Spin-Outs and Start-Ups: Common Pitfalls

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1 – Don't Bank on Investment Money until it is in the Bank!

When going through the exciting but challenging process of raising finance for a new venture, it is often possible to perceive prematurely that a deal has been achieved. Many hurdles may need to be overcome, even if the potential investors seem enthusiastic to the technology, like the offer on the table, and appear to have the cash ready.

Some of the reasons for "last minute" failures of funding deals are: -

- When it comes to the various investor agreements, the devil is in the detail. Clauses that seem perfectly reasonable to one party might become a real sticking point for another. Until it is embodied in words on paper, there may be a serious expectation gap.
- The investors' representative may need to persuade other parties as to the desirability of the investment. Many business angels and venture capitalists have review structures which must be overcome.
- The investors' own financial circumstances may change. This is particularly true of private individuals and small syndicates. Even large corporate VCs may be hit with policy changes from "on high" that scupper a deal at the eleventh hour. Either way, the effect is that the cash is no longer available as anticipated.

Care needs to be taken by the founders of new companies. There is often great urgency in getting under way as soon as cash is available. This might be in order to start research ahead of competitors, or to take advantage of a particularly lucrative window of opportunity. As a result, founders will rightly be attempting to put in place other aspects of the new venture at the same time as raising capital. Examples are recruitment of key personnel, locating suitable premises and ordering vital equipment which may have a long lead-time.

If any commitments are made in anticipation of a funding deal, and the deal falls through, the consequences can range from inconvenient, through dire, to absolutely disastrous. There are potential legal problems, with the founders being held responsible for the financial consequences of the commitment. Take care, and, if in any doubt at all, take legal advice.

The following scenario has also been known to happen. Founders and investors have been in detailed and constructive negotiation for some time and a deal has been agreed, but only orally. Founders, confident that the cash will be there, make commitments to the new CEO, the landlords and others. When this comes to the knowledge of the investors, they indicate some possible snag, and proceed to embark on negotiation for a better deal. The founders are left with the choice of accepting the new deal or trying to locate other sources, with a possible risk of reneging on commitments to vital third parties.

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2 – Watch out for the "Restricted Securities" rules

Some cunning tax-planners, in an effort to assist their "large corporate" clients to provide tax-efficient remuneration to their top executives, exploited a certain "feature" of tax legislation. In general, if any individual receives shares as a result of their employment at an "undervalue" – anything less than full market value – then tax and NI are payable on the difference. So if BigCo plc gives one of its executives a £200,000 bonus in the form of shares, there will be a tax bill just the same as if it had been £200,000 cash, and nothing will have been achieved.

Our helpful tax-planners spotted that, if the shares are tied up in "restrictions", such as a prohibition on selling the shares until a certain time interval had passed or certain conditions had been met, then H M Revenue and Customs could be justifiably persuaded that the shares were worth much less, and in the example above might actually agree that the shares were worth only £20,000, not £200,000. The income tax and NI bill would be one-tenth the size.

Later on, when the restrictions were lifted, because the appropriate time period had passed or the conditions had been met, the executive could sell the shares for their full value of £200,000 or more. The good news would be that, instead of tax at 50% and NI at 12.8%, the extra £180,000 would only attract capital gains tax, at a rate of (currently!) 18%. The potential tax savings were phenomenal. And, unsurprisingly, the Treasury didn't like it.

"What has this to do with my proposed small technology company venture?" you may ask. Well, some legislation was introduced in an attempt to counter the above scheme. And, as with a great deal of anti-avoidance legislation, the collateral damage was enormous.

The first major change was to the reporting regime for so-called "employment-related securities". The legislation places a burden on all companies to report transactions in employment-related securities annually on Form 42. The definition of "employment-related" was very widely drafted, to include, for example, anyone who was to become a director or employee of the company in question. The burden of completing Form 42 every year is yet another bit of annoying red tape for many companies; please get in touch with us at Richardsons for some expert help if you are concerned about getting your Form 42 right.

In broad terms, the rules which were introduced affect any shares which an individual receives "as a consequence of his or her employment" and on which a "restriction" applies. The term "restriction" has a very wide definition, and includes such things as terms in a shareholder agreement limiting the holders' rights to transfer the shares during an initial period. It therefore catches anyone (fortunately, with some important exceptions) who subscribes for shares in a spin-out from an academic or corporate institution, because it would be difficult to refute that, at least in part, the shareholding arose as a consequence of their proposed directorship or employment with the new company.

The Form 42 reporting requirements include the need to flag up restricted securities to HMRC. This is often one of the most difficult requirements to meet properly; we are here to help if you are concerned.

