How to Run a Mobile App Company – Legal, Financial, Fiscal and Exit Issues
Further Information and Disclaimer

This is general guide and no substitute for proper professional advice. All content, figures, rates and bands are believed to be accurate at time of writing but should be checked at time of reading. To this end, the contact details of the authors are set out below:

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1. **INTRODUCTION**

This E-book is intended mainly for mobile applications developers who are looking to build a legal structure for the commercialisation and development of what might start as a single App but have the potential to become a stand-alone business.

Businesses are waking up to how the horizons of commercial life are being opened up by mobile App technology. Thus, another key audience of this book is the business which already has a digital presence through a website but wishes to enhance its business, reach a wider audience and expand the breadth of customer utility through offering a mobile App.

While seemingly disparate, these two groups share a key concern; neither can be presumed to know much about the legal and business admin issues specific to building Apps, which will be downloaded and used by third parties.

These third parties could be existing or new customers wanting to interact with you on their iPad or videogamers trying out your latest 'hot' offering.

1.1 **Brand New World**

The most ‘switched on’ businesses are alive to the promise and the dangers of the vast, enticing and potentially business-defining brave new world of stand-alone applications. These may interact with other products, social networks, databases, portals and other resources to provide an experience which is as much defined by its technical reach as by the product or service which lies behind it.

This e-book is for those who realise that the uniqueness of the mobile App and its ever accelerating development poses challenges little understood, and thus best addressed by getting a little guidance from professionals dealing with these issues on a daily basis.

This is what we aim to do. We hope that it will allow you to avoid the worst pitfalls, pointing out the correct steps to protect yourself and probably most importantly; helping you to get the best outcome when you do have to spend your hard earned cash on essential professional advice.

1.2 **Choosing Professional Advisers**

Starting your own business obviously entails a multitude of decisions, decisions which can seem overwhelming without the right players on your team. In order to succeed, you need to equip yourself with every tool at your disposal.

One of the most cost effective tools you can utilise is the expertise of a specialist. The right accountant and solicitor can eliminate a host of problems and potentially costly errors you might make as you build the financial foundation of your successful business.

As any coach can tell you, having a first rate striker (you) won't guarantee a winning team without a first rate line of defence. The right accountant and solicitor is your
best defence. Their expertise can help save you money that in turn can be used to increase profits.

When enlisting the expertise of an accountant and solicitor, you want a specialist suited to meet your specific needs. You want a specialist who will listen to you. More importantly, you need someone you can and will listen to, as they devise strategies to help you to succeed. The right professionals will be interested in you and how your business works.

2. LEGAL ISSUES

A. INTELLECTUAL PROPERTY RIGHTS

Protecting intellectual property is essential for all businesses with a creative profile or whose originality and home grown innovative processes are significant business advantages. Angels and VCs usually ask about steps you have taken to protect these. If you claim to own important IP or other commercially exploitable creativity and haven't protected it, your credibility will plummet.

The route to achieving this isn't necessarily obvious, so you need to check through the key issues listed below, consider how they apply to your situation and discuss them with a professional.

Even if you unwittingly trespass on another party's ownership rights, you will be liable. You might think that you are not worth suing as a small start-up, but this could well come back to haunt you later, so be prepared.

Intellectual Property Rights is a term that covers a wide range of concepts. In the context of App development, the only ones likely to be relevant are copyright, database right, patents, trademarks and domain names so we will briefly consider each of those.

2.A.1 Patents

These are intended to protect novel ideas i.e. ideas which advance the “state of the art”.

This type of protection is powerful as it gives a monopolistic exploitation right. However, it is territorial which means that a successful application in one territory will not provide you with protection in any other territory. Thus, you could choose to apply to the United States Patent and Trademarks Office (http://www.uspto.gov) for a US patent, the European Patent Office for a European patent (http://www.cpo.org) or the UK Intellectual Property Office (“IPO”) for a UK patent (http://www.ipo.gov.uk).

Whereas, UK patents and US patents are unitary and cover only the territory in question, the European patent groups together separate nationally-enforceable and nationally-revocable patents.

The IPO is less disposed to granting patents for software than its US counterpart as computer-implemented inventions which merely solve a business problem using a computer, rather than a technical problem, are considered to lack the necessary
“inventive step” and are therefore unpatentable. However, if it also solves a technical problem then this is far more likely to find favour with the IPO.

A UK patent lasts for 20 years from the date of filing the patent application.

2.A.2 Trademarks

The key thing to remember about trademarks is that they only protect the brand not the underlying App.

Like patents, these are territorial in nature and obtaining a registered trademark necessitates an application to the IPO. Trademarks can protect names or brands, words or logos and even smells. Success depends on various factors, notably distinctiveness. For example, a very descriptive name e.g. “themobileappcompany” will be very unlikely to secure trademark protection whereas an original distinctive App company name e.g. “charcoalmix” would be highly likely to succeed.

Trademarks can be registered or unregistered. The former provide very strong monopoly-type protection whereas the latter depend on evincing the creation of sufficient goodwill in a particular name and its association with the product/services in question.

A registered trademark lasts for 10 years from the date of registration but may be renewed.

2.A.3 Domain Names

These are largely available on a “first come first served” basis and it is advisable to protect your key brand(s) by registering the name with the key suffixes, notably .com, .net, .mobi and, if you are in the UK, .co.uk. Pluralised and hyphenated variants should also be covered.

You should, however, be cautious about registering any names which are likely to infringe on the rights of third parties who have already registered identical trademarks or domain names. There are various levels of check that can be carried out to minimise that risk. It is wise to start with Google.

If someone gets there before you and you don’t have any established goodwill in the name in question, you should probably re-consider your brand before you cross swords. If on the other hand you have got an established brand and, ideally, an associated registered trademark you may well be able to wrest control of the brand via dispute resolution or court proceedings.

A good way to get a global view of what is already registered is by visiting the facility at www.whois.net.

2.A.4 Copyright

This is the fundamental right that protects the work of developers. The key test is originality. Under English law, there is no need to register it as it comes into existence by virtue of the act of creation. However, it is wise to keep a time-stamped
sealed/secured copy of the algorithms/code to protect your position in the event of a subsequent dispute with a third party who disputes your ownership.

There is a network of international treaties, notably the Berne and Universal Copyright Conventions which generally means that if a piece of work attracts copyright protection in the UK it will also be protected in other countries.

Subject to two key exceptions, the owner is the creator/developer. If you have employees then the copyright in their work vests in you as the employer. If, however, you engage a contractor i.e. a developer who is responsible for its own tax and National Insurance then the copyright will vest in that person despite the fact that you are paying for his/her services. The way around this is to have that person execute a copyright assignment in your favour. The issue may be complicated where the person works through a personal company or is situated overseas. In the case of a personal company, you may need the assignment to be executed by the company and in the case of overseas contractors you will need to be mindful of the impact of laws in that jurisdiction.

With a mobile App, there may well be several overlapping copyrights, covering various elements, notably the graphics, photography, sound, code and text. The copyright in each of those aspects may be owned by different people/entities and it is important from your point of view to try to centralise all of these so that all are owned by the same person/company.

2.A.5 Rights of the Copyright Owner

In general terms, the owner has exclusive rights to:

• copy the work
• issue copies of the work to the public
• rent or lend the work to the public
• perform, show or play the work in public
• communicate the work to the public – this includes broadcasting of a work and also electronic transmission and
• make an adaptation of the work or do any of the above in relation to an adaptation.

The standard UK duration of the right is the life of the author plus 70 years. In the fast-moving world of mobile Apps this is obviously more than sufficient.

2.A.6 Database Right

This right protects investment in obtaining, verifying and presenting the contents of a database as opposed to the intellectual effort in creating it, the protection of which remains in the domain of copyright. A database comprises a collection of independent works, data or other materials arranged in a systematic or methodical way. Thus a mobile Apps can be the subject of overlapping database right and copyright protection. If these rights are not all owned by the same person/entity,
difficulties can arise in different contexts but notably that of due diligence when potential investors can be frightened off if the IPR ducks are not all in a row. For information on due diligence see Section 2.E.

Like copyright, database rights arise automatically as soon as the database is made and there are no registration or other formalities.

In territorial terms, it is important to note that to obtain a Database Right, the person in question needs a connection with an EEA state either by virtue of nationality, residence, incorporation or having a principal base therein. This differs from the copyright situation.

The owner is the person who takes the initiative in obtaining, verifying or presenting the contents of the database and assumes the risk of investing in doing so.

As with copyright, where a database is created by an employee in the course of employment, the employer owns the right unless an agreement provides otherwise.

As with copyright, ownership can be transferred from one person to another but any assignment must be written to be effective.

2.A.7 Rights of the Database Owner
If it owns the database right, an App developer could take action in respect of:

• unauthorised extraction or re-utilisation of all or part of the database contents
• repeated systematic extraction or re-utilisation of parts of the database

The duration is fifteen years from the start of the year following the date of completion.

B. TERMS AND CONDITIONS

It is easy to dismiss Ts & Cs as mere 'boilerplates' which nobody takes seriously and that users will not even read before clicking on the 'I agree' box as required before being allowed to download/use the app. This is a big mistake. Properly drafted terms and conditions may make your business far more legally secure and commercially attractive.

