

TAXREP 17/99

CORPORATE VENTURING

Text of submission to the Inland Revenue by the Tax Faculty in response to a request for comments on a Technical Note issued in March 1999.

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CORPORATE VENTURING RELIEF

- 1 We welcome the opportunity to comment on the proposals outlined in the technical note issued on 10 March 1999.

GENERAL COMMENTS

Prior consultation

- 2 We responded to the pre-Budget consultation exercise, the text of which (TAXREP 7/99) is reproduced in Annex A. Whilst in principle we welcome action to encourage support and investment in small and medium sized enterprises ('SMEs') and a reduction in the productivity gap, we are disappointed that most of the points raised in our earlier representation have not been addressed. In our view, the points we raised in our earlier response remain valid.
- 3 We are disappointed that no formal report was tabled in this note on the results of the earlier consultation exercise. The Code of Practice on Consultation recognises (in section two) that feedback is an important part of the process. We think that considered feedback on the responses received to consultation exercises is a vital part of the exercise. We would be grateful for any factual analysis of the responses which may have been prepared.
- 4 As acknowledged in the Code, consultation involves expenditure of a good deal of time and resource by all those involved in the process. Such expenditure by our members in this instance appears to have been largely wasted. We expressed concerns in our representations on the Finance Bill (TAX 9/99, paragraphs 18 & 19) that certain consultation exercises appear to have been a sham. This devalues the consultation process generally, and anecdotal evidence suggests that members in recent months have expressed the view as to whether there is much point in responding to consultations, as the Government sometimes appears not to be listening to the responses. The Code of Practice on Consultation states, inter alia, that the principal benefits of consultation are that it:

'...allows a national debate to take place on the major tax policy decisions issues...and..

...enables ministers and officials to consider the merits of alternative suggestions.'

We are not convinced that these benefits are always apparent to our members.

The case for corporate venturing

- 5 We expressed the view in our earlier representation that the case remained to be made for introducing a corporate venture scheme. We were not convinced that on the basis of the proposals in this note there is sufficient incentive for entrepreneurs or major corporates to participate. We remain firmly of this view.
- 6 We suggested that further evidence of the US experience would be helpful. We would have thought that there should be an objective analysis as to what actual incentives

are made available in the US, and some discussion as to whether the incentives have been successful. However, no such analysis is included in this technical note.

- 7 We remain unconvinced that the US success (or otherwise) of corporate venturing is based primarily upon the tax advantages available. Rather, we suspect that it is due to the US's culture of relatively low rates of corporate taxes and lower burdens on businesses. In respect of the UK, in our view although the rates of UK corporation tax have been reduced, they do not appear by themselves to be sufficiently attractive to encourage investment in the UK. Furthermore, the burdens on businesses (including not only tax but also employment protection laws) have increased significantly in recent years; these will stifle initiative and smaller businesses.
- 8 The only experience of corporate venturing mentioned in this consultation to date is that of the US. It would be helpful if the experience of other major industrialised countries, particularly other EU countries, were also included, so that a balanced viewpoint could be obtained.
- 9 We suggested in paragraph 10 of our earlier representation that before a further relief is introduced, we would have liked to see some evidence as to how successful are the enterprise investment scheme ('EIS') and venture capital trust ('VCT') scheme in attracting venture type capital. We think it would be valuable for such evidence to be produced.

