



EUROPEAN COMMISSION

Brussels, 09.03.2000

SG(2000) D/ 102179

**Subject:** State aid No N 802/99 – United Kingdom  
R&D Tax Credit

Sir,

By letter dated 21 December 1999, registered at the Secretariat-General on 22 December 1999, the United Kingdom authorities notified the Commission, pursuant to Article 88(3) (ex Article 93(3)) of the EC Treaty, of the abovementioned aid scheme.

Prior to notification, the United Kingdom authorities informed the Commission of their intention to introduce this scheme by letter dated 15 July 1999, and registered at the Secretariat-General on 20 July 1999. The Commission subsequently met with the United Kingdom authorities on 27 September 1999 to discuss the proposed scheme.

## 1. DESCRIPTION

The R&D Tax Credit is a tax-driven incentive for small and medium-size companies (SMEs) to invest in research and development (R&D) and to encourage innovation. This is necessary to combat the prevailing under-investment in R&D by SMEs in the UK. The R&D Tax Credit scheme forms one component of the UK Government's broader aim to encourage innovation and boost productivity through innovation and the exploitation of R&D, particularly by smaller businesses.

The beneficiaries of the R&D Tax Credit will be SMEs, within the meaning of "The Commission Recommendation of 3 April 1996 concerning the definition of Small and Medium-sized Enterprises"<sup>1</sup>. SMEs are defined as companies with less than 250 employees whose annual turnover does not exceed EUR 40 million or with an annual balance-sheet total of up to EUR 27 million and which are not more than 25% owned by a company falling outside the definition of an SME, or jointly by several such enterprises. This ceiling may be exceeded if the enterprise is held by public investment corporations, venture capital companies or institutional investors, provided no control is exercised either individually or jointly.

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<sup>1</sup> OJ L 107, 30.4.1996, p. 4.

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In order to qualify for the R&D Tax Credit, an SME must undertake R&D in the fields of science and technology. The scheme is limited to R&D that is fundamental research, industrial research or precompetitive development within the terms of Annex I of the Community Framework for State Aid for Research and Development<sup>2</sup> (“the R&D Framework”). In particular, R&D eligible under the scheme does not go beyond the creation of an initial prototype that could not be used commercially. R&D does not include either routine or periodic changes made to products, processes and other operations in progress.

The qualifying expenditure on such R&D must exceed a minimum threshold of GBP 25 000 per year; below this threshold the tax credit is not available at all. Although the tax credit is ostensibly aimed at research carried out within the UK, it will also be available for research undertaken outside the UK by qualifying beneficiaries.

For the purposes of the R&D Tax Credit, qualifying expenditure will be limited to the aggregate of:

- the direct costs of staff directly involved in carrying out the R&D activity (gross remuneration, excluding benefits-in-kind, plus national insurance contributions and pension contributions payable by the company);
- the cost of consumable stores used directly in the R&D activity; and
- 65% of payments due to a subcontractor, where the SME subcontracts all or part of the R&D activity while retaining ownership rights over any intellectual property produced (which represents a generalised measure of the costs above). Alternatively, and exclusively in cases where the principle and subcontractor are connected, the SME may claim the actual costs of the subcontractor’s staff directly involved in the R&D and its cost of consumable stores.

The R&D Tax Credit will not be available on R&D spending that has been met by a grant or subsidy. R&D expenditure incurred in relation to a project in receipt of any other notifiable State aid will not qualify for the tax credit.

Under the UK corporation tax system, all companies may deduct 100% of their R&D expenditure from their taxable income, as they can with other operating expenses. The R&D Tax Credit will allow SMEs to deduct an extra 50% of their qualifying R&D expenditure<sup>3</sup>.

The tax credit will be treated like any other revenue expense incurred by a company. This means that an SME paying corporation tax at 20% (the small companies’ rate) will make a saving on its tax bill equivalent to 10% of its qualifying R&D expenditure. It is possible for a company to be taxed at the highest rate of 30% and still satisfy the definition of an SME. In such a case, the tax credit will be worth 15% of the qualifying expenditure.

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<sup>2</sup> OJ C 45, 17.2.1996, p. 5.

<sup>3</sup> Although this is technically a tax deduction, not a tax credit, the terminology employed by the scheme has been retained for the sake of consistency.

It will also be possible for SMEs not yet in profit, and therefore not liable for corporation tax, to benefit from this scheme. This is particularly useful for start-up and high-technology companies. Such companies will be able to surrender the R&D Tax Credit to the Exchequer in return for a cash payment representing 24% of the qualifying expenditure. The company surrendering its tax credit will lose the future (carry forward) benefit of the existing 100% deduction in return for a payment that represents a discount of 20% on the combined value of the tax credit and the existing tax relief when used against profits taxed at the small companies' rate (24% as opposed to 30%). In these cases, the amount that can be surrendered is limited to the lower of:

- the proportion of the unrelieved loss attributable to the qualifying R&D expenditure; and
- the gross pay-as-you-earn tax and national insurance contributions paid by the company for the period of the claim.

