TAX-ADVANTAGED VENTURE CAPITAL SCHEMES: ENSURING CONTINUED SUPPORT FOR SMALL AND GROWING BUSINESSES

ICAEW welcomes the opportunity to comment on the consultation paper Tax-advantaged venture capital schemes: ensuring continued support for small and growing businesses, published by H M Treasury and H M Revenue & Customs on 10 July 2014.

This response of 19 September 2014 has been prepared on behalf of ICAEW by the Tax Faculty in consultation with the Corporate Finance Faculty.

Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

Contents

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com/taxfac

T +44 (0)20 7920 8646
F +44 (0)20 7920 0547
E taxfac@icaew.com

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For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

MAJOR POINTS

Introduction

1. We welcome the opportunity to comment on the proposals in HM Treasury and HMRC's consultation document of 10 July 2014.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

Key point summary

3. We welcome the current review of tax-advantaged venture capital schemes (VCS) and continue to believe that they have an important role in supporting funding options for start ups and other small companies.

4. While the process for companies is relatively straightforward, we are concerned that the complexity of the schemes and the rigid rules for the investor, leads to many prospective investments to fail to qualify. This leads to there being less money available for the same or for other businesses in the future.

5. The recent changes to these schemes have increased awareness of VCS and our members have seen an increase in enquiries in relation to SEIS.

6. In our view, the proposal for a total investment limit of €15 million would offer more flexibility and simplicity than an annual investment limit. However, if a lifetime limit is introduced, the time limit within which the money must be used by business would need to be increased so that companies can take in money when it is being offered, but can then use it over a number of years. We consider a four to five year time frame would be appropriate.

7. An electronic version of the main forms would be welcome and would be in line with the general move to digital communication.

RESPONSES TO CONSULTATION QUESTIONS

Chapter 2: The key parameters of the tax-advantaged venture capital schemes

Q1: Are the tax-advantaged venture capital schemes currently meeting the overarching principles, as detailed in Box 2A? H

Have the recent reforms to the schemes resulted in more effective and well-targeted support?

8. The existence of the reliefs does encourage investors as the tax breaks are a valuable incentive together with the prospect of capital growth. The schemes play an important role in supporting an alternative funding option for start up and small companies.

9. For the investors, the process is relatively straight forward. However the same is not true for the companies. The rules are complex, there are numerous pitfalls for the unwary and the legislation does not facilitate the typical start up situation. Most of the companies that need this investment are early stage companies which are cash poor. They cannot afford the necessary professional advice at the outset so do not set up their capital structures correctly and the legislation does not permit rectification. In many cases the investor is identified and it is only then that any thought is given to whether any venture capital relief will be available. Where the money is already in the company and shown as a loan, it is too late to obtain the reliefs.

10. There is a paradox between the principle that the venture capital schemes "are not intended to provide a tax-efficient investment solution for investors seeking to minimise their tax liability", and the investments being made. In reality it is the availability of tax relief that attracts investors to these companies and pledged investment is on the basis that relief will be obtained. Investors are looking for a tax efficient investment and this is the incentive for them to invest in these early stage companies. We agree that abuse of the VCS is not acceptable, however there is considerable targeted anti-avoidance legislation in relation to use of funds and guaranteed exits, as well as the general 'not for tax avoidance' rule. We believe that the existing rules should be adequate to ensure that the funds are used in the company.

11. The recent changes have increased awareness of VCS with our members seeing an increase in enquiries in relation to SEIS.

Q2: Does the current limit for tax-advantaged investment into qualifying companies, of £5 million per year, achieve the same effect as a total limit of €15 million? Please provide details where you have experience with companies receiving more than €15 million under any of the schemes, and explain the need for that level of investment.

12. Where a company has a lot of interested investors, it can potentially raise more than £5m. In these cases it has to turn away investment and it may not attract this investment in a subsequent period.

13. However, the increase in the fundraising limit to £5m has been widely welcomed, and has provided greater stimulus to the sector.

14. Members have not provided any examples of companies receiving more than €15m, but this may be due to previous limits being in place in respect of the gross asset requirement.

Q3: Would a total investment limit of €15 million actually offer more flexibility and simplicity than an annual investment limit?

