

# Spin-Outs and Start-Ups: Common Pitfalls



30 UPPER HIGH STREET, THAME, OXFORDSHIRE OX9 3EZ  
TELEPHONE: (01844) 261155 FAX: (01844) 261240  
mail@richardsons-group.co.uk  
www.richardsons-group.co.uk

## **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 renegeing on commitments to vital third parties.

## **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 the Inland Revenue 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 40% and NI at 12.8%, the extra £180,000 would only attract capital gains tax, probably with taper relief, at an effective 10% or lower. 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. In broad terms, the rules which were introduced affect any shares which an individual receives “as a consequence of his or her past or future 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 who subscribes for shares in a spin-out from an academic or corporate institution, strangely whether or not they were employed by that institution, because it would be difficult to refute that, at least in part, the shareholding arose as a consequence of the employment.

If the rules apply to a particular shareholding, they allow the Revenue 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 Prof Klug of Little Puddlington University founds a spin-out to exploit his new thermal intermoiter technology, and subscribes at par for 25 one-pound shares, representing 25% of the company. The balance is held by the University itself and a couple of other founders providing management and 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 Prof down to 20% but effectively valuing the company at £7.5 million.

Another year goes by; no further investment takes place. But the restrictions on the Prof’s shares lapse and, despite the fact that he has received nothing whatsoever from the company yet, he gets a tax bill of about £600,000. Care is needed – please talk to us about this problem.

### **Stop Press on Restricted Securities**

In the pre-budget announcement on 2 December 2004, it was announced that the Treasury had realised that the new tax measure had “significantly reduced the creation of new spin-out companies.” A proposal was put forward to introduce a measure 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 was duly enacted in the 2005 Budget, to operate retrospectively with effect from 2 December 2004. It seems to go most of the way to resolving the issue. However, there is one thing to watch out for! The tax relief is only available to individuals previously employed by the “Research Institution”. In many cases, the team is enhanced by, say, a commercial CEO or CFO from outside the University, who is allowed to acquire shares as part of a package. The new relief will not be available in respect of those shares. So the newcomer will have the choice of:-

1. Electing to be taxed on the unrestricted value – which would therefore require a, possibly daunting, valuation of the IP, with consequent tax bill; or
2. Taking his or her chances that none of the later events give rise to unpleasant tax consequences.

There are ways to reduce the chances of these charges. One example might be to make use of an EMI scheme to issue shares to anyone not previously employed by the Research Institution. Advice should be sought, however, because a little planning could potentially save tax headaches later.

### **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 the Inland Revenue 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.

The Revenue’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: -

<u>Investor</u>	<u>Investment</u>	<u>Shares</u>
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. The Revenue 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.

The Revenue 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 £288,000, being 40% of £720,000.

Care must be taken!

## **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 Customs and Excise 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 venture capitalists or even 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.

## **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 Inland Revenue 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 as 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***

The status of Schedule D – income of a trade, profession or vocation – has actually been abolished as part of the tax law re-write, and replaced by the more meaningful phrase "self-employed". However, the status of "self-employment" does not apply to individuals, but to sources of income. An individual can have one or more trades (all taxable under what used to be called Schedule D) and also several jobs (all taxable as "earnings" under what used to be called Schedule E). 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.

- ***Oh, well, it's the director's problem if the Revenue find out.***

WRONG! It is the company's problem. And what is worse, the Revenue 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 the Revenue. However, there is a piece of legislation, which is referred to in the vernacular as "IR35" and will probably be referred to by that name for as long as it remains in force. 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!

## **6 – Don't Forget the R & D Tax Credit**

There is a piece of legislation which was introduced by the 2000 Budget which allows certain companies to obtain 150% tax relief on certain 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 fifty pounds! There are some very strict requirements that must be met by the company and 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 accrues, but does not actually affect anything until the company starts making profits, when it may be offset against the adjusted profit used to calculate the tax bill. This is very fair, but 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 even more generous. Essentially, 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 way in which the research is conducted and upon the company's PAYE bill, but, if it were available, it would be a shame to miss out. Let the Treasury assist your research efforts. Check with your advisors and claim if you can.

There is one unfortunate anomaly in the legislation. As stated above, there are a number of requirements which must be met by the company in order to be eligible to claim. One of these is that the company in question must be an SME (small or medium-sized enterprise) as defined by EU legislation. Among other requirements, this means that, at most, 25% of the company may be owned by shareholders who are not other SMEs, private individuals or certain types of institutional investor. The effect of this, which was almost certainly not intended by the legislators, is to exclude from the relief any company in which an educational establishment, such as a university, holds a stake greater than 25%.

In the 2002 Budget, the Chancellor introduced an additional version of the R & D tax relief which is less beneficial, but also easier to claim. The relief only gives a 25% 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 miss out!

The 2003 Budget introduced further, but less significant changes to the tax credits. These included a reduction of the minimum spend above which the tax credits become available, changes to the definition of staff costs and to the amount of staff costs that can be claimed.

Further developments in subsequent Finance Acts included a review of the definition of R&D and an extension of the reliefs to cover the costs of certain software used for R&D. These measures are clearly something that the Treasury believe in, and wish to maintain and develop.

## **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 the Inland Revenue 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. However, one of the most common benefits, a company car, must be notified much sooner, on form P46(Car). 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. 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!

## **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 point 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 are 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.

## **9 – VAT on the Costs of Share Issue**

Some time ago, HM Customs and Excise (now part of the merged HM Revenue and Customs) took a case to the VAT tribunal on the subject of a company's right to recover VAT on bills received from brokers, solicitors and others for services in connection with the company issuing new shares. They tried to establish the bizarre principle that issuing shares is an "economic activity" – like making sales of goods and services – and can thus be regarded as part of the company's supplies. Amazingly, after climbing through the various appeals procedure, they succeeded. As sale of shares is an exempt activity, this resulted in a decision that prevented companies from recovering VAT on these costs.

There was a case before the European courts, under the delightful name of Kretztechnik, which overturned this view. In theory, therefore, it should be possible to recover VAT on costs related to new share issues, and to claw back unrecovered VAT on previous such costs. HMRC have, however, indicated that they are drawing a distinction between private and public companies. They will accept claims in respect of the former, but are taking advice about the latter.

As there is a three-year time-limit on recovery of past VAT, we advise that you look back at costs incurred in the past three years. If there is any VAT potentially recoverable on costs related to share issue, make a protective claim so that, when the hoped-for outcome is finally obtained, you will not be prevented from recovering it due to the time-bar. We would be happy to help you with this process.