

a **Gripple Ltd v Revenue and Customs Commissioners**
[2010] EWHC 1609 (Ch)

b CHANCERY DIVISION
HENDERSON J
11 MAY, 30 JUNE 2010

c *Relief – Expenditure on research and development – Staffing costs – Director’s salary – Director of taxpayer also director of associated company – Director’s salary paid by associated company – Associated company recharging taxpayer in respect of its share of director’s salary – Whether taxpayer entitled to research and development tax relief in respect of amounts paid to associated company as regards taxpayer’s share of director’s salary – Finance Act 2000, Sch 20, para 5(1).*

d The taxpayer was an engineering firm which incurred expenditure on research and development. Until 31 December 2003, L Ltd was a wholly owned subsidiary of the taxpayer. F was at all material times the director of both companies. Prior to 1 January 2004, F’s salary had been paid entirely by the taxpayer and charged to the taxpayer, and it was agreed that that was a cost in respect of which the taxpayer could claim enhanced tax relief for expenditure on research and development (‘R & D tax relief’) pursuant to the provisions of s 69 of and Sch 20 to the Finance Act 2000. From 1 January 2004, F divided his time between the taxpayer and L Ltd, and the companies reached an agreement that one half of F’s salary should be met by the taxpayer and one half by L Ltd. From 1 January 2004 until 31 December 2006, F’s salary was wholly paid by L Ltd. L Ltd invoiced the taxpayer, by way of recharge, in respect of the salary costs of F that were to be met by the taxpayer. The issue arose as to whether the taxpayer was entitled to claim R & D tax relief for the accounting years 2004, 2005 and 2006, in respect of payments it made to L Ltd in respect of R & D services provided to it (in the form of work carried out by F) by L Ltd. The Revenue took the view that the taxpayer was not entitled to the relief sought. An appeal came before the General Commissioners. It was common ground that the taxpayer satisfied all but one of the conditions for grant of the relief, and was entitled to claim it if, but only if, the sums paid by the taxpayer to L Ltd constituted expenditure on ‘staffing costs’ within the meaning of para 5(1)^a of Sch 20 to the 2000 Act. Paragraph 5(1) provided that staffing costs were, inter alia, ‘(a) the emoluments paid by a company to directors or employees of the company ...’. The General Commissioners dismissed the appeal, having accepted the Revenue’s view that the relevant sums were not ‘staffing costs’ within para 5(1). The taxpayer appealed by way of case stated.

j **Held** – In the absence of express provision, the general principle was to respect the separate identity of corporate group members, and the question whether the preconditions for the grant of relief had been satisfied had to be answered accordingly. The sums recharged by L Ltd to the taxpayer in respect of F’s

^a Paragraph 5, so far as material, is set out at [3], below.

services could not be treated as staffing costs within the meaning of para 5(1)(a) of Sch 20 to the 2000 Act as they were not emoluments payable by the taxpayer to F. All F's emoluments for the relevant period were paid to him by L Ltd. Nor could the taxpayer gain any assistance from the wording of para 5(2). The purpose of that paragraph was not to expand the meaning of 'staffing costs', which was exhaustively defined in para 5(1), but rather to explain which staffing costs (as already defined) were to be treated as attributable to research and development. The taxpayer's appeal would, accordingly, be dismissed (see [23]–[25], below). a
b

Notes

For staffing costs in relation to R & D tax relief, see Simon's Taxes D1.409. c
For the Finance Act 2000, Sch 20, para 5(1), see the Yellow Tax Handbook 2004–05, Part 1a, p 2698.

Cases referred to in judgment

DHN Food Distributors Ltd v Tower Hamlets London BC [1976] 3 All ER 462, [1976] 1 WLR 852, CA. d
Harmel v Wright (Inspector of Taxes) [1974] STC 88, [1974] 1 WLR 325, [1974] 1 All ER 945, 49 TC 149.

Case stated

1. At the meeting of the said commissioners held on 27 January 2009, Gripple Ltd appealed against Her Majesty's Revenue and Customs' (HMRC's) amendment under para 34, Sch 18 Finance Act 1998 in respect of the accounting period 1 January 2004 to 31 December 2004 and also HMRC's discovery assessments in respect of the years 1 January 2005 to 31 December 2005 and 1 January 2006 to 31 December 2006 ('the relevant years'). e
f

2. The issues shortly stated were whether Gripple Ltd was entitled to claim tax relief for expenditure on research and development ('R & D') pursuant to Sch 20 Finance Act 2000 ('the Schedule') in respect of payments made by Gripple Ltd to Loadhog Ltd for the research and development work provided by Mr Hugh Facey to Gripple Ltd during the relevant years.

