Little and large

Was a small company in reality a large one for research and development tax relief purposes? MARIA KITT reports on a recent tribunal decision relating to entitlement to this relief.

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In the recent case of *Pyreos Limited v CRC* (TC04328), the First-tier Tax Tribunal ruled that HMRC were wrong to deny the small and medium-sized enterprise (SME) rate of research and development (R&D) tax relief claimed. The material issue was whether Pyreos's development partner, Siemens Technology Accelerator GmbH (STA), which had provided funding and assistance to the company, could be ignored for the SME statutory threshold tests. If HMRC had won this case, the implications for the UK's R&D sector could have been far-reaching. But the case is interesting for tax advisers generally because it highlights the role of HMRC guidance and that it is no substitute for the tax legislation itself. By coincidence, this was something touched on by Andrew Hubbard in his recent editorial comment (*Taxation*, 14 May, page 4).

The starting point for any R&D claim is an analysis of the company as an enterprise by reference to its group-wide accounting data, including linked and partnering enterprises. This will determine whether relief is given at the rate for an SME or a large company. By way of a recap and to illustrate the difference in rates and thus the importance of this distinction, see ***Deduction Scheme***.The EC thresholds are just one of the factors in determining which deduction scheme is appropriate.

The parameters for determining whether a company is an SME are those in the Commission Recommendation 2003/361 (www.lexisurl.com/xl8rf) as amended by CTA 2009, s 1119 and s 1120 and these are summarised in ***SME Definition***. When applying these thresholds, the absolute employee, turnover or balance sheet data of linked enterprises and the proportionate data of partner enterprises must be taken into account. HMRC stated that shareholdings held by venture capital companies will need to be reviewed to establish whether they may be excluded. The review was intended to include the extent of economic support and influence before this judgment.

Ordinarily, when determining whether a business is an SME and subject to certain financial limits, the accounting data of

KEY POINTS

- Determining whether an enterprise is autonomous or has a partner.
- The size of the enterprise and whether it satisfies the requirements of Commission Recommendation 2003/361 is critical to determing the R&D relief available.
- Partner enterprises may be excepted from consideration if certain conditions are complied with.
- The tribunal followed EC legislation rather than HMRC guidance.

DEDUCTION SCHEME

SMEs

Since 1 April 2012, an SME incurring R&D expenditure in a 12-month accounting period can obtain relief for 225% of that expenditure. SMEs not yet in profit or which have not yet started to trade can claim relief upfront as a cash payment (R&D tax credit).

An SME can also claim relief when it incurs expenditure on work contracted to it by a large company or by any person otherwise than in the course of carrying on a chargeable trade; or expenditure which is subsidised; or expenditure subject to the project limit (£7.5m for expenditure incurred after 31 July 2008). The relief is 130% of the expenditure.

Large companies

Large companies incurring R&D expenditure can obtain relief for 130% of that outlay. They can claim a similar relief to that for SMEs above, including tax credits, for expenditure incurred on certain vaccines research.

As an alternative, from 1 April 2013 large companies (and certain SMEs with subcontracted or subsidised R&D, or R&D subject to the project limit) can claim R&D relief as a taxable above the line (ATL) credit to the value of 11% (10% before April 2015) of their qualifying R&D expenditure (49% for ring-fence trades).

venture capital partners can be ignored. But if the partner is an R&D entity itself, several further issues can arise. Getting this analysis wrong or not carrying it out at all may double or halve the relief claimed. In these days of tax-geared penalties, an over-stated claim is arguably the worst case.

What happened?

The tribunal was told (www.lexisurl.com/vp5ds) that, in the course of carrying on its business, the German electronics giant Siemens Group would start to develop and patent products or processes that it would later decide were not of use to its operations.

Rather than simply put these to one side, the patents etc would be transferred to its subsidiary company, STA, which would establish companies to take forward their development. STA would introduce capital to fund these with a view to subsequently selling its interest in the companies. This might be done in stages as R&D improved the product and as outside investors became interested in them.

