



## TAX-ADVANTAGED VENTURE CAPITAL SCHEMES: A CONSULTATION

**Comments submitted in September 2011 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) to HM Treasury in response to the consultation on tax advantaged venture capital schemes issued in July 2011**

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# TAX-ADVANTAGED VENTURE CAPITAL SCHEMES: A CONSULTATION

## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper Tax-advantaged venture capital schemes: a consultation, published by HM Treasury in July 2011 at [http://www.hm-treasury.gov.uk/consult\\_tax\\_advantaged\\_venture\\_capital\\_schemes.htm](http://www.hm-treasury.gov.uk/consult_tax_advantaged_venture_capital_schemes.htm)
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Information about the Tax Faculty, the Corporate Finance Faculty and ICAEW is given below. We have also set out, in the Appendix, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

## WHO WE ARE

4. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
5. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.
7. The Corporate Finance Faculty is the voice of corporate finance within ICAEW. The faculty is responsible for submissions to regulators on behalf of ICAEW. Its members include corporate finance advisers, reporting accountants, lawyers, bankers, private equity houses, brokers, business angels, academics and companies. It provides a range of services to its members including a monthly magazine Corporate Financier.

## MAJOR POINTS

8. We believe that further funding support for start-up and early stage businesses is needed since a shortage of easily accessible funding is a hindrance to growth.
9. Tax relief for those investing in new businesses is one way to achieve this. The nature of these businesses makes them a more risky investment prospect and this often leads investors to ask for a greater return from the capital they invest. A tax subsidy increases this rate of return.
10. It is important that businesses and investors know with certainty whether an investment will qualify for tax relief. We see the proposed clearance procedure for the Business Angel Seed Investment Scheme (BASIS) as an essential part of the new scheme.

11. Rather than developing BASIS as a new standalone scheme, we believe that the better approach would be to incorporate the support for seed investment by special provisions within the existing EIS. This would mean
- Less new legislation
  - Easier and cheaper administration
  - Building on existing familiarity

The EIS could incorporate additional features for investment in BASIS companies

12. The qualifying tests for the company seeking funding should be as simple and objective as possible. A modest gross assets test, a minimal number of employees and pre-revenue or with low levels of revenue should suffice.
13. We do not think it is necessary for business angels to be defined. The scheme should be available to as wide a group of investors as possible. Requiring the investor to meet conditions personally will unnecessarily reduce the size of the group who can invest and therefore the funding available. The proposed requirement that an investor has to have previously invested in four or more seed-stage companies would therefore seem to be unnecessarily restrictive. Similarly, the requirement that the investor, if not a director, must provide specified support or advice with regards the project would appear to be both difficult to define and complex.
14. Investors may have business acumen, but to require their involvement in an area where the original business owner has more and better experience could be counter-productive. It will not necessarily help a project that needs only finance for the development stage to have to find a role for such investors just so that the investors can qualify for the relief.

## GENERAL POINTS

15. We are pleased that the Treasury is undertaking this early stage consultation in how best to support investment in early stage businesses.
16. In its recent report, Principles of Tax Policy, the House of Commons Treasury Committee considered the principles which should be considered when formulating or amending tax policy. It says in its conclusion:

‘...the indiscriminate use of taxation to achieve wider policy goals may increase the complexity of the system and be counterproductive. Governments should be wary about using tax policy as a substitute for direct policy measures, doing so only after careful analysis shows it to be the most effective tool.’

17. It is important that BASIS is developed with this in mind, particularly as the businesses it is aimed at will be at a vulnerable stage in their development. In particular, the rules should be simple, certain and easy to claim.

## RESPONSES TO SPECIFIC QUESTIONS

### **Q1 What evidence is there that specific support is needed to encourage seed investment? What sort of support is needed?**

18. We believe that further funding support for start-up and early stage businesses is needed. We have not undertaken a statistical survey to support this, but anecdotal evidence from our members indicates that a shortage of easily accessible funding remains a hindrance to growth.

19. Tax relief for those investing in new businesses is one way to achieve this. The nature of these businesses makes them a more risky investment prospect and this often leads investors to ask for a greater return from the capital they invest. A tax subsidy increases this rate of return.
20. It is important that businesses and investors know with certainty whether an investment will qualify for tax relief. We see the proposed clearance procedure for the Business Angel Seed Investment Scheme (BASIS) as an essential part of the new scheme.