3. The appellant's managing director Mr Hugh Facey appeared as a witness on behalf of the appellant and was represented by Mr T Holmes of Holmes Widlake Accountants. The respondent was represented by Mrs Ann Green of Her Majesty's Revenue and Customs ('HMRC') Local Compliance, Eastern England, Saxon House, 1 Causeway Lane, Leicester, LE1 1FZ and Mr Alan Bamford (of the same address). g
h

4. Mrs Ann Green provided a bundle of documents. h

- 4.1. Gripple Ltd 2004 accounts page 18 note 25 related party transactions.
- 4.2. and 4.3. Gripple Ltd 2004 accounts pages 19 and 20 trading accounts.
- 4.4. Gripple Ltd 2005 accounts page 20 note 23 related party transactions.
- 4.5. and 4.6. Gripple Ltd 2005 accounts pages 21 and 22 trading accounts.
- 4.7. Gripple Ltd 2006 accounts page 21 note 23 related party transactions. j
- 4.8. and 4.9. Gripple Ltd 2006 accounts pages 22 and 23 trading accounts.
- 4.10. Gripple Ltd 2004 tax computation Sch 2 note 1 R & D staffing expenditure.
- 4.11. Gripple Ltd 2005 Sch 2 note 1 schedule of R & D staffing expenditure.

- a* 4.12. Gripple Ltd 2006 Sch 2 note 1 schedule of R & D staffing expenditure.
- 4.13.1. H Facey 2003–04 return Gripple Ltd employment page.
4.13.2. H Facey 2003–04 return Loadhog Ltd employment page.
4.13.3. H Facey 2004–05 return Gripple Ltd employment page.
4.13.4. H Facey 2004–05 return Loadhog Ltd employment page.
- b* 4.13.5. H Facey 2005–06 return Gripple Ltd employment page.
4.13.6. H Facey 2005–06 return Loadhog Ltd employment page.
4.13.7. H Facey 2006–07 return Gripple Ltd employment page.
4.13.8. H Facey 2006–07 return Loadhog Ltd employment page.

Mr H Facey provided a schedule of Research and Development statistics. All the documents listed above are available for inspection by the court, if so required.

- c* 5. As a result of the oral and documentary evidence adduced before us, the following facts were proved.

d 5.1. Gripple Ltd is an engineering company based in Sheffield which incurs expenditure in research and development. Mr Hugh Facey at all times was and is a director of that company.

5.2. Until 31 December 2003 Loadhog Ltd was a wholly owned subsidiary of Gripple Ltd, thereafter it was a wholly owned subsidiary of Loadhog Holdings Ltd. Mr Hugh Facey at all times during the relevant period was and continues to be a director of those companies.

e 5.3. Prior to the 1 January 2004 Mr Facey's salary had been paid entirely by Gripple Ltd and charged to Gripple Ltd and both parties agreed this was a cost in respect of which the company could claim R & D tax relief pursuant to the Schedule.

f 5.4. From 1 January 2004, Mr Facey divided his time between Gripple Ltd and Loadhog Ltd and the companies reached an agreement that one half of Mr Facey's salary should be met by Gripple Ltd and one half of Mr Facey's salary should be met by Loadhog Ltd.

5.5. From 1 January 2004 until 31 December 2006 Mr Facey's salary was wholly paid by Loadhog Ltd. Loadhog Ltd invoiced Gripple Ltd, by way of recharge, in respect of the salary costs of Mr Facey that were to be met by Gripple Ltd.

g 6. HMRC's Summary of the Facts was as follows:

h 6.1. HMRC accepted that Gripple Ltd had been carrying out R & D activities for a number of years into the design and manufacture of Gripple joiners, hangers and tensulators. It was accepted that these projects qualified for R & D tax relief and the only point at issue was whether certain expenditure qualified for such relief.

j 6.2. For the three years in question some of the staff previously employed by Gripple Ltd became employed by Loadhog Ltd and were paid directly by that company. Throughout the three-year period Loadhog Ltd was either a subsidiary of Gripple Ltd or was connected with it for the purposes of the R & D legislation. Mr Facey, a Director of Gripple Ltd, was also a Director of Loadhog Ltd throughout.

6.3. Gripple Ltd's Profit and Loss account for the three years (documents 3, 6 and 9) showed directors' remuneration although no Pay as you Earn ('PAYE') or National Insurance Contributions ('NIC') had been submitted

by Gripple Ltd for the remuneration of Mr Facey. The notes to the accounts (documents 1, 4 and 7) showed payments for services purchased but no explanations as to the nature of those services. *a*

6.4. Enquiries revealed that for the relevant years all of Mr Facey's remuneration was paid by Loadhog Ltd. Gripple Ltd paid Loadhog Ltd half of those costs for the services Mr Facey provided to Gripple Ltd for R & D work. *b*

6.5. Gripple Ltd's R & D claim (documents 10, 11 and 12) included elements which were described as salary and employer's NIC for Mr Facey. These were in fact payments made by Gripple Ltd to Loadhog Ltd. The additional R & D deduction claimed was half of these figures for each year.

