

# SMEPlus

## Why are Research & Development (R&D) tax credits important?

R&D tax credits provide potentially substantial tax incentives for companies that incur expenditure on research and development (see below). The tax benefits are different depending on the size of the company.

For SME's, from April 2011 for every £10,000 of qualifying expenditure incurred, the company can claim a deduction of £20,000 (previously £17,500) from its taxable profits. Additionally, loss-making companies can choose either to increase the value of their losses carried forward, or to surrender the tax credits in return for a cash payment. HMRC will repay £25 for every £100 of qualifying expenditure up to the maximum of the PAYE (tax and National Insurance) paid over during the year.

Subject to EU State aid approval, a further enhancement of the relief has been announced. From 1 April 2012, the total deduction will increase to 225% and the cap on repayment by reference to PAYE paid will be removed.

For large companies, the claim is 130% of expenditure. Large companies are unable to surrender their tax credits for a cash payment.

Here are just a few examples of where we have agreed with HMRC that tax relief is due under the R&D provisions. These are not necessarily businesses that are typically regarded as being in the R&D area.

- Making balloons and bunting - mechanise and streamline processes.
- Improving processes for waste disposal.
- Creating a new light bulb.
- Customising emergency vehicles in terms of interior specification, animal crates, safety features, etc.
- Tuning cars to improve performance - software, brakes, suspension, etc.
- Developing new, more environmentally friendly, sandwich packs.
- Creating new food coating and marinades.

### In this issue:

Why are Research & Development (R&D) tax credits important? 01

Enterprise Investment Scheme (EIS) update 02

BASIS - New Venture Capital Relief For Business Angels 03

Time to Pay - restrictions because of dividend remuneration policy 04

For further information, please contact **Cathy Corns, Tax Partner** on 01908 605552, or alternatively email [cathycorns@mercerhole.co.uk](mailto:cathycorns@mercerhole.co.uk)

# Enterprise Investment Scheme (EIS) update

There have been a lot of changes to EIS for the current year, more are scheduled from April 2012 and a recent consultation includes some further proposals. We thought it may be useful to set out where we are now, what the position is from 2012 and what further changes are envisaged.

## The key changes can be summarised as below:

	2011/12	2012/13
Investment limits		
Minimum personal equity investment	£500	£500
Maximum personal equity investment	£0.5 million	£1 million
Maximum company annual limit	£2 million	£10 million
Qualifying company		
Not an excluded trade	✓	✓
Feed in Tariff business added to excluded list	-	✓
Gross assets limits	£7 million	£15 million
Number of employees not more than	50	250

### Certain issues are the same for 2011/12 and 2012/13

The company must not be regarded as in difficulty under the EU guidelines. The tests on connection, return of benefits, shareholdings, etc. must be met for at least three years.

### Income tax relief & capital gains exemption

Income tax relief is set at 30%. Insofar as income tax relief is obtained, capital gains may be exempt on exit after three years.

### Shares

EIS shares must be new, fully paid ordinary shares with no preferential rights to income or assets currently or in the future. HMRC regard anti-dilution provisions as preferential rights.

### Qualifying individuals

These are, broadly, UK taxpayers who, together with their associates, meet certain conditions:

- Connection - need to own not more than 30% of the share capital, votes and share and loan capital combined.

- Are not employees.
- Are not paid directors before the initial investment. However, where paid directors had an original qualifying subscription, future subscriptions for shares may still qualify.

### Future proposed changes

#### Eligible shares

The Finance Act 2011 changed the definition of eligible shares for VCT investment such that essentially all ordinary shares will qualify unless they have:

- A preferential right to assets on a winding up; or
- Redemption rights; or
- Preferential dividend rights where: The shares have capacity for the amount of the dividend to be varied; or the right to receive dividends is cumulative.

The government is considering replicating these changes for EIS investors.

The government is also considering removing the restriction on anti-dilution provisions if this can be achieved without reducing the risks of investment.