**Q2 Can any additional support be provided through reforms to existing tax reliefs or would it be better provided through non tax measures?**

21. We would like further consideration given to adapting and using the existing Enterprise Investment Scheme to encourage seed investment. For example, removing some of the restrictions which prevent certain directors, employees and family members from claiming the relief. Family members are often more willing to invest in high risk start-up businesses than unconnected parties.
22. A useful method of assisting start-ups was available through “sideways loss relief” where funding was provided through partnerships (or sole traders) with less legal and documentary process and less cost than corporate structures. This worked very well for many seed investments. Non-active traders and limited partners are now limited to sideways loss relief of £25,000 and we note that further restrictions are being considered in the consultation document, High-risk areas of the tax code: Relief for income tax, published by HMRC on 30 June 2011.
23. A suitable but limited version of this relief would be a valuable addition to seed funding techniques and funding.
24. Para 2.27 discusses allowing tax advantaged loans. It seems likely that using such low risk investments could rapidly lead to such loans replacing mortgages. Care would be needed to ensure that this relief is properly targeted.
25. The current NIC holiday for new small employers should be reviewed to assess whether it is achieving its objectives. We note that as of March 2011, over 3,000 applications had been received, of which 96% were approved. If the businesses currently benefitting are in line with the Government’s policy objective, this scheme could be extended to other parts of the UK.
26. The Current consultation, Digital by Default, proposes to make it mandatory for all new businesses to register with HMRC online and also to set up new payroll schemes online. We are concerned that this obligation will deter some new businesses from taking on employees.
27. Any help for small businesses should not add to the regulatory burden which already falls on them disproportionately.

## **Seed Investment**

**Q3 Would a new standalone scheme be an effective way of meeting the Government’s objective of providing support for seed investment?**

28. We would welcome further relief to encourage potential investors in smaller businesses. However, we do not believe a new standalone scheme is the most efficient way of providing that support. We believe that the better approach is to incorporate the support for seed investment by special provisions within the existing EIS. This would mean
  - Less new legislation
  - Easier and cheaper administration

- Building on existing familiarity

29. The EIS could incorporate additional features for investment in BASIS companies, such as allowing convertible debt instruments to be eligible for tax relief.

**Q4 Any proposal would potentially add to the complexity of the tax system and run counter to wider Government aims to streamline support for start-ups. Would additional complexity itself be a barrier to investors who might otherwise be incentivised by a higher rate of relief?**

30. Any complexity has to be seen in the light of the incentives. We believe that using the existing EIS scheme as a basis for the new relief would be less confusing than having a brand new scheme. Provided that entitlement to the relief can be established as quickly as possible, the additional legislation will be proportionate.

### **Definition of seed-stage companies**

**Q5 How best might Government define “seed-stage” activities?**

31. Most of our members favour a definition including a maximum level of gross assets.
32. The tests should be as simple and objective as possible. A modest gross assets test, a minimal number of employees and pre-revenue or with low levels of revenue should suffice.
33. We do not think this relief should be restricted to pre trading, but recommend that a low level of revenue should be permissible to allow the business to have made small sales of earlier products or prototypes.

**Q6 At what point does the need for “seed” investment cease?**

34. A company should cease to be eligible for seed investment once its revenues (perhaps annual or cumulative) or gross assets exceed a defined level. A time limit is unlikely to be appropriate as some seed companies, particularly in medical research, do not receive significant levels of revenue for several years.
35. Rather than attempting to limit allowable seed investment by reference to assets, revenues or time, it may be simpler to rely on a limit on the amount of investment that can be made under BASIS, using the same form of limits as under the EIS; that is limits on the amounts raised from individual investors and a limit on the amount that can be raised by the company in a set period of time. This will also provide greater certainty to investors.

**Q7 In particular, how might legislation distinguish between seed-stage manufacturing or production for trial purposes, and commercial large scale production or manufacturing?**

36. We consider that it would be very difficult to arrive at a definition which correctly made such a distinction. We are not convinced that such a distinction should be made since both would contribute to the growth of the UK economy. A distinction should only be made if the policy objective is to reward only investment in companies creating new concepts or intellectual property.
37. We also consider that a de minimis limit for permitted revenue would obviate the need for such a distinction.

