NEWS FROM THE TECHNOLOGY TEAM AT
ENSORS CHARTERED ACCOUNTANTS

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TAX & TECH

Tax and the Technology Sector

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- Supporting innovation through tax reliefs
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- How to structure your overseas development tax efficiently
- Maximising tax efficiency in share sales

Various UK governments have looked to incentivise the technology sector through specific tax reliefs. In addition, various more general tax reliefs are often commonly seen in conjunction with either technology companies or investments into such companies. There are therefore many regularly encountered topics that need to be considered for either technology companies or their investors.

Continued overleaf ➤

ENSORS

Making you more than just a number

Raising funding tax efficiently

The provision of business funding reliefs has been recognised by UK governments in recent years as a valuable means of incentivising investment into technology companies.

The UK provides three tax-advantaged schemes; the Enterprise Investment Scheme (EIS), the closely related Seed Enterprise Investment Scheme (SEIS) and the Venture Capital Trusts (VCT) regime.

ENTERPRISE INVESTMENT SCHEME

EIS enables individual investors to invest in small and medium-sized companies (broadly with fewer than 250 employees and £15 million of assets for standard qualifying companies) in return for generous tax reliefs. By contrast, SEIS was intended to be a temporary relief but has been retained to provide relief for relatively small-scale investments – companies can raise a maximum of £150,000 under SEIS and an individual investor can claim total relief of no more than £100,000 per tax year.

EIS's headline incentives are that an investor can subscribe for up to £1 million (per tax year) of newly issued shares in a qualifying company in return for a 30% non-repayable Income Tax credit and a potential exemption from Capital Gains Tax when the shares are sold; in both cases the EIS shares must be held for at least three years. There is a further Income Tax relief for investment losses if the investee company fails. It is also possible for investors to defer capital gains arising on the disposals of other assets by reinvestment into qualifying EIS shares.

Changes introduced from 2015 have limited the scope of EIS for many investments. For instance, investment has been limited, in general, to companies whose first commercial sale was within the last seven years. The total permitted amount of EIS investment has been reduced to £12 million for standard qualifying companies and non-EIS shareholders have been blocked from subscribing for new EIS shares going forward, even if the company itself meets the qualification criteria.

Conversely, more recent changes have made EIS more generous for knowledge-intensive companies (the employee limit is increased to fewer than 500), both in terms of how much a qualifying company can raise (total investment limit of £20 million) and the period over which it can first raise EIS investment (up to 10 years after the first commercial sale) and how much the individual can invest (up to £2 million). This applies to shares in companies carrying out a high level of innovation, are creating IP they intend to exploit or where at least 20% of the workforce is 'skilled'.

SEED ENTERPRISE INVESTMENT SCHEME

The SEIS rules give Income Tax relief equal to 50% of the amount of the subscription price of the qualifying shares. Gains on the disposal of qualifying SEIS shares are exempt from UK Capital Gains Tax provided that the shares sold have been held for three years.

A capital gains' reinvestment exemption relief also exists within the SEIS regime so that where an individual realises a capital gain, and reinvests all the gain into acquiring SEIS shares, half of the gain will not be taxable.

If the shares are sold within three years from issue, all the SEIS reliefs will be clawed back. A company cannot issue shares under the SEIS rules if it has already issued shares under the EIS rules or has received investment from a VCT.

Under both EIS and SEIS rules, in order for the favourable tax reliefs to be available it is normally necessary for both the shares to be held for at least three years from issue and for the investor and the investee company to meet the necessary conditions throughout this period – this latter point is often overlooked.

As a few words of caution, the above is just a very high-level summary of EIS and SEIS. Both reliefs are subject to a myriad of rules and complexities. For instance, in general, employees and some directors cannot benefit from these reliefs and shares cannot be issued before the cash investments are received – a common problem. Whilst EIS and SEIS offer generous tax reliefs, HMRC often interprets the rules to the letter and many proposed investments fail to obtain relief due to unfortunate technical oversights or unintentional errors.

Professional advice both at the time of investment and going forward is essential to ensure that reliefs are obtained and are not subsequently clawed back.

VENTURE CAPITAL TRUST

A VCT is an investment company whose shares are listed on a European regulated market. It is required to invest in and maintain a portfolio of qualifying trading companies. The investment is made by the investor into the VCT itself and this differs from EIS / SEIS in that, here, the investment is being made into an investment vehicle as opposed to the investee company. VCT is therefore a more passive investment, albeit one in which the risk of investment in specific companies is diluted.