6.6. Extracts from Mr Facey's personal tax returns showed him returning, correctly, the income he received from Loadhog Ltd with no remuneration from Gripple Ltd. *c*

7. HMRC's contentions were as follows:

7.1. The payments by Gripple Ltd to Loadhog Ltd for the services of Mr Facey, whilst an allowable deduction in the accounts of Gripple Ltd, did not attract qualifying expenditure R & D tax relief in the computations of Gripple Ltd. Paragraph 3 of the Schedule set out the expenditure that qualified for the additional R & D tax relief. HMRC were satisfied that the expenditure did not so qualify because the third condition in para 3(4) was not met in that (i) the expenditure was not incurred on staffing costs (ii) it did not constitute qualifying expenditure on externally provided workers (iii) it did not constitute qualifying expenditure on sub-contracted research and development. Mrs Green dealt with these in turn. *d*

7.2. The Schedule provides for tax relief for expenditure on R & D where a company may claim an enhanced allowance, generally 50% of eligible expenditure, in computing their taxable profits or losses. *e*

7.3. Qualifying staffing costs are detailed in para 5 of the Schedule. Sub-paragraph 2 says that the staffing costs are those which are paid to or in respect of directors or employees. Mrs Green contended this meant that if the directors were paid emoluments or if employer's NIC or pension payments were made in respect of them then the additional relief could be given. In this case Gripple Ltd did not pay any emoluments to Mr Facey nor did it pay any secondary Class 1 NICs or pension costs in respect of Mr Facey. The payments Gripple Ltd made to Loadhog Ltd were therefore not a staffing cost and as such were not eligible for an R & D tax relief. *f*

7.4. Furthermore the payments made by the appellant in relation to Mr Facey did not qualify for R & D relief as they did not constitute qualifying expenditure on an externally provided worker ('EPW') under paras 8A-8E of the Schedule. The condition under para 8B(b) was not satisfied as Mr Facey was a director of Gripple Ltd throughout the relevant period. *g*

7.5. Alternatively, the payments could not be considered as expenditure on subcontracted R & D under paras 9-12 of the Schedule as Gripple Ltd had not contracted out any work to Loadhog Ltd; therefore the expenditure incurred did not fall within the meaning of para 9(2). Gripple Ltd had merely made a payment for the services of Loadhog Ltd's director Mr Facey. No subcontracted R & D work had been undertaken by Loadhog Ltd. *h*

j

- a* 7.6. In conclusion it was submitted that the expenditure on payments by Gripple Ltd to Loadhog Ltd did not qualify for R & D tax relief either as a staffing cost, or as being the cost of hiring an externally provided worker or for subcontracted R & D. The payments, whilst otherwise tax deductible, would not attract an additional R & D deduction.
- b* 7.7. Accordingly, HMRC sought confirmation of the amendment and the two discovery assessments in the figures assessed which reflected disallowances as follows:
- | | |
|-----------------------|---------|
| Year ended 31/12/2004 | £56,252 |
| Year ended 31/12/2005 | £55,776 |
| Year ended 31/12/2006 | £56,400 |
- c* 8. The appellant's case was as follows:
- 8.1. Mr Facey's salary, when paid directly by Gripple Ltd had received an entitlement to R & D relief.
- 8.2. Payments made by Gripple Ltd in respect of services provided by Mr Facey to Gripple Ltd were properly charged to the profit and loss account of Gripple Ltd. The payments should be treated as a staffing cost whether or not the payment was made through the PAYE system or by invoice.
- d*
- 8.3. The Government had made available the enhanced allowance for R & D tax relief to encourage businesses to invest in R & D particularly small and medium sized enterprises. A sheet of statistics was provided to show how the sales of Gripple Ltd had increased at more than double in the years 2000–2004 and expenditure of R & D as a percentage of sales had increased from 2.53% to 6.06% in the same years. Mr Facey was at all relevant times the key driver of R & D activity of both Gripple Ltd and Loadhog Ltd.
- e*
- 8.4. When considering Sch 20 it was important to look at the situation in the round having regard to the Government's objectives.
- f*
- 8.5. If, subsequently, Gripple Ltd had operated PAYE for Mr Facey and re-charged a proportion of his salary to Loadhog Ltd, rather than the other way around, the R & D claim would have been admitted without argument. It makes no practical difference which company pays the PAYE and NIC.
- g*
9. The relevant provisions of the Schedule were cited before us. No authorities were cited.
10. We the commissioners heard the appeal and decided:
- h*
- 10.1. The appeal of Gripple Ltd should be refused. We heard that Mr HD Facey is a director of Gripple Ltd and also a director of a subsidiary company Loadhog Ltd.
- 10.2. For several years Gripple Ltd had claimed research and development tax relief under the Schedule in connection with remuneration paid to Mr Facey. During this time Mr Facey was a director of only Gripple Ltd.
- j*
- 10.3. Mr Facey became a director of Loadhog Ltd at the time Loadhog Ltd was created. He provided approximately half of his time to Gripple Ltd and half of his time to Loadhog Ltd. For convenience, his salary was paid solely by Loadhog Ltd and Loadhog Ltd invoiced Gripple Ltd for the services of Mr Facey to recover one half of Mr Facey's salary and national insurance contributions.

10.4. HMRC sought to disallow the claim for R & D relief by Gripple Ltd by finding that Mr Facey was an externally provided worker provided by Loadhog to Gripple. As a result of Mr Facey being a director, Gripple could not claim the R & D allowance due to the provisions of the Schedule. HMRC also reviewed whether the payments were a staffing cost or expenditure on subcontracted R & D but the payments did not qualify under either of those requirements.

10.5. Having regard to the above facts we had sympathy for Gripple Ltd. Having looked at the legislation, we asked the parties to consider an alternative: that Loadhog acted only as a payment or salary agent in respect of one half of the salary paid to Mr Facey. We heard representations from both parties on this point.