The estimated cost of the R&D Tax Credit scheme for 2000/01 is negligible, but it is forecast that this will rise to GBP 100 million in 2001/02 and to GBP 140 million from 2002/03 onwards. Approximately 4 500 SMEs are expected to benefit from this scheme.

The scheme is not limited to any particular industrial sectors, but the State aid rules and regulations relating to specific sectors will be respected.

The scheme has been notified for an unlimited duration.

An annual report will be submitted, reporting on the implementation of the scheme.

## **2. APPRAISAL**

### **Application of Article 87(1) of the EC Treaty and Article 61(1) of the EEA Agreement**

The notified scheme gives an advantage to the companies benefiting from it, thus strengthening the position of those companies compared with competitors in other Member States. The R&D Tax Credit is selective, within the meaning of the Commission notice on the application of the State aid rules to measures relating to direct business taxation<sup>4</sup>, since it applies only to small and medium-size companies. It must therefore be regarded as affecting trade and distorting competition. The notified scheme thus falls under the application of Article 87(1) (formerly 92(1)) of the EC Treaty). By notifying the scheme, the United Kingdom authorities have complied with the obligation laid down in Article 88(3) of the EC Treaty and Article 62(3) of the EEA Agreement.

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<sup>4</sup> OJ C 384, 10.12.1998, p. 3.

## **Application of Article 87(3)(c) of the EC Treaty and Article 61(3)(c) of the EEA Agreement**

In order to assess whether the aid can benefit from the exemption provided for by Article 87(3)(c) of the EC Treaty and Article 61(3)(c) of the EEA Agreement, the Commission must ensure that it complies with the Community Framework for State Aid for Research and Development<sup>5</sup>. In carrying out this assessment, the Commission must consider several factors, including the beneficiaries and incentive effect, the types of research, the eligible costs and the aid intensities.

### *Beneficiaries and incentive effect*

The R&D Tax Credit scheme is only available for SMEs, as defined in the Commission Recommendation of 3 April 1996 concerning the definition of small and medium-sized enterprises<sup>6</sup>. As all beneficiaries will be SMEs, it is presumed that the scheme will have an incentive effect (point 6.4 of the R&D Framework).

### *Types of research*

The types of research that will qualify for the scheme are fundamental research, industrial research and precompetitive development (as defined in Annex I of the R&D Framework). In particular, it does not include the routine or periodic changes made to products, production lines, manufacturing processes, existing services and other operations in progress.

### *Eligible costs*

The eligible costs for the purposes of this scheme, as detailed above, all fall within the categories set out in Annex II of the R&D Framework.

### *Aid intensities*

The majority of SMEs pay corporation tax at 20%. The aid intensity of the R&D Tax Credit will be 10% for these SMEs. For those SMEs that pay corporation tax at 30%, the aid intensity will be 15%. The maximum possible aid intensity under this scheme is 24% of the qualifying expenditure, for companies that have not made a profit and choose to surrender their tax credit (in reality, the aid intensity is lower, as the company will have surrendered the future benefit of the existing 100% relief).

The maximum aid intensities allowed by the R&D Framework are:

- 100% for fundamental research (point 5.2);
- 50% for industrial research (point 5.3); and
- 25% for precompetitive development activities (point 5.5).

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<sup>5</sup> *ibid.*

<sup>6</sup> *ibid.*

Moreover, these aid intensities are potentially eligible for a bonus of 10% as the aid will be to SMEs (point 5.10.1). The maximum aid intensity for the R&D Tax Credit is, therefore, well within the range permitted under the R&D Framework.

### *Cumulation*

The R&D Tax Credit is not available where the R&D expenditure is being funded by a separate State aid.

### **3. CONCLUSION**

The R&D Tax Credit scheme is, therefore, compatible with the R&D Framework.

The Commission has decided to raise no objection regarding the notified scheme, and to consider it compatible with the EC Treaty and the EEA Agreement.

The Commission reminds the United Kingdom Government of the obligation to provide an annual report concerning the implementation of the scheme, and to notify any modification of the contents thereof.

If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days from the date of receipt. If the Commission does not receive a reasoned request by the stipulated deadline, you will be deemed to agree to publication of the full text of this letter. Your request should be sent by registered letter or fax to:

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Directorate-General for Competition  
Unit G2- C150 1/79  
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Yours faithfully,  
For the Commission

Mario MONTI