

TAXREP 7/99

CORPORATE VENTURING

Text of letter submitted to Inland Revenue by the Tax Faculty in response to a request for comments issued in January 1999.

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CORPORATE VENTURING

Introduction

- 1 We refer to your press release dated 8 January 1999 requesting comments on the proposal to give tax relief to encourage corporate venturing. We are sorry that this response is a few days after the deadline.
- 2 We believe that the questions posed in the consultation are aimed very much at business, and at this stage we do not think that it is appropriate for us to comment in detail on the proposals. However, if the Government decides to bring forward detailed proposals, we would like to have the opportunity to comment further. Our comments below are concerned with the fundamental principles.

Major concerns

- 3 We are concerned as to whether the proposed tax relief will encourage larger companies to invest in smaller companies. Our concern is because, in our experience, most entrepreneurs are not particularly interested in outside investors taking equity stakes in their company. This is because most entrepreneurs prefer to own all of the business rather than giving an outside person a significant equity stake. In addition, although some entrepreneurs may welcome the financial and management expertise provided by a major corporate, many will not welcome the possible loss of any control over key aspects of their business.
- 4 Therefore, we do not believe that any limit on the size of the shareholding will be either appropriate or act as a safeguard. Nor do we believe that a minimum holding period for shares will assist in achieving the aims of this proposal.

US Experience

- 5 We think it would assist if some evidence was obtained of US experience in this area, in particular an analysis of what extent corporate venturing is successful and to what extent tax breaks are of assistance.

Position of entrepreneur

- 6 For the reasons mentioned above, our experience is that entrepreneurs will be inclined to obtain finance from banks or private sources rather than seek an outside investor. If interest rates remain low for the foreseeable future, it is likely that bank finance will remain much more attractive than other forms of equity finance. There is also the particular problem of arriving at a value for such a company which is acceptable to the outside investor and the entrepreneur.

Position of corporate investors

- 7 Large companies are generally interested in obtaining a high return in a relatively short period, which is the precise opposite of what a risk investment in a small company would give.

If large companies are willing to risk their money in this way, they are likely to do so only if they can exercise a measure of control over the company in which they plan to invest. It is important to remember that large companies are answerable to outside shareholders.

In order to satisfy shareholders' reasonable expectations, an investment in unquoted companies by a company other than a venture capital specialist is unlikely to be sanctioned without a clear method of managing the risk.

The practical experience of our members is that such investments frequently consume an inordinate amount of high level management time, particularly when the investment fails to deliver as expected.

- 8 We believe that major corporates are only likely to get involved with this sort of situation where the small company is looking for funds for 'cutting-edge' research. Experience suggests that it would take a great deal of additional tax relief to encourage a major corporate investor to take on an equity stake rather than providing funding via, say, a specific research contract with exclusive exploitation rights.

Effective tax incentives

- 9 The promise of a future capital gains exemption is unlikely to provide an effective tax incentive. Reliefs would need to be up-front and over and above what could be realised through the normal revenue deductions or through expenditure qualifying for possible capital allowances.

Enterprise Investment Scheme and Venture Capital Trusts

- 10 There are, of course, two existing tax-advantaged schemes designed to encourage venture capital, the Enterprise Investment Scheme and Venture Capital Trusts. We are not aware that these schemes have so many viable business opportunities on their books that they cannot raise sufficient funds to invest. We would like to see some evidence of how successful these schemes have been in raising finance before consideration is given to yet another scheme for tax relief to encourage investment in smaller companies.

Encouraging the entrepreneur

- 11 It is our view that the problem needs to be considered from the other way around. Entrepreneurs need to be convinced that if they make available a percentage of the equity in return for finance, they will receive a greater amount for the remainder of their equity than they would have achieved if they had held on to 100% of the business and survived on loan finance.

Encouraging small businesses

- 12 If the Government is serious about encouraging small businesses to grow, they need to take action in a number of areas. Firstly, they need to reduce the burdens on small businesses and, secondly, they need to give greater tax incentives to the entrepreneur as well as the investor. In this respect, we note that the Government's abolition of retirement relief rather confirms a widely held view that the Government is not that interested in assisting the development of small businesses.
- 13 If the main purpose of this proposed new relief is to encourage advanced technology company start-ups (which we suspect that it is), then it might make sense to extend the R

& D provisions and allow more generous tax credits in early years to such companies. Even then, however, tax relief may be of little use if the company makes losses in the opening years. Cash grants may be a much greater incentive. We will, of course, be responding separately to the consultation entitled *Research and Development: Definition and Appeals*, but we believe that these questions should be considered together and not in isolation.

Conclusion

- 14 Our initial view is that the case remains to be made for introducing a corporate venture scheme. We are not convinced that on the evidence so far, there is sufficient incentive for entrepreneurs or major corporates to participate. Further evidence of the US experience would be helpful.
- 15 If you would like to discuss these points further, please let us know.

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