10.6. It was with reluctance that we found in favour of HMRC in the current circumstances.

11. Within 30 days of the letter sent by the clerk outlining our decision, the appellant expressed dissatisfaction with it as being erroneous in point of law and requested us to state a case for the opinion of the High Court pursuant to reg 20(1) General Commissioners (Jurisdiction and Procedure) Regulations 1994, SI 1994/1812, which case we have stated and do sign accordingly.

12. The question of law for the opinion of the High Court is:

Whether we have misdirected ourselves as to the application of Sch 20 Finance Act 2000 in respect of the expenditure of Gripple Ltd relating to the cost of the services provided by Mr Hugh Facey.

Keith Gordon and Ximena Montes Manzano (instructed by *Brooke North LLP*) for Gripple.

David Yates (instructed by the *Solicitor for Revenue and Customs*) for HMRC.

Cur adv vult

30 June 2010. The following judgment was delivered.

HENDERSON J.

INTRODUCTION

[1] This appeal raises a short question about the entitlement of a company which is a small or medium-sized enterprise ('SME') to enhanced tax relief for expenditure on research and development ('R & D tax relief') pursuant to provisions which were first enacted in s 69 of, and Sch 20 to, the Finance Act 2000, and are now contained (together with provisions relating to certain other reliefs of a similar nature) in Pt 13 of the Corporation Tax Act 2009 (ss 1039 to 1142).

[2] The issue, shortly stated, is whether the appellant, Gripple Ltd ('Gripple'), was entitled to claim R & D tax relief in its three accounting periods being the calendar years 2004, 2005 and 2006 respectively, in respect of payments which it made to an associated company, Loadhog Ltd ('Loadhog'), for R & D services provided to it by Loadhog. Those services took the form of work carried out by Mr Hugh Facey, who was at all material times a director of both Gripple and Loadhog. As I understand it, he was also the founder of Gripple's business, and in conjunction with a family trust he was Gripple's controlling shareholder.

- a* [3] It is common ground that Gripple satisfied all but one of the conditions for grant of the relief, and that it was entitled to claim it if, but only if, the sums so paid by Gripple to Loadhog constituted expenditure on 'staffing costs' within the meaning of para 5(1) of Sch 20 to the 2000 Act. So far as material, para 5 provides as follows:
- b* '5(1) For the purposes of this Schedule the staffing costs of a company are—
- (a) the emoluments paid by the company to directors or employees of the company, including all salaries, wages, perquisites and profits whatsoever other than benefits in kind;
- (b) the secondary Class 1 national insurance contributions paid by the company; and
- c* (c) the contributions paid by the company to any pension fund ... operated for the benefit of directors or employees of the company. ...
- (2) The staffing costs of a company attributable to relevant research and development are those paid to, or in respect of, directors or employees directly and actively engaged in such research and development.'
- d* The wording of para 5(1)(a) which I have quoted was substituted by the Finance Act 2004 with effect for expenditure incurred after 31 March 2004, with the object of excluding benefits in kind from the definition of staffing costs. Before the substitution, para 5(1)(a) simply referred to 'the earnings paid by the company to directors and employees of the company'. It is agreed that for present purposes nothing turns on this change in wording.
- e* [4] Gripple prepared its tax computations, and paid corporation tax under the corporate self-assessment regime, on the footing that it was entitled to claim the relief for the full amounts invoiced to it by Loadhog in respect of Mr Facey's work on R & D. Her Majesty's Revenue and Customs ('HMRC') disagreed, and in due course the issue came before the General Commissioners for the division of Sheaf and Don on the hearing of appeals by Gripple against
- f* (a) HMRC's amendment of Gripple's self-assessment return for its 2004 accounting period, and (b) discovery assessments by HMRC in respect of the two following accounting periods. The hearing took place on 27 January 2009. Gripple was represented by an accountant, Mr T Holmes of Holmes Widlake Accountants. Mr Facey gave oral evidence, but there were no other witnesses.
- g* HMRC were represented by two officers, Mrs Ann Green and Mr Alan Bamford. The documents before the commissioners consisted of a schedule of R & D statistics provided by Mr Facey, and a number of extracts from Gripple's accounts and tax returns for the relevant years, and from Mr Facey's personal tax returns, produced by HMRC.
- h* [5] The General Commissioners dismissed the appeals, having accepted HMRC's submission that the relevant sums paid by Gripple to Loadhog were not staffing costs within the meaning of Sch 20 para 5. Gripple expressed dissatisfaction with the decision, and requested the commissioners to state a case for the opinion of the High Court. The case stated was duly signed by the commissioners on 4 November 2009, and the appeal came on for hearing
- j* before me on 11 May 2010. Both sides were now represented by counsel, Mr Keith Gordon and Ms Ximena Montes Manzano for Gripple and Mr David Yates for HMRC.
- [6] It is appropriate to record that this must be one of the last tax appeals to come before the High Court by way of case stated. It does so because the hearing below took place some two months before the First-tier Tribunal (Tax

Chamber) came into existence on 1 April 2009 and took over the first-instance jurisdiction in respect of direct tax appeals previously exercised by the Special and General Commissioners. Unlike the Special Commissioners and the Value Added Tax and Duties Tribunal, the General Commissioners were not automatically abolished on 1 April 2009, and by virtue of para 4 of the Tribunals Courts and Enforcement Act 2007 (Commencement No 6 and Transitional Provisions) Order 2008 (SI 2008/2696) they remain in existence where there is a statement of case for the opinion of the High Court under s 56 of the Taxes Management Act 1970, so that (for example) the matter may still be remitted to them by the High Court.

