



HM Treasury

Financing growth in innovative firms:

Enterprise Investment Scheme
knowledge-intensive fund
consultation

March 2018

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knowledge-intensive fund consultation



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Chapter 1

Introduction

- 1.1 In November 2016 the Prime Minister announced that HM Treasury would lead a Patient Capital Review (PCR) to further strengthen the UK as a place where growing innovative firms can obtain the long-term 'patient' finance that they need to scale up.
- 1.2 A consultation, Financing Growth in Innovative Firms¹, was launched in August 2017 to explore ways to improve the flow of patient capital to the UK's innovative firms. Tax reliefs intended to support investment, including the venture capital schemes; Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS), and Venture Capital Trusts (VCTs) were considered as part of the review.
- 1.3 The government responded to the consultation at Autumn Budget 2017, announcing an action plan to unlock £20 billion of investment over the next ten years. This included a number of changes to the EIS, SEIS and VCT schemes.
- 1.4 The government sees the venture capital schemes as being increasingly focused on growth and innovation in the future. Evidence gathered during the consultation suggested that knowledge-intensive firms – which have high growth potential but are R&D- and capital intensive – have the most difficulty obtaining the capital they need to scale up. The EIS and VCT schemes are therefore being significantly expanded for knowledge-intensive companies. The government also announced that it would consult on a new EIS fund structure aimed at improving the supply of capital to such companies.
- 1.5 This consultation aims to build the government's understanding of the capital gap that knowledge-intensive companies face, and seeks views on the best way of closing that gap. It explores possible options for an EIS fund structure aimed specifically at investment in knowledge-intensive companies, while making clear the limitations within which such a fund model would operate.
- 1.6 The government considers that the definition of a knowledge-intensive company that is currently used in the venture capital schemes effectively captures the types of firm that have the most acute problems gaining investment. It is also conscious of the need for both investors and companies

¹ Financing Growth in Innovative Firms consultation and government response
<https://www.gov.uk/government/consultations/financing-growth-in-innovative-firms>

to have as much stability as is possible. It therefore intends to base any new fund structure on this existing definition.

- 1.7 The EIS is a notified state aid and any changes to the scheme will have to take into account constraints on state aid. This consultation may lead to changes before the UK leaves the European Union. As the UK is still subject to state aid rules the consultation seeks responses consistent with the current state aid regime.
- 1.8 The design of any fund model would need to be proportionate to an identified market failure in the supply of capital to knowledge-intensive firms. For example, the EIS, SEIS, and VCT schemes already have among the most generous rates of income tax relief for schemes of their kind in Europe. The government is not considering raising the rates of income tax relief for the schemes.
- 1.9 Any design would also need to ensure value for money for the taxpayer and to balance the government's need to ensure fairness across the tax system. It should be robust enough to defend against attempts to use the fund model for aggressive tax planning or capital preservation purposes.
- 1.10 Chapter 2 discusses the patient capital needs of knowledge intensive companies, and how funds targeting knowledge intensive investments might help alleviate the capital gap. Chapter 3 outlines options for a knowledge-intensive EIS fund structure, along with the constraints on that structure. It asks respondents about which elements of such a structure would be most effective and necessary.

Chapter 2

The knowledge-intensive capital gap

- 2.1 The consultation Financing Growth in Innovative Firms defined patient capital as “long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses”. It noted that only some firms need patient capital to grow to scale.
- 2.2 Patient capital is particularly important to firms with ambitious plans for growth and those focusing on the commercialisation of technology, where revenues often lag investment significantly. In many cases high levels of investment are needed before a product can be brought to market, and such firms can have significant difficulty obtaining the levels of equity finance they require to grow and develop.
- 2.3 In recognition of the difficulties that these firms have in obtaining equity finance when the government reformed the EIS and VCT schemes in 2015 it provided extended time limits and further flexibilities for knowledge-intensive firms. The definition of knowledge-intensive adopted in the schemes is outlined in Box 2.A and includes a focus on relatively high R&D expenditure along with the production of intellectual property.
- 2.4 Respondents to the PCR consultation provided further evidence of particularly acute funding gaps for R&D-intensive firms. In response the government made further targeted reforms to the EIS and VCT schemes, including raising investment limits and relaxing the company age limit for knowledge intensive firms as described in Box 2.B.