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However, the really significant tax issues with restricted securities are as follows. If the rules apply to a particular shareholding, they allow HMRC to raise a tax bill not only when shares are issued, bought or sold, but also when there is ***any*** change in the restrictions which apply to them. So consider the seemingly innocuous situation in which a Professor based at Little Puddlington University founds a spin-out to exploit his new thermal intermoiter technology, and a commercially experienced individual is brought in to take on the role of CEO. She subscribes at par for 125 one-pound shares, representing 12.5% of the company. The balance is held by the professor, the University itself and a couple of other founders providing a little seed capital. It is agreed that no-one can sell their shares for two years. A year later, a milestone is met which persuades a VC to subscribe for 20% of the company for £1.5 million, diluting the CEO down to 10% but effectively valuing the company at £7.5 million.

Another year goes by; no further investment takes place. But the restrictions on the CEO's shares lapse and, despite the fact that she has, as yet, received nothing whatsoever from the company's shares, she gets a tax bill of about £375,000. Care is needed – please talk to us if you face this problem.

Restricted Securities – The Good News

After a number of objections and some cogitation, it was announced that the Treasury had realised that this tax measure had "significantly reduced the creation of new spin-out companies." The legislation was amended to allow, where a researcher subscribes for shares in a spin-out company, the value of any IP transferred to the company by the research institution to be ignored for the purposes of valuing the company. This would allow the individual to take advantage of the election to be fully taxed on the unrestricted value – which would probably be deemed to nil because the only thing of any value that the company would own would be the IP!

This measure does seem to have undone most of the damage caused by the original "blunderbuss" measure. Care still needs to be taken, but there is at least now a path through the maze allowing the founders of a spin-out from a research institution to do so without the threat of unreasonable tax bills.

There is still one small but potentially disastrous issue to watch out for, as shown by the illustration above. It is quite common when a company is spun out of a research institution that a commercial CEO is brought in as part of the founding team along with the scientists and technologists themselves. The exemption which allows the IP coming across from the research institution to be ignored for these purposes will not apply to her, as she was not involved in the research. A safer option might be to let such an individual acquire options under an EMI scheme. It is, of course, important to take advice. We at Richardsons are here if you need us!

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3 – Issue the Shares in the Right Order

Quite apart from the "restricted shares" problem already discussed, there are some really quite surprising tax traps for the unwary when a new company is started up. It is quite possible under certain circumstances for H M Revenue and Customs to argue – successfully – that an individual subscribing for some shares has a monstrous tax bill, based on income or gains calculated by reference to a number far, far in excess of any cash which has changed hands. Care and advice must be taken, very early on, to ensure that this does not happen.

HMRC's argument would be based on market values of shares and intellectual property. Envisage a scenario in which founders and investors agree the following simple but perfectly plausible deal: -

Investor	Investment	Shares
Founder A	£ 30,000	30,000
Founder B	£ 30,000	30,000
Venture Capitalist	£ 1,000,000	40,000

If the founders subscribe for their shares first, a "decent interval" is left, and then the VCs take up their shareholdings, all should be well. However, if the VCs come in first, there will be a problem. HMRC can justifiably argue that the shares are worth £25 each, as the VCs have just paid hard cash to this value. So, the logic proceeds, the founders have each received shares worth £750,000 (30,000 x £25) for a mere £30,000. They have each been "given" £720,000.

HMRC will then go on to assert that this "payment" was for whatever – intellectual property, for example – the founders bring to the venture. Such intellectual property would be the fruits of the founders' labour, and it is one of the two great certainties in life, that if someone gets paid for doing some work, the taxman will want his cut! The founders each receive a tax bill for £360,000, being 50% of £720,000.

Care must be taken!

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4 – Don't Forget the VAT on Non-Cash Transactions

It is a common misconception that VAT is payable on "sales", "turnover" or "cash received". For many new ventures, particularly in the early stages before substantial sales are made, VAT therefore only makes an appearance as a useful refund from H M Revenue and Customs every quarter.

The reality can be quite different. VAT is actually calculated with reference to what are called "taxable supplies". These are not necessarily the same as sales. It is not necessary for cash to be payable in order for a transaction to have VAT consequences.

One example might be that, early in its life and long before actual sales become significant, a venture enters into an agreement with a partner, which might, say, be a potential distributor of the venture's technology. The agreement might be, for example, to issue some shares in the distributor company to the new venture in exchange for a commitment by the new company to make its technology available when it reaches marketability.

