Contracting and Financial Management in FP7

"Research for SME Associations"
"Research for SMEs"

Issues and Recommendations

following feedback from and discussion among EARTO members

The FP7 SME instruments are aimed at SMEs, or SME associations acting on behalf of their member SMEs, which have the need to outsource research to research service providers ("RTD performers") such as RTOs, universities or research performing SMEs.

The relationship between the SMEs or SME Associations and the RTD performers is intended to be a "*customer-seller*" relationship. This relationship is formalised contractually in the "*transaction*", whereby the SMEs/Associations contract the RTD performer(s) to undertake R&D activities on their behalf at an "*agreed price*".

Several EARTO members have contacted the EARTO Secretariat with queries or complaints about the interpretation and implementation of aspects of the FP7 SME instruments. The present note is a result of discussion with and among these and other EARTO members. It identifies issues and offers recommendations.

Issues have arisen in four main areas:
- Negotiation of the grant agreement
- Project banking arrangements
- Payment of RTD performer invoices
- Value Added Tax

Additionally, EARTO members have signalled difficulties in communicating with the Research Executive Agency (REA): unanswered phone calls and e-mails, absence of voice-mail.

NEGOTIATION OF THE GRANT AGREEMENT

Coordinators of proposals that are scored above the threshold for funding are invited to negotiate a Grant Agreement.

EARTO members have reported the following issues during grant agreement negotiations:

- The Research Executive Agency (REA) requesting cuts to project budgets without giving reasoned justification
- The REA challenging agreed prices
- Difficulties regarding the legal, economic, not-for-profit and SME status of, in particular, SME Associations, and delays in validation

Unjustified Cuts to Project Budgets

REA officials ask for cuts to project budgets without providing reasoned justification.

In our view, REA officials should always provide specific arguments when calling for a reduction to a project budget. In principle, a reduction can only be justified when the evaluators have made a corresponding recommendation and when that recommendation is specified in the Evaluation Summary Form.

When reasoned budget reductions are proposed, the consortium should evaluate whether the work plan and "transaction" can be adapted to accommodate the cuts without significantly affecting the objectives, results and deliverables of the project. If so, then a revised work plan and associated "transaction" and project budget should be proposed to the REA officer. If not, the RTD performer(s) should report accordingly to the coordinator (and onward to the SME partners) and to the REA officer with a recommendation to retain the work plan and associated "transaction" as approved by the evaluators.

If the REA officer refuses the recommendation without satisfactory reason, the coordinator should lodge a formal complaint with the Director of the REA.

Challenges to Agreed Prices

REA officers have challenged agreed "transaction" prices without providing specific justification and in the absence of a corresponding recommendation by the evaluators.

Such challenges are unacceptable as a matter of principle. It is in the very logic of the "*customer-seller*" nature of the programme that the two parties should freely agree the price to be paid for the service to be provided.

Where an RTD performer can demonstrate that it has already contracted at the same or substantially similar rates under another FP7 SME project, it may wish

to inform the REA officer accordingly in order to facilitate the contract negotiation.

If the REA officer refuses the recommendation without satisfactory reason, the coordinator should lodge a formal complaint with the Director of the REA.

Difficulties regarding the Legal, Economic, Research, Not-for-Profit and SME Status of Participants

The Unique Registration Facility (URF) is applying restrictive definitions for qualifying the legal status of project participants, which considerably delays many otherwise completed grant agreement negotiations.

We advise first-time FP participants to facilitate the URF's task by high-lighting the appropriate sections of their legal documents and by providing supporting (explanatory) documentation where appropriate.

In cases where the URF considers that the only available formal legal documents do not offer sufficient proof *de jure* of the participant's legal, economic, SME or other status, then participants should offer additional documents illustrating their *de facto* status, and the URF should accept to judge their status on that basis.

The Particular Case of SME Associations

Many SME membership associations are being refused SME status, and hence the 75% funding rate. This clearly contradicts both the objectives and the spirit of the Research for SME Associations programme. Moreover, we consider it to be inconsistent with both Commission SME policy and jurisprudence.