Income Tax relief at 30% can be claimed on the investment made into the VCT, limited to a maximum investment of £200,000 per tax year. This relief will be clawed back if the VCT shares are sold within five years of the date of issue. Dividends paid by the VCT on qualifying investments are not taxable and gains made on the disposal of VCT shares are eligible for exemption from Capital Gains Tax (there is no minimum holding period).

Similar to EIS and SEIS investments, there are many rules which must be met to enable the favourable VCT tax reliefs to be available and professional advice should be taken before making any investment in a VCT.

Supporting innovation through tax reliefs

The UK continues to be one of the most attractive locations for businesses to innovate and this is supported by the UK's Research & Development (R&D) tax relief regime.

RESEARCH & DEVELOPMENT TAX RELIEF – THE BASICS

The legislation only applies to companies and to qualify for R&D tax relief, a company must be looking to develop new or improved products, software, processes, materials, services or devices that represent an advance in science or technology through the resolution of scientific or technological uncertainty. Mere commercial developments, or enhancements, of existing technology are not sufficient to qualify for the reliefs available.

The scope of the relief is broad. The reliefs can be relevant to almost any company, provided that the necessary conditions are met. Experience has shown that companies which may potentially claim the reliefs extend beyond those which would typically be associated with 'R&D' and claims are seen not just in respect of the expected sectors such as pharmaceuticals, software, biotechnology, fintech, manufacturing and engineering but also sectors that have not traditionally been associated with innovation such as retail, construction, financial services and foodstuffs.

There are now two applicable R&D tax regimes: the small and medium-sized enterprise (SME) scheme, and the R&D expenditure credit (RDEC) scheme for expenditure that does not fall into the SME scheme.

A SME for these purposes is defined, in broad terms, as a company that has fewer than 500 employees, and either:

- annual revenues not exceeding €100m; or
- gross assets not exceeding €86m.

Where a company is connected with other enterprises, for example by membership of a group or through a significant shareholder, the relevant details for the company's 'linked' and 'partner' enterprises must be included when applying these limits to assess the company's SME status.

Consequently, investment by private equity, venture capital or institutional investors should be carefully reviewed to establish whether a company is eligible for claims under the SME regime. Often such investment can push relatively small companies out of the SME scheme into the RDEC scheme.

Small and Medium-sized Enterprise Scheme

The SME regime, the most tax advantageous of the two schemes, provides relief in two key ways.

Profitable companies which are tax paying can obtain an enhanced deduction equivalent to 230% (being the original expenditure plus a 130% uplift thereon) of qualifying expenditure (generally staff costs, subcontracted costs, consumables, software licences and a proportion of heat, light and power). This enhanced deduction can be used to reduce a tax liability in a current, previous or future tax year. Based upon a corporate tax rate of 19%, this gives a £43.70 deduction per £100 of qualifying spend (being 230% x £19).

For companies that are loss making, a more immediate relief is available. A claim can be made to surrender the full 230% enhanced deduction for a cash payment at a rate of 14.5%, giving an immediate cash flow benefit of £33.35 per £100 spent. This is therefore a direct cash flow subsidy to qualifying companies.

The 2018 UK Budget announced that the amount of payable tax credit that a loss-making company can receive through the relief in any one accounting period will be capped. The cap will be three times the company's total PAYE and NICs liability for that year and will be implemented from April 2020.

R&D Expenditure Credit Scheme

The RDEC scheme is available to companies that fall outside of the SME size limits, or that are otherwise disqualified from the SME scheme (for example, due to receipt of subsidies or grants, or acting as a subcontractor to a third party).

Under the RDEC scheme, the benefit is delivered as a taxable 'above the line' credit (i.e. in the main body of the company's income statement, before the tax charge), based on 12% of the qualifying expenditure in the period (giving an after-tax benefit of £9.72 per £100 of qualifying expenditure). The after tax above the line credit can be offset against corporation tax liabilities for profitable companies or claimed as a repayment by loss-making companies.

PATENT BOX TAX RELIEF

The patent box legislation was introduced with effect from 1 April 2013 although the effect of the legislation was phased in and full relief was not available until 1 April 2017.

The relief looks to extend support through the tax system to the point in a company's lifecycle where intellectual property is not just being developed but is actually being exploited for commercial gain. Notwithstanding this, it is common for companies which are still undertaking R&D activities, and claiming R&D tax relief, to also claim relief under the patent box legislation and the patent box is designed to encourage on-going R&D.

The intention of the legislation is for qualifying companies to pay tax (as phased in by 2017) at an effective rate of 10% on patent related profits. Slightly confusingly, the relief is not actually achieved by taxing profits at this lower rate, rather the relief is given by reducing the amount that is subject to tax at the 19% rate. Profits potentially qualifying for the lower effective rate of corporation tax include those arising from the sales of patented items, licence fees, proceeds from the sale of the patent itself and infringement income

The benefit of the patent box legislation is available only to companies.