**Q8 Would an explicit limitation to “pre-trading” activity be overly restrictive?**

38. Yes. It could also prevent a business accepting early orders from potential customers.

**Q9 To prevent abuse of the scheme, Government proposes that all monies raised under the scheme should be utilised within a certain period of time for the seed-stage activities for which they were raised. Is this a reasonable requirement?**

39. We consider that this is a reasonable requirement, but the rules should allow variation with HMRC's consent. There will occasionally be an unavoidable delay due to difficulties with licences or other regulation, which has been an issue in the past.

40. It is important that tax favoured funds are employed for appropriate purposes.

**Q10 If so, what would be an appropriate period of time?**

41. The limit could be based either on the EIS rules, or alternatively use an objective measure such as two years, but with some provision for any specific and agreed long-term project provided it has been started within two years.

## **Types of Investment**

Subject to State Aid approval of the BASIS scheme, it may be possible to offer relief for both equity and some debt instruments. The government envisages a requirement that to comply with EU guidelines, any individual BASIS investor in a qualifying company would have to have at least 70% of their investment in the form of equity or quasi-equity.

**Q11 Unlike EIS, individual investors would have to ensure that their investments satisfied this new equity condition. Would this present any problems in practice, and how might these best be addressed?**

42. This should not present problems in practice.

**Q12 Should any further restrictions be placed on equity or quasi-equity instruments?**

43. No

**Q13 What restrictions should there be on the forms of debt that qualify?**

44. We do not think that restrictions should be imposed for tax relief under the scheme. We recommend that tax relief should be available for investments in convertible loans which have the following characteristics:

- Unsecured
- Convertible into equity shares at a date of a future share issue, subject to defined floor price or minimum conversion price
- Have a minimum term

## **Definition of Business Angels**

**Q14 How best might Business Angels be defined, to ensure that the additional relief was only available to those providing both finance and the benefit of their business acumen?**

45. We do not think it is necessary for business angels to be defined. The scheme should be available to as wide a group of investors as possible. Requiring the investor to meet conditions personally will unnecessarily reduce the size of the group who can invest and therefore the funding available. The proposed requirement that an investor has to have previously invested in four or more seed-stage companies would therefore seem to be unnecessarily restrictive.

46. The requirement that the investor, if not a director, must provide specified support or advice with regards the project would appear to be both difficult to define and complex.

47. Investors may have business acumen, but to require their involvement in an area where the original business owner has more and better experience could be counter-productive. It will not

necessarily help a project that needs only finance for the development stage to have to find a role for such investors just so that the investors can qualify for the relief.

48. Similarly, the requirement that the investor should participate in the governance of the company is an unnecessary complication.

**Q15 Should it be sufficient for an investor to be participating in the governance of the company if they are a director, or should there be particular requirements as to the degree of their involvement? If so, what should these particular requirements be?**

49. See Q14 above

**Q16 Should investors who are not directors be able to qualify? If so, in what circumstances?**

50. See Q14 above

**Q17 To qualify for a seed investment scheme, should investors have a track record of previous investment? If so, for how much or how long should they have invested?**

51. We do not believe this is an appropriate measure. Such a requirement could create a situation where a willing investor cannot invest only because he has not done so before.

52. Previous failure is not a guide to future success.

**Q18 What other factors might be taken into account besides previous investment and current governance?**

53. We believe that the conditions for the relief should as far as possible concentrate solely on the project and the company itself. We think it is unnecessarily restrictive to require the investor to meet subjective tests about his prior involvement and expertise in venture capital projects.

**To avoid breaking EU rules on cumulation of aid it is envisaged the money raised under a seed scheme would have to be employed on the seed-stage activities for which the money was raised before funding could be raised under EIS or VCT.**

**Q19 Would such a requirement impose unrealistic restrictions on investment? If so, how might Government ensure that the relief given under a new seed investment scheme was being given only for monies raised to support seed-stage activities?**

54. We think such a requirement could create unrealistic restrictions. It might mean a successful seed company needing ongoing development finance may not be able to move on and raise money under the EIS or VCT provisions. A restriction on the amount of funds that may be received under the seed company rules may be more appropriate.