DETAILED COMMENTS ON THE TECHNICAL NOTE

General Comments

- 10 The proposed scheme appears to be based broadly upon the EIS, and it appears that many of the rules and the rates of relief will be based upon those provisions. In view of the fact that EIS relief is aimed at individual taxpayers rather than corporations, we believe that this starting point may not be wholly appropriate. We would welcome clarification of the type of activities at which this proposed relief is aimed. However, we believe that if this relief is to be successful, it needs to be straightforward to understand and to be certain in its application. The introduction of a scheme based upon the highly complicated EIS rules does not appear to meet these criteria.
- 11 The proposed relief appears narrowly targeted. Paragraph 1 of the note states that 'corporate venturing' is 'an umbrella term for a range of mutually beneficial relationships which may be established between companies. This term appears to us to encompass a variety of business relationships, for example joint venture companies and partnerships, development funding by a third party in exchange for exploitation of rights, swapping of business assets etc. Such transactions often require some type of corporate restructuring beforehand to achieve the commercial objective. However, this may not be possible without triggering a tax charge. It would be helpful if a review was undertaken of instances where the tax rules created unnecessary restrictions on commercial decisions, and whether they could usefully be relaxed.
- 12 The relief is aimed entirely at an investment in a company. There may be circumstances where an investment is proposed into an unincorporated business, for example a partnership, rather than a company. We think that such investments should not be precluded.

Section 2 - The Tax relief

Paragraphs 2.1 & 2.2

13 We agree that with the conclusion that relief will need to be provided upfront.

Paragraph 2.3

14 It is proposed that corporation tax relief is provided at 20% on the amount invested. We appreciate that this appears to mirror the corresponding EIS rule, but do not see why it is felt necessary to restrict relief to 20%. This means that a company which pays corporation tax at the small companies rate will obtain full relief on its investment whereas a company which pays corporation tax at the full rate will have its relief restricted.

15 We do not see why relief should be restricted. If one of the purposes of providing upfront tax relief is to level the playing field, as suggested in the final sentence of paragraph 2.1, then it seems to us that relief should be given at whatever is the investing company's rate of corporation tax.

16 Even so, on the assumption that a policy decision has been taken to use the tax system to encourage investment in high risk investments which might not have been made otherwise, we doubt that the proposed relief is sufficiently attractive to achieve this objective.

Paragraph 2.6

17 We find the use of such language as 'kick-start a cultural change' inappropriate in a technical note issued by the Inland Revenue. We believe that a technical note issued by the Revenue should focus purely on the technical issues. It should not include 'spin' to justify policy decisions which appear to have already been made by the Government. If the Government wishes to justify its decisions in this way, it should do so directly and not in a Revenue technical document. We respectfully suggest that the Revenue should be allowed to use neutral wording in its publications.

18 We are concerned at the increasing complexity of the tax rules, particularly where the complexity of the rules is not justified by the numbers of taxpayers who take advantage of the relief. We agree entirely that the Government should keep the case for retaining this relief under review. We therefore suggest that if a relief for corporate venturing is introduced, it should be limited in the first instance to, say, a period of five years, after which time it will expire. Before the expiry date, the effectiveness of the relief should be reviewed by an independent committee. If it concluded that the relief should be continued, the time limit should then be extended.

Section 3 - The Investment

Paragraph 3.2

- 19 We note that the conditions are based on those found in the corresponding EIS rules. Our main concern with these rules relates to the restriction on the period allowed for investment of the subscription monies. In view of the long lead times on many projects, we think that the existing EIS requirement to apply the monies subscribed within 12 months of the investment is too stringent, and should be relaxed. We think it would be reasonable to extend the time limit for this relief (and also EIS) to three years, or the time limit could be extended to such later time as may be allowed by the Board.

Paragraph 3.4

- 20 We do not see why a de minimis of 5% of the ordinary share capital is necessary. In our view, the commercial problems of administration will lead in practice to a de minimis, but we do not see why one should be imposed. This will also lead to a position whereby, say, an investment of £50,000 for 10% of the share capital of one company will qualify whereas an investment of, say, £1,000,000 for 4.5% of a second company will not qualify. There is no logic in denying relief for the second company as compared to the first company.