Many lawyers are not familiar with how the legal environment for mobile apps is changing, so make sure you consult with an expert, dealing in this area regularly with technology companies - especially app developers.

In the life of an App developer, there are various contractual scenarios and different considerations will be relevant to each.

2.B.1 B2B or B2C?

You may be dealing with businesses or individuals. The law tends to favour consumers over businesses and it is therefore particularly important to get the drafting of a consumer contract right. Clear terms provide a clear framework for your
dealing with consumers and thereby reduce the scope for misunderstandings and disputes. It is very important that the terms are fair to consumers and lawful.

There is a considerable amount of legislation which deals with consumer contracts and ensures that consumer rights are protected, notably:

- the Unfair Contract Terms Act (“UCTA”) 1977. In relation to a consumer contract, UCTA applies to any term(s) which seeks to restrict, exclude or avoid liability, for example, a clause may be inserted into a contract which aims to exclude or limit the seller’s liability for breach of contract or negligence

- the Unfair Terms in Consumer Contracts Regulations 1999. These regulations deal specifically with contracts between a consumer and a seller of goods or supplier of services. The Regulations state that an unfair term is one that causes a significant imbalance in the parties’ rights and obligations in favour of the seller or supplier

- the Consumer Protection (Distance Selling) Regulations 2000 which cover sales made at a distance between parties. You must be aware of what is contained in these regulations and comply with them. They set out what information must be provided to the consumer before a purchase is made and also allows the consumer a “cooling off” period in which to change its mind and return the goods. However, it is likely that App downloads would be considered to constitute "services” and that therefore the right to cancel would not apply.

2.B.2 Jurisdiction

An App provider will typically do a considerable amount of business with consumers in different countries. This means that despite being based in the UK, you may be subject to the jurisdiction of another country where the consumer buying your product is based. This could affect your obligations to the consumer and the rights of the consumer.

2.B.3 Different Contractual Relationships

There are several scenarios here and we will look at each in turn.

i. Agreement between Appstore and Developer

ii. Licence from Appstore to App purchaser

iii. Licence from Developer to App purchaser

iv. Agreement between Developer and client commissioning App

i. **Appstore Developer Agreement**

*These are the terms and conditions that are imposed on the developer by the Appstore to which the Apps are uploaded.*

These are almost always standard terms of business and as such will almost invariably be non-negotiable. Thus, you are generally faced with a take it or leave it
situation. Under English law it might be possible for you to challenge the terms and conditions on the grounds of unreasonableness on the basis of the common law (i.e. decisions in previous cases) or legislation, notably the Unfair Contract Terms Act 1977 (“UCTA”). In this context, it is worth noting that under English law it is easier (although by no means easy) to challenge the reasonableness of standard terms of business where there was no scope to negotiate than the reasonableness of terms which have been freely negotiated.

ii. Appstore Licence to App Purchaser

These are the standard terms and conditions that are imposed by the Appstore on the purchaser.

The scope of these is outside the ambit of this guide as it does not directly involve the developer. Consumers generally benefit from more legal protection than businesses and a consumer’s chances of challenging the reasonableness of the Appstore’s terms and conditions are enhanced by the Unfair Terms in Consumer Contracts Regulations 1999 (“the Regulations”) which protect consumers against unfair standard terms in contracts they make with traders and UCTA. In this context, consumers can expect similar protection throughout the EU as the Regulations implement the EU Unfair Consumer Contract Terms Directive.

However, such challenges are rare due to the fact that they typically cost a lot of money to mount and also because the chances of success are typically very limited.

iii. Developer Licence to App Customer

This relates to the situation where you, the App developer are selling your own standard App via your own site or a third party site which allows you to impose your own terms and conditions.

Like an Appstore, you will want to impose standard terms and conditions on the customer. You need to be mindful of the considerations set out at II. above, notably that the reasonableness of your terms and conditions may be challenged on the basis of unreasonableness.

More generally, there may be mandatory local consumer protection laws which are effectively superimposed onto the contractual relationship between the Appstore/developer and the consumer. These will vary depending on the jurisdiction in which the consumer is based but in the EU will largely be harmonised.

It should be noted that under UCTA a company can be deemed a consumer and protected accordingly if the company is not making a contract in the course of a business. However, this is limited to “goods” and it is far from clear whether an App downloaded from a website could fall within that definition.

The sort of terms to be included will cover issues such as:-

• **devices** – you should specify on which platforms the App can be used
• **data** – you will need to specify what you will do with personal data you collect (you may also need to notify i.e. register under the Data Protection Act – see www.ico.gov.uk).

• **duration** – is the licence to be perpetual or limited?

• **termination** – you will no doubt want the right to terminate if the user breaches the licence terms or you find that there is a problem with the App

• **viruses** – you may wish to exclude liability for any viruses/malware downloaded with the App

• **liability** – you will want to exclude/limit liability for various types of loss (but see comments above re reasonableness and enforceability)

• **warranties** – the law implies certain warranties into consumer contracts but you will want to curtail these as far as possible and specify that you cannot guarantee availability or accuracy.

iv. **Agreement between Developer and Client commissioning App**

*This relates to the situation where you, the App developer are not developing an App on your own account but have been commissioned to create an App for a client.*

This is likely to be a typical software development situation. If the client is far larger than you, it may try to impose its procurement terms on you but, ideally, you will have your own standard development agreement which will be more protective of your position and use that as a basis although some degree of negotiation can be expected.

**Key issues** are likely to include the following:-

• **Intellectual Property Right ownership** – who will own the copyright in the App? The client will normally want this but, even if you are amenable to transferring the IPR, you will need to exclude any third party code you have incorporated e.g. open source. If you want to re-use any code, you should grant the client a licence to use rather than transferring the IPR in those elements

• **Indemnities** – the client may well want you to indemnify it in respect of the IPR in the code so that if a third party sues the client alleging that the IPR belong to it not you, the client can invoke the indemnity. Although indemnities are best avoided, this is not an unreasonable request. If you are in principle amenable to giving such an indemnity, you should be careful to limit its scope to IPR, cap it financially and make it subject to various provisos such as the client not making any admissions or settlement in respect of such claim

• **Acceptance Testing** – this is very likely to be demanded by the client and your payment will depend on its success. Be sure to tie the testing into an objective benchmark; typically the agreed specification and also to provide for “deemed acceptance” so that the client cannot delay its testing and thereby avoid having to make payment
• **Liability Limitation/Exclusion** – you will want a carefully drawn up set of clauses which limit or exclude your liability for a range of potential categories of loss that might result from your breach. These will include indirect losses, loss of profits, loss of data, loss of goodwill and in any event there should be a general cap – typically tied into either to a multiple of your charges or to the cap on your professional indemnity insurance.

• **Termination and Cancellation** – standard termination provisions will allow for termination for breach or insolvency but you should be careful to avoid clauses which allow the client to terminate without reason for its convenience. If you do allow what termination or cancellation for convenience, you should include express compensatory provisions.

NB as with all contractual matters, you should obtain specific legal advice on these and other issues.

C. **CHOICE OF BUSINESS STRUCTURE**

Choosing the right business structure is not necessarily difficult. However, you should appreciate that you might have to change it at a later stage, perhaps as founding partners and funders drop out and/or you want to attract outside capital which may necessitate a more formal structure than the structure you adopted at the outset.

Your accountant or solicitor should be able to advise on the best way of changing the business structure without needless expense, complications and anxiety.

You have several options when considering what type of trading vehicle you wish to adopt. Essentially your choice is between a corporate entity – a Company or Limited Liability Partnership (LLP) and a Partnership. The relevant factors include expense, liability, management structure, taxation and disclosure requirements.

2.C.1 **Partnership**

Although it is not a prerequisite, it is advisable that a partnership agreement is drawn up upon the inception of a partnership. This agreement will cover many areas, notably the parties, the duration, the nature of the business, the name, financial matters, property issues, management, restrictions on competing activities, disputes, dissolution, death, retirement and admission of additional partners.

One of the main disadvantages of a partnership is that the liability of the partners is unlimited. This means that the default position is that each partner is jointly and severally liable for all the debts of the partnership. Therefore, upon liquidation, unless dealt with otherwise in the partnership agreement, each partner loses its investment in the business and is likely to become personally liable for the unsatisfied debts of the partnership.

2.C.2 **Limited Company**

The most common form of limited company is one that is ‘limited by shares’, which means that the liability of the shareholders in the company’s debts is limited to the amount of their, shareholding. Companies must be set up in accordance with the
Companies Act 2006. To create a company, the following documents need to be prepared and completed:

- Memorandum of association
- Articles of association
- Form 10, setting out details of registered office, directors and secretary
- Form 12, a statutory declaration of compliance with the Companies Act 2006

In addition, the application for registration must state:

- the proposed name of the company;
- the proposed location of the registered office;
- any limitation on liability, either by shares or guarantee; and
- whether the company is to be public or private.

Once a company has been created, information about it has to be made available to the public. Disclosure obligations include keeping, at its registered office, its register of shareholders and directors for inspection, records of shareholder resolutions and service contracts. Companies must also disclose financial information in their annual accounts. Additionally, companies must also record and maintain minutes of all board meetings for 10 years.