Box 2.A: The knowledge intensive definition

A company must meet one or both of two operating cost conditions:

- must have spent at least 15% of operating costs on R&D or innovation in one of the three years preceding investment
- must have spent at least 10% of operating costs on R&D or innovation in each of the preceding three years.

These conditions will be amended by the Finance (No 2) Bill 2017-19 so that companies under three years of age can meet one or both of the conditions in the three years following the investment.

A company must also meet either the innovation condition or the skilled employees condition.

To meet the innovation condition the company must be creating or have recently created intellectual property, which will be used in future for its main business activities. This can be proven by:

- producing patents or licenses
- or have an independent expert (e.g. a university professor in a relevant field) verify it is producing intellectual property

To meet the skilled employees condition, at the time of investment and for the following three years at least 20% of the company's full-time equivalent (FTE) employees must be skilled employees with a relevant Master's (or higher) degree carrying out R&D or innovation activities.

2.5 The government wants to explore further the reasons why some knowledge-intensive firms are unable to obtain the sustained funding they require, and the best ways of encouraging adequate early-stage investment into such companies.

Box 2.B: Flexibilities within the EIS and VCT schemes for knowledge-intensive companies

	Standard	Knowledge-intensive
Lifetime investment limit	£12 million	£20 million
Employees (FTE) limit	250	500
Annual investor limit (EIS only)	£1 million	£2 million
Annual company investment limit	£5 million	£10 million
Company age limit	7 years	10 years
Age limit "clock starts"	First commercial sale	First commercial sale or Turnover reaches £200,000

Funds

- 2.6 Funds aggregate the capital of many investors, and are therefore able to make sustained, large-scale investments of the kind knowledge-intensive companies often need.
- 2.7 Some responses to the PCR consultation suggested that a cause of the funding gap for knowledge-intensive companies is the relatively small number of funds focusing on that sector.
- 2.8 It was suggested that syndicates of business angels – experienced businesspeople who are able to provide support and advice to the companies they invest in – currently do a great deal of work to pool funds for investments. However, funds can be marketed to a wider variety of retail investors, who may be attracted by a professionally-managed investment in a diversified portfolio of companies.
- 2.9 The government wants to consider whether there is scope for greater fund involvement in investing in knowledge-intensive companies, with a supply of fund managers developing expertise in various sectors so that they are better able to identify investments with high-growth and innovation potential.

Box 2.C: Consultation questions

- 1 Why are some younger knowledge-intensive companies unable to obtain the levels of patient capital that they require?
- 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?
- 3 What barriers are there to the development of investment funds that specifically target knowledge-intensive companies?

Chapter 3

A possible EIS fund structure

- 3.1 The UK provides several tax reliefs for venture-capital investment, including the EIS, SEIS and VCT relief. These schemes provide a tax incentive to individuals who invest in early-stage companies that would be otherwise unable to obtain equity finance because they have no track record.
- 3.2 The EIS and SEIS both apply to direct investments in qualifying companies. Investors receive an upfront income tax credit (worth 30% and 50% of the investment respectively), together with Capital Gains Tax (CGT) reliefs and further income tax relief if the investment is ultimately sold at a loss.
- 3.3 VCT relief applies to investments made in Venture Capital Trusts, which are listed investment vehicles. Investors subscribing for new shares in a VCT receive upfront income tax relief worth 30% of their investment. The VCT is then required to invest its capital in qualifying companies.
- 3.4 There are a number of EIS fund products on the market. These are arrangements in which a professional fund manager acts as a nominee for a number of investors, making investments in qualifying companies on their behalf. The EIS rules give relief to the investors on the basis that they are the beneficial owners of the shares.
- 3.5 The EIS does not contain detailed rules that apply to EIS funds. There is provision for fund managers to apply for HMRC approval, however this confers only limited administrative benefits and no substantive tax advantages for the investors. In return, the fund managers must invest in at least four different companies. Typically, very few funds seek HMRC approval.
- 3.6 The requirements that a fund must meet to be approved are summarised in Annex A.
- 3.7 The government encourages VCTs to invest in line with the venture capital schemes policy objective of supporting growth and innovation, and would support the entrance of new VCTs into the market to provide further competition.
- 3.8 However, VCTs have traditionally, though perhaps not in future, focused upon a later stage of investment than the point at which many knowledge-intensive companies first need scale of capital. As a result it is the government's intention is that any new fund structure be built on the existing EIS rules.

