



Corporate Structuring and Tax Issues for Early Stage Entrepreneurial Businesses

26 May 2008

Agenda

- ? Start-up
- ? Interim
- ? Disposal

Start-up

- ? Structure – consider any employment related securities charge
- ? Commencement of trade
- ? Treatment of development costs
- ? Other capital allowance issues
- ? R&D

Structure of initial set-up

Potential to fall within employment related securities rules

- ? Get it right first time
- ? Founder shares not normally an issue
 - ? Any shares that are acquired by virtue of employment may become taxable under income tax rules – creating income tax and national insurance liabilities. Watch out for restrictions on securities
 - ? If shares fall within this regime, can elect to take income tax hit upfront giving a capital gains only exit

Commencement of trade

As a general rule, trade starts when the principal assets are put to use.

Case law states that the purchase of plant and the erection of a factory is preparatory work and does not constitute the commencement of trade. Therefore:

- ? Capital Allowances are not available
- ? There is no corporation tax liability relating to the trade
- ? Pre-trading expenditure, if incurred in the 7 years before trading starts is treated as incurred on the first day of trading.
- ? However other income may still be taxable such as income from testing or pre-sale of electricity – if this does not take place in the same year as operations commence, risk of taxable income and no expenses to offset
- ? Company P war story

Treatment of development costs

Accounting treatment determines to an extent how we treat the costs for tax but consider:

- ? Intangibles – amortisation of intangibles relating to an interest in land do not give rise to an allowable deduction
- ? Write-off to P&L – normal practice for any costs relating to site where there is a greater than 50% probability of the project proceeding. But “capital” costs and therefore no tax relief available?
- ? Potential solution: SPV for developing project and separate company operating the plant.

Other capital allowance issues

Key Area as capital heavy

- ? No requirement for equipment to actually be in use
- ? Expenditure is deemed to be incurred on date obligation to pay becomes unconditional
- ? At this stage, CA's can often generate substantial tax losses which are of value either to c/fwd, or in a consortium / group situation

Enhanced revenue deduction available for qualifying R&D expenditure (150% for SME's, 125% for large co's, minimum spend £10k). SME's can also get a tax repayment if loss-making and certain criteria are fulfilled

- ? Qualifying R&D (defined by DTI)
 - ? Extends overall knowledge or capability in a field of science or technology
 - ? Creates an existing process, material, device, product or service which incorporates or represents an increase in the overall knowledge
 - ? Makes an improvement to an existing process, material, device, product or service through scientific or technological changes

Principle underlying the R&D work must be the resolution of scientific or technological uncertainties (at a competent professional level)

Take advice on qualifying costs, restrictions on claim due to external funding / grants, IP ownership and sub-contracted R&D

Interim

Potential Introduction of JV partner. Need to consider:

- ? Gearing / Thin Capitalisation
- ? Transfer pricing
- ? Impact of employment related securities legislation on any share restructuring

Gearing / Thin capitalisation issues

Danger of interest payable to debt holder being a non-tax deductible expense.

- ? HMRC general view of reasonable debt/equity ratio = 1:1
- ? For RE projects, higher debt / equity ratios can be agreed based on industry norms
 - ? Wind – between 4:1 and 9:1
 - ? Efw – much higher
 - ? Advance agreement from HMRC available

Transfer pricing

All transactions with both UK / non-UK connected parties to be at arm's length. If not, danger of adjustment being levied by HMRC.

- ? Benchmark industry norms
- ? Document policy
- ? Revisit regularly
- ? Corresponding adjustment

Disposal

If structured correctly from start through to exit, there need not be any excessive capital gains tax leakage

Consider:

- ? SSE
- ? Other capital gains issues
 - ? Entrepreneurs' relief
 - ? Employment related securities

Requirements include:

- ? Share sale (not trade and assets)
- ? Vendor needs to be a member of a trading group
- ? 12 month requirement for the substantial shareholding to have taken place starting not more than 2 years before disposal
- ? 10% rule (not just ord share capital, but profits avail for distribution, assets distributed on a winding up)
- ? Investee company requirements
 - ? Trading co / holding company of trading group

Other Capital Gains Issues

Entrepreneurs' Relief

- ? Gain taxable at flat rate of 18%
- ? One-off lifetime amounts of gains up to £1m
 - ? Need to be employed by co at time of disposal

Employment Related Securities

If no election on acquiring the shares, income tax could arise on exit

See example below:

? 10,000 shares acquired, 80p cost per share, £1 market value per share, eventual sale for £100,000.