LINKED ENTERPRISES

Commission Recommendation 2003/361, Annex, Article 3 para 3.
"Linked enterprises" are enterprises which have any of the following relationships with each other:

(a) an enterprise has a majority of the shareholders' or members' voting rights in another enterprise;
(b) an enterprise has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another enterprise;
(c) an enterprise has the right to exercise a dominant influence over another enterprise pursuant to a contract entered into with that enterprise or to a provision in its memorandum or articles of association;
(d) an enterprise, which is a shareholder in or member of another enterprise, controls alone, pursuant to an agreement with other shareholders in or members of that enterprise, a majority of shareholders' or members' voting rights in that enterprise.

There is a presumption that no dominant influence exists if the investors listed in the second subparagraph of paragraph 2 are not involving themselves directly or indirectly in the management of the enterprise in question, without prejudice to their rights as stakeholders.

Enterprises having any of the relationships described in the first subparagraph through one or more other enterprises, or any one of the investors mentioned in paragraph 2, are also considered to be linked.

Enterprises which have one or other of such relationships through a natural person or group of natural persons acting jointly are also considered linked enterprises if they engage in their activity or in part of their activity in the same relevant market or in adjacent markets.

An "adjacent market" is considered to be the market for a product or service situated directly upstream or downstream of the relevant market.

SME DEFINITION

The SME status for R&D purposes was set out initially in EC Detective 2003/361, but has been amended by CTA 2009, s 1119 and s 1120. An SME is a company with fewer than 500 employees and either:

- an annual turnover of €100m or less; or
- an annual balance sheet total of €86m or less.

Pyreos was such a company and STA originally held 85% of the shares although this was reduced to 49.98% and then 36.59%. In fact, the tribunal heard evidence that, since its inception in 2001, STA had been involved in 15 companies on a similar basis. In its own right, Pyreos was an SME carrying out complex R&D activity in spectroscopy. The field of microelectronics is undoubtedly an eligible one and the company was carrying out frontier project work. However, science and technology companies often engage in partnerships with larger concerns to obtain outright funding for development work, or resources and expertise for their R&D to gain traction and reach commercialisation. Pyreos was no exception, forming a number of venture capital partnerships during the development work. As new venture capital companies came on board, they would acquire shares in Pyreos from STA.

Claims refused

The company submitted SME claims for R&D relief for two years. HMRC denied the relief at the SME rate because of the "partnership" with Siemens and the company lodged an appeal. Not surprisingly, HMRC went to court. The department would not want to grant the attractive rates of R&D relief for SMEs to what, in reality, was part of a large company.

The tribunal heard that Pyreos had entered into a partnership with STA to obtain financial assistance, expertise and direction for part of the project work. Article 1 of the Annex to Commission Recommendation 2003/361 starts by explaining that an enterprise includes "partnerships or associations regularly engaged in economic activity".

Article 3 para 2 of the Annex explains that a partner enterprise is an "upstream enterprise" that holds 25% or more of the voting rights in a downstream enterprise. By holding at least 36.59% of its shares, STA had this relationship with Pyreos. However, Article 3 para 2(a) of the annex allows certain enterprises to be considered to be autonomous and not having any partners, even though this shareholding limit is exceeded as long as the investor falls into one of several specific categories – which include venture capital companies – and does not fall within the ***Linked Enterprises*** definition. Both the taxpayer and HMRC agreed (paragraph 34 of the judgment) that "the crucial question was whether STA was a venture capital company".

As well as the fact that it no longer had a controlling shareholding, evidence was submitted on behalf of Pyreos that STA was not involved in its executive management and that there was no controlling party. However, HMRC were concerned also with the scenarios within their guidance in the *Corporate Intangibles Research and Development Manual* at CIRD92100

(www.lexisurl.com/nl4rs) believing that a strategic partnership existed making the large company rate of relief applicable.

The shareholdings themselves were not an issue – see ***STA Shareholdings***. What was in dispute was the extent to which STA controlled the future benefit of the project work. HMRC looked particularly at:

- the intellectual property rights acquired and developed within the "partnership";
- commercial independence; and
- the course of the "spin out".