## **Monitoring the Impact of Changes**

**Q20 From experience, schemes can be open to manipulation (particularly where tax relief is generous). What monitoring and conditions could usefully be included to ensure the scheme remains properly targeted?**

55. We believe that the existing legislation regarding EIS and VCT should form the basis for any monitoring of the new scheme. Provided the new scheme is focused on projects that it is appropriate to support, we believe that there should be minimal other requirements to meet regarding conditions for the relief. If further safeguards are deemed necessary, consideration should be given to making the HMRC advance assurance procedure mandatory in advance of a claim for relief being made.

## Chapter 3: Simplification

### Barriers to price-setting mechanisms

**Q21 Do the current EIS rules on the use of anti-dilution clauses present a problem in practice?**

**If so, how might this best be addressed?**

56. Our members tell us that in practice the use of anti-dilution clauses does present a problem. Companies may fail to qualify because of such clauses, although previously this was not always the case. Such clauses are now considered by HMRC as providing protection to the investors against their investment. The legislation under which relief is denied is titled “Pre-arranged exits”, and we fully support the principle that a pre-ordained exit or protection of capital should prevent tax relief being given. However anti-dilution is not mentioned in the legislation and it is doubtful whether Parliament intended to prevent anti-dilution clauses for EIS investments.
57. Anti-dilution clauses should be permitted. It is best practice for venture capital investment in smaller companies, and does not alter the fact that the entire investment in the company is fully at risk. Many small companies require future funding rounds as milestones are reached, and at a later stage may be able to attract investment from institutional investors. However they may not grow to reach that stage if the early stage investors have their full risk investment severely diluted.

**Q22 Taken with the other potential areas for change in Chapter 3, what priority should be given to this?**

58. This is a high priority and should be addressed in Finance Act 2012.

**Q23 If the seed scheme described in Chapter 2 were to be adopted, would the scope to invest via both debt and equity instruments mitigate this problem in practice?**

59. No

### Mergers of EIS companies

**In a conventional merger between companies involving a share-for-share exchange, investors are deemed to have disposed of their shares and can lose EIS relief. This could deter companies obtaining the commercial benefits of such a merger or deter investors from future investments under EIS.**

**Q24 To what extent do the existing rules deter mergers made for genuine commercial purposes?**

60. Our members have reported cases where mergers, which would otherwise have been in the commercial interests of both companies, have been turned down because of the implications for EIS shareholders still within their three year period who would otherwise jeopardise their EIS reliefs.
61. We see no reason not to rely on the existing requirement that there are no 'exit' arrangements at the time the shares are issued, and not have, as currently there is, for example, for EIS purposes, rules that effectively prevent mergers, even where they are commercially driven. In such circumstances the venture capital reliefs should continue. We note that similar provisions do operate in some circumstances in the Enterprise Management Incentive scheme.
62. We would also bring to your attention the difficulties of applying the 'share matching rules' for capital gains tax purposes to determine when the shares are disposed of which are part of a holding of qualifying and non-qualifying shares. We would welcome proposals to clarify the legislation in this area.

**Q25 What priority should be given to addressing this issue (relative to other issues raised in chapter 3)?**

63. This is a high priority and should be addressed in Finance Act 2012.

**Period of grace for payment of shares**

**Q26 Would better guidance material for potential users of the scheme help to provide clarity on the rules around period of grace for payment of shares?**

**If so, how and where should that be made available to ensure it was seen by those most in need?**

64. Clear and readily accessible guidance for investors is essential.

65. Particular difficulties can arise when an investment is made by bank transfer. It may take a few days to organise a transfer, and the investee company often does not realise that the share certificate should not be issued before the receipt of payment. We suggest a period of 30 days should be given for the receipt of funds after the issue of shares.

66. Guidance should be provided on the HMRC website. It would also be useful to have links to this guidance from other sites such as Businesslink.

**Q27 A simple legislative solution might be to allow a period of grace for the shares to be fully paid up after date of issue. If this were to be adopted, what would be a suitable period of time?**

67. We suggest a period of 28 days.

**Excluded Activities**

The list of excluded activities from the schemes has grown over the years, as activities were added in response to what were seen as particular abuses. This has led to a number of inconsistencies.

**Q28 Is there a case for reviewing the current excluded activities list?**

**If so, what priority should be given to this (relative to other issues raised in chapter 3)?**

68. We consider that the variety of activities which should be permitted under the venture capital schemes should be drawn as widely as possible.

69. Many of the current exclusions are to restrict availability of relief to inappropriate investments. We do not believe that increasing this list will resolve the problem, but will instead make it more difficult for genuine small businesses to access the finance they need.

