Financing growth in innovative firms: EIS knowledge-intensive fund consultation ICAS response to HM Treasury

11 May 2018

Introduction

1. ICAS welcomes the opportunity to comment on this consultation. We are a leading professional body for chartered accountants with over 20,000 members working across the UK and internationally. Almost two thirds of our working membership work in business; others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

2. ICAS's Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key messages

3. We do not believe that the tax framework is the main barrier to accessing additional funding and are not convinced that the proposals will have more than a marginal impact. Investment should be driven by the quality of the company and, we believe, not be further driven by additional tax breaks. We believe that other non-tax barriers are a more significant issue preventing wider investment in EIS.

4. We suggest that further research evidence is needed to establish the need for tax relief reform, to identify and understand the barriers to investment, why retail investors and financial intermediaries do not currently invest via EIS and what changes would encourage them. Research could also establish the supply and demand for finance (we note the findings cited in a paper[1] of available capital but insufficient well-prepared investment opportunities) and confirm the extent to which funds are available but not invested due to a lack of viable companies. It would also help to better understand existing and potential EIS investors attitudes to a fund. We note the results of a survey which identifies that the vast majority of EIS investors prefer to invest in companies directly[2].

5. We have gathered views from members who are active investors across the start-up, business angel, venture capitalist and private equity stages. In our experience, the proportion of investor ready businesses which lead to a successful equity investment deal is very low across each stage – approximately 1%. One of the main obstacles is that the vast majority of companies who pitch for investment are not yet investor-ready. We believe that more support to educate, incubate and mentor early stage companies would enable them to better prepare and present their business potential, therefore increasing their chances of successful private investment.

6. We understand that a separate submission is being made to HM Treasury from Linc/ Nelson Gray which includes statistics on the state of the EIS market. We fully support his comments.

Response to detailed questions

1. Why are some younger knowledge-intensive companies unable to obtain the levels of patient capital that they require?

7. Only investable companies will receive funding. Investors report that there is a low volume of investable businesses able to convince them of the company's viability and potential for success.

8. Knowledge-intensive businesses tend to have a long R&D period and take a long time and many rounds of investment before they become cash flow positive or attractive to larger investors. Investors need to be convinced that the product and the management team will eventually deliver a good return. Knowledge-intensive businesses (particularly those emanating from a university) are often initially dependent and focused on grant funding. When these funds run out, they need to approach private investors but often lack the commercial experience or management skills to

[1] Cited on page 6 of Linc/ Nelson Gray's response

[2] Cited on page 4 of Linc/ Nelson Gray's response.

present a convincing case. Investors want a CEO in place who has relevant commercial experience, preferably from a start-up environment who can lead the company and develop the commercial awareness.

9. Lack of understanding of the business model is another common weakness in young companies. Incubators and mentors can help with this. We need a way to plug this experience gap which may include spending less on tax relief for investors (e.g. SEIS) but more on education to get the companies "investor-ready".

2. What would be the best way(s) of further improving the flow of patient capital to knowledge-intensive companies, bearing in mind state aid constraints?

Extending 3-year limits after 5 years

10. Our experience is that it typically takes £5m to £10m and 10 years to get a knowledge intensive business to a cash flow positive situation where it is no longer dependent on its investors. Often this results in "investor fatigue" and the later, say 4th and subsequent rounds are very difficult to complete. Many investors at that stage invest in new EIS companies. In some cases, the old company may be perceived to be near to success via a potential exit within the 3-year limits, and so investors at that stage may lose EIS reliefs on investment and capital gains.

11. We would recommend that where an investor has invested for over 5 years in a particular company the three-year rule for a minimum investment period without losing tax reliefs in that company should be suspended. Thus, investors may be more inclined to follow their money into existing companies that have already received (potentially many) earlier rounds, rather than being opposed to the risk of investing in a company which may achieve an exit in favour of backing other investments. Too many good companies with a need for later rounds fail to get the requisite follow-on investment for this reason.

Spreading investments over a longer period

12. Investors also need to understand that there may be many rounds of investment before a company reaches a cash flow positive position, so they may need to maintain the capacity to spread their investment over several years rather than front load it too heavily.

Permitting mergers between small companies without loss of EIS relief

13. Acquisitions, mergers and other capital events may make commercial sense particularly between two companies, both of which may at that stage be small and potentially eligible for EIS reliefs. They can help the business scale up, take advantage of the strengths of the two parties, and make a more viable entity. We recommend that mergers between EIS eligible entities should not trigger the loss of EIS tax relief. Tax avoidance risks can be managed through a pre-clearance procedure with HMRC, which is a good mechanism to ensure small businesses remain compliant without expensive advisors.

Sidecar funds

14. Sidecar funds could be introduced. These currently operate in the US but not in the UK due to FCA investor protection regulations. This could open up a fund for passive angels who entrust a syndicate to perform the due diligence and make investments on their behalf. These syndicates do not want to be an authorised fund manager, but a sidecar mechanism can provide a useful source of extra funds. It is feasible for such funds to be used within 12 months. All investors in the sidecar fund would have to be high net worth individuals or sophisticated investors to enable an individual to self-certify. This is consistent with the FCA's treatment of existing EIS angel investors who rely on a syndicate.

15. We would add that that HMRC's Advance Assurance Service for EIS and VCTs should be continued and consideration should be given to whether its operation could be improved for knowledge intensive companies. Feedback indicates that the changes recently implemented to rectify delays obtaining assurance have been effective. However, new companies seeking EIS are taking longer to do so, as they have to know the potential investors in advance. Perhaps this new EIS Advance Assurance rule could be relaxed where it is knowledge intensive companies seeking clearance.