The administrative running costs of a company are greater than those of a partnership. When creating a company, certain expenses will be incurred which do not arise in relation to a partnership. There is a registration fee and the cost of preparing the memorandum and articles of association. More important, following incorporation, a company has statutory obligations to keep and file accounts annually. This will need to be done by an accountant in compliance with the Companies Act. Furthermore, depending on its size, a company’s accounts may need to be audited by an independent accountant. A company is also required to prepare an annual return and the Companies Act will require other returns to be filed from time to time, for example, any charges and any changes to its basic details since the time of registration, such as its registered office.

**2.C.3 Limited Liability Partnership (LLP)**

An LLP is best classed as a hybrid of a limited company and partnership. It is a distinct legal entity like a company, and therefore the members’ liability is limited. However it maintains the flexibility of a partnership in its management structure and has less onerous reporting obligations than a company.

To register an LLP, the following information must be provided:

- name of the LLP
- statement about intended location of registered office
- names and addresses of those who are to be members.
This information should be provided with the signature of two or more persons associated with the business.

As with a company, an LLP must file:

• annual accounts
• annual returns
• notifications of appointments
• notifications of any termination of membership; and
• notifications of any change in members or registered address.

In conclusion, each form of trading vehicle has its own advantages and disadvantages and it is impossible to lay down hard and fast rules as to which is more beneficial as there are too many variables and each case must be determined according to the particular circumstances and wishes of the partners of the business.

**NB** Advice should be taken from qualified professionals before determining the most appropriate form to adopt. Tax considerations may also impact on this decision.

### D. EMPLOYEES AND SUBCONTRACTORS

The employment status of an individual is important for a number of reasons. For example, certain important legal rights only apply if an individual is an employee rather than self-employed.

#### 2.D.1 Employee or Contractor?

Recent court cases indicate there is no single satisfactory test determining the issue as to whether a person is an employee or self-employed. There is a **multiple test** and the key factors are considered below.

• **Control** - an employee is under the control of the company, in what it does and how and when it does it. A contractor has the ability to determine when and how it works and is not under the direct supervision of the company

• **Exclusivity** - an employee is not normally free to work for any other organisations without the express permission of the company. The employee may also be subject to restrictive covenants in its contract whereas a contractor is free to provide services to whomever it chooses without operating exclusively for one organisation

• **Pay and Benefits** - an employee is paid a fixed amount on a regular payment date. It may receive a pension, bonus, private medical insurance, company car or other benefit and be entitled to company sick pay whereas a contractor is unlikely to have such benefits and pay will typically vary depending on hours worked during the period in question.
2.D.2 Relevance of Distinction

The question of whether an individual is an employee is not easy to answer. It is however a very important distinction which impacts on various issues, notably:

- Income Tax and National Insurance Contributions – the employer pays these for an employee but not for a contractor
- VAT – a contractor is responsible for registering for VAT if the level of its supplies exceeds the relevant registration limit
- Intellectual Property Rights – the employer automatically owns the IPR in work done during the course of employment by an employee whereas in the case of a contractor, the employer needs to get the contractor to transfer the IPR to it by way of a written assignment
- Contractual – an employee is subject to a “contract of service” in which you are obliged to provide him/her with the “terms of employment” which will set out the employee’s rights, responsibilities and duties and which should cover issues such as the job title, pay and benefits, working hours and holiday entitlement, monitoring, IPR, restraint of business and trade secrets and termination.

Whilst containing similar provisions, the contractor’s terms of engagement take the form of a “contract for services” and are not subject to the same rigidity of form or content. The provisions of a contract for services will contain myriad provisions including:

- the manner of carrying out the services
- the standard of work
- remedies in the event of inadequate performance
- extent of rights to act on your behalf
- access to your premises
- conflicts of interest
- security of confidential information

E. DUE DILIGENCE

Of course, a successful Apps business will attract investment and possibly even parties interested in purchasing the company. Interested parties will want to ensure that they obtain sufficient information about your business to enable them to decide whether the investment or acquisition represents a sound commercial transaction. Interested parties will gain this information through the due diligence process, which is essentially an audit of your App business’ legal and financial affairs.

Given that the outcome of a due diligence review may determine whether or not a potential investor or purchaser wants to proceed with the transaction, it is important
that you ‘keep your house in order’. A non-exhaustive list of matters which you should always attend is set out below:

- Keep your company’s statutory books updated and be sure to adhere to all Companies House filing requirements (e.g. accounts, annual returns etc.)
- Record and keep minutes of all board meetings
- Ensure that all the material agreements your company has entered to are documented in professionally drafted contracts which have been fully executed. Examples of material agreements include IP licences, service contracts for staff, supply agreements, leases for premises etc.
- Maintain lists containing details of all the assets owned by the company.

F. SHARE OPTIONS

As a developer, you may have limited cash but enormous potential. You want to retain your key personnel but cannot necessarily provide attractive pay packages. The common way to achieve this is to incentivise them by letting them share in any future success. This is often through share option schemes. The best known is EMI, known as enterprise management incentives. This is a scheme approved by the Inland Revenue.

EMI options are designed for small to medium sized higher risk trading companies and attract very favourable tax treatment. The policy goal of the EMI legislation was to help companies recruit and retain high calibre individuals by allowing them to offer EMI options.

EMI options can be granted by the company whose shares are under option or any other shareholder. They can be granted over the shares of any company (including one incorporated outside the UK), provided that the following requirements are met:

- the gross assets of the company must not exceed £30 million at the time of grant
- the company must be independent of other companies
- the company must have only ‘qualifying’ subsidiaries
- the company must be a trading company, or the parent company of a trading group, with a qualifying trade
- the company must have a permanent UK establishment
- the company must have fewer than the equivalent of 250 full-time employees

No income tax or National Insurance contributions (NICs) liabilities arise on (EMI) option exercise if the exercise price at least equals the market value of the option shares at grant and there has been no "disqualifying event" 40 days or more before exercise (and exercise takes place on or before the tenth anniversary of grant). If the exercise price is below grant market value, or there has been a disqualifying event 40
days or more before exercise, part of the gain on exercise will be taxable, but part of the gain may still be free from income tax. Other noteworthy elements include:

- the exercise price of EMI options can be set at less than market value (and can be nil, if option shares are not newly issued)
- EMI option plans can be used as the basis of tax-efficient performance plan
- an employee can hold unexercised EMI options over shares worth up to £120,000 (from 6 April 2008, before that the limit was £100,000)
- with care, employees can be granted EMI options over shares worth £239,999 in a three-year period
- there is no need to get HMRC approval in advance. Each option must be notified to HMRC within 92 days of being granted
- an EMI share option plan does not need to be adopted to secure EMI tax treatment, but this can be done (and is generally convenient for other reasons). Each EMI option takes the form of a written agreement between the grantor and employee. If there is a detailed EMI share option plan, its rules should be incorporated into each EMI agreement by reference.

NB Advice should be taken from properly qualified professionals if you are contemplating setting up an incentive scheme of this or any other type

G. DATA PROTECTION AND PRIVACY

2.G.1 Personal Data

The Data Protection Act 1998 (“DPA”) imposes certain obligations on those who process individuals' personal data. ‘Personal data’ is defined under the legislation as anything that a living individual can be identified from, either from the information in question alone, or in conjunction with any other information in the possession of the data controller. A data controller is subject to the terms of the DPA, and is essentially any entity which determines the purpose for which data is to be processed. A data processor, on the other hand, is any entity which merely processes data on behalf of a data controller. Your compliance responsibilities in respect of data protection legislation will depend on whether you are considered a data controller or processor. Indeed, if, as a data controller, you hire a third party to process the data you collect, you may need to enter into a data processing agreement with it to ensure that it adheres to the principles enshrined in the DPA that you, as the data controller, are obliged to abide by.

2.G.2 Data Protection Principles

The DPA requires data controllers to adhere to certain principles when processing personal data, which include:

- Only collect personal data when it's absolutely necessary
- Personal data should be retained by the data controller only for as long is as necessary for the purpose for which the data was collected
2.G.3 Cookies

If your web-based App deposits cookies onto your users’ phones, additional compliance is needed in respect of the recently implemented regulations concerning cookies. Users of your App will need to be given full and frank information about the purpose of cookies used by the App and they need to provide their consent prior to the download of cookies onto their phones. Websites commonly contain cookies information in their privacy policies, however, given the typical screen size and mobile App user experience, creative methods to ensure adherence to the law may be needed. The Information Commissioner has placed a moratorium on enforcement of the new cookies regulations until 26 May 2012. However it is important to start considering now how you will comply with the new law. The Information Commissioner’s Office is already investigating entities which use cookies and handing out warnings to inert organisations in advance of commencing full enforcement in 2012.

H. CROSS BORDER ISSUES

2.H.1 Terms and Conditions

Successful Apps inevitably end up being sold in many different jurisdictions around the world and therefore it is important in your terms and conditions to set out specifically the laws of the jurisdiction which will govern the agreement. Moreover, you should also set out the jurisdiction where you wish any disputes arising under the terms and conditions to be heard (for obvious reasons, this is usually the same as the jurisdiction governing the law of the agreement). For more detail on terms and conditions, see Section 2.B.

