HM Treasury

Financing growth in innovative firms:

Enterprise Investment Scheme knowledge-intensive fund consultation response

October 2018

HM Treasury

Financing growth in innovative firms:

Enterprise Investment Scheme knowledge-intensive fund consultation response

October 2018

OGL

This publication is available at www.gov.uk/government/publications

Any enquiries regarding this publication should be sent to us at public.enquiries@hmtreasury.gov.uk

ISBN 978-1-912809-04-2

PU2206

Contents

Executive summary

The government published a consultation on knowledge-intensive funds at Spring Statement 2018 as part of the ongoing review of barriers to financing growth in innovative UK firms.

This built on the government's response to the 'Financing growth in innovative firms' consultation, published at Autumn Budget 2017. Evidence gathered during the consultation suggested knowledge-intensive firms, which are often particularly capital and R&D-intensive, experience the greatest difficulty obtaining the capital they need to scale up. As a result, the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) scheme were significantly expanded for knowledge-intensive companies and the government committed to assessing further barriers to financing growth.

Against this backdrop, the government consulted on a new EIS fund structure aimed at improving the supply of capital to knowledge-intensive companies. Questions in this consultation were aimed at developing the government's understanding of the capital gap that knowledge-intensive companies face, and seeking views on the best way of closing that gap.

The government is grateful to all those who responded to the consultation, both in writing or through engagement with officials in person.

Conclusions from the consultation are that:

- respondents were clear that it would be helpful to provide a more straightforward and attractive fund structure for investors to place money in knowledge-intensive companies (KIC). To this end, they supported the idea of a new KIC fund structure
- respondents did not in general consider that significant new tax advantages would be necessary to make a KIC fund work
- in particular, respondents did not support a dividend tax relief element, since this might push KICs to issue dividends early on, rather than focusing on growth. Some doubted whether further tax incentives would be effective in crowding in additional capital
- respondents suggested the most valuable changes would include: reducing the current administrative burden on investors in current approved funds; more flexibility for fund managers; and more certainty on when the tax relief could be claimed

In light of the responses to the consultation, the **government has decided to take forward its proposals to introduce a new approved EIS fund structure**, improving on the existing structure through:

- **focusing on knowledge-intensive** – a minimum of 80% of funds raised must be invested in KICs, reducing the risk of inadvertent non-compliant investment threatening approved fund status
- **flexibility for managers** – funds will have two years to deploy capital, with at least 50% of each raise to be invested within the first 12 months, with monies not yet invested held in cash. This improves on previous rules where 90% of each raise had to be deployed within the first 12 months
- **clearer timings for tax relief** – investors to be allowed to set their relief against income tax liabilities in the year before the fund closes, where previously this was only permitted in the same year the fund closes

Further to this, and in line with consultation responses, HMRC has digitalised the certificates and paperwork associated with this investment. This has eliminated the need for signed paper documents and subsequently reduced administrative burden for all parties involved.

The government will not introduce relief at the point investors contribute to the fund, as this would be a fundamental change to the entire structure of EIS as the market continues to adjust to the Patient Capital Review (PCR) changes. Responses raised concerns around introducing complexity to the current relief mechanisms.

The new approved fund structure will be rolled out in April 2020 at the same time the current approved fund structure is withdrawn, avoiding complication.

Chapter 1
Introduction

1.1 The UK continues to be a world-leading place to start and grow a business, but some of the UK's most innovative start-ups can struggle to scale-up due to a lack of finance. In 2017 the government conducted the PCR, and announced its response at Autumn Budget 2017. This response outlined a 10-year action plan to unlock over £20 billion to finance growth in innovative firms.

1.2 Since Autumn Budget 2017, the government has made considerable progress on this action plan, including:

- launching British Patient Capital, which has been given resources of £2.5 billion to invest in innovative firms, in June 2018
- launching the Managed Funds programme, a fund of funds seeded with £500 million by the British Business Bank, in May 2018
- continuing to invest in first-time and emerging fund managers through the British Business Bank's Enterprise Capital Funds
- backing overseas investment in UK venture capital through the Department of International Trade, securing £240 million of investment this financial year
- launching the National Security Strategic Investment Fund in September 2018 with up to £85 million to invest in advanced technologies that contribute to our national security mission
- launching the Regional Angels programme run by the British Business Bank in October 2018 to support developing clusters of business angels outside London

1.3 As part of the action plan, the government also announced a number of changes to the EIS, Seed Enterprise Investment Scheme (SEIS), and VCT tax reliefs, which are available to investors in small growth businesses. The changes included:

- extending the EIS and VCT schemes for heavily capital and R&D-intensive 'knowledge-intensive' companies, specifically:
  - doubling the annual investment limit for EIS investors to £2 million, provided any amount above £1 million is invested in knowledge-intensive companies
  - doubling the annual investment limit for knowledge-intensive companies from £5 million to £10 million through the EIS and by VCTs

    - providing greater flexibility for knowledge-intensive companies to determine when the 10-year age limit on receiving an investment begins

- a new principles-based test, the 'risk-to-capital' condition, to ensure that investment through the schemes is at genuine risk and is made in companies seeking investment for their long-term growth and development

- changes to VCT rules to promote faster deployment of capital, to prevent abuse, and to encourage the reinvestment of VCT gains in growth companies

1.4 These changes were introduced by Finance Act 2018 and most are now in effect. In addition, and as part of the extension of the schemes for knowledge-intensive companies, the government committed to consult on introducing new rules for EIS funds using HMRC's 'approved fund' structure. These funds would specialise in knowledge-intensive investments. A consultation published at Spring Statement 2018 outlined possible administrative changes to the approved fund rules as well as options for further incentives to attract investment.

1.5 The consultation closed on 11 May 2018, with over 40 responses received. Respondents included entrepreneurs, individual investors, EIS funds, VCTs, investment houses, and a range of representative bodies. This document summarises the responses received to the consultation, and sets out the government's response. This document focuses on the questions posed by the consultation, and not the broader PCR. It summarises a wide range of views and opinions and does not set out in detail all of the individual proposals and views put forward. However, the government's response does reflect detailed analysis of individual responses.

Chapter 2
Summary of responses

2.1 There was broad agreement that knowledge-intensive companies experience a particularly acute capital gap. Several stakeholders commented that the UK now has a good supply of start-up capital, but that later stage funding rounds have a gap. Others made the point that knowledge-intensive companies often have long product development periods, requiring large amounts of capital to take products to market, then lacking sufficient trading record to receive follow-on funding easily. Others said such companies are inherently risky as they attempt to push boundaries and produce entirely new products.

2.2 Some respondents made wider comments about the UK's venture capital markets pointing out that, as noted by the PCR, these are relatively thin compared to the United States, where venture capitalists are also more likely to have commercial, rather than financial, backgrounds. Other problems identified were a lack of pension fund investment in unlisted knowledge-intensive companies, and the relatively long length of time required for investors to see a return.

2.3 Universities often have hubs of knowledge-intensive companies built around them, particularly university spin-outs. Some respondents suggested that university support for commercialisation of technology should be increased, and that there is not adequate alignment of interests between academic founders, entrepreneurs, institutions, universities, and fund managers. Several respondents highlighted regional disparities in levels of investment through SEIS and EIS.

2.4 Other respondents reported that the risk-to-capital condition has already meant a shift of capital towards knowledge-intensive companies.

2.5 Proposals for improving the supply of patient capital to knowledge-intensive companies were varied. Some responses suggested that more could be done to bring knowledge-intensive companies up to a state of investor readiness, and to increase awareness of the changes announced at Autumn Budget 2017.

2.6 There was general acceptance that a high level of expertise is needed to make knowledge-intensive investments and that fund manager expertise could be improved. Others suggested that a lack of transparent performance data for EIS funds has caused a number of problems for the market, including the reluctance of Wealth Managers and Independent Financial Advisers to recommend EIS funds and knowledge-intensive areas in particular.

2.7 Some respondents pointed out that there have been frequent changes to tax rules around EIS, SEIS, and VCTs in recent years, in addition to regulatory changes. There were requests for regulatory and tax stability. One respondent advocated no new changes to EIS (including the introduction of a knowledge-intensive fund structure) until a 'cooling off period' had passed, to allow the industry, investors, and managers to adapt to the PCR changes. Another suggested the government should make clearer to investors and companies that the PCR changes represent a step-change in EIS, SEIS, and VCT rules, rather than minor adjustments.

2.8 Respondents who made comments on the knowledge-intensive definition set out in EIS and VCT legislation were divided. Some felt that it broadly covered the companies it is attempting to target. Others thought the definition either too broad or too narrow. One stakeholder suggested that almost any 'tech' company could meet the current R&D requirements whereas the companies facing the greatest capital gap had higher levels of R&D intensity than those set out in the definition. There were responses from the creative sector suggesting that the audiovisual industries should be explicitly recognised in the definition.