The URF considers "*an organisation is not an SME if its income consists solely or over 90% of subsidies, donations, membership fees or equivalent*". The reasoning appears to be that subscriptions do not constitute commercial income. This reasoning is incorrect. National taxation authorities generally take the view that membership subscriptions are a "consideration" given in exchange for services provided and, accordingly, are subject in principle to Valued Added Tax[1]: membership subscriptions are thus commercial income.

Therefore, SME membership associations that provide services to their members in exchange for subscriptions should be recognised as having an economic activity and, hence, be classified as SMEs. Moreover, inasmuch as such associations do not distribute profits, they should be recognised as "not-for-profit" and, hence, for that reason also, eligible for the 75% funding rate.

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1 This is clearly stated, for example, in the guidance provided by the United Kingdom HM Revenue and Customs in its guide for clubs and associations.

Question: Which of my activities are business activities for VAT purposes?
Answer: These include:

- *providing benefits to members in return for membership subscriptions*

In the specific case of European trade associations with a membership of national associations, the REA should accept to amend the grant agreement (under the Art. 7 special clauses) to enable the issuing of the RTD invoices to the national association member(s) to be claimable via the third-party special clause 10 of the grant agreement.

PROJECT BANKING ARRANGEMENTS

The security of project funds is of paramount importance, both for the European Commission and for individual SME or SME association participants. Security of funds is equally important for RTD performers, who undertake most of the research work and hence take substantial commercial risk. Indeed, the risk to RTD performers is clearly recognised by the EC, hence the guarantee for them contained in Annex III.5 of the Model Contract.

It is in the common interest of all project participants that project funds be risk-managed from the outset by the use of secure banking arrangements, such as an escrow ("trust") bank account.

EARTO members have reported several cases of the REA refusing SMEs and SME associations as project coordinators for having failed financial viability checks and for being unable to provide bank guarantees. The latter are, of course, increasingly hard to obtain, and costly to administer, in the current financial climate. In such cases, the search for an alternative project coordinator can delay contract negotiations by many months.

Escrow bank accounts provide a mechanism for avoiding such difficulties. Escrow accounts are accepted by some REA officers, but not by all. Some refuse them on the grounds that they do not provide interest. Others appear to believe that they are difficult to obtain and therefore are not expedient. Both views are exaggerated.

While it is true that escrow accounts generally return less interest than standard bank accounts, the difference is small and, in any event, currently interest rates for all manner of accounts are low. Moreover, project-specific escrow accounts are available from many banks across Europe[2], such as for example Fortis Escrow & Settlement Services (part of Fortis Bank Nederland) - see Annexe 1.

PAYMENT OF THE RTD PERFORMER INVOICES

It is usual practice in any commercial "*customer-seller*" relationship for the parties to negotiate mutually protective measures. In R&D contracting, *customers* typically insist on non-performance guarantees, while *sellers* usually want assurance in the form of advance payments (pre-financing) in order to be able to secure or employ additional staff, to fund work in progress and advance equipment/material purchases, and to pre-finance any necessary subcontracts.

[2] and are becoming more common, e.g. they are used extensively for carbon trading.

EARTO considers that research performers should receive a suitable share of the Community pre-financing when it is released by the EC. The specific arrangement should be detailed in the Consortium Agreement.

It is preferable that such advance payment is made by the coordinator directly to the research performer(s), rather than via the participating SMEs or SME associations, for reasons of efficiency and in order to best protect the financial interests of all concerned, including the EC. Where funds are released to the participating SMEs or SME associations there is a clear risk - especially in the current difficult economic climate - that they may not be forwarded in good time to the RTD performer(s) but instead be retained in order to boost liquidity or, in the worst case, to attempt to stave off insolvency. The more dispersed among SMEs or SME associations the Community funds are, the greater the difficulty for the EC to recover them in case of need.

EARTO members report that some REA officers ask that coordinators do not transfer pre-financing directly to RTD performers, even though this may have been agreed in the Consortium Agreement by all partners. Others, however, will accept the coordinator directly paying the RTD performers on behalf of the SMEs where this has been agreed in writing, typically in the Consortium Agreement. We would welcome a more consistent approach on the part of REA officers.

EARTO considers that the most efficient and effective method of managing pre-financing, in order to protect the interests of all parties, is for an appropriate share of the funding to be transferred upon receipt by the Project Coordinator to the RTD performer(s). The arrangement should be agreed in advance by all parties and set down in the Consortium Agreement.

