

Enterprise

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Foundations
for growth
The language
of entrepreneurs



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Hello ...

... and welcome to **Enterprise: a magazine that speaks the language of business and covers some of the burning issues facing today's entrepreneurs.**

Produced by the Entrepreneurial Business Team at Deloitte, **Enterprise** is a publication which will showcase some of the thinking and expertise of our highly experienced professionals. We advise many of the entrepreneurs behind today's household names from their very earliest stages. Our ambition for this publication is to provide our readers with thought provoking articles based on our experience and to foster wealth creation in the entrepreneurial business community.

The current economic challenges are far reaching and continue to persist. Despite this, there are opportunities for the entrepreneurial spirit to prevail. Whilst the business models for some will require a major re-think, others will evolve and strengthen over time.

The challenge for any entrepreneurial business is to achieve sustainable growth. Maintaining and supporting what you do well now, and growing the core to focus on building a successful future.

Whatever stage you are in that cycle, we hope the following articles will help you in your planning for the long term.

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Getting off to a

Enterprise Investment Scheme tax

Of the various tax reliefs available for investors in entrepreneurial businesses, the Enterprise Investment Scheme (EIS) is arguably the most generous. It can provide valuable tax savings provided the investor and the company meet all of the conditions.

With the demise of CGT Taper Relief (effectively raising the tax rate on unquoted trading company shares from 10% to 18%) and the limitations to the new Entrepreneurs' Relief (CGT on the first £1 million of qualifying lifetime gains capped at 10%) EIS relief could become an increasingly attractive option – both for investors and for companies wanting to raise funds.

The EIS tax benefits include:

- Income tax relief of 20% of the investment in the year the investment is made;
- No CGT on the sale of EIS shares if they are held for more than three years;
- Rollover of existing capital gains into a new EIS qualifying investment (deferring the CGT until the new investment is sold);
- Losses on EIS shares can be offset against other gains or income.



good start

relief

The small print

As you might expect, there are strings attached. EIS relief is specifically targeted at unquoted trading businesses and it is vital that great care is taken to ensure that all the necessary conditions are met.

The key conditions include:

- The investment must be by way of a subscription for new shares issued by a company, not the acquisition of existing shares.
- The company must be carrying on a trading business, not investment activities.
- A number of trading activities do not qualify for EIS (for example, dealing in land, shares and securities, financial services).
- The income tax relief of 20% of the investment is up to a maximum investment of £500,000 for each investor.
- The company's gross assets must not exceed £7 million before the capital raising and £8 million afterwards.
- The number of full-time equivalent employees of the company must be less than 50.
- There is a rolling maximum investment limit for EIS funds raised by a company of £2 million each year.
- The company must use 80% of the funds raised for the purpose of a qualifying business activity within 12 months and the rest within 24 months.

Some of the conditions must be met only at the time when the placement of shares takes place. Other rules are more enduring which means that investors and business managers need to keep a watching brief to ensure that investments continue to qualify as businesses grow and evolve.

A process exists whereby companies seeking to raise funds through placement of shares can seek advance assurance from HMRC that investors and the company will qualify under the EIS rules. As a case study example, advance assurance was secured for a new venture within an existing business which was structured to qualify for EIS, even though the existing business itself did not.

EIS – the key points

- EIS is a tax relief for individuals investing in trading companies.
- Very attractive income tax and CGT reliefs are available.
- The savings are now even more attractive as effective CGT rates have increased for most entrepreneurs.
- Advance clearance is available from HMRC that companies meet the relevant conditions.
- Potential third party investors may ask whether or not your business is EIS qualifying.

Money for

Applying for grant funding



nothing?

By exploring the many grants available, testing the full range of options and scenarios, and determining the compelling reasons for the business to receive them, the full potential to benefit from grants can be explored.



The current economic challenges facing entrepreneurial businesses are good reason to review the varied range of grants and incentives available in the UK.

The government is especially keen to encourage Research and Development and the creation of intellectual property, the 'knowledge economy'. There are also many UK regions which the EU designates as areas requiring special assistance. One of the main grants available for business, Grants for Business Investment, is available at most stages of the business lifecycle, especially on projects which involve capital investment and the creation or safeguarding of jobs. Some of the criteria and processes have been relaxed or simplified. In addition, there has been a recent decline in applications, as you might expect, so there is potentially a larger pool available to successful applicants.