2.H.2 Data Transfer

As Apps can be accessed by users around the world, you may find yourself collecting the data of a user in an overseas jurisdiction. Strictly speaking, this requires you to adhere to the user’s local data protection/privacy laws. However, the Information Commissioner takes the view that compliance with the DPA should serve as a reliable foundation for international compliance, despite differences in international laws. However, if your App goes global, it is advisable to take specific advice in respect of the jurisdictions in which your App is available.

If you transfer users’ personal data to countries outside the EEA then you must ensure that you have the users’ consent and that the recipient entity maintains an adequate level of protection in relation to the processing of personal data. The European Commission has compiled a list of non-EEA countries whose local laws are considered adequate for the processing of data – see http://ec.europa.eu/justice/data-protection/document/international-
transfers/adequacy/index_en.htm. If personal data is being transferred to the US, it is advisable that the company to which it is being transferred has signed up to the ‘safe harbour principles’ agreed between the EU and the US in 2000, which ensure that the signatories adhere to principles broadly similar to those in the DPA.

3. **FINANCIAL AND FISCAL**

This section will focus on the financing of start-ups which rely on sales of mobile Apps as their main revenue source and associated tax issues.

While many developers move up the ‘value added’ chain from writing code, to designing and finally commissioning them; it is hard to make the jump to setting up a stand-alone business reliant on income generated directly from end-users.

Many App developers are not clued up about the financial options which may be open to them and the potential impact that each such option may have on their long term business aspirations.

External funding is certain to be elusive if your team doesn't have sound operational/commercial credentials. Finding a mentor who has a track record in the sector and is actively committed to the business may be the best approach especially if the mentor is well-connected in the tech world and, ideally, committed through investment in your business.

Most early-stage App development businesses are cash-strapped and short on commercial skills. Participation in a respected accelerator programme with access to an incubator may be the best option in such circumstances.

Networking within the technical start-up community will bring recommendations; but you will need to work on your presentation skills and probably take professional advice on financial projections etc.

A. **CASHFLOW**

It has become viable in recent years to keep capital expenditure on assets to a minimum by relying on cloud services such as Amazon or renting space from physical data centres. This means that App developers can substantially reduce cash-burn by benefitting from shared/subsidised costs either independently or in an incubator type environment.

3.A.1 Initial Funding and Cashflow

However, no matter how parsimonious your financial management, there are bound to be expenses beyond the pocket of the typical App entrepreneur.

If your App can be adapted to the specific needs of a corporate, you might be able to generate some on-going income through licensing and customisation fees. Alternatively, you may be able to put out a ‘bare-bones’ version which can attract paying customers or generate other revenue through ad-sales etc.

As nascent entrepreneurs are usually over-optimistic about the economics and time required to get to “breakeven”; it is essential to validate assumptions and work
through a detailed cashflow calculation with either a serial entrepreneur or an accountant with relevant experience, ideally in the tech world.

3.A.2 Cash Planning and Forecasting

Cash is King! The lifeblood of any business is its ability to collect cash and pay bills as well as pay its employees, particularly its owners. Far too often small businesses are profitable, but they do not have enough operating capital to meet their current needs. Consequently, they may be forced to sell out to a stronger competitor, sell a portion of the company to investors at an undesirable price or close the doors and put the company out of business. None of these alternatives is typically what the owners intended when starting the business.

The ability to forecast cash resources and uses is an art and is by no means a well-defined science. None of us has a crystal ball and any cash forecast which is prepared by the management of a company or an outside consultant can be no more than a guess as to when the customers pay.

One of the most significant factors to be considered in your cashflow forecast is the volume of sales that will be generated in the next few months and for the rest of the period for which you intend to forecast. Your sales forecast must be as finely tuned as possible. It may be unrealistic to assume that there is a million pound market for your product and you will be able to capture a specified percentage of it. A sales forecast needs to be based on specific facts. These might include your sales history or the history of similar businesses you have owned or operated or the competition. In your field, what has been the experience of similar operations? In preparing a forecast, you must also take into consideration items such as the seasonality of your business, the relative state of the economy and the period over which you will forecast.

3.A.3 Cash Collections

Once you have determined a reasonably based level of anticipated sales and you are comfortable with the forecast you have made, you must address questions such as: how soon is the cash collected from debtors i.e. invoiced clients? Do I have to wait for customers to pay me or do third parties such as Visa or MasterCard or a debt factor take the customers’ account and convert it to cash for me with an appropriate discount? Where sales are through a portal such as the App Store, what is the accounting and payment schedule?

If you are relying on customer payments for collection of debtor balances you must determine what portion of the debts will be collected in thirty days, sixty days, ninety days and thereafter, and what portion, if any, may never be collected. To assume that 100% of your sales will ultimately be converted to cash is probably unrealistic especially considering the current economic environment and the tight cash situations that may face some of the customers for whom you are developing Apps.

Other sources of cash may be available in addition to sales. Do you expect to bring in a partner or other investors, or can you borrow money from a bank? When will you receive the cash and how much will you get? Part of your cashflow analysis may be
to determine how much investment money or borrowings will be required to operate your business.

Once you are comfortable with the cash receipt side of your business, and the timing of the collections of funds from your sales and other sources, it is necessary to consider the expenses and other cash needs of your business operation.

3.A.4 Disbursements

If your business requires additional skills or labour, these will have to be purchased from others. This may require a significant outlay of cash before the first pound of sales is generated and received. You should consider how often and in what amount your employees must be paid and when their payroll taxes must be paid over or, if using subcontractors, when they must be paid.

Additionally, you need to know the credit trade terms your creditors are willing to advance to you. Do you have to pay for any necessary equipment or software or data facilities on a cash on delivery basis or can you pay for them thirty or forty-five days after receipt? The timing of payments for required supplies, such as consumables, software and Data services that must be purchased in developing Apps should be considered.

If the volume of sales or the number of simultaneous projects requires more resources, will you need additional employees or subcontractors? If so, how much will they cost? Do you have to acquire additional hardware or software licences for your new people? What is the cost of the hardware and software and data services and when will you have to pay for them? Do you have enough space to cope with the additional activity or will new people work remotely from home?

Once you have determined the cost of operating your business, you need to consider what other expenses you must pay to survive. You typically will have to pay rent for your office. You must consider how much the monthly payment is and when it has to be paid. Ask yourself if there will be other cash requirements such as a rent deposit. If you are opening a new office, perhaps for the first time, you must consider what your cash requirements are to make your facility ready for your specific needs and purposes. Will you have to buy or rent furniture? Will you need to make tenant improvements or pay deposits for utilities and other services? Will a co-working environment be the best option or could that raise privacy, confidentiality and data security issues.

You also need to consider many of the overhead items and costs to open a new business that will hopefully be one-time expenses. This may be a solicitor’s fee for drafting partnership agreements, terms of business, Intellectual property licences, trademark registration or incorporating your business, the cost to obtain business licences, approval from the tax authorities, setting up an accounting system, stationery costs, costs of signs or logos.

It is imperative to make the list as detailed as possible to ensure that you have sufficient funds to make your operation ready for business prior to running out of cash. The more detailed the list and the more comprehensive the information you
can provide, the less chance there is of unpleasant surprises as you move down the stream to opening your business.

You may be able to defer some of the start-up costs until you can generate the cash from your operation to help pay them. This needs to be carefully analysed and built in to your cashflow analysis. However, a good rule of thumb is to assume that you are going to have to pay your expenses sooner than you think and that you will collect your cash more slowly than you anticipate. If you work with this attitude, any surprises should be favourable ones.

Cashflow projections can be very slow, time consuming and tedious to undertake. It is often very tempting to hire someone else to prepare the projections for you. There is a variety of individuals who can help you do this, but the critical factor is that they only help. You as the owner and operator of the business are the only one truly qualified to develop your cashflow projections. You know what it takes to open and operate your business. Certainly, a trained professional can offer guidance and ask pointed questions to be sure that you are considering all of the necessary and sometimes hidden costs of operating a business. However, the more effort you put into developing the cashflow projections, the more accurate they will tend to be. This exercise may also help you to pinpoint areas of potential cash savings that you have not otherwise considered.

3.A.5 Cashflow and Tax

The following matters are some of the major factors when preparing your cashflow forecast:

i. VAT

If you are VAT registered (compulsory for businesses with sales in excess of the statutory limit which at the time of writing stands at £73,000), your sales receipts will include “Output” VAT and some of your costs will include “Input” VAT. The net receipt of VAT has to be paid over to H M Revenue & Customs each quarter. If, however, your sales are zero rated, or outside the scope of VAT (but would have been VATable if the place of supply were in the UK), you will be able to claim back the VAT on your purchases.

ii. PAYE

If you employ people you will have to deduct tax from their pay and pay it over to H M Revenue & Customs in the following month. For a forecast it is sufficient to put the gross figure in the cashflow forecast as it automatically includes PAYE. You should however add the employer’s liability which at the time of writing stands at 13.8%. For the difference between employees and contractors see section 2.D.1.

iii. Trading Profits

If you are the proprietor of a business that is not a limited company, your wages are part of the profit of the business and referred to as “drawings”. The tax that you pay will be based on the profit of the business not the amount
that you take out. It is advisable to pay a sum into a deposit account each week to provide for this tax that will be due after your year-end – and it could be a lot of money. Many businesses go bust because they fail to provide for the taxes that are payable. Make sure that it does not happen to you!