On behalf of the taxpayer, it was argued that, although paragraph 4 of CIRD9210 suggests that venture capital company status would be challenged by HMRC where the activities of a member company were closely linked to the strategic aims of the group business, this was not what was happening here. The role of STA was to divest Siemens of technology, not to expand the group's business. There was no continuing benefit to Siemens. Whether STA was a venture capital company depended on what it did rather than on its ownership by Siemens.

The tribunal ruled that STA met the criteria of a venture capital company as it understood the term. Its objective was to maximise the financial worth of the Siemens Group's orphan technology. The management of Pyreos was conducted independently of STA. The tribunal noted there was no definition in law of how a venture capital company could remove the autonomous status of an SME. Pyreos was properly an SME.

Venture capital partnerships

Venture capital partnerships have come to dominate the UK's R&D scene. The UK has been very successful in recent years in developing an effective R&D infrastructure to attract and promote inward investment. The number of successful incubator companies engaged in viable partnerships has grown rapidly, along with the rate of tax incentives for R&D generally. Had HMRC won this case a worrying message would have been sent to the sector. The decision was also a welcome impetus for the way that R&D companies arrange themselves, reversing the negativity of *Gripple Limited v HMRC* [2010] STC 2283; and *BE Studios Limited v Smith & Williamson Limited* [2006] STC 358. Summaries of these cases are with the website version of this article.

STA SHAREHOLDINGS

STA originally held 85% of the shares in Pyreos. Before the R&D claims the shareholding was reduced to 49.98% and then 36.59%, making it a partner enterprise – ie where the shareholding was more than 25% – for EC 2003/361 purposes. In contending whether this was an excepted partnership by virtue of its venture capital company status, HMRC reviewed – in particular – the investor's strategic aims, intellectual property rights and the overall objectives of the technology partnership. The approach was shown to be inappropriate.

Under the microscope

The harshness of the HMRC analysis was remarkable and included all matters relevant to the company's administration and management and commercial business plans as well as extensive reference to its documentary R&D records. This included a full analysis of the variation in the company's shareholdings and the stake owned by STA. Initially, STA held 85% of Pyreos before this reduced to 36%. Also under review was the part that its other investors played and the rights held by them. HMRC looked at the articles of association and the degree of any control or influence over Pyreos and the review included intellectual property transfer agreements. It was clear that Pyreos had full control and these were not subject to any reacquisition at the end of the project work.

The extent of inward knowledge transfer was not so clear cut. Siemens transferred three core process patents to Pyreos. But many technological advances are abandoned even after patent and the use or value that can be placed upon frozen knowledge is questionable. The tribunal found that the knowledge transfer had little strategic influence over the partnership.

By this point in the proceedings, Pyreos may have wondered what more documentation could have been reviewed by HMRC. After all, this was a bona fide company engaged in deep R&D and was surely entitled to the full benefit of the tax relief. But HMRC went on to look at the company's business plans and the potential commercial interactions between the two businesses.

Law or guidance?

Any claim to tax reliefs and linked decisions will, of course, only originate from tax legislation itself. The applicable R&D legislation here was EC Recommendation 2003/361. The tribunal looked at this in preference to the commentary in HMRC's manuals. The regulations were judged to be intended to benefit genuinely autonomous companies rather than be used to prevent SMEs and venture capital company partnerships from obtaining full rates tax relief where appropriate.

The perspective gained from tax guidance is simply that: an insight and interpretation of often complicated tax legislation. It does not act as a substitute or alternative. As the HMRC's guidance has recently revived itself online, should a health warning be attached?

The proper role of CIRD92100 in R&D anti-avoidance is an important one. It prevents large technology or science groups obtaining SME relief on projects carried out through incubator companies that are or will become part of the worldwide group by reference to the control over the project itself or the intellectual property rights that will emerge. HMRC were therefore in a difficult situation when reviewing the claim. The tribunal's viewpoint was clear and confirmed that the legislative definition of an SME at EC 2003/361 could not be misinterpreted when a bona fide R&D venture capital partnership was made. ■

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