Government agencies responsible for awarding grants will look specifically at whether a project is likely to create or retain jobs. However, more than this, the agencies will consider the merits and qualities of the jobs being provided. Many grants are now targeted at 'smart' businesses involved in carrying out research and development and in creating intellectual property. The aim is to reward businesses which are at the cutting edge of developments and which can advance the UK in the international market place.

Application is key

Applicants should approach the grant process as thoroughly as any other application for finance with a well considered, articulated and presented plan. The application process requires sufficient time and adequate resources.

How it works

There are three main steps applicants should consider to maximise their likelihood of receiving a grant.

1. Exploring all the available opportunities for grants and understanding their requirements and application process.
2. Preparing a business plan, detailing the project and highlighting how the grant will achieve real outputs. This is sometimes referred to as 'the additionality'.
3. Preparing your case, discussing this with stakeholders and dealing with any subsequent queries and negotiations needed in finalising the grant.

The first stage is the most vital as, by exploring the many grants available, testing the full range of options and scenarios, and determining the compelling reasons for the business to receive them, the full potential to benefit from grants can be explored. This will help your business to apply for the correct type and level of grant, and to ensure you have enough money to complete your project.

Secondly, it is essential that each project is presented properly. You must be able to show that your company is willing to invest in a project and is looking for a "partner" to share some of the risk – rather than simply to foot the whole bill. Grants are there to make something happen that would not otherwise occur. So, when reviewing a project, the relevant agency is likely to consider not only its viability, sustainability and funding, but also take a view on a wide range of intangible benefits and multiplier effects on the regional and national economy.



As a case study example, a company was looking at grant opportunities in order to set up a new facility and production line which they believed would directly create around 30 jobs. On the face of it, this project did not appear to be a candidate for major grant funding. However, once some initial feasibility work had been carried out and the full upstream and downstream possibilities of this investment had been explored, it became clear that its success would lead to increased production and over 300 jobs. This understanding of the bigger picture enabled the company to increase the grant obtained from £150,000 to £1.5 million based on the potential of the business.

The Government has also extended support for small and medium size businesses in the form of three new schemes initially announced in the 2008 Pre-Budget Report and operational in the first quarter of 2009.

The £1 billion **Enterprise Finance Guarantee**, which commenced in January, provides a 75% guarantee on individual loans to viable small and medium sized businesses which otherwise might have been seen as too high-risk in the current climate.

The **Working Capital Scheme** provides banks with guarantees covering 50% of the risk on existing and new working capital portfolios of up to £20 billion. This scheme is available to participating banks in respect of portfolios of creditworthy businesses of up to £500 million annual turnover.

Finally, the **Capital for Enterprise Fund** is a £75 million fund made available to convert businesses' debt into equity. The funding will come from the Government and Barclays, HSBC, Lloyds TSB and RBS and is aimed at small and medium size businesses which have exhausted their normal borrowing capacity. Eligible businesses must have an annual turnover of up to €50 million or annual balance sheet total of up to €43 million and less than 250 employees.

Key points

- A wide range of grants and incentives are available in the UK.
- Grants are a vital source of development capital and can help reduce the risk associated with business projects.
- Grants can be available at all stages in the life of a business and can fund a range of activities.
- They are particularly attractive for projects involving research and development and the creation of intellectual property.
- Applying for a grant requires sufficient time and resources but it can reap major rewards.

Benefiting from the boffins

Research and Development tax relief

Research and Development (R&D) expenditure is a prominent issue for many entrepreneurial businesses as they seek access to new markets. The ever pressing need to improve products and processes and create bespoke solutions is a constant driver. In a climate where cash is king, the rewards for undertaking R&D activities can be generous and provide significant tax savings and cash flow improvements.

Unfortunately, too many businesses either overlook R&D tax relief entirely, believe it to be insignificant or attempt in-house claims without fully considering the extent of their entitlement. In our experience from over 700 claims which have generated more than £3bn of qualifying expenditure agreed with HMRC most entrepreneurial businesses tend to initially underestimate their entitlements to claim R&D tax relief.

