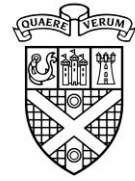


THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



Response from
The Institute of Chartered Accountants of Scotland
to HM Treasury

Tax-advantaged venture capital schemes

30 September 2011

The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to respond on HM Treasury's consultation on tax-advantaged venture capital schemes.

As the Institute's Charter requires, we act in the public interest, and our proactive projects and responses to consultation documents are therefore intended to place the general public interest first, notwithstanding our charter requirements to represent and protect our members' interests.

ICAS believes that creating a better environment for SMEs and start-ups to access the capital necessary to grow and prosper should be a priority for the Government if they are still firm in the view that private sector growth will lead to economic recovery. New businesses generate a large part of new employment, and so their funding is a vital part of this. Effective tax mechanisms can provide a very important contribution if they are:

- well thought out;
- easily understood and work well;
- provide the intended benefit for all parties involved; and
- are promoted throughout the UK by professional advisers to those with means to invest.

The lack of equity finance available to new businesses from traditional sources has led to angel groups with limited resources, becoming the principal source for funding these companies, assisted in Scotland by matching finance from Scottish Enterprise (SE).

We would encourage the Government to continue to explore all avenues that will open up the availability of finance through the use of innovative, structured and effective tax schemes that display all of the traits we outlined above.

ICAS firmly believes that a focus on seed-stage companies with a targeted scheme that is easily understood by those who use and need it, well publicised through a variety of HMG and professional channels, provides the right type of finance to these companies and appropriately rewards the investor, irrespective of whether qualifying investment is debt or equity.

The real challenge the Government faces is in finalising and implementing any new or revised schemes in a timescale that will deliver these benefits quickly and with maximum impact on the companies that are in urgent need of the finance and incentives for the investors who have the funds available but need the right environment and above all opportunities to take the risk.

Finally, we believe there are a few areas the consultation does not touch upon that the Government needs to take into consideration when looking at funding issues in general:

1. The fact that there are companies who are in need of finance but where equity is probably not a practical solution for either the company or the potential investor. These businesses cannot be left behind and need to be catered for: we would therefore suggest a "loan only" option of the relief is available in these circumstances with a maximum loan on this basis of £200k per company and £100k per lender.
2. The main gap in SME funding is at the bottom – where funding is likely to be too small to interest some Angel groups - say under £100k. A gap also exists at the top end where requirements, including likely follow on funding, may exceed around the £2m mark - which is the maximum for most Angel groups but is too small to interest most VCs: the latter are not normally best placed to serve early stage companies due to the need for extensive support, and generally only take the risks associated with them when the investment required is much larger – say over £5m. We would ask the Government to pay close attention to the smaller end of this gap and to work with banks and other funding providers in addressing this. At the higher end, the Business Growth Fund

(BGF) can be an alternative source of funds if it is prepared to be less risk averse than other competing funds and we would ask the Government to liaise with the BGF with the intention of lowering the turnover threshold and other general overall application conditions to enable these early stage companies access to the Fund.

Our responses to the consultation questions are as follows:

Chapter 2: Support for Seed Investment

Evidence on the problem

Question 1: What evidence is there that specific support is needed to encourage seed investment? What sort of support is needed?

Hi-tech companies with funding requirements of less than £1m equity have less of a problem obtaining investors than non-hi-tech companies or those companies which will eventually require more capital. The UK Venture Capital (VC) market, as opposed to the Angel market, is fairly risk adverse and concentrates in current economic conditions on supporting existing businesses as much as new ones. Part of the issue is that fund managers are judged by investors on their overall portfolio performance which paradoxically makes them more risk adverse than individuals investing their own money.

A solution to funding hi-tech companies with funding requirements of over £1m equity would be to encourage Venture Capital Trusts (VCTs) into this space and allow continuing Enterprise Investment Scheme (EIS) relief for Angel funders despite the presence of anti-dilution clauses and liquidation preferences that are now almost standard practice for VCT deals which follow on from initial Angel based seed funding.

We would reiterate the comments we made in September 2010 in our response on financing a private sector recovery in that the Government can help by providing pools of matching funding for early stage investment, as happens in Scotland, through routes which complement the work done and investment made by angels rather than competing with it.

ICAS also believes that part of the problem with seed investments is the lack of a well thought out and professionally presented business plan. Those businesses that spend the time preparing and refining their plans and that show a deep understanding of their business offering (and compelling reasons why an investor should invest) will always be in a position to receive a more positive response. Entrepreneurs and their advisors need to realise that having a “good idea” is only the start of the process – with the ability to eloquently and professionally convey these to potential investors needed to back this up. More guidance may help to sharpen up business plans, and ICAS intends to produce an offering in this area in the near future. We would also suggest that the Government might assist by offering a web-based portal with links to such information.