B. RAISING FUNDS

3.B.1 Bootstrapping

Potential investors like to see that you have taken the business as far as possible without external funding. However, “bootstrapping” has its limits and most App developers will soon get to the point where they will be looking for external capital for commercialisation and deployment in the international market place.

3.B.2 Equity and Venture Capital

At the start-up stage you are unlikely to be offered debt by banks or others and there is often no alternative to giving up shares in your business (‘equity’) for financial and commercial input.

However some VCs favour an element of convertible debt which is a hybrid with some characteristics of both a loan and equity for smaller start-ups. If you are offered this, consult your lawyer or accountant (check that they are aware of the specific issues for your type of business) or access some of the excellent web guides to raising capital.

The process for attracting venture equity usually follows the sequence set out below.

3.B.3 Tranches of Venture Capital

i. Series A

This is often the first 'institutional' round involving outside corporate investors, as opposed to friends & family, boot-strapping and angels. It typically involves VCs or possibly an investment fund set up to maximise tax benefits to investors such as a Venture Capital Trust or an Enterprise Investment Scheme. Investment could also come from a quango, such as a regional development board or equivalent.

Series A shouldn't be seen as a stand-alone round of finance, unless, as is often the case with App development companies, the amount of equity investment required is fairly low. VCs, in particular, expect to participate in further tranches of capital raising until the company, following completion of its projected development, becomes self financing from earned income.

As a company's participation in further rounds of capital raising is the norm, its prospect must be made clear in presentations to potential investors. Future capital needs must be estimated and assumptions well supported from market intelligence etc.
While most VCs will expect to support further series where applicable, they are not required to do so and you must discuss contingency plans with your accountant, if they decline to support further rounds.

Having met your agreed milestones, only to find that anticipated further funding isn't to hand, could spell failure.

To have to start looking again for funding when you have been rejected by the original funder is not only demoralising but requires an already stretched CEO to take his eye off mission critical operational responsibilities, such as turning marketing into sales. It is therefore essential to research your VC's track record in commitment to investee companies, including how much mentoring/involvement/added value/sector expertise and connections they bring.

You should note that VCs also have to raise money themselves and if they fail to get their next round, might not be able to invest further. In this scenario, where rejection is not your fault at all, alternative funders might be sympathetic. However, the climate might have deteriorated due to an economic downturn and your sector may not be so 'hot' or might be dominated by a much stronger competitor.

This makes it advisable to raise every penny that you can when it is offered unless, by having 'bankable' long term income sources through contracts or licences, you have a solid underpinning to your financial projections for the next year at least.

If you were fortunate enough to receive interest from VCs who didn't end up investing, keep in touch and do not fail to cultivate investors you meet at industry events, even if you are not looking for money right there and then.

Giving up more equity than you would have hoped for early on, means selling your stake of the company at a lower valuation than you might have achieved later on, at a time when the business has gained traction, built up sales and thus will command a higher price. Simply put, the more equity you part with at an early stage the more you diminish the share left for yourself and fellow founders on exit, without increasing the amount of Series A funds raised.

Once you are at the stage of approaching break even at the operational level, especially if there is a strong sales pipe-line building up, but you still need additional funding, asset-backed debt might be available. Options include invoice factoring, equipment leasing or hire purchase, or following the US model (but still not very common here), venture debt.

In cases where Series A funding has been raised from a top tier tech VC, venture debt might be available from a specialist provider such as the Silicon Valley Bank.

The normal range for Series A is £500,000 to £3,000,000 plus.
However the type of company which is raising money to build and market Apps will probably need much less than this.

ii. Series B

This is more the province of ‘capital heavy’ companies requiring expensive kit or having a long development cycle before becoming profitable, but could be relevant to the more ambitious App company building a portal or with an ambitious programme to acquire IP.

This is usually a follow-on to Series A and, as such, outline terms should have been agreed with the original funder. Even if this is the case, the original VC, which possibly specialises in early stage investing, would seek to syndicate (bring in additional investors) or need to step aside completely, having lost their appetite for further investment.

At this stage, the Company would already have received significant investment and be looking for several million pounds.

iii. Series C

This is unlikely to be relevant to App companies unless they have substantial other activities of a capital intensive nature.

Given the ‘serious’ money required, you should, on the advice of your accountant, seek out a specialist boutique investment bank or equivalent adviser if it looks as if you will need a ‘C’ round. This should be anticipated as early as possible in the business planning process.

This level of funding sustained over several years would normally require the resources of a substantial VC with a track record of commitment and success in the underlying technology. They will be looking for a management team with a first class reputation and proven achievement and a very professional proposition leveraged on access to leading players in the sector.

3.B.4 Preference and Ordinary Shares

The two most common types of equity offered by entrepreneurs to VC’s are preference and ordinary shares. You also have the option of offering a VC convertible debt, which is a hybrid, of sorts, of the two equity offerings. It is important to know how each works:

A VC will commonly seek to receive preference shares in return for any investment. The attraction of preferred shares to VCs arises from the fact that they bestow rights upon their holders in preference to ordinary shares in a company. You will agree the exact nature of such rights with the VC and they will be set out in the new articles of association of your company. Essentially, the preferential rights enjoyed by the holders of preference shares make them a less risky investment for a VC than ordinary shares.

Commonly preference shares will provide their owners with a right to dividends ahead of holders of ordinary shares (possibly up to a fixed sum). Moreover, they may
also carry preferential rights to returns of capital by the company (occurring on an exit or liquidation). Thus, the VC is put in the advantageous position of securing better periodic returns on dividends and on an exit, while still providing themselves with a degree of protection should the venture not pan out as expected.

Preference shares are, however, not completely advantageous to VCs. Their financial benefits are tempered by the fact they are not usually voting shares. Therefore you can issue the shares and still maintain control over the running of your company.

Ordinary shares are less advantageous to VCs as holders are only entitled to dividends, if available, after any preferred shareholders have taken their entitlement. That pecking order is mirrored in terms of entitlement to capital proceeds on an exit or winding up. However, ordinary shareholders are entitled to vote on shareholder resolutions in proportion to their percentage ownership in the company, subject to any deviations agreed between all the shareholders in a shareholders’ agreement.

3.B.5 Convertible Debt

Offering a VC a convertible debt mechanism is the alternative to the equity offerings set out above. This process entails the VC providing a loan to your company which later converts into equity in the company, commonly upon the business’ next fundraising round.

A key difference between an equity offering and convertible debt is the manner in which the company is valued. An equity offering involves the VC valuing the business prior to investing and agreeing on a price-per-share with you. Conversely, the convertible debt model involves the price-per-share being decided upon on the event triggering the conversion of the debt into equity (i.e. the next round of fundraising). As such, the VC, when providing the loan, will receive a pre-agreed discount on the price-per-share at conversion to compensate them for the extra risk of investing in the company prior to the fundraising round,

As the business isn’t actually valued at the time the loan is made to the company, it proves to be useful in scenarios where a company is particularly difficult to value or perhaps a VC doesn’t want to embark on a lengthy and costly valuation process. Convertible loan notes are, of course, also useful sources of bridging finance for you should additional capital be needed to make the business more attractive to investment between fundraising rounds.

3.B.6 Raising Sufficient Funds

The process for attracting venture equity usually follows the sequence set out below.

Consult your accountant/financial mentor regarding the amount that you require. It is generally advisable to allow a fair margin in excess of the bare minimum for unforeseen eventualities. You do not want to return too soon “cap-in-hand” to your initial funder or a third party.

A cash buffer is invaluable as, almost invariably, you will have to ‘pivot’ i.e. at some stage change your product, redesign it or even re-invent your whole game plan in
response to customer feedback, emergence of competition or for some other reason. This will inevitably mean a delay in becoming cash-positive.

Moreover, financial markets are currently very volatile and it may prove very difficult to raise additional funds sooner from existing investors and alternative funders will probably run scared if your original investors shy away.

3.B.7 Dilution and Capitalization Tables

A related issue in respect of external shareholders is the dilution in your own holding. Every time you finance by letting in an investor other than as a pure lender, you give him a piece of your business and your percentage holding consequently falls. It is not uncommon for example to let the first external investors have 30% of the business with each successive wave of funding taking 30% of the expanded ownership. This dilutes the previous funders as well as the original owners. As an example, after three rounds of 30% funding, the original owners will have been diluted to 34.3% of their original percentage holding. This is normally shown on a Capitalization table which explains who owns what and how we got here. Two weblinks with usable capitalization tables are:

www.startzentrum.ch/fileadmin/user_upload/StartZenturm/Downloads/Cap_Table.xls
www.sumwise.com/templates/capitalization-tables/

3.B.8 Making Yourself “Investable”

It is impossible to reduce this to a formula, every new business is a unique cocktail of features designed to solve some problem and/or exploit a particular market.

However professional investors whether they be angels, VCs or any of the various government quangos devoted to shelling out tax payers’ money to encourage new enterprise will have to be convinced that you have got your act together.

There will clearly be differences between a super cool media outfit as opposed to industry insiders launching a killer App for some esoteric business function and you need to judge potential investors’ perception of how comfortably you fit into your intended operating environment.