[7] By virtue of s 56(6), the appeal to the High Court lies only on questions of law arising on the case stated. The question of law formulated in para 12 of the case stated in the present case is:

‘Whether we have misdirected ourselves as to the application of Schedule 20 Finance Act 2000 in respect of the expenditure of [Gripple] relating to the cost of the services provided by Mr Hugh Facey.’

LEGISLATION

[8] R & D tax relief was introduced in 2000, with the evident purpose of providing a fiscal incentive to SMEs to incur expenditure on R & D. So long as such expenditure is incurred wholly and exclusively for the purposes of a trade carried on by the company, its full amount will be deductible in accordance with normal principles in computing the taxable profits of the trade: see s 74(1)(a) of the Income and Corporation Taxes Act 1988. Where, however, a company was entitled to claim R & D tax relief, the deductible amount of qualifying R & D expenditure was treated ‘as if it were an amount equal to 150% of the actual amount’: Sch 20 para 13. So a deduction was allowed for one-and-a-half times the amount of the actual expenditure.

[9] The basic conditions of entitlement to the relief were set out in para 1 of Sch 20. (Here, as elsewhere in this judgment, I refer to the legislation as amended and in force in 2005, unless the contrary is stated). For present purposes, the details are unimportant. The company has to be a SME (defined in para 2 by reference to EC Commission Recommendation 2003/361 of 6 May 2003, subject to certain qualifications). There is a minimum amount of qualifying R & D expenditure (£10,000 for a 12 month accounting period), and it has to be deductible in computing the profits of a trade carried on by the company. If the company is not yet carrying on a trade, it suffices if the expenditure would be deductible if the company were carrying on a trade consisting of the activities to which the expenditure relates.

[10] Paragraph 3 then defines ‘Qualifying R & D expenditure’:

‘3—(1) For the purposes of this Schedule “qualifying R & D expenditure” of a company means expenditure that meets the following conditions.

(2) The first condition is that the expenditure is not of a capital nature.

(3) The second condition is that the expenditure is attributable to relevant research and development (see paragraph 4) directly undertaken by the company or on its behalf.

(4) The third condition is that the expenditure—

(a) is incurred on staffing costs (see paragraph 5),

(b) is incurred on software or consumable items (see paragraph 6),

(c) is qualifying expenditure on externally provided workers (see paragraphs 8A to 8E), or

- a* (d) is qualifying expenditure on sub-contracted research and development (see paragraphs 9 to 12).
 (5) The fourth condition is that any intellectual property (see paragraph 7) created as a result of the research and development to which the expenditure is attributable is, or will be, vested in the company (whether alone or with other persons).
- b* (6) The fifth condition is that the expenditure is not incurred by the company in carrying on activities the carrying on of which is contracted out to the company by any person.
 (7) The sixth condition is that the expenditure is not subsidised (see paragraph 8).’
- c* [11] The remaining paragraphs in Part I of the schedule then explain and amplify the conditions set out in para 3. I have already quoted the relevant parts of para 5, which deals with staffing costs. I should also refer to the provisions relating to qualifying expenditure on externally provided workers, the material parts of which are as follows:
- d* ‘8A—(1) The provisions of paragraphs 8C to 8E have effect for determining the amount of the qualifying expenditure of a company (“the company”) on externally provided workers.
 (2) ...
 (3) For the purposes of this Schedule the company incurs expenditure on externally provided workers if it makes a payment (a “staff provision payment”) to another person (the “staff provider”) in respect of the supply to the company, by or through the staff provider, of the services of any externally provided workers.
- e* (4) Qualifying expenditure on externally provided workers is attributable to relevant research and development if the externally provided workers are directly and actively engaged in such research and development. ...
- f* 8B For the purposes of this Schedule a person is an “externally provided worker” in relation to the company if the following conditions are satisfied—
- g* (a) he is an individual,
 (b) he is not a director or employee of the company,
 (c) he personally provides, or is under an obligation personally to provide, services to the company,
 (d) he is subject to (or to the right of) supervision, direction or control by the company as to the manner in which those services are provided,
 (e) his services are supplied to the company by or through the staff provider (whether or not he is a director or employee of the staff provider or of any other person),
- h* (f) he provides, or is under an obligation to provide, those services personally to the company under the terms of a contract between him and the staff provider,
- j* (g) the provision of those services does not constitute the carrying on of activities contracted out by the company.’