On a related issue, some REA officers have argued that transfer of funds by the coordinator, rather than the SMEs or SME Associations, to an RTD performer might not be accepted by auditors or others as "defrayment[3]" of the latter. The EC should give guidance to auditors in order to clarify the matter.

EARTO considers that by submitting the RTD invoice as part of their cost claim, the SMEs/Associations thereby authorise the coordinator to make firm the payment to the RTD performer on behalf of the SMEs/Associations. Where an RTD performer has already received pre-financing, this does not trigger further payment but authorises the RTD performer to offset part of their share of the pre-financing as payment of the invoice to the said SMEs/Associations[4]. For reasons of clarity, the Consortium Agreement should specify that the coordinator is authorized to pay the RTD performer invoices on behalf of the SMEs/Associations[5]. In addition, an RTD performer should state on its invoice that the RTD performer is offsetting all or part of its share of the pre-financing in payment of the invoice.

[3] "Defrayment" here means formal proof of settlement of an RTD performer's claim against the customer for services rendered.
[4] Grant Thornton, an experienced auditor of FP projects, have stated that as auditors they would accept this as evidence of defrayment provided that the invoice/statement to the SME/Associations specifies this is the defrayment method being used.
[5] By the same process that allows a coordinator to sign the Grant Agreement with the EC on behalf of all of the Consortium members.

It would also be prudent that at consortium project meetings SMEs'/Associations' acceptance of deliverables to date be recorded in the minutes of the meeting. Further security could be obtained through signed acceptance notes for results and deliverables from the SMEs/Associations.

VALUE ADDED TAX (VAT) ASSOCIATED WITH RTD PERFORMER INVOICING

EARTO members report that in some countries SMEs/Associations have been given to believe that VAT on RTD performer invoices in FP7 is not recoverable through their normal VAT returns.

In previous FPs, up to and including FP6, the financial contribution of the Commission was interpreted to be a "consideration" given in exchange for the supply of goods or services, which meant that FP monies were considered to fall within the scope of VAT and that participants could recover VAT on goods and services which they had purchased for the purposes of the project. Some national VAT authorities appear today to consider that FP7 financial contributions should be considered to be a "subsidy" and hence do not fall within the scope of VAT. As a result, recovery of input VAT might no longer be possible.

Some EARTO members have sought expert advice on this matter, which concludes that VAT paid on goods and services purchased for the purposes of an FP project are deductible. The following is an extract from the opinion of international tax advisors Grant Thornton (see Annexe 2)

"It is a fundamental principle of European VAT law that taxable persons are entitled to reclaim in full any Value Added Tax incurred on the supply to them of goods or services which are used for the purposes of his taxable transactions. Case law (Belgium v Ghent Coal Terminal NV Case C37/95) of the European Court of Justice (ECJ) has established that VAT incurred on goods or services which constitute a cost component of a taxable supply may be deducted in full even if the intended taxable supply in question does not materialise.

Consequently, it is considered that where VAT is incurred on costs by SME's involved in research projects funded under Framework 7 and there is a clear intention at the outset that the SME will commercially exploit any intellectual property which arises from the research, any costs incurred by the SME on goods or services supplied to it is a cost component of the intended taxable supplies and, in principle therefore, any input VAT incurred on those costs can be reclaimed in full even if no commercial exploitation actually takes place."

SME Associations which are not registered for VAT are presently unable to recover the VAT charged by research performers. This puts them at a serious disadvantage, significantly reducing the effective rate of financial assistance accorded by the Commission.

EARTO advises SME Associations that are not registered for VAT nevertheless to request that the Commission reimburses the VAT that they are unable to recover. The justification for this is that while the Rules of Participation mention

identifiable VAT as an example of an ineligible cost, the Financial Regulation – which is the overarching regulatory framework concerning the administration of the Community budget – explicitly provides for the possibility of reimbursement of VAT which participants in Community programmes are otherwise unable to recover[6].

In the case of European SME associations that have national associations as their members which are registered for VAT, it may be possible to construct the transaction in such a way that the VAT-registered national associations settle the RTD performers' invoices.