If your street cred is based on being funky; don’t go too ‘preppy’; however no matter how leading edge your product; investors will want to see that you are well organised, accepting of the norms of the mainstream business and can demonstrate a well researched and viable business strategy measured against data from the real world and are articulate and assured in putting over your story.

Considerate social behaviour is essential; being courteous, punctual and responsive is important; team inter-action is critical, make sure that you are all on the same page of the script, that your body language doesn’t give away any insecurities or weaknesses in inter-personal relationships.

Pitching is critical and isn’t confined to conventional presentations, but might take the form of a teleconference or video conference (however most investors expect to
meet management before parting with any money) or initially could be a power-point presentation or video. In the App world, they will probably want to see a mock up, screen shots and possibly code.

Whatever the type of investors, it is critical to research them well, go through their website thoroughly—make sure you meet their criteria—if in doubt ask, check out other recent investments. If possible speak to owners of companies they have invested in and check their reputation!

3.B.9 Know Your Competition

This is often the unexpected killer; the investor will either be a specialist in your sector or have commissioned some research; competition is sure to come up early in discussions and if a name is mentioned which is met by dumb stares, the door beckons.

You should be familiar with their strengths and weaknesses and be able to establish that you have significant market-defining ‘deep blue water’ between you and them,

3.B.10 The Initial Approach

Wherever possible this should be through a personal introduction through somebody well known to the investor and this is particularly strong if the introducer has credibility in the sector; consider using a tech-savvy accountant or lawyer; they tend to have great networks of investors with whom they work with closely and regularly; industry networking events are also very good; investors are usually keen to know who knows you and depending on the event, you might meet investors personally or enter their circle of confidants; intelligent participation in industry forums, posting helpful and/or informed comments on technical chatboards etc., participating in relevant social networking groups also helps.

Some VCs will not look at unsolicited business plans sent by snail mail or emailed to their website, even though they offer a facility for uploading such; or will just get a junior associate to give a cursory scan before binning. However some are genuinely keen on seeing these and will give them some consideration. If you have to go down this route, try to get the private email address of a partner specialising in the sector; also be aware of geographical and other preferences which in reality might differ from what is shown on their website.

3.B.11 What to Send to VCs

Generally, brevity is best; initially VCs will most likely want to see an executive summary and probably will not give more than about ten minutes on it.

If it merits follow up, they will let you know exactly what is required. Unfortunately some VCs have elaborate requirements for presenting information, usually through an on-line or downloadable form.

This isn’t so much the case with the sort of investor which specialises in very early stage ‘seed’ rounds; investments in typical mobile App situations which tend to require small fundings.
Where you are applying for an accelerator or incubator, requirements can be quite informal, but probably will require an early pitch usually with a powerpoint or similar visual presentation to their team.

Some of the best accelerator programs for mobile Apps are based in The Valley and require setting up shop there for at least several months.

3.B.12 Other Sources of Capital

i. Friends and Family

This is almost always the most attractive option, especially if capital requirements are fairly small. Just because these sources are on a 'friendly' basis doesn't mean that professional contractual documentation isn't required. It is essential that this is done properly with professionals, knowledgeable in the particular issues, giving advice to all parties.

Proper investment documentation reduces the risks of disputes and litigation further down the road. Terms must be clear, legal and enforceable.

For fairly simple agreements, standard forms are available which will keep the costs low.

Having a successful industry figure as an investor greatly strengthens your situation; as it not only shows palpable confidence from somebody who knows what they are talking about; to the point where his or her money is at risk; but this commitment is likely to express itself in active help, which could well make all the difference in making your fledgling fly high.

ii. Seed

This a 'catch-all' term for early stage finance provided by organisations rather than individuals, and is thereby specifically institutional in nature.

Some VCs which traditionally favoured investing in companies already some way along to commercial success have turned to earlier stage investment. This calls for special expertise, as such deals whilst smaller are more risky and often require a lot of due diligence and other evaluation input.

Not all early stage institutional support is private money. There is a plethora of quangos which provide seed funding, such as regional development funds (which are periodically re-organised but can be accessed through government websites), non-government (but publicly-funded) entities such as NESTA (www.nesta.org.uk), lottery backed funds. Additionally, some major corporates also run their own funds for promising early stage talent in their own industry.

iii. Angel

Angel funding is probably the oldest form of external funding for new businesses. Angels have traditionally been wealthy 'amateurs', albeit with deep expertise, great networks in specific industries and a lot of shrewd
insight. They generally put up small amounts (tens, rather than hundreds of thousands of pounds). Recently, the number of angels has increased and they have become more professional, organising into clubs and other groupings to compete aggressively with VCs for the best deals.

Many entrepreneurs will also know people in their business sector who have made money and have time to mentor new businesses. These potential mentors can be pitched to informally and you can also apply to present your company at investor events which are held regularly in major cities.

iv. Crowdfunding

A useful resource where you have a track record and a commercially attractive product in the offing is to use a crowdfunding resource. Crowdfunding is a newish phenomenon, originating in the 'Valley' but which has spread internationally.

Appbackr (appbackr.com) is probably the leader and describes itself as:

*the first and only digital wholesale marketplace for the application market. By applying the time-honored wholesale model to the digital age, we solve common funding and distribution problems of application developers. Developers sell copies of an App to wholesale buyers ("backrs") on our marketplace, giving developers immediate funds. We make this easier still with the innovative use of social media tools and more.*

C. COMPLIANCE AND REGISTERING WITH THE TAX AUTHORITIES

Compliance is the name we give to all the regulatory requirements which must be dealt with on time. Failure to do so may result in swingeing penalties. The obligations are mostly tax and accounting related. Some of these obligations are presaged by a handy reminder letter from the relevant authority, but not all. The significant penalties for non-compliance are a very unwelcome additional financial burden and are wholly avoidable if you are well organised. However, this is sometimes a big ask for creative individuals caught up in developing their business!

A significant task for the new business owner is ensuring that the business is properly compliant with the extensive tax and information filing requirements imposed by the various authorities. Problems and penalties could arise if the new business is not registered with the appropriate tax authorities in a timely fashion. While not intended to be an all-inclusive list of filing requirements, some of the more prominent requirements are:

3.C.1 H M Revenue & Customs

It is necessary to notify H M Revenue & Customs of your existence by completing forms CT41G (companies) or CWF1/SA400 (sole traders/partnerships). The form notifies H M Revenue & Customs of your accounting date, your accountant, and also enables a PAYE (Pay As You Earn Scheme) to be set up, which is a requirement if you are to be an employer.
If you fail to register within the first three full months of commencing business a penalty of up to £300 plus a continuing penalty of £60 per day can be payable, or £3,000 if information is given negligently or fraudulently by a company.

3.C.2 National Insurance Contributions Office

Depending on the level of profit, sole traders and partners have a liability to Class 2 NIC, and these are payable either quarterly or monthly by direct debit. Class 2 contributions are at a weekly level of £2.50 (where annual earnings are £5,315 or more for 2011/12) and the necessary form to collect Class 2 contributions should be completed at the same time as the form CWF1. Leaflet CF10 'National Insurance Contributions for Self-Employed people with Small Earnings' gives full details and an application form for exemption from liability.

3.C.3 VAT Registration

You need to consider if it is beneficial to be VAT registered from the outset. If you are registering for VAT, form VAT 1 needs completing, and if you are a partnership, form VAT 2 needs to be completed giving details of all the partners.

3.C.4 Compliance Calendar

The following summarises some of the more significant filing dates for a corporation using a calendar (31 December) year end. Many of these requirements also apply to partnerships and sole traders. Naturally, if a year-end other than 31 December is used, some of these dates will vary.

<table>
<thead>
<tr>
<th>Date</th>
<th>Event/Action</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual Events</strong></td>
<td></td>
</tr>
<tr>
<td>28 January</td>
<td>Submission of Limited Company and LLP Annual Return as at 31 December to Companies House</td>
</tr>
<tr>
<td>31 January</td>
<td>Payment of Balancing payment and 1st payment on account of Income tax for Sole traders and partners</td>
</tr>
<tr>
<td>19 May</td>
<td>Submission of forms P35 and P14’s</td>
</tr>
<tr>
<td>6 July</td>
<td>Submission of form P11D</td>
</tr>
<tr>
<td>19 July</td>
<td>Payment of Class 1A NIC</td>
</tr>
<tr>
<td>31 July</td>
<td>Payment of 2nd Payment on a count of Income tax for sole traders and partners</td>
</tr>
<tr>
<td>30 September</td>
<td>Payment of corporation tax (9 months after the end of the accounting period); Submission of Limited Company and LLP accounts to Companies House</td>
</tr>
<tr>
<td>November/December</td>
<td>Year-end tax planning</td>
</tr>
<tr>
<td>Date</td>
<td>Event/Action</td>
</tr>
<tr>
<td>----------------------</td>
<td>------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>31 December</td>
<td>Submission of corporation tax return (12 months after the end of the accounting period)</td>
</tr>
<tr>
<td>February/March</td>
<td>Final year end planning for individuals</td>
</tr>
<tr>
<td><strong>Quarterly Events</strong></td>
<td></td>
</tr>
<tr>
<td>14 April</td>
<td></td>
</tr>
<tr>
<td>14 July</td>
<td>Forms CT61 to be submitted – tax deducted/received on interest payments</td>
</tr>
<tr>
<td>14 October</td>
<td></td>
</tr>
<tr>
<td>14 January</td>
<td></td>
</tr>
<tr>
<td>Quarterly</td>
<td>VAT returns (can be monthly by request)</td>
</tr>
<tr>
<td><strong>Monthly Events</strong></td>
<td></td>
</tr>
<tr>
<td>19th</td>
<td>Payment of payroll taxes (under certain circumstances – quarterly)</td>
</tr>
</tbody>
</table>

### 3.C.5 Operational tax issues

Broadly, individuals, either alone or in partnership (including LLPs) pay Income tax at rates of up to 50% on trading profits and pay Capital gains tax at rate of up to 28% on capital gains. UK resident Companies pay corporation tax on combined profits and gains. Both companies and partnerships pay National insurance contributions but on different bases.