Question 2: Can any additional support be provided through reforms to existing tax reliefs or would it be better provided through non tax measures?

We believe that EIS tax relief is generous (and will be enhanced when the proposals in the 2011 Budget are implemented in April 2012) and yet there are comparatively few Angel investors.

The reasons for this need to be understood and we believe there are a number of areas the Government should be looking at, not all of which are specific tax measures:

- We believe professional advisors don't do enough to encourage EIS investments amongst their clients due to the fact the investments can be very risky; the advisor can't do an effective due diligence exercise on every investment that their client might be interested in, and so the sensible course for advisers is to avoid mentioning all such investments; this

situation might be ameliorated by more publicity for such opportunities, and work with the FSA to ensure that FSA registered businesses, and indeed tax advisers, are not penalised for regulatory failure or negligence issues for making their clients aware of the opportunities;

- EIS tax relief is very complicated and there have been numerous incidences in the past when relief has been given for the first round of funding but lost for subsequent funding rounds (e.g. due to the impact of arbitrary limits on employee numbers) leading to many advisors being “frightened” of EIS investments where follow-on finance is almost inevitable;
- Angel groups tend not to be registered with the Financial Services Authority (FSA) – effectively meaning that Angel groups cannot readily advertise;
- We believe the Government should take the lead in promoting Angel investing as a viable source of finance through media statements or other direct messaging.

Seed Investment

Question 3: Would a new standalone scheme be an effective way of meeting the Government’s objective of providing support for seed investment?

A new standalone scheme to support seed investment would have the effect of specifically highlighting seed investing and as such would hopefully attract more Angels into this form of investing. This could also have the desired effect of encouraging Angel groups to invest more in earlier stage companies. We would also hope that extensive publicity backing any new scheme (of similar intensity to that which has over the years been provided to PEPs and ISAs) would also encourage more high net worth individuals to become Angel investors.

This would undoubtedly come down to the ability of the Government to effectively market the new standalone scheme to encourage the desired take-up.

Question 4: 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?

The complexity of the existing EIS scheme needs to be addressed as we believe it is not sufficiently understood by those advisors who may only occasionally come across it.

There are also “legacy issues” with EIS as it has a reputation (and this is probably justified) for being a potential disaster for those who innocently and inadvertently contravene even a relatively minor requirement leading to the relief being withdrawn.

This is not to say that a new relief for seed investment might not encourage new Angels and existing Angels to invest in seed companies. Any new relief would need to be easy and simple to understand, operate and comply with. We do not believe that introducing any new reliefs with additional complexities would assist in bringing about the change desired by the Government.

Definition of seed-stage companies

Question 5: How best might Government define “seed-stage” activities?

We note the examples of a definition of seed-stage companies as set out in section 2.25 in the consultation document and believe that the agreed upon definition should be as simple and logical as possible.

We would acknowledge that a definition based on gross assets (if set at an inappropriate level) might include more companies than HM Treasury/HMRC would ideally wish due to the fact that seed companies and other early stage companies tend not to invest in assets. It is important that the target companies are not discriminated against by inappropriately tight gross asset definitions.

To simplify matters, we would suggest that a turnover definition would be the easiest to understand and implement – and that a turnover of less than £500k a year (pro-rated where necessary) would be acceptable.

Question 6: At what point does the need for “seed” investment cease?

We believe that seed investment would normally cease when sales revenue could be generated.

This would be an expensive time for a company as it starts to gear up its marketing activities and begins the task of building a sales force. However, we believe at that stage, the risk of the product not working, not being produced at a competitive price or not being what the market wants should have been reduced, giving more certainty over the likelihood of revenue generation.

Question 7: In particular, how might legislation distinguish between seed-stage manufacturing or production for trial purposes, and commercial large scale production or manufacturing?

We believe this comes back to the definition of seed-stage companies and would refer you to our response to question 5.

Question 8: Would an explicit limitation to “pre-trading” activity be overly restrictive?

We believe that a restriction to “pre-trading” activity would be overly restrictive and would suggest that such a measure misses the point about how a seed-stage company operates in reality.

The company needs to be able to prove that there is a demand for its product at a price that it can be delivered at. Inevitably there is a necessary stage where trial production and some early sales are made so that reference sites can be established and market research conducted using real inputs. We would suggest that in reality, this is still the ‘seed’ stage.

Question 9: 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?