15. It would definitely provide more flexibility as companies could take in more that the £5m limit where there is an 'over subscription'. However if a lifetime limit is introduced, the time limit within which the money must be used by business would need to be increased so that companies can take in money when it is being offered, but can then use it over a number of years. A four to five year time frame would be appropriate.

16. There is a view that an annual investment limit is simple and would be easier to manage and monitor than a lifetime investment limit, particularly if this limit is denominated in euros.

Q4: Do the qualifying companies rules and limits on company size effectively target the investment towards less established companies? How would a limit on the time that a company had been trading in the market impact on any investments made? Please provide details where you have experience with older companies, or companies with more established trades, receiving investment under the schemes, and explain the need for that investment.

17. The qualifying companies and size limit targets companies of a particular size rather than at a particular stage of their life cycle. This gives established companies the opportunity to attract funds for expansion and explore new markets. The 'new' company test for SEIS has caused a lot of problems as many businesses start quite slowly and are often carried out on a part-time basis first. The 'new' test is, in the view of our members, overly restrictive. Also in relation to SEIS the employee number test discriminates against labour intensive businesses. Depending on the industry in which a company operates, the set up time can vary enormously, so that companies in certain industries can be locked out of this relief.

Chapter 3: Supporting SME access to finance in the current market

The impact of the 2012 reforms – expanding EIS and VCT, introducing SEIS

Q5: What do you think the impact of the increase to £5 million as annual limit for investment into qualifying companies has been? Has it unlocked investment throughout early and growth stages of company? Has it allowed for further rounds of funding over time?

18. The increase from £1m to £5m has resulted in a wider range of companies being able to access funds through venture capital schemes.

Q6: What do you think the impact of the increased employee limit for qualifying companies has been? Has it unlocked investment throughout early and growth stages of company? Has it allowed for further rounds of funding over time?

19. This increase has had a positive effect, enabling a wider range of companies to access funds through venture capital schemes.

Q7: Do you believe that these increased limits are now supporting more established companies that are less in need of support? Please provide evidence to support your answer.

20. Our members rarely come across companies that are prevented from using EIS because of the gross asset limits. However the increased limits do enable a wider range of companies and can assist companies which have grown rapidly and now wish to raise further finance.

Q8: What do you believe the impact of SEIS has been on the market more generally?

21. SEIS is not as available as companies would like. The positive impact is that its existence has increased awareness of VCS however the rules are restrictive and many businesses struggle to dealing with the requirements.

Investors using the tax advantaged venture capital schemes

Q9: Do you believe that the type of investors using the venture capital tax reliefs is changing? What are the risks and benefits of this?

22. There is no single type of investor, and any investor will consider a company seeking to raise funds under venture capital schemes on its own merits. Certain types of company may attract a certain type of investor.

23. However, there is a view that the type of investor has been changing for reasons that are unrelated to the venture capital schemes themselves. Reasons put forward by members include the following:

- Changes to market conditions and low interest rates
- The tightening of the Financial Conduct Authority (FCA) requirements in relation to evidence of suitability of investors;
- The changing attitude generally to tax avoidance schemes, and there is a danger that venture capital schemes could be tarred by the same brush;
- In view of the inherent high risk, a limited number of financial advisers may be prepared to recommend investments in companies raising funds under venture capital schemes.

Q10: Is the lack of a minimum investment limit for SEIS, EIS, and VCTs a help or a hindrance for investors, companies and intermediaries including fund managers?

24. It allows investors to spread their investments.

Q11: Do you believe that the recent change to allow VCT shares to be subscribed for by nominees will have a significant impact on the market going forwards?

25. This is a positive change and it is in line with the UK's recognition of trusts. It may encourage investors who do not want their involvement with a particular company on public record.

Q12: Is there more that the government should be doing to facilitate the use of tax reliefs by retail investors?

26. The biggest barrier that companies face in raising finance is the ability to access investors who have funds and an interest in this type of investment. Any assistance to companies in overcoming this problem is to be welcomed, including a reduction to the amount, and to the myriad sources of regulation.

Q13: Do the current mechanisms for claiming tax relief create difficulties for investors or investee companies? How?

