



HM Treasury

Consultation on the Taxation of Innovation & Intellectual Property

Response from BT

18th February 2011

Introduction

1. BT is pleased to submit this response to the consultation on the Taxation of Innovation and Intellectual Property. We have confined our comments on R&D Tax Credits to those questions relevant to us as a large company. With regard to the proposed Patent Box scheme, we have provided a brief overview of the issues as we see them in relation to our business model, rather than specific responses to the questions in the consultation.

Research and Development Tax Credits

2. Investment in innovation is critical to driving business success in today's global economy. BT recognises and values the important role the Government's R&D Tax Relief scheme has played in stimulating investment in innovation within the UK, playing its part in safeguarding high quality UK jobs, and ensuring that the UK remains an attractive location for the creation and exploitation of IP. For BT, relief for both our research and innovation activities, and our large scale strategic development programmes which are often the key enablers for further innovation, has provided welcome tax incentives and additional working capital.
3. BT is an extremely innovative company, ranking third in the UK for total R&D investment (source: Business, Innovation & Skills 2010 R&D Scoreboard), number one in Europe and number two globally for R&D investment in the Fixed Line Telecommunications sector (source: 2010 EU Industrial R&D Investment Scoreboard), with our annual R&D investment reaching as much as £1.25bn since the relief became available to large companies in April 2002.
4. During this period much of our R&D effort has been directed at large scale, long term strategic programmes such as the 21st Century Network (the world's first carrier class IP Network), and now the delivery of Next Generation Access/Super Fast Broadband in the UK. These key R&D programmes will provide the UK with the advanced, feature rich communications infrastructure, upon which the UK's future economic success will depend. Our success at driving Broadband in the UK has and will continue to create, fantastic opportunities for R&D investment. However, programmes such as these are not just about advances in technology or high quality jobs for BT. The delivery of such radical undertakings requires huge collaborative R&D programmes with other Communication Providers and equipment manufacturers, with elements of their R&D also being carried out in the UK.
5. BT is also recognised as a champion of global open innovation. As one of the largest investors in R&D in the UK, BT places many research contracts with UK universities. This industry lead investment ensures our universities undertake research aligned to business and commercial drivers, to ensure maximum advantage is leveraged for the economy. At the same time it helps to foster the creation of a strong innovation skills base, upon which the country's long term success and prosperity ultimately depends. R&D tax credits in this space are vital to continued investment.
6. Our success in winning significant networked ICT business both in the UK and globally requires the substantial development and integration of new technology. In the UK, this includes the design, development and delivery of critical national infrastructure programmes such as the Defence Fixed Telecommunications Service for the MOD, the N3 network for the NHS, voice and data networks and IT services for the Dept for Work & Pensions, and the network to support the forthcoming London 2012 games.
7. Overall, BT's annual R&D investment has a huge impact on jobs and the wider economy in the UK, and in many cases, acts as an enabler for innovation by others.

Responses to specific questions raised in the consultation document:

Question 4A: Are there any changes to the structure of the schemes that would significantly improve their impact in stimulating investment in R&D by UK companies, in the context of the wider corporate tax reforms?

8. There are two specific issues we wish to address:-
 - the potential impact on the perceived value of the R&D Tax Credit as a consequence of the reduction in the headline Corporate Tax rate for large companies from 28% to 24%; and
 - structural changes to the scheme which we believe would further enhance the direct impact of the tax credit on R&D investment.

Corporate tax rate cut

9. We welcome and recognise the value of a corporate tax rate cut and its importance in the Government's overall tax strategy of making the UK a lower tax jurisdiction in which to conduct business and attract investment. However, this reduction will also have the effect of 'eroding' the incremental rate of relief for large companies engaged in R&D in the UK from the current 8.4% to 7.2%. This could be seen as running counter to the Government's stated aim of making the UK the most attractive place in which to undertake R&D. It also may, over time, lead to a lower take up of the R&D tax incentives, potentially impacting future R&D investment, perhaps even driving future R&D investment abroad where R&D tax incentives are often more generous. It is also conceivable that should the Government wish to target growth in the economy outside of financial services, it could achieve that aim by reconsidering its decision to reduce the future headline corporation tax rate in favour of increasing the incentives offered by way of R&D tax reliefs.
10. We urge the Government to ensure that the rate of relief for R&D, provided by R&D tax credits, is at least maintained as the rate of corporate tax reduces. This would be a positive signal of the Government's commitment to R&D without increasing the cost of the scheme. We believe, as the economy improves, and higher rates of relief become affordable, increased relief would provide a positive boost to further innovation and inward investment in the UK.
11. Overall, this will reinforce the importance and value of R&D to the UK's future prosperity, particularly as the government seeks to rebalance the economy away from financial services. It will also encourage more students to consider science and engineering as a career, and ensure that companies like BT continue to fund collaborative research and development programmes with UK universities to underpin this strategy.