[6] Article 172a, §2 – Implementing Rules
Without prejudice to paragraph 1 and to the basic act, the following costs may be considered as eligible by the authorising officer responsible:
[...]
(c) value added tax paid, and which cannot be refunded to the beneficiary according to the applicable national legislation;[…]

APPENDIX 1 - Project Specific Escrow Bank Accounts for SME Coordinators

Fortis Bank Nederland

Date 20 January 2010
Subject Fortis Escrow & Settlement Services
E-Mail lout.lapidaire@fortis-escrow.com

To whom it may concern

Fortis Escrow & Settlement Services has been requested to provide information on its settlement account structure for FP7 Research for SME projects, it's characteristics and most important the advantages for all parties involved in an SME Project.

Fortis Escrow & Settlement Services is a specialized department of Fortis Bank (Nederland) N.V. (**FBN**). Fortis Escrow is an independent party specialized in structuring settlements as required by large NGO's, corporates, medium sized companies and SME's in the EU. Our unique proposition enables our clients to ensure riskfree and efficient distribution of funds to all beneficiaries of NGO projects.

What is our involvement in the settlement of SME projects?

Fortis Escrow, as independent third party, opens a dedicated SME project bank account in the name of FBN (an **SME Account**). This SME Account is managed on the basis of a settlement agreement specifically tailored to each respective SME project. The settlement agreement stipulates that all funds received under an EU SME project shall be received in the SME Account and that the funds shall be disbursed in line with the EC Grant Agreement and consortium agreement. Thus when the EU pays funds into the dedicated SME Account, the coordinator is notified by Fortis Escrow of this deposit. Subsequently, the coordinator provides Fortis Escrow with the distribution schedule after the calculation is verified. One of the beneficiaries, usually an RTD performer represents the other beneficiaries in the settlement agreement. The same day the distribution schedule is received by Fortis Escrow the funds are distributed to all beneficiaries simultaneously.

As indicated above, each SME Account is governed by the provisions of the underlying settlement agreement, with the aim to ensure the safe and efficient distribution of the funds to all beneficiaries. The settlement agreement stipulates the obligations of Fortis Escrow; i.e. which notifications it needs to provides, under what conditions it is entitled to distribute funds to beneficiaries. The settlement agreement thus ensures that the distribution of funds is at all times in conformity with the relevant provisions of the EC Grant Agreement.

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The SME Account as arranged and allocated by Fortis Escrow is a bank account held by the bank. One SME Account is allocated to each SME projects. This means that the funds in the blocked bank account are insolvency remote. The depositor and beneficiaries are not exposed to the risk of either of those parties becoming insolvent, but instead rely on Fortis Escrow (FBN) to distribute the funds to all beneficiaries of an SME project. The advantage is that the funds in the SME Account are also safe from a possible insolvency of the coordinator irrespective of where a coordinator is domiciled.

The RTD performer, being the representative of other beneficiaries, will also perform a check of the distribution schedule as submitted by the coordinator. In this way a coordinator can only make disbursements that are in accordance with the EC Grant Agreement and Consortium Agreement.

The EU may rely on these obligations of Fortis Escrow preventing that funds will disappear or cannot be paid through because of insolvency of a coordinator. It is in the interest of the EU, that the funds allocated to an SME project find their way to the correct beneficiaries in the most efficient, risk free and cost efficient manner. The EU has the additional security that funds not disbursed due to project cancellation, will be paid back to the EC. The SME Account is closed after all entitlements during the project life cycle have been disbursed.

In the EU SME program there are generally between 10 and 20 beneficiaries. Fortis Escrow distributes the funds as received from the EU to all beneficiaries simultaneously and in line with the EC Grant Agreement. Fortis Escrow also ensures that the bank details of the beneficiaries are correct prior to international transfers being executed which saves considerably on time and money.

All SME Accounts are structured under Dutch law, which fully supports these arrangements. If required by the EU, an opinion of a reputable law firm may be provided, which will confirm that the underlying legal documentation is fully in conformity with the relevant provisions of Dutch law.

From a cost efficiency perspective it is sensible to locate the SME Accounts in the Netherlands where the costs of international transfers for SME projects are amongst the lowest in Europe. In contrast opening SME Accounts in the country where the coordinator is domiciled, since most of the funds need to be transferred to beneficiaries elsewhere in Europe. The opening of accounts all over Europe as presently requested by the EU creates a lot of avoidable cash management costs, as well as substantial delays in the transfer of funds.