70. Provided that the focus of the EIS and VCT schemes can be refined as desired in section 4, then we believe there is a clear case for reducing the list of excluded activities. For example, small hotels and nursing homes find it extremely difficult to raise finance in the current environment. However such businesses can employ significant numbers of staff. Hotels support the UK's tourist industry, and with an ageing population, and with many care homes struggling financially, there is a strong case that such industries should receive further support.

71. The restrictions on the creation of intellectual property should be reconsidered, especially in the case of university spin-out companies, and where there has been a restructuring of a group which is creating intellectual property.

**Improving the Focus of the Schemes**

**Companies established for the purposes of accessing relief**

The Government has concerns over companies that appear to have been created solely for the purpose of allowing relief under the schemes to be accessed. One proposal to tackle this problem is a test which would consider a number of characteristics commonly displayed by such companies. Companies found to be displaying a certain amount of these characteristics would be disqualified from the scheme.

**Q29 Is this type of test likely to deliver the desired outcome?**

72. We support the principle of making sure relief is targeted and available only to those investments which the Government wishes to support and consider that it would be helpful to have a statement of purpose in the legislation as suggested in para 4.11. However, we are concerned that objective tests such as a requirement to employ four people within a specified time, would be inappropriate if they were to be seen as compulsory requirements. New businesses need to be able to employ staff according to their business needs rather than to secure tax relief for their investors.

73. Similarly, most of the 50% tests in para 4.12 seem to be unduly restrictive. For example, we cannot see any sinister reason why the directors might hold less than 50% of the ordinary share capital during the relevant period. It is also quite possible that a BASIS company, or indeed any new small business, might have only one supplier initially.

**Q30 If not, what alternatives might be considered?**

74. The proposed tests in para 4.12 should be used as 'safe harbour' tests. Companies which displayed three or more of the characteristics, would know for certain they qualified.

75. Other eligibility criteria could include the business being eligible for other tax reliefs or credits such as the research and development tax credit. This would allow the Government to focus the relief on activities it was particularly keen to support.

**Q31 If such a test were to be used, how appropriate are the characteristics listed (at section 4.12)? What others might be used as alternatives?**

76. See Q29 and 30.

**Q32 If such a test were to be used, would it be more effective with a precursor "purpose statement" followed by the list of characteristics as indicators, or alternatively with a provision that a company would be disqualified if it met a certain number of the characteristics?**

77. Yes

**Q33 If the latter, what would be an appropriate number?**

78. Certainty and simplicity are critical both for the investor and the company. If focussed on qualification rather than disqualification, the fewer the better. Depending on which tests are being used, around three would seem reasonable. Companies failing to achieve safe harbour certainty should still be allowed to qualify, although further evidence may need to be provided to support the claim.

## **Acquisition Companies**

Government intends to tackle concerns around acquisition companies by stipulating that where monies are used by a company "preparing to trade" to acquire an existing trade or trading subsidiary, at the time that existing trade or trading company is brought into the group, the group still meets the size conditions of the schemes.

**Q34 Are there any other areas that Government should be concerned about?**

**Q35 Are the areas identified here the most serious areas for concern?**

**Q36 Are the proposed solutions likely to be effective against the intended targets?**

**Q37 Are the proposed solutions likely to have a disproportionate impact on companies and investors?**

79. No comment

### **Exclusion of some Feed-in Tariff Business**

At Budget 2011 it was announced that trades based substantially on the receipt of feed-in tariffs would be excluded from eligibility for both of the schemes. The legislation sets out certain companies that will continue to qualify for the scheme.

**Q38 Are there any other sorts of community based company that ought to be included?**

**Q39 Will the definitions included in paragraph (9) of new clause 198A in the draft legislation give the right result in practice?**

**Q40 The Budget announcement applies to the "commercial generation" of electricity on or after 6 April 2012. The draft does not use this term, but instead has regard to when a company first begins to carry on the FIT-subsidised generation of electricity. Is this sufficiently clear?**

**Q41 The legislation applies not only to UK FITs but to similar schemes established outside the UK. However for simplicity, it does not seek to list such schemes or refer to the legislation establishing them. Is this sufficiently clear?**

80. No comment

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## APPENDIX

### 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.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide\\_towards-a-better-tax-system.ashx](http://www.icaew.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide_towards-a-better-tax-system.ashx))