

TAXREP 6/10

VENTURE CAPITAL SCHEMES

Memorandum submitted on 1 February 2010 by the ICAEW Tax Faculty to HM Revenue and Customs setting out comments on Venture Capital Schemes: draft legislation and explanatory note published on 9 December 2009.

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VENTURE CAPITAL SCHEMES

INTRODUCTION

- 1 We welcome the opportunity to comment on the proposals published by HMRC on 9 December 2009 at <http://www.hmrc.gov.uk/pbr2009/venture-capital-1260.pdf>.
- 2 Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

KEY POINT SUMMARY

- 3 Whilst state aid approval was received on 29 April 2009, the proposed draft legislation makes a number of changes to the EU definitions. Please clarify that this draft legislation will still satisfy the state aid rules.
- 4 The draft legislation lacks clarity and certainty. The legislation needs to be redrafted so that the EU definition of a small enterprise as set out in Annex A is properly integrated into the UK legislation.
- 5 We recommend that HMRC provides further clarification and guidance, with examples, of when a company will be regarded as 'in difficulty' and therefore ineligible for EIS relief.
- 6 The adoption of the EU definition of small enterprise results in a number of major policy changes in the UK EIS legislation that appear to make the venture capital schemes much less attractive. These policy changes and their effects need to be clarified and publicised.
- 7 Given that these policy changes appear to have made the UK's venture capital schemes unattractive, we think that the UK should have further discussions at the EU level about these proposals to see whether there is scope to relax these proposed rules.

SPECIFIC COMMENTS ON THE LEGISLATION

- 8 *The EU definitions needs to be set out in UK legislation*
The UK rules in this area were given EU state aid approval on 29 April 2009. The key requirement is that to qualify for the reliefs companies must satisfy the definition of a small company as set out by the EC in the Annex to the Commission Recommendation 2003/361/EC of 6 May 2003 (the Annex). However, the precise details of the definition are not set out in this draft legislation and many taxpayers may struggle to find the EU definition.
- 9 Given that this definition is crucial and that the draft legislation makes amendments to it, we think that the definition as amended should be set out in the draft legislation or in a separate statutory instrument so that UK taxpayers have ready access to a definition that is essential to determine whether a company qualifies for these reliefs.

The Tax Faculty of the Institute of Chartered Accountants in England and Wales

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If this is not possible, then HMRC should ensure that a version, as amended by this draft legislation, is made readily available to taxpayers.

- 10 Similar comments also apply in respect of the reference to 'enterprise', 'partner enterprise', and 'linked enterprise' which again refers back to the Annex. It would be helpful if the UK legislation set out precisely where these definitions are found in the Articles.
- 11 Generally, we are concerned that the approach of adopting EU rules but with modifications without clearly setting out the EU rules in the UK legislation is a recipe for confusion. We believe that these provisions need to be rewritten to make them far clearer.

The financial health requirement

- 12 In order to meet EU requirements, the draft regulations insert new financial health requirements. The VCT definition is set out in new s 180B ITA and the corresponding EIS definition is set out in s 286B. The tests are that 'it would be reasonable to assume that it would be regarded as a firm in difficulty for the purposes of the Community Guidelines on State Aid for rescuing and restructuring firms in difficulty (2004/c244/02)'.
- 13 We are concerned that this test could be open to a very wide interpretation given that, for example, paragraph 10(a) of the Community Guidelines states that a company will be regarded as in difficulty where more than half of its registered capital has disappeared (sic) and more than one quarter of that capital has been lost over the preceding 12 months. This requirement is far from easy to interpret in a UK context. We recommend that HMRC provides further clarification and guidance, with examples, of when a company will be regarded as 'in difficulty'.

State aid approval

- 14 State aid approval was given on 29 April 2009. We note that the EU definition of small company also includes a restriction on turnover of not more than 10m euros whereas the draft UK legislation only includes a reference to gross assets and the number of staff. Whilst we welcome this exclusion given that the existing rules do not have a turnover test, we would welcome clarification that the exclusion of this test was approved at EU level.
- 15 Further, proposed new s 191A ITA 2007 makes a number of proposed changes to the definition as set out in the Annex. Again, we would welcome clarification that these changes are acceptable at EU level.

