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The new tax rules for university spin-outs: An answer to all the problems?

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Abstract

This paper gives an overview of the potential tax position for an academic participating in a university spin-out following the new legislation in the UK Finance Act 2005. The paper outlines a university spin-out transaction and explains the possible tax problems in this area since 2003. It then discusses the conditions that need to be met for an academic to potentially benefit from the new tax relief and some of the remaining issues. It concludes with some practical advice for structuring transactions.

Keywords: *university spin-out, tax, intellectual property*

BACKGROUND

University spin-outs are a popular way of exploiting intellectual property (IP) developed by an academic working for a university or other research institution. The structure can vary but, at its simplest, a new company is set up and the university licenses or assigns IP with a potential commercial application to that spin-out company. The academics subscribe for shares in the spin-out at nominal value and some shares are issued to the university in return for the IP. A venture capitalist provides additional funding by way of a subscription for shares and/or loans. 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 a gain.

The university spin-out industry suffered a blow in July 2003 as a result of the adverse income tax charges experienced by academics following the 'Schedule 22 legislation' (as contained in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA)). The Schedule 22 legislation overhauled the law in relation to shares issued or transferred by reason of employment. It was intended to counteract perceived tax abuse arising from the payment of salary and bonuses in a non-cash form. It may be inevitable that academics will be treated as acquiring their shares in a spin-out company by reason of employment and therefore such shares fall within the Schedule 22 income tax net.

Prior to Schedule 22, the authors considered that there was no tax charge when academics acquired shares in a spin-out. If the shares in a successful spin-out were sold, the academics paid capital gains tax and could potentially benefit from taper relief so as to reduce their effective tax rate to as little as 10 per cent.

Following Schedule 22, however, the Inland Revenue's (now HM Revenue & Customs) position was that, when the university transferred the IP to the spin-out company, income tax (and possibly national insurance) arose for the academic (and a corresponding employer's national insurance charge potentially arose for the employing institution). The tax and national insurance charge arose under the 'undervalue' legislation if the IP was transferred before the academic acquired his spin-out shares or under the 'special benefit' legislation if the IP transfer was after the share acquisition. There is potentially a notable difference between the price an investor pays for spin-out shares and the nominal price paid by the academics. To the extent that the venture capital investors paid a higher

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price for shares in the spin-out company at first round financing, HMRC sought to charge income tax. This was obviously disastrous for the academics; a significant income tax charge arose at a time when there may have been no cash to pay the tax bill (and, indeed, there may never have been any cash unless the spin-out was successful).

Some structures were negotiated with HMRC (for instance the UNICO 'safe harbour' structure involving convertible preference shares) that avoided a tax charge in the early stages of a spin-out transaction. However, such structures subjected 'profit' when the academics exited the spin-out structure to income tax and national insurance. If the academic was required to bear the cost of employer's national insurance, the effective tax rate was over 48 per cent!

The Chancellor announced on 2nd December, 2004, that new legislation would be introduced in 2005 to address the tax problems experienced by academics participating in a university spin-out. There was a consultation exercise and the Finance Act 2005 then introduced new legislation to alleviate some of the problems experienced (new chapter 4A of Part 7 of ITEPA). The new tax relief is available for the acquisition of spin-out shares by an academic after 2nd December, 2004. It is also available for a share acquisition before this date if the IP agreement between the spin-out and the research institution was after 2nd December, 2004.

CONDITIONS TO POTENTIALLY BENEFIT FROM THE NEW UNIVERSITY SPIN-OUT TAX RELIEF

Conditions to benefit

If the academics benefit from the new tax relief then, to the extent that the lower price they pay for their spin-out shares can be attributed to the value of the IP transferred to the spin-out, no upfront income tax or national insurance charge will arise. The academics will simply pay capital gains tax on gains they make on an exit from a successful spin-out.

To potentially benefit from the new university spin-out tax relief four conditions need to be met, as follows:

- there must be an agreement to transfer IP from one or more research institutions to a spin-out company (the authors think that the reference to an IP agreement rather than an IP transfer may address IP pipeline arrangements where IP is transferred in tranches);
- the academics must acquire shares in the spin-out company either before the IP transfer agreement or within 183 days thereafter;
- the right or opportunity to acquire the spin-out shares must be available by reason of the academic's employment with either the research institution or the spin-out company (this will almost certainly be the case based on the way the Schedule 22 legislation is worded); and
- the academic must be involved in research in relation to the IP that is the subject of the IP transfer agreement.