We believe that the imposition of a sufficiently long time limit is a reasonable requirement and could be managed by companies raising investment in tranches, the next tranche becoming due when an agreed milestone has been reached. Monitoring that seed investment is only used at the seed stage would be challenging but not impossible and there would have to be an agreed cut off time when the company was deemed to be no longer at a seed stage. The difficulty is that some types of business require years to go through the seed stage, where others can achieve a viable business in a much shorter time frame. The limits would have to be flexible enough to accommodate years of testing and development in some cases.

Question 10: If so, what would be an appropriate period of time?

We believe that a period of two years from the date the first investment tranche is received should be appropriate in the majority of cases. This could be extended on a case by case basis with prior agreement from HMRC where the two year period is insufficient and the company can produce evidence to substantiate this.

Types of Investment

Question 11: 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?

We believe that in practice, individual investors or their advisors or their Angel groups if they are part of a syndicate should be able to manage this without too much difficulty providing the guidance material provided by HMRC is clearly written and easily understood.

Question 12: Should any further restrictions be placed on equity or quasi-equity instruments?

We are satisfied that the restrictions on equity and quasi equity appear adequate and see no need for anything further.

Question 13: What restrictions should there be on the forms of debt that qualify?

We believe that an acceptable restriction on the form of debt would be interest (by reference to base rates of 0.5%) of no more than 8% with the term of the loan not less than 3 years.

Definition of Business Angels

Question 14: 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?

For this purpose, an individual Business Angel could simply be defined as someone who invests in a seed-stage company or is investing as part of a syndicate that has made five or more investments in seed-stage companies.

Question 15: 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?

We believe that an individual serving on the board with relevant experience should be sufficient e.g. a qualified accountant or lawyer or a manager with the appropriate sector or other business experience. If this is a syndicate appointment the bar for relevant experience should be set at a higher level than for an individual appointment. Angel investing has a history of some Angels providing capital while others prefer to provide a combination of capital and expertise. We strongly believe that both should be encouraged by the Government and that it is important for an investor not to lose reliefs by reason of participating in company management.

Question 16: Should investors who are not directors be able to qualify? If so, in what circumstances?

We are not entirely convinced that simply being an investor qualifies an individual to be competent enough to be involved in the running of the company. That however should not necessarily be a barrier in qualifying for the relief. We would add that in situations where the investor is part of a syndicate or a group of other investors who already have an investor director on the board, there should be no need for that investor to also participate in the governance of the company.

Question 17: 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?

We would argue that a seed investment can be different from investing in an existing company that is already trading profitably and the management of the seed company will in all probability need some sort of mentoring help. Investors with some experience or track record of previous seed investing would be a benefit in these situations. Again though, we do not believe this should necessarily be a barrier in qualifying for the relief.

We believe that the main purpose of the scheme should be to ensure that seed companies are in a position to gain access to the finance and management experience they may need and that the Government can help by placing as few obstacles in the way for investors as possible.

Question 18: What other factors might be taken into account besides previous investment and current governance?

We believe that the most useful and desirable experience would be experience in the relevant field and in particular the ability to access senior contacts in the industry.

Question 19: 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?

It is clear that the definition of seed stage would also need to define when a company was no longer at seed-stage and at that time, if the investment monies have not been used, there would have to be an adjustment. We would propose that any amounts over £200k would then be subject to EIS relief and not the proposed Business Angel Seed Investment Scheme (BASIS) relief, with any difference having to be recovered from the tax payer. In practice it is unlikely that the investor will have received their BASIS relief by then and so the claim would be for EIS and not BASIS relief.

Monitoring the Impact of Changes

Question 20: 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?

We note that seed investments are normally for (relatively) small amounts (under £1m) and would suggest that HMRC should pay more attention to those investments over £1m where there may be greater tax at risk. We believe that existing Angels who have a history of claiming EIS relief each year should pose less of a risk than someone who claims large amounts of the proposed new BASIS relief without previously having claimed EIS relief.

Chapter 3: Simplification

Barriers to price-setting mechanisms

Question 21: 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?*

There are two areas where anti-dilution clauses could benefit EIS investment

- In establishing a price for seed investment. We would suspect that there are many more cases of seed investment not going to plan than going to plan and that more often than not, seed investments require additional funding rounds. When this occurs, the price drops and those investors who took the greatest risk at the outset suffer. It must be remembered that the risk of failure for a seed investment is far higher than for later stage investments so whilst anti-dilution clauses mitigate some of the risk there still remains a tangible and potentially very substantial risk;
- We would point that as a generality, Angel investors are not keen to invest when there is a significant potential for subsequent VC investment due to the latter's (typically) very aggressive attitude to pricing which often includes anti-dilution clauses and liquidation preferences. You will usually find that Angel investors won't invest in a company that will obviously (and it is apparent at the outset) require VC funding in the future. That said there are circumstances where sometimes they have no choice in the matter: generally when things don't go to plan. At that stage if the Angel investor does not invest again, they will suffer substantial dilution but won't receive any EIS relief if they invest on the same terms as a VC. Allowing anti-dilution within the EIS rules will enable Angels to be bolder when investing in a Company that may require VC investment in the future.

