Tax issues and brief practical tips for Tech or R&D startups

2013

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<u>R&D tax credits</u>

To qualify for R&D tax relief and to continue receiving this relief, the project involved should be well documented, and records should be kept to show when R&D started and stopped.

Need to consider:

- what is the technological advance?
- what are the uncertainties?
- how and when were the uncertainties actually overcome
- why was the knowledge being sought not readily deducible by a competent professional?

Details should also be recorded of all R&D work carried out.

<u>Large scheme</u>

Currently, can claim 130% tax deduction on R&D expenditure to increase losses or reduce tax liability. From April 2013 to 2016 there is an optional scheme for a 10% credit received on R&D expenditure instead. This can be paid out in cash to companies without any corporation tax liability. But it is capped by the amount of the PAYE/NI liabilities for R&D staff

<u>Small scheme</u>

Can claim 225% tax deduction on R&D expenditure to increase losses or reduce tax liability. Can receive also choose to forgo the losses and receive a cash sum from HMRC of 12.5% of the surrenderable loss.

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If grant funding is received which is notifiable state aid, the SME scheme cannot be used at all. However, a claim could still be made under the large scheme. If any subsidies are received, these will reduce the R&D expenditure eligible.

SEIS

This is often a requirement for investors as they will receive upto 50% tax relief on their investment.

Key requirements:

- company may raise no more than £150,000 in total under SEIS (cumulative limit, not annual) .
- full time equivalent number of employees must be less than 25.
- immediately before the shares are issued, the total value of the company's assets must not exceed £200,000.
- company must not have been incorporated more than two years before the shares are issued.
- issuing company itself must carry on the new qualifying trade and any preparation work or R&D leading to it.

Shares issued do not qualify if:

- they're not subscribed for wholly in cash upon issue .
- the investor disposes them before termination date - so needs hold 3 years .
- the shares carry any present/future preferential rights:
  - to assets on winding up;
  - to be redeemed;
  - to cumulative dividends ;
  - to dividends for which the amount and timing depend on a decision of the company or any other person.

Investors (or their associates) cannot:

- be employees prior to share issue, unless they are also a director.
- hold more than 30 per cent.
- have loans from the company which are linked to their share subscription.
- subscribe as part of a tax avoidance arrangement, must have genuine commercial reasons.
- subscribe for the shares as part of a wider arrangement which includes somebody else subscribing for shares in a company in which the investor – or anyone else party to the arrangement – has a substantial interest.

EMI Share options
The grant of the option is tax free and there is no tax or NIC to be paid by the employee or employer on exercise if the exercise price is market value at grant date.

If the options are sold at a profit by the employees, there will be capital gains tax. However, if at least 12 months elapse from grant date to exercise date, they will be eligible for entrepreneurs relief.

The company will also get a tax deduction on corporation tax upon exercise for the difference between market value of the shares issued and the amount paid by the employee.

Eligibility

- Employees
    - must have a be under a contract of service
    - must work at least 25 hours per week, or 75% of their working time (ie if work less than 25 hours)
    - cannot own/control > 30% ordinary share capital (or rights to assets if close company) whether directly or indirectly along with associates or family
    - Directors can also qualify as employees if meet criteria above

- Shares must be ordinary share capital, fully paid up and not redeemable
- Must have option agreement in writing and be exerciseable within 10 years
- Company cannot be controlled by another company, or have gross assets > £30m or have > 250 employees

Entrepreneurs relief
The first £10m of qualifying gains within a lifetime are taxed at 10% instead of the normal 18%/28% basic/higher rates. So a shareholder can save tax on exit.

Eligibility for shareholder
must hold > 5% ordinary share capital and voting rights
must be an officer or employee of the company
the company is trading

The above must apply for the 1 year qualifying period immediately prior to disposal

Investor returns: Dividends vs Loans

If receive share capital from investors and pay dividends to them, there is no tax deduction for this. Dividends can only be paid once the company has sufficient distributable reserves available.

If the investment is in the form of loans, then interest payable is normally tax deductible.

If there are redeemable preference shares, the dividends are not usually tax deductible, but may be in certain circumstances.

Corporation tax

A company has to pay corporation tax on its profits. Expenses will reduce a company's profits, such as salaries, rent, legal fees etc.

Expenditure on plant and machinery, such as computer equipment, will also qualify for a 100% deduction in the year of purchase, upto a limit of £25k.

However, some legal and other expenses are deemed to be “capital” and are not tax deductible, for example legal fees to startup to a company.

Once a company starts to make a profit, it can initially be offset by losses brought forward (eg if make £100k loss in yr 1, can offset against £20k profit in yr 2 and £80k profit in yr 3). Once the losses have been exhausted, corporation tax has to be paid at 20%.

If trade has not yet commenced, HMRC will classify the company as “dormant” for corporation tax purposes. In this case, no tax return is required, and capital allowances on plant and machinery, R&D tax credits and pre-trading expenditure will need to be claimed as tax deductions once the company starts trading. This will reduce taxable profits or will create tax losses to be used against future profits.

If the company is in a position to sell goods or if it has a contract or MOU with a potential buyer of a proto-type, an R&D company could potentially be classed as trading. In this case, they would prepare tax returns as normal and claim R&D tax credits immediately.

It may be possible to structure the company with operations in low tax jurisdictions, for example to have an offshore subsidiary owning the IP rights. They could then charge licence fees or royalties to the UK company. However, to escape UK tax, the foreign subsidiaries may need to be managed overseas and we would need to check whether the CFC rules apply (ask us if you need to find out more).

VAT

If a company is intending to trade and the intended supplies are not exempt or outside of the scope of VAT, it can voluntarily register for VAT and reclaim input VAT paid to suppliers for business purposes.

