

**Memorandum of Understanding between University Companies Association (UNICO) and the
Inland Revenue on the tax treatment of Academics' shareholdings in university "spin-out"
companies – 14 April 2004**

1 Background

- 1.1 University spin-outs are complex commercial arrangements, designed to deliver a number of different commercial and public objectives. These vary from requiring university employees (usually academics, and therefore referred to in this memorandum as the Academics) to risk their own money by buying shares, to rewarding those employees under the university's Intellectual Property Sharing Policy.
- 1.2 Any shares acquired by the Academics will be acquired in connection with their employment and will be covered by the income tax rules dealing with "employment-related securities". However, that fact alone will not, of itself, mean that income tax or National Insurance Contributions (NICs) will arise.
- 1.3 When the Academics acquire the employment-related securities they may do so wholly as an investment; wholly as a reward for services; or as a combination of both. In the latter case, the correct identification of the divide between the two will dictate when, and in what amount, income tax and NICs arise – drawing a distinction between capital investment and revenue reward.

2 Introduction

- 2.1 This memorandum follows discussions between UNICO and the Inland Revenue with regard to the tax treatment of the Academics who acquire shares in spin-out companies, following the Finance Act 2003.
- 2.2 This memorandum describes a shareholding structure which meets UNICO's objectives to:
- give the Academics shareholder status from the outset;
 - ensure that the Academics do not have to pay significant tax or NIC charges, until they cash-in their shares; and
 - produce predictable tax and NIC consequences.
- 2.3 The approach set out in this memorandum is a "safe harbour", which if applied will give certainty of tax treatment. It does not affect the right of any taxpayer to argue that a different interpretation should apply to his or her specific circumstances.
- 2.4 The structure is based on the Academics holding convertible preference shares conferring some or all of the rights - and being subject to some or all of the restrictions - set out in paragraph 3 below. Paragraph 4 sets out the agreed tax treatment of such shares.
- 2.5 The Inland Revenue will not be bound by this memorandum:
- if the main purpose, or a significant purpose, of the arrangements is avoidance of liability to tax or NICs, or
 - to the extent that there are material deviations from the structure described below.

In these circumstances the Inland Revenue reserves the right to consider the application of all provisions relating to tax and NICs, including Chapters 1 to 5, Part 7, ITEPA 2003.

2.6 All statutory references in this paper are to the Income Tax (Earnings and Pensions) Act 2003 as amended by the Finance Act 2003 unless otherwise stated.

3 Share rights

3.1 The preference shares shall confer some or all of the following rights:

- The right, at any time, to convert into ordinary shares on a one-for-one basis. While a further payment on conversion could be required, typically there will be no further payment on conversion.
- The right on a return of capital to receive the amount paid up on the shares (which will be a nominal amount of, say, 1p per preference share) in priority to the ordinary shares.
- The right to attend general meetings and a proportionate right to vote.
- The right, *pari passu* with the ordinary shares, to participate in a rights issue of ordinary shares. On a bonus issue of ordinary shares, holders of preference shares will receive a bonus issue of preference shares in the same ratio.
- The right to “tag-along” on a takeover.

3.2 The preference shares shall confer no rights:

- to receive dividends; or
- to receive more than the amount paid up on a return of capital.

3.3 The ordinary shares shall confer the following rights:

- to attend general meetings and vote;
- to receive dividends;
- to participate in a return of capital; and
- to “tag-along” on a take-over.

3.4 The above rights will be set out in the Articles of Association of the spin-out company. The Investment Agreement may in addition confer some or all of the following rights:

- While they hold a prescribed percentage of the issued shares (making no distinction between preference and ordinary shares) the Academics will be entitled to appoint, remove or replace at least one director but always less than 50 per cent of the directors. (An Academic may be paid a reasonable fee for serving as a director without any effect on the tax analysis set out in this note.)
- The Academics will be entitled to receive financial information on a regular basis.
- The non-Academic shareholders will be able to prevent changes to the spin-out company’s business, finances or shareholdings.

3.5 The Articles of Association may contain pre-emption provisions applying to all shares and providing that an Academic who severs his or her connection with the spin-out company may be deemed to have served a transfer notice in respect of all some or all of his or her shares (ordinary and preference). “Bad leavers” (which may be variously defined according to the circumstances and/or the timing of the departure) might not receive the full market value of their shares. There may also be a “drag-along” clause compelling all shareholders to accept a takeover offer, which has already been accepted by a stipulated majority.