3. What barriers are there to the development of investment funds that specifically target knowledge-intensive companies?

16. We are not sure of the need in Scotland, syndicates already invest heavily in these companies.

17. In terms of expanding the investor base, EIS investment is highly risky with a low probability of a satisfactory return and the likelihood that the investment will take at least 10 years to achieve any return[3], hence the importance of maintaining tax relief incentives. As such it is best suited to investors with expertise in early business as it is a 'hands on' process. Our understanding is that financial intermediaries are reluctant to offer this product to retail clients due to the high risk of loss, the requirement for specialist knowledge, and the consequent reputation risk and the unlikely ability of earning fees on the considerable due diligence they will be required to carry out. The expertise required is different and beyond what almost all IFAs can offer. The risk profile of EIS funds could create a mis-selling problem which would be inconsistent with FCA rules. From a limited ICAS survey of financial intermediaries, we concluded that the potential reputational risk of advising on EIS investments was too great for them to wish to be involved in the sector.

18. We note a current lack of publicly available performance information on EIS investments. An EIS fund would require greater transparency including further information on investment performance of EIS funds, their strategy and due diligence used and available to support decision-making. This is particularly useful given the changes following the removal of the capital preservation schemes which makes a number of the EIS funds' performance to date unrepresentative of what may happen in the future.

19. The requirement to invest 90% of funds within 1 year is not practical and potentially leads to one of two outcomes:
    i) Investments are lined up well in advance of a fund closing, and
    ii) There is a last-minute rush to invest funds into companies which may not otherwise, have received such levels of investment.

20. It also does not allow for follow-on funding. Investors need to spread risk through investing in several companies over at least 5-10 years, as experience shows that the majority of investments will have a poor outcome. Without diversification, time and scale, there is an even greater likelihood of poor fund performance. The implication being that they will have great difficulty in raising money for their next fund which in turn, makes follow-on funding even more problematic.

21. We also note that many angel syndicates, particularly in the English regions would benefit from a more formal structure to help them run effectively. We would recommend that an equivalent umbrella body such as Linc in Scotland, should be set up in England and Wales to help angel syndicates be formed. This could also help with education of investors e.g. encouraging a longer-term perspective to initial and follow-on investment (as identified in our response to question 2).

4. Would a targeted knowledge-intensive EIS fund model help increase the supply of patient capital to knowledge-intensive companies?

22. We are not convinced this will increase funding of early stage knowledge intensive businesses. (see response to question 3).

23. More specific evidence of the lack of funding as opposed to low volumes of viable investment opportunities is needed.

5. Which of the options outlined above would most attract investors to knowledge-intensive funds? Please rank and critically compare the benefits and disadvantages of each.

24. We do not believe that the difficulties in attracting investment are due to the tax reliefs (which are already generous). Tinkering with the tax reliefs is therefore unlikely to have much effect on investment. It will however increase complexity which is inconsistent with the government's commitment (para 3.15 of the consultation paper) to simplify the tax system.

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[3] See submission from Linc/Nelson Gray.

25. The proposals to encourage EIS investment are too heavily focused on tax benefits which risks creating a diversion to chase tax benefits instead of focusing on the quality of the investment.

26. Assessment of the options:

    i. Dividend tax exemption (not supported) – early stage companies are unlikely to have sufficient profits to meet the company law requirements for distributable profits. Profits will be needed to invest in growth. Introducing a tax exemption risks creating a wrong incentive to put dividends before reinvestment. It also risks creating a market distortion by moving investors focus to later stage companies who can distribute dividends. Furthermore, offering a dividend exemption may pave the way for unscrupulous fund managers to encourage the investee company to repurchase shares after 3 years, actively seeking the distribution to be assessed as a dividend and be non-taxable through this opportunity.
    ii. Capital gains tax relief (not supported pending evidence) – insufficient evidence is available to confirm whether this would influence investor behaviour. Given performance rates where most investments make a loss and any return is generated by a small minority, capital gain rollovers are mostly written off anyway. We recognise that this option could offer an incentive to someone with a large capital gain to invest in a knowledge-intensive fund but do not believe this would make a material difference to the total investments being made in knowledge-intensive businesses.
    iii. Extended carry-back of income tax or CGT deferrals (not supported pending evidence) – as above. It also does not address the non-tax barriers to investment. However, there are some high net worth individuals who have scope to relieve income tax or capital gains tax from earlier periods who may be incentivised to invest on the back of the availability of further relief.
    iv. Up-front tax relief (partly supported) – this would assist tax planning but does not address the non-tax barriers.

6. What other features would a knowledge-intensive EIS fund need in order to address the funding gap for knowledge-intensive companies, keeping in mind the constraints within which such a structure would be created?

27. We highlight the following:
    - A longer-term awareness for investors to sustain a growing company's needs and provide for follow-on funding (see our response to question 2),
    - A large enough fund to offer diversification of risk and which is investable for at least 8 years,
    - Performance information,
    - Evidence of demand for a structured fund (we note the preference for most EIS investors to directly invest in the company).

7. Would a 'patient' dividend tax exemption provide the right incentive to both attract investors in the fund structure, and encourage longer term approaches to investment?

28. No, see our response to question 5.

8. To what extent would relief at the level of the fund be attractive when weighed against the additional complexity that would be necessary?

29. Whilst upfront tax relief at the point of investing in the fund (rather than a company) would be beneficial for tax planning, we are not convinced that the obstacles to greater EIS investment are significantly related to tax.