Structural changes to the scheme

12. The nature of BT's R&D investment is primarily focused on large scale, long term, strategic development programmes, where large elements of the R&D labour and associated costs are capitalised. This means that we are only able to take limited advantage of R&D Tax Credits (for example, on research).
13. Whilst we recognise that the present economic conditions do not support an immediate increase in tax credit benefit, a structural change in how the tax credit is claimed and accounted for would be advantageous in ensuring better alignment of the relief to the R&D costs within an organisation. Making the relief a visible 'saving' on the units that conduct R&D (i.e. above the line treatment, rather than a below the line reduction to tax), would go some way to ensuring that the benefit continues to deliver on its original stated aims of fostering greater investment in R&D. We recommend the Government investigate the

feasibility and benefits of changing the tax credit to a refundable investment type credit, applied as a reduction on the costs to which the relief relates. We would welcome the opportunity to contribute to any debate on this structural change. As a consequence of any changes here we would want to ensure that the 100% relief on capitalised R&D costs remain unchanged.

Question 4B: Are there additional costs that should be eligible for relief under the schemes?

14. There are two areas where we believe the Government should consider including additional costs, namely: externally provided workers and overheads. We believe that an enhancement to the existing relief focused on Industry funded R&D with UK universities should also be considered. As these would increase the overall cost of the scheme we are not suggesting that these changes should be implemented immediately. Rather they should be considered as part of any enhancement to the relief when the economy grows.

Externally Provided Workers

15. Currently where an externally provide worker (EPW) has a '1 Man Service Company' who is engaged by an Agency who is BT's supplier, a four party commercial arrangement exists and the EPW costs relating to qualifying R&D activity, are excluded from the R&D Tax Credit. This adds complexity to the scheme and penalises companies on the basis of the EPW's personal tax situation. This issue has been raised before, but we ask the Government to look again at this legislation and consider changes in the interests of simplification. In the short term the amount allowable for qualifying EPWs could be reduced from the current 65% of costs, thus limiting the costs to the Government, and then gradually increased back to the original level when appropriate.

Overheads

16. Other R&D tax relief schemes (notably those Canada and France) allow for the inclusion of a % of overheads associated with R&D. The widening of the relief by the previous Government to include qualifying indirect activities (QIAs) was welcome and has gone some way to providing tax relief towards the full costs of R&D. Including a % of overheads directly attributable to and accounted for as part of R&D, would close the final gap. To simplify the claims process, this could be linked with QIAs and both claimed by allowing a % of total R&D salary costs to be claimed.

Industry funded R&D with UK universities

17. We believe that any opportunity to increase R&D Tax Credit relief should include a targeted stimulus package aimed at increasing collaborative research programmes between UK industry and UK universities. Increased investment in R&D in the UK can only be realised if the necessary skills are available within the UK labour market and closer collaboration between industry and universities will help drive this agenda. We recommend that the present super deduction of 130% for large companies should be increased to 200% on the costs of R&D contracts placed with UK universities.

Question 4C: Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?

18. The inclusion of internal use software is of particular relevance to BT, where much of our R&D activity includes this classification of work. We are unclear as to the rationale for the exclusion or limitation of such activity from the scheme. In BT's case, our internal use software is a key component of our large scale R&D programmes. Much of it underpins network management capability and next generation operational support systems, which in themselves are fundamental to the delivery of existing and future advanced products and services to residential customers, SMEs, large corporations and the public sector alike. In addition it supports the design, development and delivery of wholesale products and

services and network management capability to other Communication Providers in the UK. As such it has a significant wider economic impact and benefits the whole communications sector in the UK. We believe it is vitally important that the eligibility of this activity is maintained.

Question 4D: Is the R&D definition contained in the guidelines issued by BIS an effective definition for recognising genuine R&D activity through the R&D tax credit schemes?