4 Tax treatment

Preference shares

4.1 Acquisition

Because the conversion right is ignored for tax purposes (as required by section 437), the value of the preference shares will not exceed the nominal amount paid for them. There will therefore be no tax charge on acquisition.

Example 1

The Academics acquire convertible preference shares for 1p per share. The other investors and the university pay £1 per share for ordinary shares. The market value of the convertible shares is £1 per share of which all but 1p is attributable to the right to convert. Since the right to convert is ignored for tax purposes (S437), the Academics are paying 1p for a share, which is deemed by the legislation to be worth 1p. There is no tax charge on acquisition of the shares.

4.2 Issue of ordinary shares to investors after acquisition of preference shares by Academics

If the subscription for ordinary shares by other investors takes place after the convertible shares have been acquired by the Academics, this will not give rise to a tax charge for the Academics, provided the Academics still hold convertible shares falling within paragraph 3 above.

4.3 Conversion

On conversion into ordinary shares, there will be a charge under Chapter 3. The chargeable amount will be:

$$\text{CMVCS} - (\text{CMVERS} + \text{CC}) - \text{CE}$$

Where:

CMVCS is the market value (taking account of any restrictions) of an ordinary share on the conversion date;

CMVERS is the market value of a preference share ignoring the right to convert;

CC is the price paid for the conversion, if any; and

CE is the price paid for the right to convert.

Example 2

As in Example 1, the Academics acquire preference shares for 1p per share which, ignoring the right to convert, is the market value on acquisition and on conversion. On conversion, an ordinary share would be worth £20 but the existence of restrictions reduces this to £15.

Using the above abbreviations:

$$\text{CMVCS} = \text{£15}$$

$$\text{CMVERS} = 1\text{p}$$

$$\text{CC} = \text{NIL}$$

$$CE = \text{NIL}$$

Therefore, the chargeable amount per share will be:

$$£15 - £0.01 = £14.99$$

The Initial Uncharged Proportion (IUP) to be used on a future disposal will be:

$$(\text{£}20 - \text{£}15) / \text{£}20 = 0.25$$

4.4 Disposal of preference shares before conversion

The spin-out company may be sold before the conversion rights have been exercised and the holders of the preference shares may be paid a cash sum, without first requiring them to convert.

In such cases, the chargeable amount will be (section 441(3)):

$$DC - \text{CMVERS}$$

Where:

DC is the amount paid to the Academics on disposal

CMVERS is the market value of a preference share, ignoring the right to convert.

The chargeable amount is, therefore, simply the amount paid to the Academics on the disposal, less the market value of a preference share, ignoring the right to convert.

Using the figures in Example 2 above, this would give the same answer of £14.99 because the amount paid to the Academic would presumably be £15 per preference share, and CMVERS would remain at 1p.

4.5 Disposal of ordinary shares acquired by conversion

If the conversion to ordinary shares and the sale of the ordinary shares are simultaneous, there will be no income tax charge on sale, as the amount charged on conversion will be based on the sale price, as in paragraph 4.4 above.

However, if the Academic chooses to convert the preference shares and retain the ordinary shares, a charge under the "restricted securities" regime may arise, if the ordinary shares are "restricted securities" within section 423.

The shares will be "restricted securities" if the market value is reduced because of any restriction on any right conferred by the employment-related securities. Such restrictions may include "bad leaver" provisions on termination of employment, a "drag-along" clause in the Articles of Association, or the fact that the ordinary shares held by the Academics may lack the additional veto rights vested in the major shareholders by the Investment Agreement.

The later disposal of "restricted securities" will be a chargeable event (section 427(3)(a)). The charge is calculated in accordance with section 428.

The chargeable amount (assuming no previous restricted securities chargeable event, no expenses incurred in connection with the disposal and that all restrictions fall away on sale) is:

UMV x IUP

where:

UMV is the Unrestricted Market Value of the ordinary shares on sale;

IUP is the Initial Uncharged Proportion.

Example 3

Each ordinary share is subsequently sold for £30.