### 3.C.6 Offshore structures

Non-UK resident companies pay income tax and only on UK source income, not foreign source income. Simplistically, the use of an offshore company can reduce taxation provided that its income is not UK source. Such income is often Intellectual property income from exploitation of rights outside of the UK e.g. a licence for USA. Exploitation of UK rights often yields UK source income. To complicate matters there is a great deal of anti-avoidance legislation which can deem such arrangements ineffective.

To make a company non-UK resident it must not be “controlled and managed” in the UK and it must either be incorporated outside of the UK or be incorporated in the UK but managed and controlled in an appropriate double tax treaty country. No tax haven qualifies as an appropriate double tax treaty country and it is common to use non-UK incorporated companies.

The general rule is that unless at least £¾M of non-UK income is going to arise in respect of non-UK rights, there is probably little point in setting up such a structure as the costs will not result in a worthwhile tax saving. The difficulty is judging how much profit will arise overseas as the decision must be made before the IP has any material value since its very transfer to the overseas company is liable to tax. It is the
author’s view that such planning is perhaps better left to a second business, having profitably sold off your first business, when there is sufficient funding to set up a tax-efficient structure. Better use your energies in your first business venture to build up the business!

3.C.7 Intellectual Property Rights

The key IPR involved in App development is copyright. It is effective in all countries which are part of the Berne Convention and typically entails no registration formalities.

The other kind of IPR which is relevant is trademark/servicemark which is the protected manifestation of the Brand which the App developer is hoping to build up and make valuable for future sale. The value of the Mark is often the value of the goodwill of the business. The mark is valid in all countries, which are part of the Paris Convention, similar to the Berne Convention for copyright. The trademarks/servicemarks are likewise separate assets in every country.

This separate sourcing presents tax planning opportunities on the one hand, and local taxation charges on the other hand.

3.C.8 Intellectual Property Rights Source of Income

The source of income of IPR is not only important in tax planning using overseas IPR exploiting structures, but also because it can allow foreign countries to tax the income by way of withholding and/or directly. Double taxation treaties can reduce withholding taxes and even direct that the income is taxable wholly in one country or the other. The normal rule is that specified country taxes first and the second more senior country has to tax under its own laws and give credit for the tax paid in the other country. This “double taxation with credit” always results in the income paying tax at the worst (highest) of the two countries taxation rates.

3.C.9 Profit Extraction

The use of a company allows more tax effective profit extraction than a partnership or sole trader, irrespective of income level. Whether the compliance burden costs outweigh this is in the end a personal choice. If due to compliance failure, penalties, administration costs and professional costs are involved, a sole trade, partnership or LLP is almost certainly better. The two main benefits of partnership are:

• better capital allowance treatment on partners’ motor cars
• greater ease in remunerating spouses in a tax-efficient manner

Companies which pay the small (reduced) rate of corporation tax, will normally pay salaries to bring profits down to £300,000 and then pay dividends for the last £300,000. This is the most tax effective result. If the profits are less than £300,000, it is usually best to pay salaries for basic everyday living costs (kept as low as possible) with quarterly or if the admin can cope, monthly dividends. In a company therefore, payments to owners have to be carefully and explicitly labelled as salary, dividend or loan with the appropriate recording and PAYE applied as failure to get it
right will lead to penalties and perhaps a different label being applied. Partners do not have to get any of this right because it doesn’t apply to them as they pay tax on their profits at the year end, irrespective of their drawings.

It is usual for individuals to claim for “Use of home as office” whether as partner or through a company.

In general personal cars should be kept outside companies and instead the maximum approved mileage rate should be charged to the company. Partnerships would show car running expenditure but normally not the cars themselves, although there would be claims for capital allowances on the cars.

With companies paying dividends, the use of Alphabet shares is often seen. The advantage is that different dividends can be paid on different classes of shares, although the shares are, in most if not all cases, otherwise identical. All such arrangements are best implemented right from the start, particularly where spouses and family are holders of the “A”, “B”, “C” etc shares.. Severe difficulties can arise if Alphabet shares are introduced into a mature company, even if they have no rights other than to a dividend if voted.

D. RESEARCH AND DEVELOPMENT (R&D) TAX RELIEF

One of the most valuable tax reliefs is R&D tax relief which comes in two versions: one for large companies and a more generous version for small and medium sized companies (SMEs). The relief does not apply to unincorporated business, i.e. sole traders, individuals in partnership or even LLPs but it does apply to any companies in partnership or in LLPs although not to any individuals with whom the companies are in partnership.

SMEs liable to Corporation tax are eligible to claim R&D Tax relief which is a superdeduction in arriving at their taxable profits for corporation tax purposes. Qualifying R&D expenditure is eligible for up to 200% relief on project and overhead costs from April 2011 and an enhanced 225% from April 2012 except for costs which constitute capital expenditure. Qualifying capital expenditure is eligible for 100% capital allowances from April 2011. Until April 2012, the company will have to incur a minimum qualifying expenditure of £10,000 for any accounting period in which a claim for R&D tax relief applies (pro rata for accounting periods of less than 12 months). This minimum spend is scheduled to be abolished from April 2012.

Special rules apply to R&D qualifying expenditure incurred as pre-trading expenditure, giving a choice between treating the pre-trading expenditure as incurred in the first trading period or being in a special standalone period.

If the superdeduction turns an existing tax loss into an even bigger tax loss or converts a taxable profit into a tax loss, the R&D tax loss for pre-trading R&D qualifying expenditure or trading R&D qualifying expenditure can be converted into a cash payment (called an R&D tax credit) irrespective of the absence of taxable profit against which the tax loss would normally be offset. The amount of cash repayment is the lower of 12.5% of the R&D tax loss and the sum of the company’s PAYE and NIC liabilities (for the whole of the workforce not just those involved in R&D) for the
accounting period. This contrasts with relief of 20%/26% available if the loss were offset against taxable profits.

There is a fairly tight deadline for making a claim for R&D tax relief and R&D tax credit which is 12 months after the filing date for the accounting period i.e. 24 months after the end of the accounting period. Once outside of this period it is too late to make a claim for R&D tax credit. The claim for R&D tax credit is irrevocable and is often delayed (but watch the time limit) until an assessment can be made of the likelihood of using the R & D tax loss against future taxable profits as opposed to the cashflow advantage of a cash repayment.

The pivotal point for any R&D claim is that there must be an R&D project, which is demonstrably in ‘the pursuit of an advance in the field of science/technology’. The advance must be in overall knowledge or capability and not just in the company’s own state of knowledge or capability alone. The advance need not be positive but it must contribute to knowledge or capability.

The expenditure which qualifies for the R&D tax relief is not the entire cost of developing an App but only that part which resolves technological uncertainties. Uncertainties that can be resolved through discussions with peers or through established methods of analysis are routine design uncertainties rather than technological uncertainties. The HMRC guidance concentrates on the ability to demonstrate from the project’s records an appreciable improvement in the technological field concerned.

The DTI guidelines list examples of qualifying software costs. Put simply, expenditure in App Development around the following heads is potentially qualifying:

- creating new search engines using materially new search methods
- resolving conflicts within hardware or software, where the existence of a problem area and the absence of a known solution have been documented
- creating new or more efficient algorithms whose improvements depend on previously untried techniques
- creating new encryption or security techniques that do not follow established methodologies

Projects lacking in demonstrable innovation are unlikely to qualify. This would include software costs where the development simply uses or adapts known methodology or advances existing processes. Also unlikely to qualify are projects where there is configuration, maintenance or upgrading of existing software products. Similarly, projects which modify existing software applications for intellectual property or commercial reasons will not qualify. Nor will remedial project costs on adapting known software faults or defects.

Interestingly, combining standard technologies can be qualifying R&D if a competent professional in the field cannot readily deduce how the separate components should be combined to have the intended function.
**E. VAT NOTES**

VAT applies to supplies made (virtually all of which will be sales) if they are standard or zero rated. VAT must be accounted to HMRC on such supplies if the seller is or should have been VAT registered. Whether the seller actually charged his client VAT is the seller’s problem; he must account to HMRC regardless, subject to the special relief for bad debts rules. VAT is due on sales made i.e. invoices unless the special Cash Accounting scheme is used.

VAT registration is compulsory if the potentially standard and zero rated sales in the previous 12 months exceeds the registration threshold of £73,000 or if sales in the next 30 days will exceed £73,000.