A case study which illustrates this is where a fast growing business made a multi-million pound investment with a third party to develop an automated assembly process. Even though the payments were made to a third party, the intellectual property rights in the research and development remained with the payer company. The subsequent claim featured the third party sub contracted R&D costs and a sizeable cash flow benefit was obtained.

It all adds up

In brief, expenditure on qualifying R&D activities in a profitable small or medium sized enterprise (SME), can benefit from a 175% tax deduction. A loss making SME can surrender tax losses for cashback of up to 24.5% of expenditure. If capital expenditure is necessary to support your R&D activities, then a 100% corporation tax deduction in the year of expenditure is available.

What is an SME?

An SME is a company (including associated group companies) with fewer than 500 employees and an annual turnover not exceeding €100 million and/or a balance sheet total not exceeding €86 million.

What expenditure qualifies?

The current guidelines on the meaning of R&D make it clear that activities which seek to achieve an advance in science or technology through the resolution of scientific or technological uncertainties are R&D, provided the solution is not readily available to or deducible by a competent professional working in the field. So, the good news is that any development work where the personnel face considerable technical challenges has the potential to qualify for the tax relief.

Key points

- From 1 August 2008, small and medium sized enterprises can claim 175% of their qualifying revenue costs.
- If your business has overcome technological challenges to develop products, processes, materials or services, then you may qualify for generous R&D for incentives.



In brief, expenditure on qualifying R&D activities in profitable SMEs can benefit from a 175% tax deduction.

Going public

Listing on the Alternative Investment Market



The classic reasons to float a business are to access capital, raise profile and create a liquid market for its shares.

These benefits must be balanced against an increase in regulation, public accountability and scrutiny. A board considering an Initial Public Offering (“IPO”) must have empathy with the City, enjoy talking to analysts and embrace a stewardship relationship with its new shareholders. For a board that prefers privacy, funding from private equity or the banks might be preferable.

It is important to understand that the IPO market is cyclical and is occasionally reduced or ‘closed’ as a result of wider economic concerns. The liquidity crisis and the impact of the recession is a good example of this. However, businesses that still intend to float this year or who are postponing a planned floatation until the markets improve need to consider the timing and process carefully.

The Alternative Investment Market (“AIM”) is the most logical market for companies with valuations up to circa £200 million. For smaller companies, with valuations of less than £25 million, the investor audience would likely be orientated towards Venture Capital Trusts and private client brokers. Some other advantages of AIM over the main market include less regulation of acquisitions and equity issuances and certain tax benefits. There is also more sympathy towards companies maintaining significant management or founder shareholdings, allowing control to be preserved.

There is a misconception that IPOs allow management entrepreneurs and shareholders to engineer a substantial exit. Our current experience is that shareholders of an established business may be able to sell down between 25% and 30% of their ownership through an IPO. For younger businesses, this might be much less.

An average IPO takes a minimum of 3–4 months to deliver and encompasses an intensive phase of legal and financial due diligence, documentation and marketing. Then there are stock market conditions to consider. Put all this together and the process can stretch over a much longer period.

Appointing a nominated advisor, called a NOMAD, at the outset is critical. This should ensure the entire flotation process is carried out in a structured and controlled manner. It is normal for there to be a period of grooming ahead of the flotation process to enable the company to meet the more rigorous regulatory requirements of being a public company and so as to maximise its potential valuation on IPO. Examples here include: selling non-core assets, reducing debt, strengthening accounting systems, tax planning, designing and implementing appropriate remuneration and incentive schemes for management and appointing non-executive directors.

In summary, planning an AIM flotation can be a viable option for a successful entrepreneurial business. Appointing the right financial adviser/NOMAD early in the process is important.

Key points

- AIM flotations enable companies to access capital, raise profile and create a liquid market for their shares.
- AIM is the most logical market for companies with valuations up to circa £200 million.
- The AIM market is sympathetic to significant management or founder shareholdings being maintained.
- A period of grooming ahead of the flotation process is advisable.



Grooming

Understanding the sales process

When considering a sale, there are both internal and external factors to take into account. These will affect price and the marketability of a business.