For example, if the coordinator is in Latvia, a bank account needs to be opened in Latvia, and the distribution schedule needs to be executed by the Latvian bank on request of the Latvian coordinator. Many coordinators have little experience with international bank transfers, information is delivered to the Latvian bank incomplete, causing a delay in the onward distribution. Also, often no interest is paid on the account and the transfer costs are substantial. Fortis Escrow is specialized and therefore ensures all bank details are correct before executing transfers, which saves on cost of transfer.

Date 20 January 2010
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Fortis Bank Nederland

Fortis Escrow executes such projects on a daily basis which is a huge economies of scale advantage to all beneficiaries and the EU in distributing the SME subsidies.

The funds in the blocked bank account cannot earn interest if those accounts are all over Europe with many different banks. Because of the fact that these accounts are opened on a 'one off' basis, the charges are substantial and no cost efficiency can be derived from concentration of these activities with one service provider. If all accounts are opened with FBN in the Netherlands, all accounts will be interest bearing from the day the funds arrive until the moment the funds are disbursed.

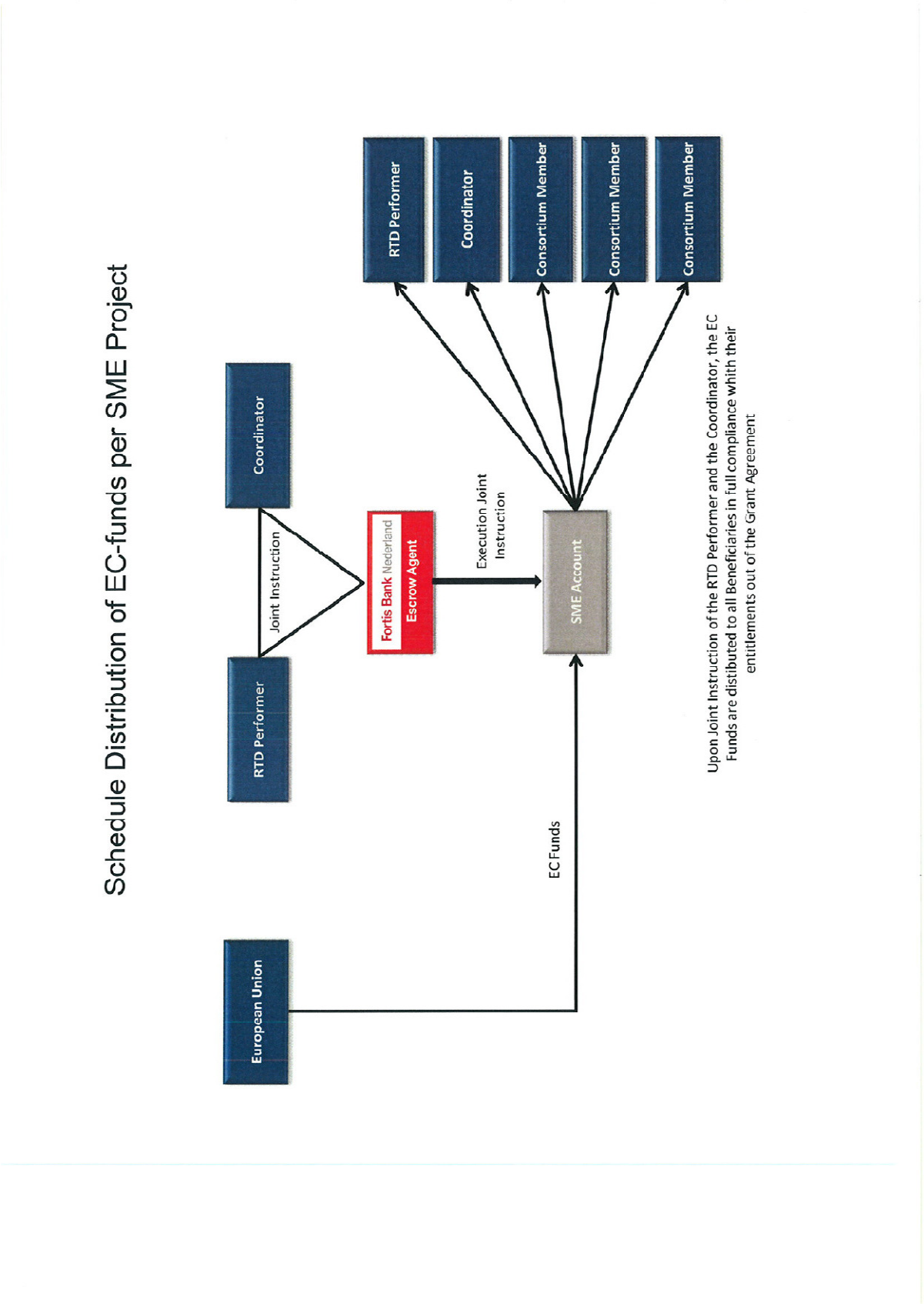
Fortis Escrow in the Netherlands have worked out a best practice procedure for the cash management of SME projects. All of this experience is now available and we would very much welcome EARTO and the EU to adopt this best practice since it provides safety to all parties involved, it is cutting banking cost to a minimum and it is increasing efficiency. And it is at no cost or burden to EU itself. In fact it will also provide efficiency advantages to the EU, less administration since the checks and balances are carried out by an independent trusted third party.
The EU may rely on Fortis Escrow for the immediate and correct distribution of funds but also for the execution of the "know your client'" procedures as they are mandatory for the bank.