### 30% connection test

Currently individuals are debarred from relief where they (alone or with associates):

- Control the company.
- Hold more than 30% of the combined share and loan capital.
- Hold more than 30% of the votes.
- Are entitled to more than 30% of the assets on winding up.

Associates include business partners, certain trustees, spouses or civil partners, parents, grandparents, children, and grandchildren, but excludes siblings.

The government proposes to remove the restriction on loan capital other than on loans which carry the right of conversion into shares.

### Anti-avoidance provisions

There are also proposals to tighten up on companies which are effectively created solely for the purposes of obtaining relief, and on companies raising funds for acquisition, such that the group must still meet the size conditions when the target(s) is acquired.

For further information please contact our **Tax Partners Cathy Corns** or **David Mansell** on 01908 605552

# BASIS - New Venture Capital Relief For Business Angels

The Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) reliefs were originally designed to address the equity gap for businesses where funding requirements were between £250,000 and £2 million. The increases scheduled for April 2012 are designed to extend the scope from £2 million up to £10 million.

However, the government recognises the need to encourage investment for the smallest companies and start ups. Accordingly, it is consulting on a new venture capital scheme targeted at seed level investment by business angels – the Business Angel Seed Investment Scheme (BASIS) designed to:

- Address the fund-raising issues faced by start up businesses.
- Encourage investment from business angels.

The proposal is that the scheme will provide tax relief at a higher rate than under EIS (currently 30%) and on a wider basis of investment. However, both the target company and the investor would be more closely defined than under the current EIS or VCT schemes.

The consultation document addresses three key issues:

- What is a seed stage company?
- What constitutes a qualifying investment?
- How do you define a business angel?

## Seed company proposed definitions

The proposals outlined indicate that a seed company would be one with certain characteristics, including:

- Not yet started to trade.
- No sales contracts in place.
- Gross assets under a specified limit.

- Preparing to trade, eg by developing prototypes, creating a business plan, negotiating contracts, etc.
- Not yet engaged in large scale commercial manufacturing.

One difference from EIS is that the intention of the proposals is not to require the company to start trading within a specified period. However, the monies raised will be required to be spent during the seed stage activity.

## Type of investment

It is envisaged that qualifying investment could be made by way of equity and loans. There is likely to be a minimum equity requirement, currently indicated to be at least 70%. In those circumstances it is proposed that equity could include some form of unsecured finance where the return is based on the results of the company.

The overall investment limit, though, is likely to be lower than £500,000.

## Business angels

The EC definition of business angels refers to wealthy private individuals who invest directly in young, new and growing unquoted businesses and provide advice to the businesses. Their investment is usually by way of equity, but they may also provide other long-term finance.

The government proposal is for a business angel to be classified as an individual who:

- Has previously invested in four or more seed stage companies.
- Is a director of the target company, or provides other support or advice.

The consultation expresses a concern that individuals may take up nominal positions on boards without making a real contribution, just to facilitate relief, and does not want to encourage this. However, the government also wishes for the scheme to be flexible enough to permit investment by both individuals and syndicates.

## Summary

There is potential for the new relief to be attractive to certain investors who have an interest in helping to create and develop new companies. The tax relief appears to be relatively generous and could well encourage investment.

The key concern is on the definition of business angels, particularly the requirement for previous investments. Hopefully the legislation will permit earlier EIS investments to count toward this.

For further information please contact our **Tax Partners Cathy Corns** or **David Mansell** on 01908 605552

# Time to Pay - restrictions because of dividend remuneration policy

HMRC's stance concerning 'Time to Pay' (TTP) arrangements is that TTP will not be available where companies are paying out dividends to their shareholders. It is HMRC's opinion that the cash should be used to pay tax before paying dividends the company cannot afford!

