the netting would be in the form of a UK withholding tax, which could be offset against the recipient’s corporation tax liability. The accounting treatment of income paid net of a withholding tax, and of that tax, is also set out in FRS 16. The application of a withholding tax does not change the nature or accounting treatment of the receipt itself. It would be expected that initially the income would be shown grossed up for the tax withheld. In terms of FRS 16, withholding tax is defined as “tax on dividends or other income that is deducted by the payer and paid to the tax authorities wholly on behalf of the recipient”. Whilst HMRC may administer both the R&D credit and the corporation tax payments system, such the transfer is likely to be an internal accounting entry only. However, as long as legislation and procedure properly provided this net effect, the fact that the payer is also the tax authority should have no practical impact on the accounting treatment.

6. Another design option, at para 3.8, is to discount the payable credit for a loss making entity, by 20%. The discount element would become payable, contingent on future profits, and deferred pending receipt of those future profits. For a loss making business, SSAP 4 would require reasonable certainty of future profits in order to recognise the 20%, and it is likely that there would be no recognition of that 20% element pending reasonable certainty on future profitability. It is also likely that the receivable would be dealt with a contingent asset, under FRS 12 and recognised only when its receipt was virtually certain.
7. A further design option, at para 3.19, provides for a deferral of payment of the R&D credit for loss makers for a 4 year period, but there would be no contingency element dependent on future profitability. Whilst this option is apparently not being taken forward, there is likely to be recognition of the R&D credit in the year of first claim, despite the receipt of the 20% being delayed.

**UK GAAP treatment requirements, design principles and observations on the R&D credit**

1. In order to achieve the ‘above the line’ treatment, it is fundamental that the R&D credit should not be a “tax” credit. There should be no relationship between the determination of the quantum of the R&D credit and the computation of taxable profit for the year in the corporation tax computation. This gives difficulties when considering the accounting treatment of the discount, in the proposal to pay a discounted credit, at 80%, to loss making companies, with the discounted 20% being payable contingent on future profits. However, in the same way that the current regime has a condition relating to the claimant being a going concern, it is considered that if the 20% discount were to be contingent on an accounting profit, and not a tax computation profit, it would not prevent the 20% being treated under SSAP 4 ‘above the line’. This may need further exploration as design details develop as design alternatives may exist. This should not affect the accounting treatment of the 80% if it is not related to the corporation tax position.

2. The nature and substance (and not just entitlement) of the 20% discount needs more detailed consideration. If the substance of the 20% of R&D credit is that it is only effectively able to be realised by offset against corporation tax liabilities on the profits of the business, it is likely to be seen as a tax credit dressed up as something else. The 20% would then have to be accounted for as part of the tax charge rather than ‘above the line’.

3. The payment of an R&D credit net of a withholding tax could still see the R&D credit accounted for gross above the line, with the tax offset in the tax line. Any irrecoverable withholding tax would be written off below the line.

4. The measures under consideration at para 4.20 to avoid abuse could mean a capping of R&D credits by reference to, for example, an NIC and PAYE cap. Any limits on relief, such as these, which are conditions for the R&D credit are akin to conditions requiring the creation of employment in other government grant schemes, and should not affect the accounting treatment. As noted at point 1 above, the condition to avoid is any condition or quantum related to the taxable profit or loss in the corporation tax computation.

5. The introduction of a general anti-abuse rule, incorporating a purpose test, at para 4.20 may also not be relevant to the accounting treatment. What is being proposed appears to be a condition of entitlement to an R&D credit, and so the grant regime, rather than the tax legislative background, should be the reference point. It is not clear how any condition as to payment of this nature would affect its accounting treatment, unless of course it related to the quantum of corporation taxable profits.

6. Whether the new R&D credit is taxable, or exempted by statute from the calculation of profits liable to corporation tax, is not determinative of its accounting treatment. The substance of the support is.

7. The administrative body involved in the R&D credit should not be relevant to its accounting treatment; it may or may not be HMRC without accounting consequence.
8. It is assumed here that existing legislative wording around R&D tax credits can be adopted for R&D credits. Definitions of eligible expenditure and much of part 13 of CTA 2009 could be adopted unchanged to avoid taxpayer complexity.

‘Above the Line’ under IFRS

The corresponding IFRS provisions are IAS 12 “Income Taxes”, defined as all “taxes that are based on taxable profits or losses”; IAS 18 regarding the disclosure of income gross of withholding taxes, and IAS 20 “Accounting for Government Grants and Disclosure of Government Assistance”.

IAS 20 does not however deal with “government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or loss or that are determined or limited on the basis of income tax liability (such as income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates)”. Investment tax credits are not defined, and government grants are defined almost identically to SSAP 4.

IFRS treatment requirements, design principles and observations on the R&D credit

1. Due to the similarity of provisions, the observations on design principles under UK GAAP are likely to be equally relevant to IFRS.

2. Although investment tax credits are not defined, nor is their accounting treatment provided for under IFRS, a judgement needs to be formed as to the nature in substance of an R&D credit and therefore its accounting treatment. As noted above, if there is no relationship between the determination of the quantum of the R&D credit and the computation of taxable profit for the year in the corporation tax computation, rather the R&D credit is based on R&D expenditure levels, it should be considered as a government grant. ‘Above the line’ accounting would follow.

3. The treatments and comments for IFRS are then essentially the same as for UK GAAP above.

Response to Consultation Document Annex A – summary

An R&D credit related purely to expenditure incurred may be accounted for ‘above the line’.

Any payment of R&D credit net of a withholding tax, may still be accounted for gross ‘above the line’, and with the tax withheld in the tax line.

Any discount on the payment of R&D credit which is contingent on future taxable profits, and payable on those profits arising, is unlikely to be accounted for ‘above the line’ although the undiscounted element may be ‘above the line’.