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Planning your taxes in the UK

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Two of KPMG in the UK's tax consultants summarize basic tax principles to bear in mind when starting a life science venture.

The United Kingdom, like many other knowledge-based economies, relies on university spin-outs to exploit intellectual property (IP) developed by academics working for a university or other research institution. The structure of these start-ups can vary, but in the simplest case a new company is set up and the university licenses or assigns IP with a potential commercial application to that new venture. The academics subscribe shares in the spin-out at nominal value and some shares are issued to the university in return for IP. A venture capitalist may provide additional funding by way of a subscription for shares and/or loans, or the spin-out may attract grant funding. If the IP does prove to have a commercial application, and it is successfully developed, an exit can be achieved by the shareholders selling their spin-out shares. At the moment, UK company founders can obtain tax exemption for spin-out shares if conditions are met, but they should be aware of several important issues that may affect their status in relation to income tax and social security.

The current tax environment

Following some unhelpful changes to UK tax legislation in 2003, further tax law changes were made in 2005 that had the effect of introducing income tax exemptions for spin-out shares acquired by academics on or after December 2, 2004, provided various conditions were met.

As a result of the 2005 changes, to the extent that the value of a spin-out founder's shares is attributed to IP or funding that meets certain conditions, UK academics are not subject to income tax or social security contributions when the shares are acquired. Instead, on a successful exit for the spin-out, any gains will be subject to Capital Gains Tax (CGT), which will normally be at a lower effective rate than income tax. In addition the gains will not be subject to social security contributions.

Only since the tax exemption came into force has UK spin-out activity begun to grow again. Estimates suggest that major UK universities and institutions are now seeing about four spin-outs per year, which indicates that the tax exemption has had some success in once again allowing academics to participate in spin-out companies.

In order to qualify for income tax exemption, the following conditions must apply:

- There must be an agreement to transfer IP from one or more research institution to a spin-out company;
- The shares must be acquired by the academic before the IP transfer or within 183 days of that transfer;
- The opportunity to acquire the shares must arise as a result of the academic's employment with either a research institution or the spin-out company;
- The academic must be or have been involved in the research and development of the IP that is subject to the transfer agreement; and
- Any funding must be provided to the spin-out at the same time as or after the acquisition of spin-out shares by the academic.

The devil is in the detail

Critical to complying with these rules is an understanding of the terms used. Here we set out detailed definitions, but the guidance note published on April 29, 2005, by Her Majesty's Revenue and Customs (HMRC) at (http://www.hmrc.gov.uk/manuals/ersmmanual/ERSM100010.htm) is also

useful in understanding the important definitions: 'research institution', 'IP', 'transfer of IP' and 'involved in research'.

Research institution. The definition covers universities and other institutions of higher education and also extends to include not-for-profit institutions, as long as they are not controlled or mainly funded by a person whose activities are carried out for profit. This definition would therefore cover a health trust and some charities, but not a commercial enterprise, such as a company, that happened to be carrying out research.

IP can be transferred from several research institutions to a spin-out as part of a collaborative research program and still meet this definition. Thus, for example, if academics from several different universities or institutions were working on a project together, it would be possible to transfer the IP from each institution to one spin-out, and the academics at both institutions would be able to claim the tax exemption on all of the IP transferred.

Finally, IP can be transferred from a company that is controlled by a research institution and still be defined as coming from a 'research institution'.

Intellectual property. IP can take a variety of forms. HMRC defines IP within the Income Tax Earnings and Pensions Act 2003 (ITEPA), which governs income tax charges on employment related securities, and all of the following are included:

- Patents, trademarks, registered designs, copyrights or design rights, and similar rights under countries outside the EU;
- Information or technique that has industrial, commercial or economic value;
- Any other license in respect to the above; or
- Any goodwill (as defined for UK accounting purposes) associated with any of the above e.g. reputation.

It is interesting to note that if any form of IP has been overlooked, Her Majesty's Treasury has the power to amend the definition, so this list may grow in the future.

Transfer of IP. The definition of 'transfer' is broad and includes sale of IP, granting of a license or other right, and assignment of a license.

Involved in research. In practice, this definition causes the greatest number of problems. An academic must have been actively engaged by the research institution in connection with research that is relevant to anything to which the IP relates. Examples in the HMRC guidance note state that a technician or computer modeller would meet this definition, but an administrator would not.

