

CLAUSE 209: RESEARCH INSTITUTION SPIN-OUT COMPANIES

SUMMARY

1. This draft clause, which will be included in the next Finance Bill, amends Part 7 of the Income Tax (Earnings and Pensions) Act 2003 by inserting a new Chapter 4A. The rules in this new Chapter 4A apply to persons involved in research who acquire shares in spinout companies created with research institutions (RIs) to further develop intellectual property (IP). If certain conditions are fulfilled the rules provide relief against certain charges to tax to the extent that the charges arise as a result of an agreement for the transfer of IP to the spin-out company, or as a result of the transfer of IP pursuant to such an agreement..
2. The rules provide definitions of persons involved in research, research institutions, and intellectual property. In general terms, rules work by ignoring the effect on the researchers' shares in the spinout company of transfer of intellectual property into that company.

DETAILS OF THE CLAUSE

3. Clause [j209] (1) inserts a new Chapter 4A in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). All references to numbered sections are to ITEPA (unless otherwise indicated). Where shares are mentioned this includes an interest in shares.

Chapter 4A Shares in research institution spin-out companies

Section 451: Application of the Chapter

4. Section 451, subsection (1) sets out four conditions for the Chapter to apply. All must be satisfied.
5. Subsection (1)(a) sets out the first condition. The Chapter applies where an agreement is made to transfer intellectual property IP from one or more RIs to a spinout company. It and other

conditions acknowledge that two or more RIs may bring together IP into a single spinout company.

6. Subsection (1)(b) sets out the second condition. The Chapter applies where a person acquires shares in the spinout company either the IP transfer agreement is made or within 183 days thereafter.
7. Subsection (1)(c) sets out the third condition. The Chapter will apply where the right or opportunity to acquire the shares was available by reason of employment by any of the RIs or by the spinout company.
8. Subsection (1)(d) sets out the fourth condition. The Chapter will apply where the person who acquires the shares is involved in research in relation to any of the IP that is the subject of the IP transfer agreement.
9. Subsection (2) provides that the Chapter will not apply if avoidance of tax or National Insurance Contributions is one of the main purposes of the arrangements under which right or opportunity to acquire the shares is made available.

Section 452: Market value on acquisition

10. Section 452, subsection (1) sets out how the market value of the shares at acquisition will be calculated. This will be calculated disregarding the effect on that market value of the IP agreement and any transfer of IP pursuant to it.
11. Subsection (2) provides that this will apply for the following purposes:
 - (a) determining any amount that will constitute earnings from the employment under Chapter 1 of Part 3 of ITEPA;
 - (b) determining the amount of any gain on a chargeable event by virtue of section 439(3)(a) when shares are converted;
 - (c) operating Chapter 3C of Part 7 of ITEPA, which covers shares acquired for less than market value;
 - (d) determining any amount that counts as employment income of the employee under Chapter 5 of Part 7, which covers securities acquired pursuant to a securities option.

Section 453: Taxable amount under Chapter 4

12. Section 453, subsection (1) applies where shares are acquired before the IP transfer agreement, or before any actual transfer pursuant to the agreement. In these circumstances the taxable amount determined as a post-acquisition benefit from a security under section 448 in respect of benefits arising from the IP transfer is to be treated as nil.
13. Subsection (2) provides that this will not apply if something which affects the shares has been done as part of a scheme or arrangement one of the main purposes of which is to avoid tax or National Insurance Contributions. The test may be failed as a result of something done at or before the time when the agreement is made or the IP is transferred.