[12] It is unnecessary for me to cite any further provisions of Sch 20. I would, however, make the general point that the provisions form a detailed and meticulously drafted code, with a series of defined terms and composite expressions, and a large number of carefully delineated conditions, all of which

have to be satisfied if the relief is to be available. The schedule runs to 26 paragraphs, and occupies ten pages in Tolley's Yellow Tax Handbook for 2005–06. I emphasise this point because one of Mr Gordon's submissions for Gripple is that the schedule evinces a general intention to provide enhanced relief for expenditure on R & D, and that a generous construction should where possible be adopted in order to further that general aim. I am unable to accept this submission. It seems to me, on the contrary, that a detailed and prescriptive code of this nature leaves little room for a purposive construction, and there is no substitute for going through the detailed conditions, one by one, to see if, on a fair reading, they are satisfied. It also needs to be remembered, in this context, that the relief is a generous one, which grants a deduction for notional expenditure which has not actually been incurred. Even if the relief is not available, there will be nothing to prevent the company from deducting its actual R & D expenditure in full in the computation of its trading profits, provided only that the normal 'wholly and exclusively' test is satisfied.

THE FACTS

[13] The facts found by the General Commissioners are set out in para 5 of the case stated, as follows:

'5. As a result of the oral and documentary evidence adduced before us, the following facts were proved.

5.1 [Gripple] is an engineering company based in Sheffield which incurs expenditure in research and development. Mr Hugh Facey at all times was and is a director of that company.

5.2 Until 31 December 2003 [Loadhog] was a wholly owned subsidiary of [Gripple], thereafter it was a wholly owned subsidiary of Loadhog Holdings Ltd. Mr Hugh Facey at all times during the relevant period was and continues to be a director of those companies.

5.3 Prior to the 1 January 2004 Mr Facey's salary had been paid entirely by [Gripple] and charged to [Gripple] and both parties agreed this was a cost in respect of which the company could claim R & D tax relief pursuant to the Schedule.

5.4 From 1 January 2004, Mr Facey divided his time between [Gripple] and [Loadhog] and the companies reached an agreement that one half of Mr Facey's salary should be met by [Gripple] and one half of Mr Facey's salary should be met by [Loadhog].

5.5 From 1 January 2004 until 31 December 2006 Mr Facey's salary was wholly paid by [Loadhog]. [Loadhog] invoiced [Gripple], by way of recharge, in respect of the salary costs of Mr Facey that were to be met by [Gripple].'

[14] These findings of fact are consistent with the documents produced by HMRC. The relevant extracts from Mr Facey's personal tax returns show that he returned employment income of £135,675 from Gripple for the tax year ended 5 April 2004, and employment income of £50,000 from Loadhog during the same year. In the two following tax years he returned no employment income at all from Gripple, and employment income of £200,000 from Loadhog. In the year to 5 April 2007, he still returned no employment income from Gripple, but his employment income from Loadhog was reduced to £183,333. The extracts from Gripple's 2004, 2005 and 2006 returns included details of expenses recharged by Loadhog to Gripple in the following total

a amounts, but without any breakdown or explanation of the arrangement pursuant to which the expenses were recharged: £83,220 (2004), £171,002 (2005) and £160,419 (2006).

b [15] Although nothing turns on the point, I should mention that the relationship between Gripple, Loadhog and Loadhog Holdings Ltd was not quite as simple as the commissioners say in para 5.2 of the case stated. Without objection from counsel for Gripple, I was shown a letter from Gripple's accountants to the Inland Revenue's Business Tax Clearance Team dated 29 September 2005 seeking clearance in respect of a proposed reacquisition of Loadhog by Gripple. It appears from this letter that clearance had been given for an earlier demerger of Loadhog from Gripple which took effect in January 2004. Since that date, Loadhog had struggled and had made substantial losses, but two new products were under development which it was hoped would turn the business round. In those circumstances, the directors of both companies were of the view that Loadhog should be brought back into Gripple's ownership, and steps were proposed in order to achieve that goal. I was told that Loadhog again became a wholly owned subsidiary of Gripple in or about November 2005.

THE COMMISSIONERS' DECISION

[16] After setting out the rival contentions of the parties, the commissioners gave their reasons for dismissing the appeal in para 10 of the case stated:

- e* '10. We the Commissioners heard the appeal and decided:
- 10.1 The appeal of [Gripple] should be refused. We heard that Mr H D Facey is a director of [Gripple] and also a director of a subsidiary company [Loadhog].
- f* 10.2 For several years [Gripple] had claimed research and development tax relief under the Schedule in connection with remuneration paid to Mr Facey. During this time Mr Facey was a director of only [Gripple].
- g* 10.3 Mr Facey became a director of [Loadhog] at the time [Loadhog] was created. He provided approximately half of his time to [Gripple] and half of his time to [Loadhog]. For convenience, his salary was paid solely by [Loadhog] and [Loadhog] invoiced [Gripple] for the services of Mr Facey to recover one half of Mr Facey's salary and national insurance contributions.
- h* 10.4 HMRC sought to disallow the claim for R & D relief by [Gripple] by finding that Mr Facey was an externally provided worker provided by Loadhog to Gripple. As a result of Mr Facey being a director, Gripple could not claim the R & D allowance due to the provisions of the Schedule. HMRC also reviewed whether the payments were a staffing cost or expenditure on subcontracted R & D but the payments did not qualify under either of those requirements.
- j* 10.5 Having regard to the above facts we had sympathy for [Gripple]. Having looked at the legislation, we asked the parties to consider an alternative: that Loadhog acted only as a payment or salary agent in respect of one half of the salary paid to Mr Facey. We heard representations from both parties on this point.
- 10.6 It was with reluctance that we found in favour of HMRC in the current circumstances.'