What is covered?

The relief extends to patents granted by the UK Intellectual Property Office and the European Patent Convention and to certain patents granted by specified EEA states.

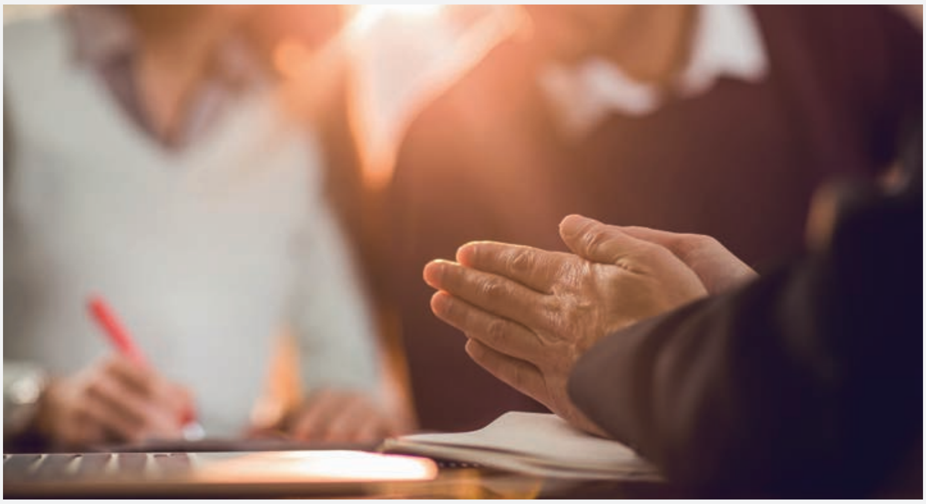
Importantly, US registered patents do not qualify for relief (unless the patents have also been registered with the above bodies). It should be noted that the legislation does not apply to profits arising from other intellectual property such as copyright or trademarks. Relief is also available in respect of the patent pending period provided that the company has elected into the patent box, although the tax savings are only crystallised when the patent is actually granted.

How to claim

Computing tax relief under the legislation requires a complex eight-step calculation with income and costs being streamed into patented product or process streams – this must be done separately for each patent. Further adjustments have to be made for 'routine' and marketing returns and various other steps before finally reaching an amount to be deducted from taxable profit so as to give the required relief. Claims under the legislation are restricted to ensure that the claimant only benefits for patents developed in-house or by the use of unconnected subcontractors.

The benefit of the patent box legislation is not automatic, and companies must elect to make use of the scheme.

Using share options to attract and retain key personnel



An established route for growing businesses in the tech sector to provide competitive remuneration to employees has been the use of share options. These offer the incentive to employees of the potential for significant wealth accumulation if the business grows.

With 'conventional' share options, when the options are exercised and shares acquired, the employees are taxed under income tax rules on the 'spread', being the difference between the market value of the shares acquired less the exercise price paid. Income Tax is charged at up to 45% on the spread, depending on the level of the employee's income and NIC is also potentially payable (including employer's NIC at 13.8%).

ENTERPRISE MANAGEMENT INCENTIVES

Generally, under the Enterprise Management Incentives' (EMI) legislation, no tax charges arise on the grant of a share option, whether under a non-tax advantaged or an EMI scheme. Under the legislation, however, provided that the qualifying conditions are met, no tax charge arises when the options are exercised, meaning that the only tax payable is Capital Gains Tax (potentially at 10% if certain conditions are met) when the shares are eventually sold. The annual Capital Gains Tax exemption of £12,000 can also be used to shelter gains.

Conditions of using EMI

Conditions to be met by the company issuing the shares:

- Must be independent; the company cannot be a subsidiary of, or controlled by, another company;
- Gross assets of £30m or less;
- Can have only 'qualifying subsidiaries' – any subsidiaries must be 51% subsidiaries of the company and cannot be controlled by anyone else;
- Must carry on only 'qualifying trades'; there is a list of excluded trades which are generally lower risk activities including (but not limited to) legal or accounting services, property development, farming, leasing and financial services.
- Fewer than 250 full-time employees;
- Have a permanent establishment in the UK. This test will be met if there is, say, a UK trading subsidiary and the EMI options are over shares in the foreign parent;
- A company may not have more than £3 million of unexercised EMI options outstanding. This is based upon the value at the time of the grant of the options.

Where there is a group of companies, the financial and employee numbers' tests are based upon the group as a whole. These two tests only need to be met at the time of the grant of the EMI options; if the limits are subsequently breached, there is no adverse impact on existing EMI options.