UMV (Unrestricted Market Value) = £30

IUP (Initial Uncharged Proportion) as in example 2 = 0.25

So, chargeable amount is $£30 \times 0.25 = £7.50$

The proportion of the sale proceeds which is chargeable will be equal to the proportion of the unrestricted value of the shares which is not charged on conversion because of the depressive impact of the restrictions on the ordinary shares acquired at that time.

Alternatively, the Academic and the employing entity could, at any time before or within 14 days following conversion, make an election under section 431 for the restrictions to be disregarded. In that case, the charge under the "convertible securities" regime will increase (from £14.99 to £19.99 in example 2) to reflect the unrestricted value; but there will then be no charge under the "restricted securities" regime on sale.

4.6 Ordinary shares

The Academics may hold ordinary shares (either ab initio or by conversion of their preference shares), in order to deliver an objective of ensuring that they are risking some of their own capital in the venture. Provided such shares are acquired for their full Unrestricted Market Value, as reflected in the price paid by other investors, there will be no liability to income tax or NICs in respect of the acquisition of those shares, on any later lifting of restrictions or on disposal.

5 Capital Gains Tax

5.1 A disposal of ordinary shares will be subject to capital gains tax but the base value will be increased by any amount that has already been taxed under either the "convertible securities" or "restricted securities" regimes.

5.2 Provided at least 1 year has elapsed since the original acquisition of the preference shares, taper relief may reduce the chargeable gain. Business asset taper relief gives a maximum reduction of 75 per cent after 2 years of ownership whereas non-business asset taper relief gives a maximum reduction of 40 per cent after 10 years of ownership. It is a condition of obtaining relief at the higher business rate that either the shares are in an unquoted company or the shareholder is a director or employee of the company or a connected company.

Example 4

The ordinary shares are sold for £30 after the conversion.

If no election had been made when the restricted shares were acquired (using the figures from Example 3), the amount subject to CGT is:

£30 (sale proceeds) - £0.01 (cost of preference shares) - £14.99 (charge on conversion) - £7.50 (charge on lifting of restrictions) = £7.50

which 2 years of business asset taper relief would reduce to £1.875.

If an election had been made the amount subject to CGT becomes:

£30 - £0.01 - £19.99 = £10.00

which 2 years of business asset taper relief would reduce to £2.50.

6 National Insurance/PAYE

- 6.1 Amounts chargeable to income tax will give rise to a PAYE obligation and will be treated as earnings for NICs purposes if, at the relevant time, the shares in the spin-out company are, or are treated as, readily convertible assets (RCAs). Following Finance Act 2003, shares are treated as RCAs unless they are “corporation tax deductible”.
- 6.2 In the case of spin-out companies, the shares will not be corporation tax deductible unless the Academics are employees of the spin-out company or another group company (as required by para 6 of Schedule 23 to Finance Act 2003). Also, the shares will not be corporation tax deductible if the spin-out company is under the control of an unlisted company (para 4(3) of Schedule 23).
- 6.3 It will be possible¹ for the employing entity to agree with an Academic that the Academic will bear any employer’s Class 1 NICs arising on post-acquisition chargeable events under either the “restricted securities” or “convertible securities” regimes.
- 6.4 It will therefore be possible to protect the university or the spin-out company from an uncertain future NICs liability. Nevertheless, there will be an obligation to account to the Revenue for PAYE and NICs. The university, as the principal employer, will be the Revenue’s first port of call, even if the Academic were a part-time employee of the spin-out company. To ensure that the university is able to recover the payment from the Academic, it may include a pre-condition to conversion that the Academic deposits with it the amount required to meet the PAYE/NICs liabilities

7 Reporting requirements

- 7.1 Either the spin-out company or the university must notify the Inland Revenue of the acquisition of shares by the Academics and of any subsequent chargeable events relating to those shares. It is important that a clear decision is made as to which entity will take responsibility for this. Notification must be made no later than 6 July following the tax year in which the reportable event occurs.
- 7.2 Once one responsible person has satisfied its obligation, there is no requirement for other responsible persons to provide the same information. But if nobody satisfies the reporting requirements within the time allowed, all responsible persons are liable for penalty action by the Inland Revenue.

¹ This facility will be introduced by Royal Assent of the National Insurance Contributions and Statutory Payments Bill 2004. However, it will only be available from a date to be set by Treasury Order, following Royal Assent of the Bill.