The consideration for the issue of shares is outside the scope of VAT. However, depending upon the circumstances, the other leg of the transaction, the supply of the commitment or licence, might well be a taxable supply. And, unfortunately, the argument that "no cash changed hands and 17½% of zero is still zero" does not work. The value of the shares will be used as a way to compute the consideration. It would be fair to assume that, by the time the partnering deal takes place, the shares will have been established as having a substantial value. This might be because of substantial cash subscriptions by other venture capitalists or even on company asset value. Either way, the company might well be obliged to pay output VAT on the licence grant, equal to the VAT rate multiplied by the value of the shares issued.

It is advisable to watch these "barter" transactions carefully and to take advice before entering into one! There are many possibilities, where one valuable commodity is exchanged for another, but without any cash changing hands. Accommodation is one particularly difficult example, as provision of commercial property (rented or owned) may be either exempt from VAT or standard-rated depending upon circumstances. But if "free" accommodation is provided in exchange for some other service, there can often be a nasty VAT consequence. Another example might be where one organisation with spare administrative capacity provides photocopying, phone-answering and word-processing services in exchange, say, for accommodation.

The simple way to get round this is to consider what would be the position if the two parties actually billed and paid each other for the two services. If in doubt, that may be that best way of ensuring there is no unexpected VAT liability.

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5 – Put the Directors on the Payroll

There is a great deal of case law on the subject of the argument between employed and self-employed status. However, it is almost impossible to get the H M Revenue and Customs to accept that a company may pay one of its directors on a self-employed basis. There are some common misconceptions regarding the option to pay a director without operating PAYE, including: -

- ***He or she is a non-exec, so it'll be all right.***
  This is just not true. In fact, in company law and tax law, there is no subdivision of directors. An individual either is a director or isn't. And services of a director are taxable under what used to be called Schedule E – income from an office or employment – whatever "kind" of director the individual is.

- ***He or she is "Schedule D", so it'll be all right***
  Apart from anything else, the concept of Schedule D has now been abolished! Nevertheless the status formerly known as Schedule D – income of a trade, profession or vocation – does not apply to individuals, but to sources of income. An individual can have one or more trades (all taxable as trading income) and also several jobs (all taxable as earnings). The only way to decide the correct tax treatment is to look at each arrangement individually.

- ***He or she has signed a contract to deal with his or her own tax***
  Lovely though it would be, you cannot contract to set aside the law. The obligation on companies to apply the PAYE system is enshrined in statute, and no agreement between the company and one of its directors will remove that obligation. This would be like contracting with the garage that supplied your Lamborghini that it will not go faster than 30 mph and producing this document as your defence when the police catch you doing 140 on the A34!

- ***Oh, well, it's the director's problem if H M Revenue and Customs find out.***
  WRONG! It is the company's problem. And what is worse, HMRC will deem the amounts paid to the director to be the net amounts, after deduction of PAYE tax and NI contributions. They will gross it up, and send the company the bill for all the tax and NI. And if they discover the errant treatment some years after it starts, they can go back over many years and demand back tax and interest.

- ***It's OK because the director is working through a limited company***
  This is, to a certain extent, true. If the venture company pays bills rendered by the director's own company for his or her services, then the venture company cannot be attacked by H M Revenue and Customs. However, there is a piece of legislation which, for historical reasons, will probably always be referred to as "IR35". The effect of that legislation is to pass the problem on to the director's own company, and force it to apply PAYE to nearly all of the income it earns.

In summary – there are many pitfalls to be aware of. To be safe, put the directors on the payroll!

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6 – Don't Forget the R & D Tax Credit

This is a collection of legislation which allows certain companies to obtain 175% tax relief on particular types of expenditure. This is a very rare situation in tax law indeed. Spend one hundred pounds, and get tax relief as if you'd spent one hundred and seventy-five pounds! There are some strict requirements that must be met by the company and by the activities on which the expenditure is incurred. Take advice to ensure that the company and its activities qualify, and it can be the beneficiary of some very helpful law indeed.

Normally, however, tax relief of this kind is not particularly exciting for a research company in its early days. The tax relief does not affect anything until the company starts making profits and the enhanced loss can be offset against these profits. This is usually too late to be of any significant value in actually assisting the research. It will only benefit the company's cash flow after the research has already proved successful.

This was recognised by the legislators, and the rules were made more generous. Under the right circumstances, a part of this tax relief can be paid, in cash, to the company, before it has even made a profit. It is dependent upon the company's PAYE bill, but, if it were available, it would be a shame to miss out. Check with us and claim if you can.

Because of EU legislation, the company must qualify as an SME to obtain this very generous relief. There is another version of the R & D tax relief, often referred to as the "large company scheme", which is less beneficial, but also easier to claim. The relief only gives a 30% uplift to the expenditure, and cash cannot be recovered. However, the SME requirement does not have to be met. Again, take advice, because if this were available, it would be a pity to pay more tax than is necessary!