- 3.9 Subject to the responses to the questions in Chapter 2 of this consultation document, the government would like to explore possibilities for a new EIS fund model focused on knowledge-intensive companies.
- 3.10 Any new fund structure must meet a number of criteria to be deliverable:
- any tax advantages for investors must be proportionate to an identified market failure that is adversely affecting knowledge-intensive companies,
 - it must attract investors while not unreasonably distorting the market,
 - the economic benefits must be commensurate with the Exchequer cost, and
 - it must not introduce unfairness to the tax system.

General approach

- 3.11 The government does not intend to introduce a new scheme, and envisages any new fund model as building on the existing EIS rules. It does not, for example, plan to change the requirement that all EIS investment must be equity investment in ordinary shares, or to reduce the three-year holding period that applies to EIS investments.
- 3.12 Any new fund model would need to focus on investing nearly entirely in knowledge-intensive companies. However it is possible that a small proportion of investments, possibly 10-20%, could be in non-knowledge-intensive EIS companies.
- 3.13 The government anticipates that any new knowledge-intensive fund would be subject to HMRC approval. This would place a compliance obligation on fund managers, although the precise extent of this would depend on the incentives attaching to the fund and the way in which tax relief is given.
- 3.14 For example, approved fund managers already provide information to HMRC concerning their investments, the investors in the fund and other relevant information. These obligations would need to be formalised and strengthened, to ensure that HMRC has adequate oversight of the fund, including annual reporting obligations and that the structure is robust against attempts to use it for aggressive tax planning.
- 3.15 The government is committed to simplifying the tax system. Any new EIS fund model would therefore be accompanied by the removal of the current HMRC approved fund structure for general investments, which has a low take-up and confers relatively few benefits on fund managers or investors.
- 3.16 Several possible alternative approaches are outlined below, and the government welcomes respondents' views about which incentives would be most effective in:
- attracting investment to high-risk, knowledge-intensive companies, and
 - ensuring that those investments are made for the long-term (including follow-on investments where necessary).

Options

Dividend tax exemption

- 3.17 A 'patient' dividend tax exemption could be applied in respect of investments made through a knowledge-intensive fund. Investors would not pay tax on dividends received from knowledge-intensive investee companies after a fixed holding period (say five or seven years).
- 3.18 This would encourage and reward patient investment. However the rules would need to address the risk that companies could be pressured into issuing dividends before they are making adequate profits, instead of reinvesting profits into the growth of the company.
- 3.19 A dividend exemption effective only after a given period would fit well with the objective of encouraging patient investment. However there is a question about whether it would be effective at motivating additional investment given some stakeholders identify the potential for large capital gains, rather than an income stream, as the primary motivation for investment in high-growth companies.

Capital Gains Tax relief

- 3.20 The EIS currently allows investors to defer CGT on gains to the extent that the disposal proceeds are reinvested in EIS qualifying companies. An alternative approach could be taken under which investors are allowed to write off a proportion of a capital gain on reinvestment into a KI fund. This type of relief is offered under the SEIS, and would provide a more concrete incentive for investors.
- 3.21 Such a write-off would provide relief at a lower rate than the current SEIS version, and evidence would be needed that such a relief would provide substantial additional capital to knowledge-intensive companies. It would aim to encourage successful entrepreneurs and those who make large capital gains to reinvest in the UK's highest-risk companies.