In the first VAT return, a company can also reclaim input VAT on expenses for services in the 6 months prior to registration.

Once a company registers for VAT, 20% VAT will need to be added to its sales. A company will compulsorily have to register for VAT once it breaches the turnover limit of £79,000.

If sales are to customers outside of the UK, they may be outside of the scope of UK VAT, but this depends on the “place of supply”:

Customer belongs in another EC Member State and receives a B2B supply of services: services are “supplied” in the other Member State and are outside the scope of UK VAT.

Customer belongs in another EC Member State and receives a B2C supply of services: services are “supplied” in the UK and the supplier accounts for any UK VAT due.

Customer belongs outside the EC and services are supplied outside the EC: are outside the scope of UK (and EC) VAT. But if services are used and enjoyed in the UK the supplier accounts for any UK VAT due.

Please refer to our company guide for details about the Flat rate scheme, annual scheme and more details: http://www.mah.uk.com/CompanyGuide.pdf

PAYE/NI

The company will need to register for payroll taxes if it employs any staff or pays salaries, or if directors enjoy any P11d benefits such as health care or company cars etc.

If the directors have no other income, and are not receiving any cash salaries from the company, they may still wish to accrue salaries upto £7.6k. This will increase tax losses for the company without incurring tax liabilities for the directors, and will also sustain their state pension.

Monthly returns have to be filed with HMRC to give details of salaries paid. The company has to deduct income tax and national insurance from staff wages and pay them to HMRC by the 19th of each month, along with employers' national insurance.

For a more detailed understanding of how wages are taxed please refer to our guide at: http://www.mah.uk.com/wealthextractionstrategiesMAH.pdf.

We have noted some brief issues from working with various R&D/technology companies over the years. Some of them may seem very obvious, but then there are many companies that fail for avoidable reasons, so we apologise if some of the points seem patronising!

Reality of R&D projects

If technology works in theory, this does not necessarily mean that it will work in practice.

There are often unforeseen problems or obstacles that need to be overcome. Certain components may not work well together, or may not be tolerant of the physical environment or the stresses from use or operation of the product. Many companies have had great ideas which they could not effectively put into practice in a commercially viable manner. We have seen on many occasions that R&D took a lot longer and was harder than anticipated.

There may be a temptation to initially use whatever materials or components are available to develop a working prototype. However, if they are too expensive to be commercially viable, it may require another cycle of lengthy testing to find suitable replacements which are cheaper. For example, a company produced a working prototype using aluminium electrodes however, these were far too expensive, and to find another material electrode meant effectively starting from scratch.

The team is very important. For example, a company was failing to meet milestones and was getting stuck in its project. However, a new chief scientist was recruited who approached the project from a completely different angle and effectively saved it.

Cashflow should be very carefully managed. Many R&D companies run out of cash, especially if they have high overheads, which means they are burning cash. R&D can often take longer than necessary if things are not quite working. Sometimes things just go wrong for no ascertainable reason and it may take a lot of trial and error before things work. The cashflow forecasts/budgets should contain the necessary headroom.

Although its possible to raise additional funds in the future, investors may not look kindly upon a project which has repeatedly missed its milestones or targets.

We have seen a number of companies run out of cash, mainly because the R&D took a lot longer than expected and paying for staff and rent is expensive.

Speed is very important. It is imperitive to get the product to market as quickly as possible. We have seen instances where businesses wasted time trying to perfect the product or were not dynamic enough, and other companies gained market share in the meantime.

Marketing

Just because a product or service is a great idea, doesn't mean that people will want it or use it.

Products very rarely sell themselves. A lot of work is involved in first, obtaining exposure to potential buyers and then secondly, convincing them to buy.

The sales/marketing director will be a key member of the team. We have seen some companies fail because the wrong strategy was pursued.

Sufficient funds should also be made available to market the product. There have been many instances in which companies have raised funds, developed a good product, but not have had any funds left to market it.

Even if a product is free (or freemium), it will still be competing against many other products in the marketplace or other uses of users' time/money. So it is always a good idea to see if there will be demand for the product before pressing ahead. Ideally, the product will meet a gap in the market or fulfil a need that is not currently being met. Although, it could also aim to do something better, quicker, cheaper etc than existing products.

Raising finance

Investors normally look for a great idea, in a large or growth market, from a great team. They often need to have experience of the relevant sector or product space to appreciate the idea. They will generally look for significant returns, eg 5x – 20x depending on their size and portfolio. (the successes will compensate them for all the failing companies they've invested in)

If the team does not have a track record, it may need to show that it has mentors or bring in the right people.

It can be important to demonstrate the potential return on investment by showing the potential growth of the business, but the assumptions used need to be reasonable.

Cashflow projections should be built using logical assumptions wherever possible. Investors often perform due diligence on the figures and dislike “hard” numbers without any explanations or which are not formula driven.

Whilst different scenarios can be presented, it will get confusing if too many are used.

Care should be taken over the investment mechanism and the precise details of the instruments used, whether they are ordinary/preference shares, debt or convertible debt. Good lawyers should be used for all contracts and agreements, wherever possible. This will help to govern future disagreements.

Some investors effectively try to take over the business or fall out with directors, so it is important to try and work with the right investors, although it can be difficult to determine/appraise their previous track record. We have even seen directors completely forced out of the companies that they built.

Entrepreneurs can also lose motivation if too much equity is given away, because their profit share/return falls as their shareholding gets more and more diluted in further rounds.

Equity

Shareholders or co-founders agreements should be used to govern arrangements when starting a company, especially if people are working for equity as this will help to avoid disputes.

Different share classes can be used with different rights and this can will allow different dividends to be paid to different shareholders. In addition, some investors may insist upon preference shares which will give them excessive rights/returns on exit.