JAMES COWPER KRESTON
Accountants & Business Advisers

Academics - The tax implications of getting shares in university spin-outs

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Introduction

Many universities and other research institutions have a policy of sharing IP that acknowledges the academic's role in research by letting them benefit from the IP's commercialisation. This may result in the creation of a 'spin-out' company where the academics often get shares.

This can be a great opportunity for the academics themselves, but they should be aware of the possible tax consequences of accepting the shares.

How could a tax charge arise up-front?

When an academic gets shares in a spin-out company they are usually subject to the employee-related share ("ERS") tax rules. As a result, if the academic pays less than market value for their shares, then they may have to pay income tax on the difference or undervalue.

In many cases the academic will get their shares when the spin-out company has no assets; before the IP is transferred or the first funding round happens. As a result, the shares might have no value when they are acquired. However, that is not the only time an income tax charge can arise. The ERS tax rules also have provisions that may cause a tax charge for the academic when the IP is transferred or licenced to the spin-out.

If income tax is due at spin-out, it will likely be payable before there is a market for the shares in the spin-out company, so the academic cannot sell shares to pay their tax bill, (known as a "dry tax charge"). This could be a problem if the academic does not have other funds available to pay HMRC.

What is Academic Spin-out Relief?

A tax exemption ("Academic Spin-out Relief") is available to avoid a dry tax charge. Broadly, the relief works by ignoring the impact of the transfer of the IP on the market value of the shares in the spin-out company and therefore seeks to remove the income tax charge on the academic.

For the exemption to apply there must be an agreement to transfer the IP, ("the IP Agreement") from the university to the spin-out company. Transfers can be a sale of the IP or a licence or other right for it. IP is widely defined and includes items like patents, trademarks, registered designs, copyright, information or techniques which have an industrial, commercial or other economic value and goodwill. It is not necessary to have registered the IP.

Transfers of IP by companies controlled by the university, (for example, technology transfer companies), will also usually mean the exemption can apply.

For an academic to fall within the exemption, the right to get the shares in the spin-out company must have happened either because of an employment with the university or with the spin-out company itself. Also, the person must have been involved in researching the IP that is subject to the IP Agreement.

Therefore, employees of the university who get shares because of their contribution to the creation of the spin-out, should be covered by this exemption if they have been involved in researching the IP. Students who are involved in the research of the IP and later become employees of the spin-out may also qualify.

The relief is available not only in the context of universities but can also apply to any institution that does research activities other than for profit, which is not controlled by a person who does activities for profit.

If more than one university or research institution works together on a project, the employees of one would generally be exempt from tax on any IP transferred by the other, if they meet the employment conditions mentioned above.

Although the above might seem simple, there is much complexity around the relief – especially with regards to the timing of steps during the spin-out process. As such we strongly recommend that any academics involved in a spin-out get advice specific to their situation before they accept any shares.

What about funding?

There is also the potential for a tax charge when initial (“seed”) funding is provided to a spin-out company. The legislation specifically states that Academic Spin-out Relief applies only to any value added to the shares as a result of an IP transfer and not therefore to funding.

HMRC have indicated that if the funding happens after the academics have acquired shares, and if there is no specific tax avoidance motive, then an income charge should not normally arise for them. However, it is again crucial to consider the timing of any funding round particularly the agreement of any associated term sheets.

What is a s431 ITEPA 2003 election?

It is likely that academics will be asked to sign a s431 ITEPA 20023 election, (sometimes also known as a restricted securities election), within 14 days of getting the shares. Very broadly this election should protect the spin-out company and the individual from income tax and national insurance when the shares are later sold.

In theory, signing the election could slightly increase any income tax charge arising on spin-out, but if Academic Spin-out Relief applies this is unlikely to be an issue.

What if founders don't qualify for Academic Spin-out Relief?

While the spin-out process can be arranged so that most academic founders qualify for Academic Spin-out relief, this is not always the case. Also, it is possible that not all the founders in the company will be academics – for example it is not uncommon to include individuals from the business community with experience of commercialising IP.

For these individuals it is even more important that tax advice is taken at an early stage in the process. If the tax risks are too high it might be that share options or other share incentives, (for example a growth share plan), might be a better alternative.

What is SEIS / EIS?

The Enterprise Investment Scheme (EIS) and the SEED Enterprise Investment Scheme (SEIS) help smaller higher-risk unquoted trading companies get a competitive edge in securing equity funding. They do so by providing income tax and capital gains tax reliefs to investors in these companies. Qualifying for these schemes may be critical to the spin-out company in securing funding and this may also dictate how the spin-out process is structured.

Academics sometimes ask if they can also benefit from these tax efficient arrangements. This could be a possibility if they invest their own funds alongside the other investors, but the rules are complex, and it is important that specific advice is obtained before the investment is made and preferably before the spin-out company is set up.

What about tax when shares are sold?

If the company is a success and the academics get the chance to sell their shares at a profit, then tax will be due on the gain. The default position is that capital gains tax will apply, but there can be complexities and advice should be taken at the time.

How can we help?

We have extensive experience of working with companies and their founders as they spin-out from universities and other research institutions throughout the UK.

Our practical experience means we can give relevant and pragmatic tax advice, so that any tax risks and opportunities are fully understood, and the parties can concentrate on making the spin-out company a success.

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