27. The process for investors is relatively straight forward. However as outlined in our comments in response to 0 above, many companies struggle to get the company 'investment' ready. The rules are complex and cumbersome for companies who are at a stage where they cannot afford to take professional advice.

28. An electronic version of the main forms would be welcome.

Q14: Do you believe an alternative process, such as that used for Gift Aid, would work more easily? Why? How would HMRC be able to verify the tax liabilities with this type of mechanism?

29. The use of a system similar to gift aid would cause even more complexity and would require a complete change in the way in which VCS are administered. We do not believe that this would assist with making investments.

Convertible loans

Q15: Do you agree with the summary of the issues relating to convertible loans set out at paragraphs 3.22 and 3.24?

30. We disagree. While some loans can protect against risk there could be a way in which loans could be used under VCS. The loans would have to be unsecured and carry no interest.

Q16: Have you used an advance purchase agreement to facilitate investment? If not, would you consider doing so if the process were formalised? Why?

31. Small companies often have informal versions and it is this which prevents VCS relief as there is a delay in issuing shares. Our view is that a formalisation of this approach would make a big difference to companies issuing VCS qualifying shares.

Q17: Do you believe that a change in legislation to enable shares received on the conversion of a loan note to qualify is necessary? If so, what conditions do you believe are reasonable to ensure that the use of loans in this circumstance does not create significant opportunities to mitigate risk?

32. A change in the legislation would increase the use of VCS for start ups which are more focussed on getting the money into the bank than on issuing the shares. Our view is that three months is too short and a period of six months to a year would be more appropriate. Where convertible loans are used' these should be unsecured, have a minimum term and carry no interest on the basis the return is an increase in the value of equity in the longer term.

Q18: Are there other approaches that you believe would be preferable? Why?

33. Where funds are put into a company with the expectation that the investor will get an equity stake in the company the amounts should qualify for VCS reliefs notwithstanding that there is no formal loan document in place. There needs to be a means of accommodating delays between cash being injected and shares being issued. In particular, this arises where funds are introduced to pay specific expenses on the understanding that it is part of a total investment that that person is making.

Example:

34. John agrees to invest £50,000 into XYZ Ltd on the understanding that he will get EIS relief. He immediately transfers £12,034 to cover the salary bill for the month. Two days later he transfers £1,257 to pay some office overheads. Over the next few months he pays in the balance. When the year end accounts are done the directors realise that the shares have not been issued. In these circumstances EIS relief would not be available.

Qualifying investments

Q19: Has the recent change in shares eligible under EIS been beneficial? Have investors continued to make investments in line with the overarching principles of the schemes (see Box 2A)?

35. The changes to the shares have allowed the founding shareholders to have lower ranking shares that the EIS shareholder so from that perspective it is useful in attracting investor. However the legislation is complex and advisers are reliant on HMRC comments which are not evident from the legislation itself.

Q20: Are there cases where the current rules on qualifying shares have created barriers to investments being made? What changes to the rules could prevent these cases without creating opportunities for investors to benefit from tax relief on investments where they are protected against risk?

36. Anti-dilution clauses should be looked at again, although there is a wide range of views from members as to how these should be treated. In general commercial anti-dilution clauses should be permitted with reasonable safeguards.

37. Ratchet mechanisms may assist further investment in a company, but should not be so generous as to protect an investor from the inherent risks of investing in a venture capital company.

Q21: Have the current rules relating to the creation of intangible assets facilitated investments?

38. The restriction of relief to investors on companies which have created the intangible is within the spirit of the relief. However where there are joint ventures or other joint collaboration the relief is not necessarily available. Many businesses have no option but to enter into a joint venture at the development stage where resources are needed from another party. The rules could be extended so any company actively involved in the creation of intellectual property should qualify under VCS whatever the level of their participation in the income stream from the intangible asset that has been created.

Q22: Are there cases where the current rules on qualifying shares have created barriers to investments being made? What changes to the rules could prevent these cases without creating opportunities for investors to benefit from tax relief on investments where they are protected against risk?