Paragraph 3.6

- 21 We accept the policy purpose not to provide tax relief for companies investing in subsidiary companies. However, we do not accept that the company in which the investment is made should be safeguarded from possible takeover. It seems to us that a corporate venturer may wish to acquire control at some stage in the future as commercial reasons may overtake events, or the venturer may come to the conclusion that the existing management may not be capable of exploiting the idea that it is funding. It would seem unfair that in those circumstances relief would be withdrawn. We recommend that this restriction is limited to, say, three years from the date that the investment was made, and that relief is not withdrawn in the event that control is acquired in certain circumstances, for example to prevent the company becoming insolvent.

Paragraph 3.7

- 22 We are not convinced that the 20% upper limit is practical or desirable. Ultimately this is a decision in which a balance will need to be struck between the investor company and the company in which the investment is made. The proposed level of 20% means that the venturer has little actual influence and cannot, for example, block a special resolution to wind-up the company in which the investment is made. Such 'negative' control could be a vital safeguard. We appreciate that such safeguards could be built into the arrangements by way of contract, for example in the company's Articles of Association, but think it reasonable that a venturer is not denied the opportunity to invest up to, say, 30% without losing relief.
- 23 There also needs to be some protection when things go wrong. It is quite common to find that the company in which the investment was made has cash flow problems, and in order for the original investment to be protected, the investing company may wish to invest more money into the company. It seems unreasonable that the further investment may then prejudice the relief obtained on the original investment.

Section 5 - The company in which the investment was made.

Paragraph 5.3

- 24 The proposed maximum investment in a company is £1 million, and relief is only available if the company in which the investment is to be made had gross assets of not more than £15 million before the shares are issued. We appreciate that these limits mirror the relevant EIS rules, but we would have thought the opportunity could have been taken to increase these limits significantly, otherwise the scheme is unlikely to be sufficiently attractive to the investing company.

Paragraph 5.4

- 25 We note that the list of non-qualifying activities is based upon that found in the EIS rules. This list excludes companies which receive royalties or license fees, unless they relate to the production of films or research and development. Experience has shown that the research and development test is restrictive in that it does not include, for example, the development and exploitation of computer software. It is common with modern technology, such as in the computer industry, to exploit any products developed by way of licensing, with the result that for EIS purposes such companies do not carry on a qualifying trade. We appreciate there may be a concern that some royalty flows are in the nature of investment rather than a trading, but blanket exclusion of companies that generate royalties undermines the concept of the relief. The Government appears keen to encourage the exploitation and use of computer software and associated technologies, and it is logical to allow companies in these fields to qualify for this proposed new relief and also EIS relief.

Paragraph 5.7

- 26 We do not see why there must be a restriction that only 40% of the proportion of ordinary shares should be held by corporate shareholders. It would not be at all unusual to find that some or all of the shares in the proposed investment company are held by intermediate corporate vehicles of the other investors. In this situation, no relief would be available.
- 27 We appreciate that without some limit, the relief could be exploited by seeking to apply it to the whole of the joint venture, and we would not object to a limitation that a maximum of 40% of the shares in the investing company could qualify for relief. This would address the problem outlined in paragraph 26 above but it would ensure that the potential for exploitation is limited. It should also ensure that relief is not be lost in respect of earlier qualifying investments.

Other Points

- 28 In view of the increasing influence of EU rules on UK taxation matters, we would welcome confirmation that this proposed new relief will not discriminate against companies resident in the EU or be viewed as harmful tax competition under the draft Code of Conduct.
- 29 In view of the desire to encourage enterprise and promote investment, we think that the Government should take a close look at the restrictions in all of the various schemes, namely EIS relief, capital gains deferral relief and now corporate venturing relief, to decide whether each restriction is necessary.

CONCLUSIONS

- 30 We concluded in our earlier representation that if the Government is serious about encouraging small businesses to grow, it needs to provide greater tax incentives to the entrepreneur and also reduce the burdens on small businesses.
- 31 We are not convinced that effective action has been taken in either of these areas, with the result that in our view the take up of this scheme will be limited.
- 32 If you would like to discuss these points further, please let us know.

10 June 1999
FJH/AM
14-45-37

ANNEX A

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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