



TAX INSIGHT UK

UK R & D Tax Reliefs

RD relief for SME's - small and medium size companies

February 2016

Tax for Innovative Companies

February 2016 Insight 2016: RD Reliefs – Proceed with caution

It is good to start the year on a positive footing. The changes which arrived in April 2015's Finance Acts have increased the generosity of the UK reliefs to an all-time high. However as we see below, claiming all that is due can be fraught with difficulty; where inexperienced advice this can also lead to penalty and interest charges being levied by HMRC whose approach is detailed and often querulous.

RD Tax Case Update

2015 saw two interesting cases come before the tax tribunal. Both companies' RD claims were subjected to very detailed investigations and both faced protracted legal processes following HMRC's own internal reviews. The justifications are simply that not only are UK tax procedures involved in RD claim formulation, but so too are often obscure EC Regulations applying particularly to SME (small company) reliefs as a State Aid. Both cases came before the Tax Tribunal in 2015 amongst other factors, the HMRC approach to collaborative RD projects was shown to be without a legal basis. The detailed circumstances set out within Pyreos Limited v The Commissioners for HMRC [2015 UK, 0123(TC)] and Monitor Audio

Limited [2015] UKFTT 357 (TC) provides at the same time,

encouragement for the reality of innovative companies' RD project planning and disappointment at the legal battles which both companies were then subjected to.

RD Investment Funding:

These were both important cases for RD companies to win. Were HMRC to have been successful this would have negated both the ordinary arrangements many spin off and incubator companies put in place to commercialise innovation. Access to know-how partnerships and institutional investment are both key lifelines for many SME companies pursuing valid RD projects; HMRC's challenges to both sets of circumstances were vitally important showing the CIRDS guidance and interpretations were without justification

Expertise and know-how:

In Pyreos Limited v. HMRC, the material issue was whether the Company's development partner, Siemens Technology Accelerator GmbH. (STA), who had provided funding and assistance to the Company, could be ignored for the SME statutory threshold tests. The Company was, in its own right, an SME carrying out complex R&D activity in the field of spectroscopy. The field of microelectronics was undoubtedly an eligible one and the Company carried out frontier project work. But as is common for science and technology companies it engaged in a 'partnership' to obtain either 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 course of the development work. The Company submitted two years SME claims for R&D relief. HMRC denied the relief at the SME rate because of the 'partnership' with Siemens and the Company lodged an appeal .

HMRC Analysis & Enquiry

The asperity of the HMRC analysis was remarkable and included all matters relevant to the Company's administration and management, 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 as this reduced to 34%. What part did its other investors play, and what rights did they hold? HMRC looked at the Articles of Association and the degree of any control or influence in searching for estrogenic or direct interest over the SME, 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 as clear cut. Siemens transferred three core process patent to the SME. But technological advances are frequently abandoned even after patent and what use or value can be placed upon frozen knowledge. The FTT found the knowledge transfer had little strategic influence over the partnership, and that the HMRC approach had no valid basis.

Monitor Audio Limited v HMRC, October 2015

This case looked at the effect of institutional investment upon SME reliefs following a management buyout of the RD company some time earlier. As a result of a management buy-out in 2007, the Company had obtained what it recognised as institutional investment from the RBS Group securing both capitalisation funding and debt reorganisation facilities through a debt for equity arrangement.

Monitor's problem was the 'institutional investor' noted in its account and the EC RD rules within EU Recommendation 2003/361. HMRC opened enquiries and subsequently refusing the claim on the basis that Monitor was not an SME Monitor appealed to the FTT.

The FTT's decision

The question for the FTT to consider was whether, with the considerable shareholding of RBS, Monitor was a small and medium-sized enterprise within EC / 361 / 2003. Section 1119(1), CTA 2009, defines a small or medium-sized company as a "micro, small or medium-sized enterprise as defined in Commission Recommendation (EC) No 2003/361...". Most pertinent is Article 3 of the Recommendation, which provides a definition of a 'partner enterprise' to include an upstream enterprise which holds more than 25% of the capital or voting rights of another enterprise. However, an entity will not be treated as a partner enterprise if the upstream enterprise is a 'venture capital

company' or an 'institutional investor'. Due to limited evidence provided about the activities, strategies and risk appetite for the relevant periods, the FTT agreed with HMRC and concluded that the investor was not to be treated as a venture capital company.

Just to recap, for the purposes of Article 3. It considered the definition of an institutional investor provided in Article 3 of the Commission Recommendation (EC) No2003/361 "an investment organisation which aggregates investments from a number of, or on behalf of, small investors. The essential test was whether the investor, through its involvement in the company, was putting the business in a stronger market position. Little evidence was found; the FTT therefore concluded the status of the institutional investor for the purposes of Article 3. was satisfied - Monitor was an SME and fully entitled to claim R&D relief. The appeal was therefore allowed.

The decision fits well with the Pyreos Limited ruling, providing realistic legal commentary on the UK's RD reliefs for smaller companies.

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Contact:
Maria Kitt
Corporation Tax Partner:
01483 685 185
07583 036 956
info@tax-insight.co.uk

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