19. We believe that the current R&D definition remains a workable and sensible overall framework in which to identify qualifying R&D, particularly as it has been in place now for a number of years. We believe any major change here would only serve to create uncertainty as companies, advisors and HMRC engage in a debate on the definition of R&D again.
20. We note that some parties have suggested that specific industry sector definitions may be helpful. BT has in fact sought its own industry specific definition by engaging with HMRC and our advisors in the early days of the tax relief, to agree guidance which relates the R&D definition to specific BT activities, and we continue to use this alongside the official definition.

Question 4E: Would respondents welcome a statutory definition of production? If so, what should it include and exclude?

21. We support further clarification on the definition of production costs with a view to allowing certain costs and activities to be included as R&D.
22. Often BT will provide existing customers with new technology, enabling them to participate in new technical pilots. Although the bulk of our technical trials are carried out within a captive, test environment, it is impossible to replicate and fully understand the technological challenges and consequences that may be encountered at scale in the live environment. Hence pilots with customers play an important role.
23. We believe an important distinction can be made between pilots/production aimed at designing and establishing a completely new technical capability, technically complex scaling issues or significant enhancements involving underlying technological uncertainty (in which case they should be allowable), and pilots/production aimed at say a routine uplift or scaling of technical capability, where the underlying technical solution has already been proven. We would be happy to discuss this further.

Question 4F: What further enhancements would be most effective in promoting additional investment in R&D by the smallest companies, taking into account the risk of adding additional complexity to the schemes?

24. Not applicable to BT.

Question 4G: Is VRR an effective intervention for incentivising research into drugs and vaccines for the prevention and treatment of disease prevalent in less-developed countries, or would it be more effective to deliver the support through other mechanisms?

25. Not applicable to BT.

Question 4H: Are there improvements to the claims process that would make it more streamlined and certain for companies, particularly smaller companies with limited resources? Would there be significant benefits from an external auditing process for claims or a more formal pre-clearance procedure of R&D projects with HMRC?

26. We do not foresee the need for any major structural changes to the claims process from our large company perspective. Over the years our technical community has gained a widespread knowledge of the R&D reliefs and an understanding of their applicability to BT

activities, and we have developed and refined a process to make claims which is cost effective, complementary to existing information and systems, and acceptable to HMRC.

27. We have been audited twice by HMRC over the period (including a systems review) and we found these audits to be both business like and balanced in nature. We now have a high certainty as to what qualifies and can feed this back into the planning cycle. With only minor revisions to the R&D tax relief scheme in the past few years, this tax stability has been very helpful.

Summary

28. BT believes that the R&D Tax Relief scheme has been a success, with the additional tax incentives and enhanced capital reliefs helping to off-set the significant investment required in long term strategic development programmes and the design and development of critical national infrastructures. At the same time it has provided valuable tax incentives for collaborative R&D programmes with UK universities.

29. BT, therefore;-

- wishes to see at a minimum the continuation of R&D tax relief (both Tax Credits and Research & Development Allowances) for all qualifying companies in the UK, for all activities currently covered by the legislation;
- urges the Government to maintain the rate of relief for R&D for companies as the reductions in corporation tax are implemented;
- wishes to contribute to discussions on statutory definitions of production;
- welcomes the opportunity to contribute to discussions on how the R&D tax credit might be treated as an 'above the line' saving; and
- looks to the Government to consider enhancing the R&D tax relief further as and when economic conditions allow.

Patent Box

30. The question of a Patent Box and associated tax savings is an interesting one, and we note that government thinking in this area is at a very early stage. We do not feel qualified at this time to make specific recommendations to the Government but would welcome the opportunity to discuss further and help formulate future policy in this area. As such we have not sought to answer the specific questions in the consultation document, but rather set out the potential issues as we see them from our particular industry and business model perspective.

31. This initial consultation document has focused its attention on patents and products, but for BT the issue is more one of patents and services. Establishing metrics which enable the measurement of a patent's contribution to a product will be complicated enough, but trying to measure its contribution to a service will be altogether more problematic. However, if the Government is serious about providing relief for patents, then patents and their contribution to a service must be given consideration.

32. To highlight the issue here, in certain circumstances we may have a service which is dependent on a BT patent. For example, we would have products and services which rely on standards (e.g. BT Home Hub) where patents are necessary to the implementation of the standard. In these cases we might be able to estimate the number of patents essential to a standard and apply some proportionality to revenues etc, but this would not be simple or straightforward.

33. We look forward to further discussion on this topic.