Synopsis of advantages:

- Dedicated account,
- Insolvency remote, no exposure to the risk of insolvency of participants
- Coordinator has control but disbursements are verified to be in line with Grant Agreement
- Distribution of funds efficient and at lowest possible cost though economies of scale
- Blocked accounts under legal safe structure
- All SME Accounts with Fortis Escrow to safe considerable amount of money when disbursing funds to beneficiaries all over Europe.
- Less monitoring & administration for the EU since Fortis Escrow is a neutral third party
- Accounts become interest bearing if held with one bank instead of spread all over Europe with many different banks.

Fortis Escrow will be happy to work with any Coordinating organisations and EARTO members to provide such secure and efficient banking arrangement for FP7 Projects across Europe and the ERA.

L.H.M. Lapidaire
Managing Director


Schedule Distribution of EC-funds per SME Project
Coordinator
RTD Performer
Joint Instruction
Fortis Bank Nederland
Escrow Agent
Execution Joint Instruction
SME Account
RTD Performer
Coordinator
Consortium Member
Consortium Member
Consortium Member
European Union
EC Funds
Upon Joint Instruction of the RTD Performer and the Coordinator, the EC Funds are distibuted to all Beneficiaries in full compliance whith their entitlements out of the Grant Agreement

APPENDIX 2 – VAT Opinion on Research for SMEs/SME Associations

Grant Thornton

Our Ref GCB/VAT

To Whom it may concern

18 November 2009

Dear Sir

Value Added Tax: Framework 7

It is a fundamental principle of European VAT law that taxable persons are entitled to reclaim in full, any Value Added Tax incurred on the supply to them of goods or services which are used for the purposes of his taxable transactions. Case law (Belgium v Ghent Coal Terminal NV Case C37/95) of the European Court of Justice (ECJ) has established that VAT incurred on goods or services which constitute a cost component of a taxable supply may be deducted in full even if the intended taxable supply in question does not materialise.

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Consequently, it is considered that

- where VAT is incurred on costs by SME's involved in research projects funded under Framework 7 and
- there is a clear intention at the outset that the SME will commercially exploit any intellectual property which arises from the research,

any costs incurred by the SME on goods or services supplied to it is a cost component of the intended taxable supplies and, in principle therefore, any input VAT incurred on those costs can be reclaimed in full even if no commercial exploitation actually takes place.

SME's should therefore retain evidence of the intention to commercially exploit intellectual property arising from the research.

It is possible that Tax Authorities in other member states may interpret these rules differently. Any SME which encounters difficulties reclaiming VAT incurred on such costs should consult their own tax advisers or should contact Grant Thornton at the address shown in this letter.

Yours faithfully

Graham C Brearley
Senior VAT Manager
For Grant Thornton UK LLP