Timing of funding provision. The examples set out in the guidance note suggest that if funding is provided to the spin-out at the same time as or after the shares are acquired, the value attributable to this funding will not trigger an income tax charge. Even so, any funding provided, or any business development that adds value to the shares before the share acquisition is potentially taxable income.

Practical issues to consider

So, is it safe to assume that no income tax or social security charges will arise in connection with spin-out shares? Unfortunately not; there are some key issues to be aware of (see Box 1).

Timing. Timing is key in relation to the IP transfer, share acquisition and funding provision. As noted above, if funding is put in place before the spin-out shares are acquired, then it is likely that HMRC will consider this funding to have added value to the spin-out, and this will not be covered by the exemption.

New blood. There may be issues involved in introducing 'new blood' (individuals who join a spin-out company after its initial establishment) to a spin-out. The spin-out tax relief will not apply if shares are acquired more than 183 days after entering the IP transfer agreement. Even if shares are acquired during that 183-day period, it may still be necessary to determine whether any value (which will not be covered by the relief) has been added to the shares – for example, as a result of business development.

Different classes of shares. If the exemption does not apply – for example because the individual has not been 'involved in research' or there is doubt around this – share valuations may be required to determine tax liabilities arising on award of the shares.

Thought may be given to awarding different classes of shares, with different share rights to these individuals and any third-party investors. This will mean that HMRC cannot automatically assert that an individual is acquiring shares at an undervalue to the extent that the individual pays less than the third-party investor, as that is not a comparison of like with like.

Share incentive schemes. If spin-out shares are to be issued to a wider employee pool, an HMRC approved share incentive scheme, in which separate rules can, with care, be applied to each person or group of people, may be desirable. The tax implications, structure and accounting implications would need to be considered in the context of the particular transaction.

Other income tax charges. A discussion of other employment income tax charges that might arise in connection with the spin-out shares is beyond

the scope of this article, but it may be necessary to consider other forms of taxation. For example, employees might be taxed on benefits in kind, or on non-arm's length transactions between the research institution and the spin-out company, or if the academics benefit disproportionately as compared to other non-employee shareholders (see Box 2).

Acknowledgments

The views and opinions expressed herein are those of the authors and do not necessarily represent the views and opinions of KPMG LLP (UK). The information contained is of a general nature and is not intended to address the circumstances of any particular individual.

Box 1: Dos and don'ts in managing your taxes

- DO ensure that you are comfortable with the definitions contained in the legislation and that the circumstances of your particular spin-out fall within these definitions.
- DO get your timing right – the shares must be acquired before the IP transfer to the spin-out or within 183 days of that transfer. Also ensure that the shares are acquired before or on the same day that any investor provided funding, as otherwise income tax charges could arise.
- DON'T assume that the tax relief necessarily eliminates all income tax and social security charges.
- DON'T take for granted that 'new blood' can be introduced to the spin-out at a later stage at the same price per share without incurring income tax charges – after 183 days, the tax relief will not be available, but even before this cut-off, HMRC could argue that value has been added to the company and a tax charge could arise.

Box 2: Example

Mr. White and Mr. Blue are researchers, currently working on a vaccine to the avian influenza virus. Mr. White is employed by City University, whilst Mr. Blue is employed by Vaccine UK, which is a charity. The two researchers have been working on the vaccine collaboratively.

The IP developed is jointly owned by City University and Vaccine UK, as they have both funded the work on the vaccine. Initial data surrounding the vaccine is very positive and suggests it should be developed further.

Mr. White and Mr. Blue, along with City University and Vaccine UK decide the best way to progress the vaccine is to set up a spin-out company. A venture capitalist organisation ("VC") has agreed to invest £100,000 for a 50% stake in the spin-out; City University and Vaccine UK will licence the IP for a combined 25% stake and Mr. White and Mr. Blue will receive shares in the spin-out in return for a payment of £50. Provided that the shares are acquired by Mr. White and Mr. Blue:

- prior to or within 183 days of the IP being licensed to the spin-out; and
- at the same time as or prior to the funding being provided to the spin-out,

there should be no upfront income tax charge for Mr. White or Mr. Blue. To ensure the exemption applies, it is necessary to establish that the shares have no other value e.g., as a result of any business development activities that would not fall within the definition of goodwill attaching to the IP. If the spin-out company is successful (i.e., if the vaccine is found to work and is commercially viable) and Mr. White and Mr. Blue sell their shares for a gain, they will be subject to capital gains tax on the gain.

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