Lack of capital and onerous HMRC rules are restraining tech start-ups

THE chancellor's announcement this week that employees could get a stake in their companies in exchange for waiving certain employment rights was a rare flash of creativity from the Treasury.

But it will come as no surprise if, in a year's time, the opposition starts impishly asking how many businesses have made use of the chancellor's big new idea. With this in mind, now might be the time to consider alternatives for stimulating growth via the government's approach to share ownership. As ever, the key lies in reducing complexity.

At a recent City roundtable discussion on intellectual property, I met a former engineer and investment banker who helps technology start-ups. A few years ago, he had worked as a part-time chief financial officer for a tech spin-out from one of Britain's top research universities. Backed by a quasi-governmental venture capital fund, the technology was sold prematurely to a large French company. It had proved impossible to eke out limited venture capital to expand the fledgling enterprise. I was told that had it not been for the complexity of HMRC's rules and an equity gap in first stage venture capital, the Treasury would by now be gayly receiving fresh job and corporation tax receipts.

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New tech businesses are typically nucleated when a piece of intellectual property is picked up by a small team of high calibre executives who practically apply and market the technology. It is not difficult to get the seed funding of £50,000-£250,000 necessary for these start-ups to achieve lift off. The founders' own resources, or those of business angels, can be tapped, and new government mechanisms – such as the Seed Enterprise Investment Scheme – incentivise investment in early-stage companies. It is the next part of the corporate journey – obtaining £1-5m in first stage venture capital – that represents the greatest stumbling block to expansion.

The structural shortage of this type of funding in the UK is exacerbated by the fact that prior to generating any revenue, a large share of these start-ups' funds goes towards paying executives' salaries. It is the taxman, therefore, who gets much of this venture capital through employer and employee national insurance and PAYE tax – somewhat ironic in instances where a quasi-public source has granted the venture capital funds.

To avoid this problem, a number of start-ups eke out their venture capital by rewarding executives with "sweat equity". Since many are in the 45-60 age bracket, they tend to have an existing financial cushion that leaves them prepared to work for "free" in return for shares. However, HMRC currently insists that those shares are valued and treated as taxable salary. In order to pay the tax charge associated with the granting of shares for which there is no liquid market, executives must raid their savings. In short, when a start-up fails, executives will have paid from their own pockets for the privilege of working for free.

Partial workarounds are in place based on approved share option schemes and the recognition of capital losses on shares in companies that fail.

> Obtaining first stage venture capital is the greatest stumbling block to expansion

But these are complex, costly to administer, and hard for many small and medium-sized enterprises to understand. As a result, many corporate mentors simply don't get involved, their wisdom and experience lost in the process.

The government could solve this problem by allowing qualifying early stage tech companies to reward executives with shares on an ad hoc basis that could be held escrow by HMRC, but would not crystallise any taxation in the year they were awarded. Instead, a tax charge could be levied (on the individual rather than the company) on withdrawal of the shares from escrow, which presumably would only happen once there was a liquid market for them that would establish their fair value.

The downside for HMRC would be the delay in levying tax, but the only net loss would be the employer's national insurance. And the simplicity of collecting the tax would more than offset this. Also, if venture capital was used not for meeting PAYE bills but expansion and development, it would be HMRC that would reap the reward from the uplift in economic activity.

If the chancellor is looking to prove that rejigging HMRC's approach to shares can tick the box for economic growth, this could be a handy extra weapon for his arsenal.

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