This will clearly hit hardest those companies where directors have chosen to receive remuneration on a dividend basis rather than by way of salary. The adoption of HMRC's stance means that two businesses in a similar financial position will receive different levels of support simply because of the way in which their directors have chosen to be remunerated. One has to question the fairness of this approach from a commercial standpoint, although it is quite difficult to argue against the principle taken by HMRC of not paying dividends when a company cannot meet its operating costs.

Even for those companies who do not operate a dividend policy, there is still the hurdle of persuading HMRC that remuneration levels are not 'excessive'. HMRC, when considering TTP applications, will consider whether the level of directors remuneration is appropriate given the financial difficulties of the company. If they are not satisfied then clearly TTP will not be granted.

It is clear that HMRC are slowly but surely restricting the circumstances in which they are prepared to provide assistance with TTP. It was never intended that HMRC should be a long

term source of funding but simply provide financial support at a time when all else has failed. HMRC are likely to continue to apply more stringent tests, and future applications will require careful consideration before presentation to HMRC.

**Peter Godfrey-Evans is a Restructuring & Insolvency Partner at Mercer & Hole.** If you would like to discuss this article with Peter, you can call him on **01908 605552** or [petergodfrey-evans@mercerhole.co.uk](mailto:petergodfrey-evans@mercerhole.co.uk)

Would you like to receive more information from Mercer & Hole? We produce a range of publications throughout the year, including Tax Plus and Charities and Not-for-Profit Plus, if you are interested in receiving either of these publications or an e-version of this publication, please email [natalieclare@mercerhole.co.uk](mailto:natalieclare@mercerhole.co.uk).

## About Mercer & Hole

Whether you are a business or charity, an individual or representing your family in seeking assistance, the Partners of Mercer & Hole can help you with much more than standard accountancy or tax compliance. We take the time to understand our clients' current situations and their future aspirations, and we aim to provide a very personal service tailored to their specific requirements. We achieve the highest standards of technical excellence, but what we believe singles us out is our passion and determination to exceed our clients' expectations.

Our personal, partner-led service extends far beyond the UK, as Mercer & Hole is a founding member of TIAG (The International Accounting Group), a global alliance of

high quality, independent accounting firms, which has more than 100 member firms based in over 60 countries. We use the Group, or its sister network, TAGLaw, whose members include over 150 law firms based in nearly 100 countries, at least once a week responding to both the business and personal issues of our clients.

This newsletter will give you an insight into the firm and you can find out much more by visiting our website at [www.mercerhole.co.uk](http://www.mercerhole.co.uk). The site includes full details of the services we offer, and also provides visitors the opportunity to subscribe to our blogs, which offer regularly updated comments and solutions to topical issues facing organisations and individuals.

This newsletter is a short selection of items extracted from complex legislation. Further specific advice on any matters referred to must be taken at all times. The information is given for general guidance only and publication is without responsibility for loss occasioned to any person acting or refraining from acting as a result of the information given. No part of this publication may be reproduced without the prior permission of Mercer & Hole.

### St Albans

T: +44 (0)1727 869141  
[stalbens@mercerhole.co.uk](mailto:stalbens@mercerhole.co.uk)

### London

T: +44 (0)20 7353 1597  
[london@mercerhole.co.uk](mailto:london@mercerhole.co.uk)

### Milton Keynes

T: +44 (0)1908 605552  
[miltonkeynes@mercerhole.co.uk](mailto:miltonkeynes@mercerhole.co.uk)

[www.mercerhole.co.uk](http://www.mercerhole.co.uk)

[www.smeplusblog.com](http://www.smeplusblog.com) [www.insolvencyblog.com](http://www.insolvencyblog.com) [www.taxplusblog.com](http://www.taxplusblog.com)



Mercer & Hole is registered by the Institute of Chartered Accountants in England and Wales to carry out company audit work. M&H Financial Planning is the trading name of M&H LLP which is authorised and regulated by the Financial Services Authority. M&H LLP is a Limited Liability Partnership registered in England No. OC335040.