In order to apply these tests, it is important to understand the definitions of 'research institution', 'IP', 'transfer' of IP and 'involved in research'. The HM Revenue & Customs guidance note published on 29th April, 2005, helps to interpret the meaning of some of the definitions.

Research institution

The definition of research institution (section 457(b) ITEPA) has two limbs. The first limb covers any university or other institution that is a publicly funded institution as defined in certain legislation relating to higher education. However, the second limb importantly extends this beyond universities as it

covers any institution that carries out research activities other than for profit and that is neither controlled nor wholly or mainly funded by a person who carries on activities for profit. Thus, a research institution will include an NHS trust and some charities, for example, but will not cover a commercial enterprise. It is possible to benefit from the new tax relief where IP is transferred from more than one research institution, so a spin-out to develop a collaborative research programme can also benefit from the favourable tax regime. Also, IP can be transferred from a company controlled by a research institution, so a transfer of IP from a technology transfer company is not excluded from the relief (section 459 ITEPA).

Intellectual property

IP is widely defined (section 456(1) ITEPA) to be:

IP

- any patent, trademark, registered design, copyright or design right, plant breeder's rights or rights under section 7 of the Plant Varieties Act 1997;
- any corresponding or similar right under the law of a country other than the UK;
- any other information or technique that has industrial, commercial or other economic value;
- any licence or other right in respect of any of the above; and
- any goodwill (as defined for accounting purposes) associated with any of the above.

HM Treasury has the power to amend the definition and this may prove useful if it comes to light that any type of IP has been overlooked.

Transfer of IP

This test (section 456(2) ITEPA) is broad and covers the sale of IP, the grant of a licence or other right and the assignment of a licence.

Involved in research

The authors think that this definition is causing difficulty in practice (section 458 ITEPA). A person is involved in research in relation to any IP transferred or to be transferred from one or more research institutions if he/she has been actively engaged for the research institution (or any of them) in connection with research (whether as an employee or otherwise) and that research is relevant to anything to which the IP relates. Examples 14 to 16 of the HMRC Guidance Note state that where a research project also uses the services of a technician and a computer modeller those individuals would qualify; however an experienced administrator 'known through mutual employment by the Research Institution' will not qualify.

SOME REMAINING ISSUES

The special tax relief for university spin-outs does not recognise the value that the spin-out shares have as a result of the IP transferred into the spin-out by the research institution. But if, for example, outside investors are acquiring shares at a higher price than the academics, there can still be potential income tax and national insurance charges if it is not possible to attribute the difference in pricing entirely to the value of the IP. Valuation therefore remains a key issue on a university spin-out.

Concerns may be expressed in relation to funding injections provided by institutional investors in return for shares. The HMRC guidance note usefully states that if a spin-out is set up with one document in which it is agreed that IP will be transferred, shares will be acquired by each party, and funding will be invested by a third party all on the same day, HMRC will not consider that

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potential funding could be taken into account. However, the guidance note also makes it clear if an academic acquires shares after funding has been provided, or after other business development that could affect the share value has taken place, then the shares may have a considerable value and there could be a charge to tax and national insurance even having ignored the value of the IP transfer to the spin-out company.

As indicated above, there may be problems deciding if an individual is 'involved in research' when the individual has worked for the research institution other than in a purely scientific capacity, eg someone who has more of a business or commercial role. This may boil down to an individual needing to have their name on at least one of the relevant patents. Only time will tell, however, what approach HMRC adopt in practice. The fact that there is no advance clearance procedure to obtain certainty of tax treatment makes this area more difficult.

There may be problems introducing 'new blood' to a spin-out. If any individual is to acquire spin-out shares at a later stage, careful thought about the price to be paid may be needed. If the individual acquires shares more than 183 days after the IP agreement, then the special tax relief will not be available. Even if the individual acquires shares within that timeframe and meets the 'involved in research' test, it may not be possible once the spin-out has been operating for a period to establish that the value of the shares equates to the value of the IP transferred to the spin-out.

HMRC have the power to disapply the legislation affording tax relief to an academic participating in a spin-out if they believe that the transaction has a tax avoidance purpose. The authors think that HMRC will only invoke this power where there has been obvious and deliberate tax planning to manipulate the rules but, once again, only time will tell.