Conditions to be met for the employees receiving the options:

- The employee must work at least 25 hours per week on average for the company (or its 51% subsidiaries) or 75% or their working time, if less;
- An employee cannot be granted EMI options if they beneficially own or have the ability to control more than 30% of the ordinary share capital of the company.
- An individual may not hold unexercised EMI options to acquire shares worth more than £250,000 (at the time of grant). Any options in excess of this amount do not qualify for the favourable EMI treatment.

If the exercise price of EMI options is less than the market value of the options at grant, tax implications can arise on exercise of the options. It is customary therefore for EMI options to be issued with an exercise price equivalent to the market value at the date of grant of the shares under option. Furthermore, if certain events ('disqualifying events') occur between the date of grant and exercise, an Income Tax charge may arise on the exercise of the EMI options. The most common disqualifying events are the issuing company ceasing to meet the independence test or the employee ceasing employment with the issuing company (or group). The EMI benefits can still be retained, however, if the employee exercises their options within 90 days following such an event.

The option grant documentation must contain appropriate wording which refers to the EMI legislation and the grant must be notified electronically to HMRC within 92 days of grant.

Employers can also benefit from a Corporation Tax relief when the EMI options are exercised. However, the applicable conditions need to be carefully considered. The EMI legislation will clearly not be applicable for all companies but it is often ideally suited to growing, tech companies.

How to structure your overseas development tax efficiently

Commercial opportunities may require international expansion so that a company is no longer trading with a country, but rather is actually trading within a country.

At this stage, it is likely that the company has fallen into the scope of overseas corporate taxes and a decision normally needs to be made as to whether to regularise this by forming a local branch of the UK company or by incorporating a local subsidiary. In deciding which is the most appropriate route, local legal and fiscal advice should be sought but there are likely to be certain common factors which should be borne in mind. As an example, a subsidiary is a separate legal person and so ring fences liability, whereas a branch may have less onerous local accounts and tax filing requirements. It is possible however that commercial considerations may drive the decision as a subsidiary may be perceived as showing more commitment to a marketplace.

Irrespective of the structure adopted, it is likely that there will be a need to register with the local fiscal authority for corporate taxes, value added taxes and payroll withholdings. Penalties could be charged for late registrations and may impact adversely upon the relationship with the local fiscal authority going forward.

Once the overseas business is up and running, the following taxation issues may arise.

TRANSFER PRICING

Where transactions are undertaken between the UK company and the overseas entity, it will be necessary to comply with both the transfer pricing legislation of the UK and of the overseas territory. If the overseas territory follows the OECD's approach to transfer pricing, it is likely that transactions will need to be undertaken at open market value ('arms length') to meet the local and UK requirements.

REPATRIATION OF PROFITS

Hopefully, the overseas operation will be profitable. It will therefore be necessary to consider how profits, or surplus funds, may be repatriated to the UK in a tax efficient manner. For a branch, this can be relatively straightforward as it can simply repatriate surplus cash to the company of which it forms part. A subsidiary can achieve the same by lending surplus funds to a UK parent, but this can have unfortunate taxation consequences dependent upon the territory at issue.

Conventional ways for an overseas subsidiary to repatriate funds to a UK parent are dividends (unlikely to be subject to UK corporation tax on receipt), interest on loans or royalties charged for the local use of intellectual property owned by the parent. Withholding taxes may be applied locally on such payments to the UK. These may be reduced by applicable double taxation treaties or potentially mitigated completely by EU law if the subsidiary is resident in an EU member state – this latter relief may well disappear of course following Brexit. Dependent upon the UK parent's corporation tax position, UK tax relief may be available in part or in full for such withholding taxes.

Alternatively, parent companies may choose to repatriate profits by charges made to the overseas subsidiary for services provided. Any such charges will need to be carefully considered to ensure that they are tax deductible in the subsidiary and comply with appropriate transfer pricing rules.

SECONDMENT OF STAFF

It is quite usual for staff to be seconded from a UK parent to assist in setting up and developing the subsidiary's operations. It is important to ensure that local income tax requirements are met and that, to the extent possible, double taxation does not arise to such employees. It is essential that professional advice is taken in advance of secondment arrangements being put in place so that any available tax reliefs may be obtained and tax costs minimised.

OTHER ISSUES

Where a UK company imports goods into the EU and supplies these onward to an EU resident subsidiary, it is possible (dependent on the manner in which Brexit is undertaken), that a double charge to customs duties may arise post Brexit – on the import of goods into the UK and on the subsequent import into the (then) EU. This should be considered when looking to put in place commercial operating structures pre Brexit.