Important internal factors affecting a sale include the track record of the business, underlying quality of assets, future profitability, the retention of key personnel and whether the purchaser sees an opportunity to create additional value.

External factors will include things such as stock market conditions and the market dynamics in the particular sector. The current conditions in the debt markets and the potential impact on underlying value should also be considered when contemplating a sale.

The process

Forward planning is essential.

Ensuring that all legal affairs are up to date is part of preparing a business for sale. Any sale process will involve substantial legal paperwork.

There will also be commercial factors to consider such as resolving or minimising potential issues which could delay a sale. This would mean looking at contentious areas such as outstanding customer or staff disputes or pension scheme funding.

Once the decision to sell has been taken, creating a structured and tight timetable for the process is crucial in establishing and maintaining best value. This will also serve to minimise the risks associated with a sale process, including adverse reaction of customers or suppliers if they hear rumours the business is being sold.

Various actions can be employed to achieve this objective including:

Prospectus

Production of a sale prospectus to include information on what the business does, where it is situated, its markets, financial performance and any other information which will help attract a buyer.

Vendor-initiated due-diligence

Any purchaser will require independent verification of the information presented by the vendor. Initiating these reports prior to marketing can substantially reduce the time taken to complete the transaction.

Bid points

Structured bid points during the process allow the vendor to assess the purchasers' appetite, without releasing too much confidential information. This also serves to increase competitive tension which is key to driving best value.

In this way, purchasers are asked to reconfirm price and terms at each bid point having seen additional information. This should reduce conditions attaching to their offer whilst maintaining the offer at original terms. The over-riding objective is to move purchasers from indicative/non-binding offers in the first round to an unconditional binding offer, completed in short order.

the business

Sources of funding

Various types of institutions might provide sources of finance if vendors are contemplating a partial sale of equity or a sale to second tier management. These include banks, private equity houses and public sector funding. Before raising finance, it is good practice to prepare answers to questions which providers are likely to ask. Any finance provider will focus on the balance sheet and future cash flows of the business.

These types of transactions are proving more complex, and taking longer to complete, in the current economic environment. Bank funding is not readily available and this severely impacts the private equity funding model. There is even more reason, therefore, to plan effectively for the transaction process and for vendors to appreciate that valuations are unlikely to reach levels seen in recent years.

Key points

- Planning, and timing your exit well, is vital to a successful sale.
- Grooming the business ahead of time shortens the timeframe of the sale process.
- Finding a buyer should be a targeted exercise.
- Vendor due diligence and a well run process helps the vendor stay in control .



The downturn

The current business environment makes it all the more vital to maximise cash through tax efficiencies and good housekeeping. The checklist below is a quick reference guide for entrepreneurs highlighting some key opportunities.

Corporation tax	
Monetise losses	Avoid trapped losses in group companies. Consider changing accounting period to increase the possibility of loss carry back. Make use of 3 year terminal loss carry backs by transfer of profitable activities to a new entity. Conduct a detailed review of overseas EU tax losses: claim those where there is no future possibility of recovery.
Group issues	Avoid up-front intra group stock profits: consider sales on consignment within group production chain. Review to maximise R&D claims and Capital Allowances. Review transfer pricing methodology to ensure it is not overstated. Relocate income to low tax jurisdictions where possible.
Good housekeeping	Reclaim overpaid tax. Reduce tax payment estimates where appropriate. Ensure cash not wasted on penalties by timely compliance filing.
Defer profits	Consider changing accounting period to defer tax on profit spikes.
Tax efficient expenditure	Ensure you claim all available relevant reliefs. Review timing of expenditure to ensure claim for specific accruals. Ensure deductible costs are in the right place from the outset.
VAT efficiency	
VAT accrual	For tax invoices received but not processed businesses typically claim 25-40% of input VAT later than necessary. Consider one-off adjustment for this.
Invoice planning	Review the format and timing of invoicing & self billing arrangements to aid cash flow (proformas or requests for payment rather than tax invoices).
VAT recovery	Improve VAT recovery on trade debts older than 6 months. Capture VAT on employee expenses and pension fund costs.
Customs duty	Review product classification and valuation procedures. Consider bonded warehouse arrangements to defer duty.