The need for greater clarity

- 16 The adoption of the EU definition of a small company, but as amended by the proposed draft legislation, is a major change of policy in this area. Given that the existing rules have been in place (albeit amended) for many years, the precise scope of the proposed new UK rules is far from clear and lack clarity in a number of key areas.
- 17 It is not clear from new s 191A(4)(c), ITA 2007 exactly how Article 4 of the Annex should be amended. This provision also introduces a new reference to 'as at the time under consideration' rather than the definition contained in Article 4 and we would be grateful for clarification as to why this is considered necessary.

Euros v sterling limits

- 18 The current gross assets test set out in s 186, ITA 2007 is by reference to amounts, ie not more than £7m before any relevant share issue and not more than £8m afterwards. The new test is that the annual balance sheet total (subject also the new requirement in 186(1)(b), ITA 2007) must not exceed 10m euros although the maximum amount that a company can raise in any one year remains at £2m.
- 19 The reference to the need to convert the annual sterling denominated balance sheet to euros will create considerable uncertainty and could result in a company losing its EIS status merely as a result of exchange rate movements at the end of each year. This is likely to undermine further the attractiveness of these schemes to investors. We think it should be possible to devise rules which provide some protection in such circumstances but presume that any such change would require state aid approval.

EFFECTIVE CHANGES IN VENTURE CAPITAL POLICY CAUSED BY THE ADOPTION OF THE EU DEFINITION OF SMALL ENTERPRISE

- 20 The effective importation of the EU definition in effect creates a number of major policy changes in the operation of the venture capital rules. Whilst we recognise that these changes may have been required to comply with EU rules, the changes look likely to decrease further the attractiveness of these schemes to investors. Set out below are three changes that appear major changes in EIS policy.

Partner and linked enterprises

- 21 The new references to linked and partner enterprises marks a fundamental change to the application of existing EIS rules. Under s 185(2), ITA 2007, an EIS company must not be a 51% subsidiary existing UK rules or under the control of another company without being a 51% subsidiary.
- 22 These rules will continue but the staff and balance sheet totals must now be computed including proportionate amounts of any 'linked/partner' enterprises. Under article 3(2), a partner enterprise is any enterprise that holds 25% or more of the capital or voting rights.
- 23 Therefore, if an EIS company is owned 30% by another enterprise, it appears that in applying the small company limits, 30% of the assets and staff of the other enterprise will be included in the calculations. This appears a major change in the rules of the EIS scheme which may result in many enterprises failing to qualify as small.

Breach of size limits

- 24 Under existing rules, an EIS company which has issued shares could acquire a qualifying subsidiary at a later date without EIS relief being withdrawn. It now appears that because the EU definition of small must be tested on an annual basis, a later acquisition of what is currently a qualifying subsidiary could cause the size limits to be breached.
- 25 Under the existing gross assets requirement in s 186, ITA 2007, where there are qualifying subsidiaries the test is applied by adding up the gross value of the assets of each member of the group. Under the EU definition, the test is applied by reference to consolidated accounts (Article 6(2) of the Annex). The effect of this

change is that items such as goodwill and intangibles arising on consolidation will now be included in the test as to whether the group breaches the size limit.

- 26 The draft legislation and accompanying note does not make clear these policy changes nor provide examples of how existing EIS companies may be affected by these changes. There is a need for HMRC to redraft the explanatory note to clarify exactly what policy changes are being made and what their impact might be.
- 27 Taken as a whole these policy changes appear to have made the UK's venture capital schemes unattractive to investors. We think that the UK should have further discussions at the EU level about these proposals to see whether there is any scope for relaxing these proposed rules so as to ensure that these schemes remain viable and contribute to bridging the 'equity gap' faced by many small companies.

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ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 130,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Innovation and Skills through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**; see www.icaew.co.uk/index.cfm?route=128518.