? With election

Tax on acquisition (10,000-8,000@40%)	£800
Tax on disposal (100,000-8,800@18%)	£16,416
Total tax	<u>£17,216</u>

? Without election

Tax on acquisition	£nil
Tax on disposal: Capital Gains (80,000 @18%)	£14,400
Income tax (20,000 @41%)	£8,200
Total tax	<u>£22,600</u>

Case Study 1

Income Tax / Capital Gains Tax Implications for shareholders

On incorporation of Co X, Mr S and Mr T acquired 1 founder share each. Some months later, they both subscribed for more ordinary shares at par. A few years later, Mr T transferred his shares to Mr S via pre-emption provisions for no consideration.

- ? No IT issues here as all of the above transactions are by reason of the men's (founder) shareholdings not as a result of their employment (this can be challenged by HMRC)

Case Study 1

Income Tax / Capital Gains Tax Implications for shareholders cont.

In 2002, the share capital was subdivided and redesignated as A shares.

- ? When Mr S disposes of the A shares in the future, it would be a straightforward CGT disposal (probably eligible for entrepreneurs' relief)

AT THIS STAGE THEY STOPPED TAKING ADVICE.

Case Study 1

Income Tax / Capital Gains Tax Implications for shareholders cont.

Subsequently, the balance of unissued but authorised share capital was redesignated B shares. New Articles were adopted and a new shareholders agreement put into place. Mr U subscribed for some B shares which had restrictions attaching

- ? Mr U did not make an election
- ? When Mr U disposes of the shares, any increase in value would be subject to PAYE and NIC rather than CGT

Case Study 1

Income Tax / Capital Gains Tax Implications for shareholders cont.

During 2006, the authorised share capital was doubled by creation of C shares and new set of Articles and a new shareholders agreement was adopted. Both Mr S and Mr U subscribed for C shares, Mr S paying par value and Mr U paying a much higher amount per share

- ? Arguably Mr S's shares were acquired at less than market value and therefore liable to income tax on the benefit received.
- ? On future disposal of the C shares, there is a high risk that a proportion of the sales proceeds would be subject to PAYE and NIC, not CGT.

Case Study 2

Corporation Tax implications of disposal of shares in subsidiary

- ? If requirements of the UK substantial shareholdings exemption are met, any gain arising in a UK company on disposal of shares in a subsidiary are exempt from UK corporation tax

Case Study 2

Corporation Tax implications of disposal of shares in subsidiary cont.

- ? Substantial shareholding requirement:
 - ? Holding of not less than 10% of OSC
 - ? Beneficial entitlement of not less than 10% of profits available for distribution to equity holders of company
 - ? Beneficial entitlement on a winding up of not less than 10% of the assets of the Company available for distribution to equity holders

Case Study 2

Corporation Tax implications of disposal of shares in subsidiary cont.

Company A and Company B held equal numbers of ordinary and preference shares in Company C so at the commencement of this joint venture, the shareholdings appeared equal and SSE would be available.

Case Study 2

Corporation Tax implications of disposal of shares in subsidiary cont.

- ? Stumbling block was the rights attached to the shares:
 - ? The beneficial entitlement both to dividends and assets on a winding up was allocated rateably in accordance with the subscription price paid. The price paid by Company B on entering into the JV was so much higher than that paid by A on subscription that Company B was entitled to 99.9% of any distribution or assets on a wind-up.
 - ? Result was that SSE was unavailable



Thank you

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