checklist

Personal tax

Good housekeeping	Ensure you utilise allowances, exemptions and spouse basic rate bands. Consider remortgage planning to reduce borrowing costs.
Losses	Income tax relief may be available for losses on unquoted shares in trading companies. Sole-trading losses can be offset against other income and gains.
Owner managed businesses	Maximise Entrepreneurs' Relief for management or family stakeholders by reorganising the share capital. Take advantage of the temporary extension of the loss carry-back rules to help struggling businesses. Consider restructuring e.g. transfer of a trade to LLP.
Inheritance tax strategy	Review the tax efficiency of your Will. Consider making lifetime gifts to family to reduce tax on death estate. Think about transferring assets while values are depressed in the current climate. Trusts: would they help or hinder you? Review whether Business Property Relief is available: potential 50% or 100% exemption from inheritance tax.
International & non-UK domiciled	Remittance Planning: the new rules are complex and contain many pitfalls. Review your offshore structures/bank accounts to ensure you don't fall foul of the new rules. Make use of your non-domiciled status as far as possible.
Real estate	Is the way you hold UK or overseas property tax efficient?

Cash

Customers	Be firmer – ensure that overdue accounts are chased quickly, but fairly. If you offer certain customers preferred terms, can you tighten these without damaging the relationship?
Suppliers	Talk to them. Discuss extending payment terms. Whilst they are likely to be under pressure too, if you are a reliable customer with a good payment history, they may be willing to temporarily relax payment terms.
Bank financing	Banks don't like surprises so communicate regularly. Keep them informed and don't be afraid to discuss additional funding if you have a plan or an immediate need, but always think ahead.
Information	Make sure you know what's happening with every penny in your business or, more importantly, that you have the ability to find out. A good financial system will pay for itself in no time.
Costs	Are there areas of fat that can be trimmed? These may not be apparent to those close to the business, so sometimes an outsider can identify opportunities that won't adversely impact performance.
Operations	Is your technology or machinery up to date? Whilst capital expenditure may be off the agenda, even small steps to improve your process can save time and money, and improve profitability.
VAT	Scrutinise your payments. Many businesses overpay and fail to claim possible rebates. Take advice if you are not clear on how to do this.
Currency	If you source materials overseas, can you protect yourself and improve your ability to plan by using derivatives to guarantee price? Not for everyone.
Credit insurers	Increasingly important both as a customer and supplier. Ensure you have a good relationship and shop around for the best terms.

Substantial Shareholding Exemption

A valuable relief not to be overlooked

Substantial Shareholding Exemption (SSE) gives many groups of companies the ability to sell subsidiary trading companies without liability to tax on any gain.

SSE is a generous tax exemption available to many companies who own 10% or more of trading companies. It should be considered when structuring groups of companies, whether in an existing group or with new acquisitions. As a case study example, a fast growing media company that wished to sell the assets of a business at a gain was facing a substantial corporation tax exposure. SSE enabled them to sell the company shares instead resulting in no tax on the gain.

Given the potential value of this exemption, groups should review their current structure to see whether or not they can benefit. Of course there are conditions which need to be satisfied before the relief is claimed. Planning may well be possible to increase the availability of the exemption. Even where no sale is currently contemplated, a group structure that enables tax-free disposals may be a commercial advantage, allowing increased flexibility in response to future changes.

Key points

- SSE is a tax relief allowing trading groups to sell 10% plus holdings in trading companies tax free.
- It increases capital available for re-investment by the group.
- SSE allows more flexibility when restructuring groups of companies.



The Entrepreneurial Business Team at Deloitte

Ours is a highly skilled team combining expertise from across the firm, and providing tailored business and personal solutions. We help entrepreneurs address the complexities of today's market through our integrated service offering across audit, tax, consulting and corporate finance.

The challenge for any entrepreneurial business is to strike the balance between sustainability and growth. Maintaining and supporting what does well now, and growing beyond the core to focus on building a successful future.

Accordingly, a passion for exploring new avenues and developing bespoke solutions is an integral part of the way we work. Our commitment to innovation and fresh thinking helps keep our clients ahead of the game.

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