[17] Although the commissioners do not say so expressly, it is implicit in their decision that they rejected the alternative analysis referred to in para 10.5, and

counsel for Gripple did not seek to argue the contrary. For his part, counsel for HMRC accepted that, if the true position had been that Loadhog acted only as a payment or salary agent on behalf of Gripple, the relief would indeed have been available. He submitted, however, that such an analysis was impossible to reconcile with the primary facts found by the commissioners, and with the evidence of Mr Facey's personal tax returns. In my judgment that is right, and although I can understand why the commissioners wished to hear submissions on the point, I have no doubt that their conclusion on it was correct.

DISCUSSION

[18] In their written submissions in support of the appeal, counsel for Gripple argued that the General Commissioners interpreted para 5(1)(a) of Sch 20 too narrowly and restrictively, and in particular that they failed to interpret it in the light of the wording of para 5(2) which refers to staffing costs 'paid to, or in respect of, directors or employees ...'. They submitted that the purpose and intention of the legislation, which had remained essentially unchanged since its introduction in 2000, was to provide relief for expenditure on R & D undertaken by a SME. In those circumstances, para 5 should be construed so as to include emoluments paid indirectly by a company to a relevant director or employee, and the recharge arrangement in the present case, between two closely related companies, should be characterised as an indirect payment of emoluments by Gripple to Mr Facey.

[19] In the alternative, counsel argued that this was an appropriate case for the court to lift the veil of incorporation and to treat Gripple and Loadhog as a single commercial entity that was undertaking R & D. The two companies were working in conjunction with each other, and in order to achieve a common goal. In support of this submission they referred to the decision of the Court of Appeal in *DHN Food Distributors Ltd v Tower Hamlets London BC* [1976] 3 All ER 462, [1976] 1 WLR 852 a compulsory purchase case concerning the payment of compensation for disturbance in respect of a wholesale grocery business carried on by a group of three closely associated companies, one of which owned the land which had been compulsorily acquired, the second of which owned the business and the third of which owned the vehicles. The companies which owned the land and the vehicles were both wholly owned subsidiaries of the third company which ran the business, and the directors of all three companies were the same. Against this background it was held by all three members of the Court of Appeal (Lord Denning MR, Goff and Shaw LJ) that it would be appropriate to lift the corporate veil. At [1976] 3 All ER 462 at 467, [1976] 1 WLR 852 at 860 Lord Denning said this:

'This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point. They should not be deprived of the compensation which should justly be payable for disturbance. The three companies should, for present purposes, be treated as one, and the parent company D.H.N. should be treated as that one. So D.H.N. are entitled to claim compensation accordingly. It was not necessary for them to go through a conveyancing device to get it.'

Lord Denning's reference to a conveyancing device was a reference to the fact that the companies could easily have arranged matters (by conveying the land to the parent company) in such a way as to put themselves in an unassailable position to claim not only the value of the land but also compensation for

a disturbance: see [1976] 3 All ER 462 at 467, [1976] 1 WLR 852 at 858. Goff LJ agreed with Lord Denning MR, but emphasised that he did so in reliance on the particular facts of the case: see [1976] 3 All ER 462 at 468, [1976] 1 WLR 852 at 861. Shaw LJ also stressed ‘the complete identity of commercial interest and personality’ between the three companies at [1976] 3 All ER 462 at 473, [1976] 1 WLR 852 at 867.

b [20] In his oral submissions, Mr Gordon clarified his case on this point. He did not argue that the court should ignore the separate corporate existence of Loadhog, nor did he contend that the court should treat R & D carried out by one company in the group as if it were carried out by another. His argument was, rather, that a similar spirit of commercial realism should inform the construction of para 5(1), and although as a matter of form Mr Facey received his remuneration in the three years from Loadhog, and half of it was recharged to Gripple, the commercial reality was that Gripple paid half his remuneration and channelled it to him through Loadhog.

c [21] Mr Gordon also referred me to the decision of Templeman J, as he then was, in *Harmel v Wright (Inspector of Taxes)* [1974] STC 88, [1974] 1 WLR 325, where the question was whether certain sums received by the taxpayer in the United Kingdom in the form of interest-free loans from a South African company were to be treated as emoluments received by him in the UK under Case III of Schedule E, then contained in s 156 of the Income Tax Act 1952. In an attempt to avoid the application of this charge, the taxpayer entered into arrangements whereby his South African employers paid his salary to him in South Africa, he then used the money to buy shares in a South African company which he controlled, the proceeds of sale were lent to a second South African company in which he held no shares, and the money was then lent to him in the UK. Templeman J had little difficulty in holding that the attempt failed, and said at [1974] STC 88 at 94, [1974] 1 WLR 325 at 328 that the case depended ‘on keeping one’s eye on the emoluments, on the original sum of £25,000, and seeing what happened to it’. He then continued:

d ‘It is true that it was paid over at one stage as purchase price for shares, and it is true that one cannot normally identify money, but in the present case you can; you do not need to get behind the corporate veil to perceive and know that the £25,000 which went in as purchase price for shares came out on the instant in the form of the loan to Lodestar. In my judgment, on the wording of section 156, one does not need to strip aside the corporate veil if you find that emoluments, which means money, come in at one end of a conduit pipe and pass through certain traceable pipes until they come out at the other end to the taxpayer.’

