

Tax Representation



TAXREP 47/08

ENTERPRISE INVESTMENT SCHEME

Memorandum submitted in June 2008 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document published in March 2008 by HM Treasury and HMRC

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ENTERPRISE INVESTMENT SCHEME

INTRODUCTION

1. We welcome the opportunity to comment on the proposals published by HMRC on 12 March 2008 at http://www.hm-treasury.gov.uk/media/4/C/bud08_eis_758.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.

GENERAL COMMENTS

3. The enterprise investment scheme ('EIS') is complex and contains many traps for the unwary, for example the connected parties rules, which can result in withdrawal of the relief. The tax position of investors also depends on the behaviour of people within the investee company, a factor which may be outside the control of the investors.
4. The result of the complexity and traps is that investment using the EIS is less than it might be. If the government wants to encourage entrepreneurs to invest in businesses by using EIS, then the scheme needs to be simplified and some of the restrictions eased. The list of qualifying trades requires modernisation and the scheme also needs more realistic limits for amounts invested and numbers of employees.
5. Where conditions are breached, we suggest that rather than clawback all the relief that was given, a proportionate approach should be taken. We suggest that HMRC should first try to ensure that companies change their behaviour so that they comply with any conditions rather than claw back the relief, and that the clawback should be reduced after, say, eighteen months of compliance.
6. The focus of our response is equity investment into private companies at the smaller end of the investment market.

ANSWERS TO QUESTIONS

Q1 In October 2007 PricewaterhouseCoopers LLP published the survey "Enterprise in the UK: Impact of the UK tax regime for private companies", which showed 65 per cent of respondents were aware of the EIS - up from 52 per cent in 2006. What more can be done to continue this trend of increasing awareness of the scheme?

7. The problem is not so much a lack of awareness that EIS exists but the perception, particularly among smaller firms of advisers, that EIS is too complex and risky for them to advise on with confidence. The result is that many firms have decided not to advise on EIS and many others that do advise temper their advice with so many caveats that potential investors are invariably discouraged from using the scheme.

Q2 *Is there anything in the broader regulatory regime that hampers investee companies seeking external investors under the scheme? If so, how could this be addressed?*

8. We made observations which respond to this question in our representations on Clause 50 and Schedule 16, Finance Bill 2007 (TAXREP 36/07 – see <http://www.icaew.com/index.cfm?route=147867>). The Bill proposed reductions in both the investment limit and the maximum number of number of full time employees, resulting in disqualification of many companies that would otherwise have been eligible for EIS funding. We recommended in TAXREP 36/07 that this could be addressed by increasing the limits, as the EC State Aid rules appear to us to be sufficiently flexible to allow this.

9. See in addition our reply to Q1.

Q3 *How well do advance assurances serve their purpose? Are there any ways in which the process of gaining an advance assurance could be simplified?*

10. This process works well in practice.

Q4 *The list of excluded activities (see Box 2.1) has remained largely unchanged since the inception of the scheme. Do respondents feel it has kept up with commercial and technological developments? Are there any anomalies affecting particular industries or sectors?*

11. We feel that the list has not kept pace with the change in UK business from manufacturing to services. As the UK economy is becoming more knowledge based, the exploitation of intellectual property rights, whether created in-house or acquired from a third party, should be encouraged and we consider that this should not be excluded from the list of qualifying activities. Also farming is not a low risk activity and neither is the hotel trade, both of which have also been adversely affected by the withdrawal of agricultural and industrial buildings allowances respectively. While it may be felt that farming in general may not need encouragement, there are specific areas of farming where encouragement might be beneficial, for example organic farming, biomass production for energy applications (covering for example willow and miscanthus) or allowing certain forms of diversification by farmers to revitalise the rural economy.

Q5 *How well does the current control test achieve its objective of focusing relief on financially independent enterprises that have most difficulty raising capital?*

12. The intention of EIS is to help small independent companies so a control test is a reasonable way of targeting the relief. How well it does this varies depending on the company and circumstances. However, it can be quite restrictive for the very smallest of companies where the owners and families wish to become involved and invest themselves.

Q6 *The Sainsbury Review of Science and Innovation http://www.hm-treasury.gov.uk/independent_reviews/sainsbury_review/sainsbury_index.cfm recommended that "The conditions of the EIS scheme concerning the time constraints for the start of trading and the expenditure of money raised should be reviewed." While the*

Government believes that it is necessary to preserve rules requiring the investment to be put to good use promptly, views are welcome about how the requirements might be refined in practice, especially whether there are particular industries that they do not fit well (for example, those whose ability to commence trade is dependent on potentially long regulatory approval procedures).

13. We suggest that the rules are modified so that the funds have to be used within the three year period, but that there is an option to extend the time limit on request to HMRC to whatever period HMRC allows. This would benefit companies where the nature of the trade is such that it is not possible to spend all the funds within the deadlines laid down or it is unable to commit the funds due to factors outside its control, for example until planning permissions are obtained. This may also give more flexibility where Boards of directors would otherwise feel pressured into making unwise decisions to ensure that the funds are spent and relief is not lost.

