

FIN(4)FW052
Finance Wales Inquiry
Response from Bevan & Buckland

3 January 2014

Direct Line No. (01792) 410110

Email: paul.arnold@bevanbuckland.co.uk

FAO: Clerk of the Finance Committee

National Assembly for Wales
Cardiff Bay
Cardiff
CF99 1NA

Dear Sirs,

Invitation to provide evidence – Finance Wales

I am writing to set out my concerns regarding any potential change to the corporate structure of Finance Wales.

These concerns relate to the R&D tax relief schemes available to companies. In essence, there are two schemes (i.e. the SME scheme and the large company scheme), and I have summarised below the benefits that can be derived from each of these:

SME scheme

Let us assume an SME was to incur £1m of qualifying R&D expenditure. The implications of this are as follows:

Scenario 1 - Profitable company

The company could claim tax relief for the £1m of expenditure actually incurred and a further notional tax deduction of £1.25m could be claimed (i.e. this is the benefit of the R&D scheme). The R&D tax relief claim would therefore reduce taxable profits by an additional £1.25m, and at the 20% tax rate would reduce the amount of corporation tax the company would have pay to HMRC by £250,000.

Scenario 2 - Loss making company

Under the SME scheme there is a mechanism that enables loss making companies to surrender (i.e. give up) the losses relating to the R&D expenditure and in return HMRC makes an actual cash payment to the company. Based on £1m of spend, the amount of cash the company actually receives from HMRC could be up to £247,500.

Large company scheme

Again, based on £1m of qualifying R&D expenditure, the actual cash benefit could be in the region of £80,000 - significantly less than under the SME scheme. Changes have recently been made to this scheme and the mechanics of these changes mean that both profitable and loss making companies could derive a cash benefit of approximately £80,000 based on £1m of qualifying spend.

However, there are also a few adverse implications associated with the large company scheme compared to the SME scheme. These include:

- There is certain expenditure that qualifies under the SME scheme but does not correspondingly qualify under the large company scheme. Therefore, the £1m of qualifying R&D expenditure under the SME may be less, potentially nil, under the large company scheme; and
- Under the SME scheme the actual cash payment made by HMRC to loss making companies is no longer restricted by that company's PAYE/NIC liabilities. However, under the large company scheme there is such a PAYE/NIC restriction. Therefore, a loss making large company may receive less than £80k, even if all expenditure were to qualify, if there are insufficient PAYE/NIC liabilities.

In summary, if a company qualifies as an SME and £1m is spent on R&D the cash benefit it could derive from making an R&D claim could be in the region of £250k (whether profitable or loss making). However, if that company has to claim R&D tax relief under the large company scheme as opposed to the SME scheme, the cash benefit it could derive would range between approximately £80,000 and nil. Hence, a company would generally not want to be large.

This principal could apply to any level of qualifying spend as it does not have to be £1m, that number has just been chosen for illustrative purposes.

A key question, therefore, is what is an SME? The SME test applies an EU definition, with a couple of modifications that have been under UK law (these modifications are unlikely to provide any benefit in this instance).

I have set out below the relevant tests used in assessing whether a company is an SME.

SME definition (under EC Recommendation 2003/361)

To qualify as an SME a company needs to satisfy both of the following:

- Employees < 500; and
- Turnover ≤ €100m or balance sheet ≤ €86m

This EU definition also has rules regarding "partner" and "linked" enterprises, which takes into account scenarios where, for example, the company being considered owns another company or is itself owned by another company.

To explain briefly what a "partner" enterprise is, let us assume (for example) another company owns shares in the company being considered. For example, if we were considering company X and 30% of the shares in company X were owned by BT it would be necessary to include 30% of BT's employees, turnover etc. in making an assessment as to whether company X is an SME. This is because BT would be a "partner" enterprise as it owns 30% of company X, and therefore 30% of BT's (and its wider group) employees etc. would need to be taken into consideration.

However, within the EU definition there is a section which states that an exemption to this rule applies in certain scenarios i.e. you do not have to take into account the employees etc. of a partner enterprise in assessing whether the company is an SME. One of these exceptions is a "venture capital company", and there is a definition of such a company.

Where my concern arises is in the wording in another section of the EU definition, in which it states, *"Except in the cases set out in paragraph 2, second paragraph {this contains the venture capital companies exemption}, an enterprise cannot be considered an SME if 25% or more of the capital or voting rights are directly or indirectly controlled, jointly or individually, by one or more public bodies."*

Hence, my concern would be that although Finance Wales should be able to currently hold (for example) 30% of the share capital of a company and that company still qualify as an SME, given the "venture capital company" exemption, any change to the structure of Finance Wales could jeopardise this. If such a change resulted in that company being owned 25% or more by an entity that was deemed to be a "public body" but not a "venture capital company" the company might lose its SME status, and this in turn could have serious adverse financial implications i.e. a company that previously qualified as an SME could potentially become large, solely because of changes made to the structure of Finance Wales.

I have not looked at this in any detail but based on what I have read in the press, and my understanding of the SME definition, I just wanted to make you aware of this potential issue so that it can be considered in detail prior to any change being made to the structure of Finance Wales.

Should you have any queries or if you would like to discuss these points further then please do not hesitate to contact me on 01792 410110 or paul.arnold@bevanbuckland.co.uk.

Yours sincerely

Paul Arnold
Tax Partner – Bevan & Buckland