RESEARCH INSTITUTION SPIN-OUT RELIEF

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Where certain conditions are met, spin-our relief prevents an income tax and NIC charge arising for academics and researchers acquiring shares in a start-up or spin-out company. The intellectual property is transferred into the company and it creates or increases the value of the shares.

What is a ‘spin-out’ company?

Universities and other Research Institutions (RIs) which own Intellectual Property (IP) often develop that IP further through companies created in association with the academics and researchers from the institution (Researchers) who worked on the project. These are commonly referred to as spin-out or spin-off companies.

Most RIs have in place an IP-sharing policy that acknowledges the Researcher’s contribution to the IP by sharing the benefit of it with the Researcher through a share of royalties or, where the IP is developed through a spin-out into which IP has been transferred, shares in that company.

Issue of shares

When issuing shares to individuals, the possibility of being subject to income tax (and possibly NICs) on the value of the shares needs to be considered. The basic problem is that shares acquired by an individual in a company by virtue of being an employee or director (‘employment related securities’) are governed by tax legislation which aims to ensure that value or benefits that flow to employees through or from share-based remuneration are subject to employment income tax. This means that where:

- A Researcher was/is works for the RI and acquires shares in a spin-out, and
- The RI puts value in the spin-out company by transferring IP into it,

then a charge to income tax (and possibly NICs) could arise either:

- Because the Researcher acquires shares which have a value that reflects the value of the IP, so the value of the shares exceeds the price paid (and the excess is subject to income tax), or
- Because there is an increase in the value of shares already acquired by a Researcher due to the IP being transferred into or made available to the company (and the increase in value is subject to income tax).

However, Researchers may well be able to benefit from “Research Institution Spin-out Relief”, so avoiding any income tax or NICs liability on either the acquisition of the shares, or as a result of the increase in the value of the shares when the RI makes IP available to the company (either through a licensing arrangement, or outright transfer of IP).

To qualify for this relief, certain conditions have to be met including those surrounding the timing of the share acquisition, the type of share and the individuals’ personal circumstances.

For all individuals, whether they be academics, employees, or directors, who have shares or share options, the company (or RI) needs to make a return to HMRC after each tax year providing details of shares acquired, share options granted and other transactions or events involving shares.

The relief

The relief prevents income tax and NICs charges arising on Researchers on an increase in the value of the shares in the

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spin-out company that is caused by the transfer of designated IP from the RI and, where the Researchers acquire shares after any IP transfer, the relief excludes the value of the IP from being reflected in considering whether the Researchers have acquired the shares at undervalue. The conditions that have to be made to qualify for the relief are:

- There must be an agreement to transfer IP from one or more RIs to a spin-out company
- The Researcher must acquire shares in the Spin-out company either before the IP transfer agreement is made or within 183 days thereafter
- The right or opportunity to acquire the shares must have been available by reason of the Researcher's employment with the spin-out company or with any of the RIs, and
- The Researcher must be involved in research in relation to the IP that is the subject of the IP transfer agreement.

The relief directly covers the impact of IP in a spin-out company but not other events such as the introduction of funding or business development that would increase the value of the company. In such cases, there could still be a residual charge to income tax (and possibly NIC) based on the values of the shares attributable to these other events, even though the value attributable to the IP has been ignored.

Example 1

A university decides to set up a spin-out company to develop its IP further. The University subscribes for 30 shares in the new company at par (£30). It then transfers the IP as it stands into the spin-out company. A further 10 shares are allocated to a Researcher (R) for which he pays £10. Each share is now worth £1,000 and the tax relief for the researcher will be:

	£
Value of shares received 10 x 1,000	10,000
Payment for shares	(10)
Potential charge on undervalue	9,990
Spin-out Relief – effect of IP	(9,990)
Liability	**nil**

Example 2

The facts are the same as in example 1 and once the IP is in place, negotiations are concluded with an investor who introduces £500k and subscribes for shares at their market value of £2,000 per share. The increase in value of R's shares to £2,000 per share each as a result of the funding support will be a normal commercial increase and therefore not taxable to income tax or NIC.

Example 3

Moving on from examples 1 and 2, five months after the IP was transferred in and after the funding was introduced, the University asks another researcher (R2) actively involved in the research to join the spin-out and subscribe for five shares at par of £1 each. The shares are currently worth £2,200 each. There will be a potential liability as shown below on acquisition of shares by R2 at an undervalue, only partly relieved by spin-out relief:

	£
Value of shares received 5 x 2,200	11,000
Payment for shares	(5)
Potential charge on undervalue	10,995
Spin-out Relief – effect of IP	(5,000)
Subject to income tax	**5,995**

What if my shares do not qualify?

For shares not qualifying for the research institute spin-out relief, the tax position of the recipient of the shares can be minimised through a number of different approaches, including the terms for payment of the shares or having certain rights and restrictions attaching to the shares. Ideally, shares should be acquired by academics, employees and directors at the earliest opportunity, when the share value is likely to be at its lowest. Combined with the use of certain time limited tax elections, this could reduce the overall tax liability, or even eliminate it.

Alternatives to outright acquisition of shares can be considered. This might include shares with right to conversion into a different class of share, an option to acquire new shares, shares that may have to be forfeited or surrendered if certain conditions are not met, and share acquisitions with deferred payment terms. All these have their own tax implications and opportunities, and all have a place under the right circumstances to result in the most appropriate tax outcome given the individual's facts, circumstances and attitude to risk.

Your next steps

BDO can help with all aspects of share transactions in spin-out companies. Please get in touch with your usual BDO contact or any of our experts listed overleaf.