SOME PRACTICAL ADVICE FOR STRUCTURING TRANSACTIONS

Even if the four conditions for the new university spin-out tax relief are met, income tax and national insurance charges can still arise for academics (and employer's national insurance can arise for a research institution or the spin-out) depending on the detail of a transaction. Careful timing of the different steps in a spin-out transaction helps to reduce tax charges, especially where third party investors are involved.

As stated above, valuation remains a key issue particularly where some of the participants in a spin-out will not benefit from the special tax relief because they were not 'involved in research' or where there is doubt about whether an individual was 'involved in research'. In some cases it may be desirable to instruct a professional valuation firm to value the shares in a spin-out. However any such valuation is not binding on HMRC and the valuation may be unhelpful in relation to bringing in 'new blood' to the spin-out at a later stage.

Academics can be given a different class of share to the institutional investor with different share rights (commercially an institutional investor may require a preferential share class in any event). This means that HMRC cannot simply assert that an individual is acquiring his/her shares at an undervalue to the extent that he/she pays less per share than the institutional investor – because that is not a comparison of 'like with like'. Having different classes of shares can give more scope to put forward arguments to help establish that the price paid by an individual equates to the actual market value of a share (or at least that the undervalue is such as can produce a manageable tax charge).

If it is expected that spin-out shares will be issued to lower-tier employees as well as the founders, it may be desirable to put a share incentive scheme in place (which may involve share options or an employee benefit

trust). The tax implications, structure and accounting implications of this may need to be considered in the context of a particular transaction. There are various other detailed rules, such as the restricted security legislation, that can impose post-acquisition income tax charges in the context of shares acquired by reason of employment and all of these rules will still need to be considered in the context of a particular transaction.

An academic who benefits from the new tax relief makes a deemed restricted security election when he/she acquires his/her shares. It is possible, however to disapply this deemed election. Although a full explanation of the restricted security legislation is beyond the scope of this paper, it could be important to consider whether to disapply this deemed election. In practice, this may only be desirable where it is not possible to attribute the lower price paid by an academic for his/her spin-out shares to the value of the IP transferred to the spin-out. It could be an issue, therefore, where an individual acquires shares a few months after a spin-out has been established at a time when its activities have enhanced the value of the shares.

SPIN-OUT TRANSACTIONS PRE 2ND DECEMBER, 2004

Spin-out transactions before December 2004

An academic who acquired shares in a spin-out company prior to 2nd December, 2004, was given the opportunity to make a joint election with the employing spin-out company to defer a charge to income tax and national insurance contributions. However, any such election needed to be made prior to 15th October, 2005; no further elections can now be made. An election does not put affected individuals on a par with academics who could benefit from the new tax relief as all profit on exit will still be subject to income tax rather than capital gains tax. However, it was potentially useful for academics who entered into historic transactions without appreciating that they had triggered upfront income tax charges.

Example

Bill and Ben are academics at Flowerpot University. They have been conducting research into plant fertiliser. When it looks as though there might be a commercial application, Bill and Ben and Flowerpot University decide to set up a spin-out company to develop it further. Venture capitalists (VCs) are willing to invest £50,000 for a 50 per cent stake in the venture; Flowerpot University will licence the IP in return for a 25 per cent stake; and Bill and Ben will receive shares in the venture, in return for a payment of £25 (considered by the market value of the shares).

Prior to July 2003, the authors consider that there would not have been upfront tax charges for Bill and Ben and that Bill and Ben would have paid capital gains tax if the spin-out was successful and they sold their shares at a gain.

Following the Schedule 22 legislation, the authors would expect Bill and Ben were charged income tax to the extent that they paid less than the VCs. The VCs pay £50,000 for a 50 per cent stake, ie £1,000 per 1 per cent. Accordingly, Bill and Ben would be charged income tax to the extent that they paid less than £25,000 for their 25 per cent stake. The income tax charge was therefore on £24,975 (as they only paid £25). If Bill and Ben are higher rate taxpayers and pay tax at 40 per cent, their tax bill was £9,990. There might also be national insurance charges for Bill and Ben and the Flowerpot University.

If Bill and Ben benefit from the new tax relief introduced in the Finance Act 2005, provided the price differential between their shares and the VCs' shares can be attributed in its entirety to the value of the IP licensed to the spin-out, the authors expect there to be no upfront income tax charge for Bill and Ben. It is therefore crucial to establish that the IP is worth at least £24,975 and fully accounts

for the higher price the VCs pay for their shares. If the spinout is successful and Bill and Ben sell their shares at a gain, they will pay capital gains tax.

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