39. See responses to Qs 20 and 21 above.

Other

Q23: Are there other areas where current rules have created barriers to investments being made? What changes to the rules could prevent these cases while continuing to ensure that the overall principles, as outlined in Box 2A, are maintained?

40. The sheer complexity of the rules is a barrier to investments.

Chapter 4 Ensuring the tax reliefs remain focussed

Current rules to target the tax reliefs

Q24: Do the current rules for determining qualifying companies work effectively overall?

41. The idea of excluded activities is to rule out ‘safe’ trades. These should be revisited. The exclusion of property backed companies is in line with this as the assets tend to support the company and provide a level of security for the investor.

42. A pub company will qualify but a hotel company will not. In some cases there is little difference between a small hotel and a pub.

43. Legal and accountancy services are excluded whereas other consultancy services are not. There is no commercial rationale for this.

Q25: Do you find the flexibility offered by the interpretation of “substantial” useful in determining whether a trade can qualify? Or, would it be helpful to set this out in legislation, with rules explaining both the proportion of activities that can qualify and determining the criteria to which that applies (turnover, capital etc).

44. The “substantial” test applies to groups of companies, but for a single company the trading requirement is that “the company, ignoring any incidental purposes, exists wholly for the purpose of carrying on one or more qualifying trades”. A group company receiving the funds must also meet this latter test. The test for a stand-alone company is more onerous than it is for a group of companies. If there are non-qualifying activities a group can accommodate them but a standalone company cannot. This can force the creation of a group structure. This anomaly should be addressed, so that the same level of flexibility is available to a single company, which is otherwise forced into the creation of a group simply to fall within the “substantial” test.

45. There should be further guidance on what “incidental” means as the existing guidance is based on the old Business Expansion Scheme (BES) guidance.

46. The term substantial is important for the purposes of VCS, so a definition in legislation would be helpful.

Q26: Considering the existing exceptions to the excluded activities list for community energy projects, AD, and hydro, do you believe there is still a strong justification for these exclusions? To what extent are these projects reliant on venture capital tax reliefs?

47. These projects have a high up front capital requirement, and such companies would benefit from being able to raise funds under venture capital schemes. Moreover, these companies support the government commitment to energy efficiency targets. The exclusions should be reconsidered, although in refocussing the reliefs to take into account other government incentives available to such companies could give rise to complexities in the list of qualifying trades.

Q27: What impact, if any, would the removal of tax relief under EIS and VCT for investment in companies receiving energy subsidies, together with the absence of SITR, have on community energy schemes?

48. Appropriate energy projects should be permitted. Venture capital is an important source of finance while community energy schemes are still at the infancy stage.

Q28: Are there any areas where the excluded activities list precludes investment into genuinely high risk investments?

49. Many hotels are high risk businesses and are on the excluded list. The collapse of hotel businesses in the past few years is evidence of this. The list originates from the BES in the early eighties with some modifications. The list should be revisited with the policy objectives in mind and the changes in business practices over the last 30 years or so.

Alternative approaches to target the tax reliefs

Q29: Are there particular areas where low-risk investment activity is taking place and that may be diverting investment away from higher-risk, innovative companies?

50. How is high risk defined? It means different things to different investors. If funds are being attracted into companies which have no other way of raising finance that has to be positive.

Q30: Are there particular areas where high-risk investment activity into innovative companies with growth potential is not taking place? Are there any common features that could be used to identify these sectors, or investment opportunities?

51. It is difficult to see how these could be identified. Some of the most traditional business have innovative ideas to make changes in business processes.

Q31: Do you believe that a new “principled” approach is necessary?

52. This would be difficult to create and implement. The current approach of using size and activity to identify qualifying companies is probably the most appropriate although the criteria need to be modernised.

Q32: Do any of the options outlined in paragraphs 4.19 to 4.22 appeal to you? Why?

53. No, they are too subjective and would probably exclude more companies that are actually appropriate to this kind of investment.

Q33: Are there any other approaches that you believe would be preferable? Why?

54. The broad idea does work but the identification of qualifying activities needs to be reappraised and there are still too many complexities within the legislation, many of which could be dispensed with without undermining revenue protection.

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APPENDIX 1

ICAEW 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 icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)