e *g* *h* [22] Mr Gordon relied on this passage as providing support for his submission that the court should make a commercially realistic assessment of the manner in which Mr Facey was remunerated by Gripple. However, the case is in my judgment too far removed from the present context to be of any assistance. The statutory provisions in issue were entirely different, and notably included a direction (contained in para 8 of Sch 2 to the Finance Act 1956) that for the purposes of Case III ‘emoluments shall be treated as received in the United Kingdom if they are paid, used or enjoyed in or in any manner or form transmitted or brought to the United Kingdom ...’. In the light of that express provision, it is hardly surprising that Templeman J held that the taxpayer’s South African emoluments had been transmitted or brought to the UK.

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[23] I am equally unable to accept Mr Gordon's submissions about lifting the corporate veil, even in the more moderate form in which he advanced them orally. It is a commonplace of UK tax law that companies in a group, however closely related, are normally to be treated as separate entities. Indeed, it is precisely for this reason that special provision has to be made, for example by the provision of group or consortium relief, to enable the tax treatment of a group to correspond more closely with the underlying commercial structure. I am aware of no authority, and none was cited to me, which provides any support for the notion that the court should somehow coalesce separate corporate entities in construing fiscal legislation, unless, of course, the legislation properly construed permits such an approach. It is enough for present purposes to say that I can find no encouragement at all for such an approach in the detailed and meticulously drafted code of Sch 20. On the contrary, there are detailed provisions relating to connected persons (for example in paras 8C to 8E and paras 10 to 12) which show that the draftsman was well aware of the existence of corporate groups and the need to fit them within the structure of the relief. In the absence of express provision, I have no doubt that the general principle must be to respect the separate corporate identity of group members, and that the question whether the preconditions for grant of relief have been satisfied must be answered accordingly.

[24] Once Mr Gordon's more adventurous submissions have been disposed of, the answer to the present case is in my judgment clear. The sums recharged by Loadhog to Gripple in respect of Mr Facey's services cannot be treated as staffing costs within the meaning of para 5(1)(a), for the simple reason that they were not emoluments paid by Gripple to Mr Facey. All Mr Facey's emoluments, during the relevant three-year period, were paid to him by Loadhog. The position would be different if Loadhog had merely acted as a payroll agent on behalf of Gripple, but as I have already said this possibility was considered and rightly rejected by the commissioners. It just does not accord with the evidence which was before them.

[25] Nor, in my judgment, can Gripple gain any assistance from the wording of para 5(2). The purpose of this sub-paragraph is not to expand the meaning of 'staffing costs', which has already been exhaustively defined in para 5(1), but rather to explain which staffing costs (as already defined) are to be treated as 'attributable to relevant research and development', that being the second of the six qualifying conditions laid down in para 3 of the schedule. The sub-paragraph provides an illustration of the rather laborious way in which the draftsman states a condition, here that the expenditure must be attributable to relevant research and development, and then provides further definitions in order to flesh out the content of the condition. 'Relevant research and development' is defined in para 4, and para 5(2) tells us when such expenditure is to be treated as attributable to staffing costs, namely when it is 'paid to, or in respect of, directors or employees directly and actively engaged in such research and development'. The words 'or in respect of' are there because not all staffing costs, as defined in para 5(1), are paid to directors or employees. Staffing costs within para 5(1)(b) and (c), that is to say secondary Class 1 national insurance contributions paid by the company, and contributions paid by the company to any pension fund operated for the benefit of directors or employees of the company, are payments 'in respect of' directors or employees, but are not payments to them.

[26] It is common ground that the payments in issue could not be 'qualifying expenditure on externally provided workers' within the meaning of paras 8A to

a 8E, because Mr Facey's position as a director of Gripple meant that he could not qualify as an 'externally provided worker' within the meaning of para 8B. The words 'he is not a director or employee of the company' in para 8B(b) are clear and unambiguous, and they clearly apply to Mr Facey.

b [27] The commissioners reached their conclusion with avowed reluctance. I can understand their feelings, because the group could easily have arranged matters in such a way as to attract relief for the full amounts paid to Mr Facey. Gripple was not attempting any form of tax avoidance, but inadvertently failed to obtain the maximum relief to which it might otherwise have been entitled. However, as the commissioners rightly appreciated, their duty was to apply the law to the transactions which the parties had actually entered into, and not to some alternative transactions which they might have entered into with the benefit of better advice. The mere fact that the same economic result could have been achieved in a different, and more fiscally attractive, manner cannot avail the taxpayer where the clear words of the relevant legislation preclude the grant of relief for the transaction which the taxpayer has actually undertaken.

d CONCLUSION

[28] For these reasons Gripple's appeal will be dismissed.

Appeal dismissed.

Aaron Turpin Barrister.