Extended carry-back of income tax or CGT deferral

- 3.22 The EIS rules allow investors to set their income tax credit against tax liabilities of the year of investment, or the prior year. This could be widened to permit a further carry-back for investors in a knowledge-intensive fund.
- 3.23 This could be an alternative to providing income tax relief at the time of contributing capital to the fund, discussed below, which would be highly complex and involve significant additional burdens for fund managers.

Up-front tax relief

- 3.24 Under the current EIS rules investors in unapproved funds receive income tax relief at the time the fund invests in an underlying company, not at the time the investor contributes capital to the fund. The investor can claim tax relief

in the year of investment or the preceding tax year. Investors in approved EIS funds can claim tax relief in the tax year in which the fund closed, even if the investments are made in the following tax year. The approved fund manager must invest at least 90% of the funds raised within 12 months of the date the fund closed to subscriptions.

- 3.25 This may be making it difficult for funds to raise capital for deployment over an extended period, because investors may currently only be willing to invest funds on which they receive immediate tax relief.
- 3.26 As an alternative incentive the government could therefore consider giving income tax and CGT deferral relief for investment in the *fund*, on the condition that the capital is invested within a specified time window, for example two years. This might enable fund managers to raise larger sums of money for investment over a longer period. This would be accompanied by a longer holding period to ensure that funds are invested in companies for a minimum of three years.
- 3.27 These options would add greater complexity to the EIS rules than other options. It would be necessary to regulate how capital awaiting investment is dealt with, for example in bonds or cash. It would also be necessary to introduce new compliance processes to withdraw relief if the fund ceases to be eligible. The time such legislation would take to develop and implement would be longer than other options. There would be additional administrative obligations, and constraints on what can be done with yet to be invested funds would be placed upon fund managers.
- 3.28 The government will not provide all of these additional incentives, and the final model will focus on the most important elements for helping to address the knowledge-intensive patient capital funding gap.
- 3.29 Respondents should be clear about which incentives they recommend the government prioritises.

Box 3.A: Consultation questions

- 4 Would a targeted knowledge-intensive EIS fund model help increase the supply of patient capital to knowledge-intensive companies?
- 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.
- 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?
- 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?
- 8 To what extent would relief at the level of the fund be attractive when weighed against the additional complexity that would be necessary?

Next steps

- 3.30 The consultation is open for 9 weeks and closes at 5pm on **11 May 2018**.
- 3.31 The government wishes to ensure that the EIS knowledge-intensive fund is well designed and targeted while being robust against abuse. It will provide an update on implementation as part of its response to the consultation.

Responding to the consultation

- 3.32 Responses can be emailed to PCR.KI.Fund@HMTreasury.gsi.gov.uk
- 3.33 Printed responses can be sent to:
- Joseph Spencer
Business and International Tax
1 Yellow
HM Treasury
1 Horse Guards Road, SW1A 2HQ

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Box 3.B: Summary of Consultation Questions

- 1 Why are some younger knowledge-intensive companies unable to obtain the levels of patient capital that they require?
- 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?
- 3 What barriers are there to the development of investment funds that specifically target knowledge-intensive companies?
- 4 Would a targeted knowledge-intensive EIS fund model help increase the supply of patient capital to knowledge-intensive companies?
- 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.
- 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?
- 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?
- 8 To what extent would relief at the level of the fund be attractive when weighed against the additional complexity that would be necessary?

Annex A

Current EIS approved funding model

- The shares in which the fund capital is invested should be subscribed for by, issued to and held by the manager, acting as a nominee for each individual fund participant.
- The participants must at all times be the beneficial owners of the shares, each being entitled to a whole number of shares in each company.
- Provision may be made for participants to be allowed to end their participation in the fund at any time, but if a participant exercises any such right the manager must sell all the shares which are held on behalf of that person.
- The fund should be invested in a minimum of four companies, and the amount invested in any one company should not exceed 50% of the fund capital.
- If 90% of the fund capital is invested within 12 months of the date on which the fund closed, the investments are treated as made in the year in which the fund closed, even if they were actually made in a later year.
- If a fund receives approval, the fund manager is able to apply for relief on behalf of the participants using a single, collective claim certificate. This is administratively more straightforward than filing separate certificates, which unapproved funds are required to do.

HM Treasury contacts

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