Before investment - the investor

Q7 *Is there an adequate level of awareness among potential investors of the existence of the EIS? If not, do you have specific proposals regarding how investor awareness could be increased?*

14. Awareness is still low: many would-be investors think it is far too complicated and bound by conditions that have in fact been eased. However, easing the conditions has not materially decreased the complexity of the scheme and reducing complexity in conjunction with a relaxation of some of the conditions would be likely to increase take up.
15. We recommend as proposals for increasing awareness using Business Link and making available a better version of the HMRC leaflet which should be targeted at the initial contact points for most new businesses, namely solicitors, accountants, incorporation agents and banks.

Q8 *Is there anything in the broader regulatory regime that hampers external investors seeking potential investee companies under the scheme? How could this be addressed?*

16. See our reply to Q2.

Q9 *Could any added value be gained from adapting the carry back provisions to allow carry back or carry forward for one year either side of investment?*

17. Increasing the flexibility of offset as suggested would enable investors more readily to be able to use the relief and is likely to encourage take-up.

Q10 *Are there examples where the rules surrounding connected parties work in a way that seems anomalous to, or at odds with, the purpose of the scheme?*

18. This is a difficult area where we would welcome clarification on remuneration arrangements. The position of business angels on second round investment can be a problem. For example, a business angel is unconnected with a company into which he invests £100k. He starts receiving a salary. The company needs more

money so he considers investing another £100k. If he does so, he will be treated as connected subject to the proviso whereby further investments by remunerated directors within three years of the original investment are eligible for relief. However the fact that further investments after that time will not qualify causes serious problems in practice where a director is otherwise willing to make the further investment.

19. Also where an investor makes an investment of just under 30% then if a further equity raising is required and other investors do not take up their rights then the investor could become connected. The rules could be further refined in this area as both these issues are a disincentive to investing the further funds required.
20. We also consider that the 30% rule can be unhelpful commercially because the greater the interest the individual has in the company, the more likely it is that the individual will devote himself to ensuring that the company succeeds.

Before investment - HMRC

***Q11** Are HMRC or other Government departments missing any opportunities to raise awareness of the scheme among potential investors and/or companies? Is there anything that HMRC or other Government departments are doing that impedes the links between potential investors and companies?*

21. See our reply to Q7.

Making the investment

***Q12** Are there any ways in which the process of obtaining EIS relief (or the forms themselves) could be simplified?*

22. The system works satisfactorily, although shortening statutory response times would be welcomed.

The three-year qualifying period

***Q13** Is three years a sensible time period for the company to have to continue meeting the qualifying conditions to ensure that the funds raised under the EIS are being used according to the policy objectives of the scheme?*

23. Three years is a long time for a company to be at risk of inadvertently breaching the conditions and causing withdrawal of relief. Such a long timeframe may result in investors not investing because they perceive that the risk of an inadvertent breach of the conditions leading to a total clawback of relief is too high.

***Q14** What more could be done to ensure that companies meet their obligations and avoid accidental breaches?*

24. We recommend that removing some of the traps and pitfalls, such as the three year business angel director requirement noted above, even if such simplification might lead to tax leakage. In practice, many pitfalls are only appreciated when it is too late. For example, if two people have formed a company with say £10 share capital and

then seek advice about how to come within the EIS regime, it is too late to remedy the situation so that EIS relief can be claimed on that or subsequent investments.

Q15 Are there alternative ways of treating breaches of the requirements that still support the scheme's objectives and deter misuse, but apply more proportionately?

25. This is one of the most important questions and we are disappointed that it is insufficiently considered in the consultation document. The difficulty arises from not distinguishing between full EIS relief and CGT deferral relief. The restrictions may be reasonable for full EIS but are grossly disproportionate for what is in reality a roll-over relief. For example, an investor invests £1 million as qualifying shares following a result of a business disposal. If his directors' loan account becomes more than £1,000 overdrawn then the whole deferral gets clawed back. This is excessive. There are a number of other similar breaches which are punished severely. We see no reason why this should be necessary in all cases when in the example cited the overdrawn director's account will be caught also by the benefit-in-kind rules and s 419 ICTA 1988.
26. Clawing back relief should be the final resort rather than the first sanction for breaches during the three year period. If the company is not conducting itself properly, then we recommend that first HMRC should approach the company to explain how it can get back on track. Re-educating company officers would provide an opportunity for them to explain their actions to HMRC – and perhaps help HMRC to increase its understanding of how business works which may enable it to apply the rules in a commercial manner.
27. Where clawback of relief is appropriate within the three year period, then we suggest that a more proportionate approach would be to have a graduated loss of relief if the conditions are breached on or after, say, 18 months, phased from 100% loss of relief at 18 months to no loss at three years.

EIS funds

Q16 Are there any procedural or administrative aspects of the processes concerning EIS funds that you feel could be simplified? If so, how?

28. We have no comments on this question.

Other

Q17 Do you have any other suggestions on how the administration of the EIS could be simplified and/or improved?

29. See above.

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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 128,000 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, Enterprise and Regulatory Reform 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 <http://www.icaew.co.uk/index.cfm?route=128518>.