It should not be assumed that, for employees of the local subsidiary, share options will be tax effective or even desired as a means of remuneration.

Maximising tax efficiency in share sales

In order to ensure that the post tax return from the investment is maximised, it is important that any share sale takes place in as tax efficient a manner as possible. In maximising tax efficiency, both the structure of the sale and the manner of taxation of any gains arising need to be considered.

CONDITIONS OF USING ENTREPRENEURS RELIEF

Where UK investors have previously acquired or subscribed for shares in a company which are sold, and did not make any subscription through tax advantaged funding schemes such as EIS or SEIS, such investors will wish to ensure, if possible, that entrepreneur's relief (ERS) will be available to give an effective tax rate on any capital gains arising of 10%.

ERS should not be assumed and, in order for the relief to be available, the following conditions must be met throughout the two year period up to the date of the share disposal:

- The company must either be a trading company or the holding company of a trading group;
- The individual shareholder must have been an officer or employee of that company or another company in the same group.
- The company must have been the individual's 'personal company' during the period. This is defined as a company in which the individual not only holds at least 5% of the ordinary share capital but also is able to exercise at least 5% of the voting power by virtue of that shareholding and meets one of the following conditions during the two year period.
  - that the individual is entitled to both 5% of the profits available for distribution to the company's equity holders and assets available for distribution to its equity holders in a winding up or
  - In the event of a disposal of the ordinary share capital of the company the individual would be entitled to 5% of the disposal proceeds.

SHARES SUBSCRIBED VIA EIS OR SEIS

For investors who subscribed for their shares via either EIS or SEIS, then provided that the shares have been held for at least 3 years, and the appropriate conditions under the relevant legislation have been met by both the investor and the investee company throughout this period, gains on sale are exempt from capital gains tax.

ALL OTHER SITUATIONS

UK investors who did not subscribe for their shares through tax advantaged funding schemes and who are not able to obtain entrepreneur's relief on the share disposal will potentially pay capital gains tax at 20% on gains made.

The above essentially looks at the simplest position where an investor is paid cash in full at the time of sale for their shares. However it is quite possible that the sale consideration may be, wholly or partly, in a non-cash form such as shares in an acquiring company or loan notes.

Alternatively, even if the consideration is wholly cash, part of this may be deferred to a later date or may be contingent on later events. In such circumstances, the taxation position becomes more complex; it is quite possible that the entire consideration may be taxable up front and it may be necessary for tax purposes to value any contingent consideration that may ultimately be received and tax this up front.

It is common for part of the consideration to be met by shares in an acquirer company. Such a share exchange can be 'tax free' in the hands of the seller with the new shares being treated for capital gain tax purposes as being acquired at the same time and for the same price as the shares that have been disposed of. A potential difficulty arises if it is likely that the seller will not be able to claim entrepreneur's relief on the eventual sale of the replacement shares even though such relief may have been available if the original shares had been sold for cash consideration. Here, tax legislation allows the seller to elect to disapply the share for share rules and to tax the gain that then arises on the share exchange; the effect is to accelerate payment of tax but potentially reduce the amount of tax actually arising.

Alternatively, consideration may be received by way of interest bearing loan notes in the purchasing company. You should be aware of the following points when loan notes are offered:

- If structured correctly, capital gains tax may not arise until loan notes are redeemed.
- Loan notes can impact adversely on the availability of entrepreneur's relief.
- If the loan notes are deemed to be 'qualifying corporate bonds', capital gains tax may still arise if the loan notes are not redeemed, i.e. there is no bad debt relief in such circumstances.

MEET THE TEAM

James Francis
PARTNER
01480 417800
james.francis@ensors.co.uk

Jayson Lawson
ASSOCIATE PARTNER
01223 428317
jayson.lawson@ensors.co.uk

Joanna Boatfield
ASSOCIATE PARTNER
01223 428344
joanna.boatfield@ensors.co.uk

Robert Leggett
BUSINESS & CORPORATE TAX PARTNER
01473 220022
robert.leggett@ensors.co.uk

Ben Croston
CORPORATE FINANCE MANAGER
01223 428312
ben.croston@ensors.co.uk

Chris Barrett
PARTNER
01284 722340
chris.barrett@ensors.co.uk

David Fairbank
DIRECTOR
01473 220022
david.fairbank@ensors.co.uk

"We have been working with James Francis and his team for a number of years now. They provide us with expert advice for all of our accounting and taxation requirements. The team at Ensors are very professional, rigorous, technically minded, and provide us with guidance in a clear, prompt and efficient manner."

Tim Fell – CEO Synthace Ltd

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