Section 454: Deemed election for disapplication of Chapter 2

14. Section 454, subsection (1) provides that where restricted shares are acquired the employee and employer will be treated as making an election under section 431(1). This is the election for disapplying Chapter 2, so that the unrestricted market value is taken into account at acquisition. This means that on acquisition of the restricted shares relief can be given under Chapter 4A on their unrestricted market value and that no later charges will arise under Chapter 2.
15. Example. Homer is invited to join a spinout at set-up and satisfies the conditions for relief. He is offered shares at par (£1) which are forfeitable under certain circumstances for a period of 3 years. The value taking into account the IP transfer agreement is £1+. Under Chapter 2 there is no charge on acquisition but after 3 years when the risk of forfeitable lifts this would be treated as a chargeable event. The market value of each share at that date is £10, but by then the original IP transferred under the agreement will only be one element contributing to this. Others might be money from external funding or the value of further developments to the IP by the spinout itself. The deemed section 431(1) election means that the full market value of £1+ is chargeable to tax at the date of acquisition. Full effect of Chapter 4A can be given to disregard the “+” element relating to the IP transfer agreement and no tax will be due. There will be no further chargeable event when the forfeiture lifts.
16. Subsection (2) provides that the employer and employee may agree that subsection (1) will not apply. The effect of such an agreement would be that there would be no deemed election under section

431(1) and therefore only the actual market value of the restricted shares would be taken into account at acquisition and relief under this Chapter would only be available in respect of that amount. Further relief will not be available when the restriction is lifted. This course of action may be chosen if the unrestricted market value at acquisition reflects things other than the transfer of IP so that bringing the unrestricted market value into charge would result in a large taxable amount.

17. Example Plato is invited to join the spinout after 150 days, when funding has also been received and further research been done within the spinout. The shares are restricted. Plato will be aware that relief under Chapter 4A extends only to the value derived from the IP transfer agreement and has the choice to allow the deemed election to stand, and be chargeable on the unrestricted market value of the shares at acquisition, disregarding value attributable to the transferred IP but including any value attributable to the funding. If he does this he will not be subject to any later charges to tax under Chapter 2. Alternatively he can opt out of the deemed election by making an agreement under subsection (2) of section 454 so that he is only charged to tax on the restricted value of the shares at acquisition. If he does this he will be charged to tax under Chapter 2 at a later date when the restrictions on the shares are lifted.
18. Subsection (3) gives the terms and conditions for opting out of the deemed election. An agreement to opt out is irrevocable. It must be made in a form approved by the Board of Inland Revenue and within 14 days following the acquisition. However the time limit is adjusted by subsection of clause [j209] in relation to shares acquired before 1st October 2005 (see paragraph 40 of these notes).
19. Subsection (4) provides that if an agreement is made under subsection (2) to opt out of the deemed election then subsection 5 will apply for the purpose of determining the amount of the charge when a restriction lifts.
20. Subsection (5) provides for an adjustment to the initial unrestricted market value (IUMV) to be taken into account when a charge arises under section 428. The IUMV is to be calculated disregarding the effect on the IUMV of the IP transfer agreement and any actual transfer pursuant to it.
21. Example. When Plato acquires his restricted shares (see paragraph 9) he pays nothing for them. The actual market value is 10 (of

which 5 related to the value of the IP transferred) but the IUMV is 20 (of which 12 related to the value of the IP). Plato opts out of the deemed election so at acquisition he is charged only on the value of 5 (because the market value of the shares is calculated disregarding the IP transferred). When the restriction lifts the market value of the shares is 50. Under subsection 5 when applying the formula used to calculate the taxable amount at that chargeable event under section 428(3) of ITEPA 2003 the value of IUMV will be 8, rather than 20.

Section 455: Disapplication of Chapter 3B

22. The effect of section 455 is that Chapter 3B will not apply. This is achieved by providing that for this purpose neither the IP agreement nor any transfer of IP pursuant to it are things done otherwise than for genuine commercial purposes.

Section 456: Meaning of “Intellectual Property” and “transfer”

23. Subsection (1) defines intellectual property. It means:
- (a) any patent, trade mark, registered design, copyright or design right, plant breeder’s rights or rights under section 7 of the Plant Varieties Act 1997;
 - (b) any right under the law of a country or territory outside the UK corresponding or similar to a right within (a);
 - (c) any information or technique not protected by a right within (a) or (b) but having industrial, commercial or other economic value;
 - (d) any licence or other right in respect of anything within (a) - (c);
 - (e) any goodwill, as defined for accounting purposes, associated with anything within (a) to (d).
24. Subsection (2) allows the definition to be amended by Treasury order.
25. Subsection (3) gives some particular examples of what may constitute a transfer of IP:
- (a) a sale of the IP;
 - (b) the grant of a licence or other right in respect of it;
 - (c) the assignment of a licence or other right in respect of it.