An App developer can apply for Voluntary registration if his sales are less than this, even if his sales are outside of the scope of VAT because of the place of supply rules, but would have been zero or standard rated if the place of supply had been in the UK.

It is essential to know exactly who the client is and where he “belongs” as, under the place of supply rules, App developers selling to a client in the UK will be making a standard rated sale but if they sell to a non-UK business client the sale will be treated as made outside of the UK and therefore outside of the scope of VAT. Sales can include fees and royalties receivable and commission receivable as well as other income.

Where royalties are administered by a publisher/licensee, it is common for the client to have the billing information and to “Self bill” on the App developer’s behalf. The App developer will normally receive an accounting and a self-billed invoice (generated by the licensee) on which VAT must be accounted. In the absence of self-billing the publisher/licensee will have to account to the App developer who must then generate the sales invoice from the information provided.

A special cash accounting VAT scheme applies for sales of less than £1,350,000 per year. UK VAT incurred on costs incurred are generally offsettable against VAT due on sales subject to special rules e.g. on entertaining. VAT incurred in other countries can also be recovered subject to special rules. VAT is recoverable on an invoice basis unless the special cash accounting scheme is used.

Costs from suppliers in other EU countries which are outside of the scope of their VAT because of the place of supply rules must be reverse charged by the UK recipient of the supply i.e. treated as a sale by him for VAT purposes and simultaneously recovered as VAT on a cost.

Instead of accounting for VAT on sales and recovering VAT on costs, it is possible to elect for a “Flat rate scheme” charging 20% VAT as normal but only accounting for a reduced fixed percentage (usually 14.5%) on the VAT inclusive amount and not recovering VAT on costs.
VAT never was a simple bookkeeper’s tax and there is considerable complexity in everyday transactions relating to place of supply, time of supply, anything to do with land and buildings, non-UK customers and suppliers, which all have resonance with App developers as part of the creative community.

4. ALIGNMENT OF OBJECTIVES AND EXIT

A. ALIGNMENT OF OBJECTIVES

4.A.1 Different Perspectives

Although your business activity may be your life’s work and the fulfilment of every childhood dream, this view may not be shared by your co-owners. Indeed, if the business grows with the benefit of finance from external investors, whether friends and family or venture capital partners, your co-owners’ objectives may be different and more mercenary. You may enjoy what is dismissively termed a “lifestyle” business. You may be content to continue in the same way whilst others may want a rapid return at a substantial profit. That will probably require pushing the business profits up as high as possible to appear ever more desirable and valuable. Different perspectives and aspirations are liable to lead to friction and it is best to try to agree and align your objectives at the outset.

4.A.2 Internal Realignment

Whatever the mix of ambitions amongst the owners, it is important to establish each person’s preferred exit route. If they are incompatible, a re-organisation might be the best option. For example you might personally buy out one co-owner with your savings, arrange for a purchase of own shares by the company, gift all or part of your holding to family etc. The purchases and sales could be financed by bank borrowing and at the end you will hopefully have a more unified set of ambitions.

B. EXIT

4.B.1 Outright Sale

It may be that an outright sale of the business itself or of the various assets of the business is necessary and desirable but there will be a number of factors leading up to this decision and an amount of primping (getting the business ready for sale) to be done.

4.B.2 Assets for Sale

The nature of Apps is that their life may not be long and their back catalogue value may be very low. The short life is a factor in their valuation since the earnings must be made in a short time span and a buyer is looking for maintainable earnings. The short life means that in order to maintain earnings there must be a continual flow of new Apps to produce revenue to replace the revenue from old Apps.

It is likely that the business will only have three things of value to a purchaser:

- the proven creative ability of the designers i.e. specific people (this is the most vital)
• the trademark/brand if well known or well respected
• the back catalogue to the extent that it still produces income or is protective of another App

In the event however that not much value attaches to the Brand, the real value is in the designers who might be approached as individuals and therefore there will be no profitable business sale, only the sign-on fee for a poached designer. An exit geared to the sale of a business requires there to be a valuable business i.e. a team not a star player. This is an issue in the creative industries and if “selling for millions” is an aim, it must be borne in mind.

4.B.3 Personal Factors

There are many personal factors that are likely to influence your decision with regard to whether and when to sell your business. You may need to think about:

• What you will do when you no longer own the business
• What do you wish to do with your life
• When do you want to retire
• Has your health begun to deteriorate
• Do you still relish the challenges of running your business
• Does your business have an heir apparent
• Do you want to passing on your business to your children or other family members, or a family trust
• What do you wish to do with your capital
• Will your income stream and wealth be adequate, post sale
• How can you minimise your tax liability
• Will the new owners will need or desire your involvement after the sale

4.B.4 Business Factors

External factors can also be important in timing your sale. If you can time your business sale to coincide with a period of economic growth, when buyers outnumber sellers and will pay premium prices, you will most likely secure the best price. The following questions may assist in assessing the climate for selling your business and what you should do:

• How has the adverse economic environment impacted your business
• What is the effect of the current state of the stock market
• To what extent is your business ‘trendy’ or at the leading edge
• Is your business forecasting increases to the top and bottom lines
• Is your business doing better than other similar businesses
• Is your business at, or near, its full potential
• Can you sell your share in the business to your co-owners or partners
• Can you sell your business to some or all of the workforce
• Do you want to sell the business to a third party
• Should you wind the business up?

4.B.5 Maximising the Value of Your Business

App development is slightly special in that the Apps have in many cases a short life and there is therefore relatively little value in the back catalogue of IP rights. What is of value is the brand, an expression of the goodwill in your business’s line in Apps and the business’s proven ability to create Apps people want. In reality it may be that a third party can acquire all it needs by taking over the key workers and leaving the business to die. It is important therefore to ensure that the business is more than a shell for your personal talents and is instead a homogeneous business with interdependent people. Only in this way can value be placed on the whole business rather than key people. To build the maximum capital value, it is the business whose value must be maximized and this will involve working as part of an interdependent team and not as a star striker.

Whoever buys your business will want to be clear about the underlying profitability trends - are the profits on the increase or decrease? What has been the effect of the ‘recession’? Up-to-date management accounts and forecasts for the next 12 months will be close to the top of the list of the information which you should be prepared to make available to prospective purchasers. The value attributable to many businesses is driven by the historical profits and therefore a rising trend in profitability should result in an increase in the business’s value.

4.B.6 Maximising Profitability

Profitability planning is always important but particularly in the years leading up to the sale. So, what is the range of values for your business? Although you may think you can make an educated guess, a professional valuation gives you more solid ground. Assess your position today and then work with us to see how you can make your business more valuable. These are the sort of questions a potential purchaser might ask:

• Are sales flat, growing only at the rate of inflation, or exceeding it?
• Is yours a service business with limited fixed assets, or are stock and equipment a large part of your company’s value?
• To what extent does your business depend on the health of other industries or of the economy?
• What is the outlook for your line of business as a whole?
• Will your company’s products and processes be outmoded in the near future?
• Does your company use up-to-date technology and have a well-developed research and development programme?
• How competitive is the market for your company’s goods or services?
• Are your company’s products and services diversified?
• What are your competitors doing that you should be doing, or could do better?
• How strong is the company’s staff that would remain after your sale?

4.B.7 Important Tax Issues

There are many tax issues involved in selling a business and a surprising number of permutations. Here is a selection:

i. Minimising Capital Gains Tax

When you raise that final sales invoice and take the proceeds from the sale of your business, you should be completing one of the last steps in a strategy aimed at maximizing the net return by minimizing the capital gains tax (CGT) on sale.

ii. Entrepreneurs’ Relief

Entrepreneurs’ relief normally applies to the sale of a business and can reduce the rate of tax paid from 18% to 10%. It is vital if you want to maximise your net proceeds that you take advice about the timing of a sale, and the CGT reliefs and exemptions which you might be entitled to claim. The maximum relief is £800,000 which is 8% of the £10 million exemption available at the time of writing.

iii. Holdover Relief

This relief generally applies to gifts of business assets and will normally reduce the tax payable to zero. It works by treating the donor’s gain as if it were attached to the asset - effectively passing on the donor’s gain to be added to any gain realised later by the recipient of the gift. Holdover relief must be specifically claimed by both the donor and the recipient of the asset. If you are passing all or part of your business on to a member of your family (including for onward sale to a third party acquirer), this relief may be relevant to you.

iv. Rollover Relief

This relief applies to the replacement of business assets, and is intended to allow the seller to reinvest all of the proceeds of the disposal in a replacement asset, which he would not be able to do if it had to pay a tax liability. It normally operates by reducing the cost of any new asset by some or all of the gain realised on the disposal of the old asset.
v. Eliminate CGT altogether?

CGT is only chargeable where the taxpayer is resident in the UK at the time the gain arose, provided the taxpayer remains non-resident for tax purposes for five complete tax years. Furthermore there is no liability to CGT on any asset appreciation at your death. However, it is becoming increasingly difficult to establish non-residence and HMRC are likely to challenge any attempt to do so artificially – through the courts if necessary. To benefit from this exemption, it is therefore likely that you would have to leave the UK for good, cutting all ties in favour of a new place of residence. Remember that the country you move to may also charge a form of CGT on disposals.