Question 22: Taken with the other potential areas for change in Chapter 3, what priority should be given to this?

We would comment that it is not clear from clause 3.16 if the intention is to remove the restriction on Business Angel directors who invest in a company after they are appointed and receive a reasonable fee or those that invest first but no longer qualify after three years. We believe this should be altered as experienced directors with domain experience are invaluable to the company in many different aspects as such should not be discouraged from investing.

The argument that the director has more information and therefore takes less risk does not, in our opinion, paint an entirely accurate picture of the realities of this scenario. Most of this investment is taking place against a backdrop of losses and on average it takes over seven years for an Angel investor to get an exit. This is a statistic that the Government must not lose sight of. At the time of the investment the investor should have a business plan, be meeting with the

company and be given as up to date an assessment as possible of the company's prospects. Unlike the situation with quoted investments, we believe a company in this position has no reasons why it should not be entirely open with a prospective investor.

Question 23: 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?

We believe that if the seed scheme of debt and equity was put in place it would not mitigate a genuine emergency funding as described in 3.15. Time should be given – say for example eight months to a year – for the company to put in place a proper round of funding. This would also allow an acceptable time for those who saved the company with their emergency funding to be partially repaid so that they don't have to invest more than their rights. We believe it is vital that this repayment should not disbar them from EIS relief if it occurs within a reasonable window.

Mergers of EIS companies

Question 24: To what extent do the existing rules deter mergers made for genuine commercial purposes?

We believe that mergers should be allowed EIS rules under the Government's proposals – provided these are for genuine commercial reasons.

Question 25: What priority should be given to addressing this issue (relative to other issues raised in chapter 3)?

Whilst we would appreciate this is an important issue, we believe that greater weight should be given to the investor director point as noted in question 22 or the repayment of emergency funding within a given time scale as noted in question 23.

Period of grace for payment of shares

Question 26: 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?*

We would agree that better guidance on EIS, which is contained and clearly signposted within the HMRC web site, would be helpful to potential investors.

Question 27: 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?

We believe that should this be adopted, a period of grace of one month would normally be sufficient to allow the shares to be fully paid up after the date of issue. We would ask that HMRC take a sensible and pragmatic approach in applying this.

Excluded Activities

Question 28: 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)?*

We believe that as part of the overall review of tax-advantaged schemes, there is clearly a case for reviewing the list of excluded activities in the light of actual experience and investment requirement but this should be viewed as a low priority relative to the other issues raised in Chapter 3.

Improving the Focus of the Schemes

Companies established for the purposes of accessing relief

Question 29: Is this type of test likely to deliver the desired outcome?

We would argue that placing further restrictions on EIS relief is unlikely to result in a growth of investment in early stage companies and would work against the desired outcomes – more business formation and more employment. We believe that not applying the test to those companies achieving an employment head count of four people within two years of trade commencing is not unreasonable but care would need to be taken to ensure this did not discourage investment in the smaller end of the market.

Question 30: If not, what alternatives might be considered?

We believe that where EIS relief is being sought on investments of £500k or more, then simply making it a condition that four people were employed by the company within two years would be a simple test as opposed to a mixture of the list of tests as noted in 4.12. We would suggest that such a mix of tests would be cumbersome to comply with and additionally would be difficult for HMRC to effectively monitor.

Question 31: 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?

Please see our response to question 30.

Question 32: 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?

Please see our response to question 30.

Question 33: If the latter, what would be an appropriate number?

Please see our response to question 30.

Acquisition Companies

Question 34: Are there any other areas that Government should be concerned about?

There are no other areas we are aware of.

Question 35: Are the areas identified here the most serious areas for concern?

We have no issues with the areas identified in the consultation paper.

Question 36: Are the proposed solutions likely to be effective against the intended targets?

We see no reason for these not being effective.

Question 37: Are the proposed solutions likely to have a disproportionate impact on companies and investors?

We are not aware these will have any disproportionate impacts.

Exclusion of some Feed-in Tariff Business

Question 38: Are there any other sorts of community based company that ought to be included?

Question 39: Will the definitions included in paragraph (9) of new clause 198A in the draft legislation give the right result in practice?

Question 40: 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?

Question 41: 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?

We have no comment to make on this area.