Meaning of “research institution”

26. Subsection (1) defines a research institute as:
- (a) any university or other institution that is a publicly funded

institution as defined in section 41(2) of the Higher Education Act 2004, or;

(b) any institution that carries out research activities otherwise than for profit and that is neither controlled nor wholly or mainly funded by a person who carries on activities for profit.

27. Subsection (2) allows the definition to be amended by Treasury order. The amendment may include in, or exclude from the definition either a specified person or persons of a given description.

Section 458: Meaning of “involved in research”

28. Section 458 defines what is meant by a person involved in research. It provides that a person is involved in research in relation to intellectual property transferred or to be transferred from one or more RIs if:
- (a) he is actively engaged for any of the RIs in connection with research, whether as an employee or otherwise;
- and
- (b) that research is relevant to anything to which the IP relates.

Section 459: Transfer of IP by associated company

29. Where one or more RIs control a company, a transfer of IP from the company is to be treated as a transfer from the RIs. ‘Control’ is defined at section 460(4) as having the meaning given in section 416 of the Income and Corporation Taxes Act 1988. This reflects the use of some universities of intermediate companies which hold the IP and set up spinout companies themselves.

Section 460: Definitions

30. Subsection (1) provides that interest in relation to shares and shares have the meaning indicated in section 420.
31. Subsection (2) provides that “market value” has the meaning indicated in section 421(1). This is the same meaning as for the purposes of the Taxation of Chargeable Gains Act 1992.
32. Subsection (3) provides that “the acquisition”, “the employee” and “the employer” have the meaning indicated in section 421B(8).
33. Subsection (4) provides that “restricted interest in securities” and “restricted securities” have the meaning indicated in sections 423 and 424.

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34. [insert new heading – notes relate to clause not Chapter 4A]
35. Subsection (2) of clause [j209] introduces amendments to Chapter 1 of Part 7.
36. Subsection (3) of the clause extends the application of subsections (1), (4) and (8) of section 421B and subsections (5) and (6) of section 421D.
37. Subsection (4) of the clause extends the list of reportable events in section 421K(3)(g) to include the receipt of a benefit which would give rise to a taxable amount under section 447 of ITEPA but for Chapter 4A.
38. Subsection (5) of the clause provides that Chapter 4A applies if either the date of acquisition of the shares or the date on which the IP transfer agreement was made, or both, fell on or after 2nd December 2004.
39. Subsection (6) of the clause provides that when there is a deemed election under section 454 in relation to shares acquired before 2nd December the election is treated as made on that date.
40. Subsection (7) of the clause provides that when section 454 applies in respect of restricted shares acquired before 1st October 2005 the time limit in subsection (3)(b) of that section for making an agreement to opt out of the deemed election under section 431 is 15th October 2005 rather than within 14 days after the acquisition of the shares. This reflects the likely timing of Royal Assent to the Finance Act and the academic year.

Background Note

41. Many universities, public-sector research establishments, entities such as NHS Trusts and MOD and some charities own IP created by their employees. They have “IP sharing policies” (sometimes also called “employee incentive or compensation schemes”) to reward employees who have created IP – the inventors – if it is subsequently exploited.
42. The form and timing of this reward varies. It may be cash representing a share of royalties received by the university from licensing or selling the IP, to which the normal tax and NICs rules apply. Alternatively, it could be a transfer of value to inventors via

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their ownership of shares in a spin-out company set up to further develop the IP to the point where it can be exploited commercially.

43. The value of the shares in the spinout company held by the researcher will be affected by an agreement for the transfer of the IP into the spinout or by the transfer of the IP pursuant to such an agreement. Consequently, a charge to tax can arise on the acquisition of the shares by virtue of section 62 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) or on the receipt of a benefit in connection with the shares under Part 7 of ITEPA (as amended by Schedule 22 of Finance Act 2003), before cash is available to meet the bill.