The 2008 Budget changes included an amendment to both the SME scheme and the Vaccine Research Relief scheme to prevent taxpayers' money being paid to "lame ducks" which are unlikely to survive to see the work through to a conclusion. Companies whose most recent accounts are not produced on a going concern basis are now prevented from claiming a repayment of the relief. Also, a cap was introduced to restrict the amount of aid available under these schemes to €7.5 million per R&D project.

More Recent Changes to R&D:

The more generous version of the relief, which is only available to SMEs, had a requirement that any IP deriving from the R & D be owned by the company undertaking it. It was confirmed by HMRC in the pre budget report on 9 December 2009 that this would be abolished for accounting periods ending on or after that date.

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Another change, not of legislation but of interpretation by HMRC, allows certain activities, previously excluded, to be treated as R & D and the relief to be claimed on their costs. The phrase used by HMRC is "Activities which form part of the project but do not directly contribute to the resolution of the scientific or technological uncertainty". They include such things as information services, activities of staff working in support of the direct R & D function, training and feasibility studies. Because this is not a change of legislation, it means that HMRC regard this view as always having been the correct one. As a result, provided a claim is made within the normal time limits, earlier claims can be revised to increase the relief available.

How can Richardsons Help?

We have been involved in a great number of tax claims for R&D –if you would like some expert advice, please contact Alison McDowell or Simon Husband.

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7 – Don't Overlook Benefits in Kind

Sometimes, even when nothing is actually paid to the employee or director, there is a tax liability arising as a result of the individual receiving a benefit in kind. For this very reason, it is easy to overlook. Take care, as the company has a responsibility to notify H M Revenue and Customs of all benefits provided to directors and employees, except in a very small number of unusual cases.

Most benefits are notified annually on form P11D. Do not overlook submitting these forms, as there are significant penalties for failing to notify. If fuel is also provided, this usually gives rise to a further tax liability.

Private medical insurance is another benefit customarily provided by many, but by no means all, employers. It is worth noting, however, that in most circumstances, pension contributions paid by an employer on behalf of an employee do not give rise to a tax liability – but beware as even that is set to change! Life assurance premiums that meet the rules can also escape tax.

If a company lends money to staff or directors at interest rates below those commercially available, a taxable benefit arises, equal to the shortfall of loan interest actually paid, compared with the commercial equivalent. Accommodation provided by an employer is normally taxable, except in special circumstances where it can be demonstrated to be "job-related".

None of the above should discourage employers from providing benefits to their staff, provided it is commercially sensible to do so. Indeed, in the current environment which is highly competitive for technical skills, it may be necessary to provide benefits to attract the right calibre of staff. A generous benefit package may be the right approach.

The important thing, though, having decided to provide benefits, is not to overlook the tax paperwork!

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8 – Set an Operating Budget and Use It

New ventures will invariably have a business plan containing financial projections for the early period of activity. It is also the yardstick by which the investors will measure the financial performance of management. After all, the investors' cash was provided to enable the founders and their management team to achieve the goals set out in the plan, so this is only fair.

It is in the management team's interest to compare actual performance regularly and frequently against this yardstick. Failure to do so could allow the company to fall significantly behind, without giving management any opportunity to take remedial measures. In most cases, the principal aim is to bring the company's offering to the point of technical acceptance or marketability, or to a milestone at which sufficient success can be demonstrated to enable further funds to be raised. The intention would always be to achieve such a target without running out of cash. Small variances each month can add up, resulting in significant cumulative shortfall if not checked.

Many business plans do not have sufficient detail to allow a meaningful, month-by-month comparison to take place. The purpose of the business plan – convincing an investor of the merit of the project – does not require it. An early task in any new venture of this type should be to create and agree an operating budget. It will be more detailed than the business plan, but firmly based upon it. This will allow the management team and the investors to see, on a regular basis, that progress is being made according to plan.

The other part of this comparison is the "actual" figures. Management information, in the form of accounts and associated key indicators, must be produced regularly and frequently. Monthly is usually appropriate. It is important to ensure that management financial information has the content and is in the right format to be of use to management. It is also vital that it be prepared on a basis which enables the comparisons with budget to take place and be meaningful.

This takes the problem back one stage further. The system of recording transactions – the bookkeeping system and procedures – must facilitate the timely and accurate presentation of management information. Also, sufficient and appropriate analysis must be available to ensure that the comparison is meaningful. In other words, the "budget" and "actual" must be computed on the same basis.

Preparation and review of useful management information is vital to the functioning of any business. Make it a priority to be informed.

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