2.9 Nearly all respondents suggested that a well-targeted EIS fund model would help knowledge-intensive companies, but there was a wide variety of views over the form it should take. Many responses suggested that increased generosity of tax relief is unnecessary, and stakeholders expressed preference for a range of administrative easements for EIS funds. Nearly all responses suggested that a dividend tax exemption would do little to make knowledge-intensive investments more attractive, as they are often many years from being able to issue dividends.

2.10 The consultation asked respondents to rank options. Here there was an extremely wide variety of responses and orderings. Some respondents suggested that a partial Capital Gains Tax (CGT) exemption could encourage entrepreneurs to invest in EIS after selling their businesses. Others thought the reliefs were already generous enough but that providing the EIS carry-back facility to EIS approved funds, not just other EIS investments, would remove a barrier that approved funds currently face.

2.11 Many responses expressed support for upfront tax relief available to investors at the point they contribute to a fund, saying it would make the knowledge-intensive fund popular with wealth advisers and other investors. Others were concerned that this option could lead to additional complexity, increase the scope for abuse, and represented a new, untried scheme that would bear characteristics of both EIS and VCTs. Several respondents also expressed a desire that an approved fund with upfront tax relief should not create a 'cliff edge' dilemma for funds, whereby an inadvertent investment in a non-knowledge intensive company could lead to a loss of status, and therefore relief. One angel investor suggested that "Up-front has a danger of substantial complexity. Simpler for the investor but then lots of rules and a tendency to create lots of small annual funds. [The] best balance may be to continue the current practice with the ability to carry back and forward tax allowances…"

2.12 There was a wide variety of other ideas included allowing EIS capital in receipt of relief to be used for manager fees, extending the holding period for KIC investments to 5 years with 35% tax relief, an evergreen fund modelled on a unit trust, or tapered 'holding relief' for longer-term investments. Some responses also suggested that a knowledge-intensive fund should allow for a small proportion of non-knowledge-intensive investments, so that the approved fund status would not be imperilled by an inadvertently non-qualifying investment.

Chapter 3
Government response

3.1 The government has considered responses to this consultation carefully, and balanced these against several criteria:

- that any tax advantages for investors, and the flexibilities granted to the fund structure itself must be proportionate to the identified market failure adversely affecting early-stage knowledge-intensive companies
- that any new fund rules should not unreasonably distort the market
- the economic benefits must be commensurate with the Exchequer cost
- it must not introduce unfairness to the tax system

3.2 In addition, the government has considered its responsibility to ensure that EIS tax reliefs are used as the scheme's policy objective intends, and the need to bear in mind State aid constraints.

3.3 As stated in the consultation, the government is not introducing a new scheme. The changes outlined here are intended to respond to specific concerns about the HMRC approved fund structure, and attempt to utilise additional flexibilities to encourage:

- more EIS investment into knowledge-intensive companies where there are acute capital gaps
- longer-term investment into those companies
- more fund managers to develop expertise in knowledge-intensive areas

3.4 In light of broad consensus raising doubts about the effectiveness of additional tax incentives on top of already generous EIS reliefs at crowding in additional capital, the government is not introducing a new dividend tax relief or CGT write-off. This is also intended to ensure that the focus of these early stage KICs remains on reinvesting profits into business growth, rather than on paying out early profits as dividends.

3.5 The government has also decided not to introduce relief at the point investors contribute to the fund, as this would be a fundamental change to the entire structure of the EIS as the market continues to adjust to the PCR changes.

3.6 Instead, the government will legislate to reform the HMRC 'approved' fund structure from 6 April 2020, targeting it on knowledge-intensive investments and introducing several new easements. The new approved fund structure will retain their current nominee structure and have the following features:

- a new requirement that at least 80% of funds raised must be invested in knowledge-intensive companies will be introduced
- the time period over which approved funds must make their investments will be extended from one year to two. Funds will be required to invest at least 50% of each raise within the first 12 months, and to keep that monies not yet invested in cash
- a carry-back rule will be introduced so that investors will be able to set their relief against income tax liabilities in the year before the fund closes
- approved funds will be required to submit annual statements to HMRC to demonstrate that they continue to meet the relevant conditions

3.7 Further to the new approved fund structure, additional changes have been made to simplify the administrative procedures surrounding EIS investments, regardless of participation in an approved fund. HMRC introduced digital certificates from October 2018, which removed reliance on signed paper certificates for investors and fund managers, significantly reducing the administrative burden on all parties involved.

3.8 The government intends that draft legislation for the new 'approved fund' should be included in the 2019-20 Finance Bill, to take effect from 6 April 2020. All aspects of the introduction of the fund are contingent on normal State aid processes, which in turn are subject to the outcome of EU exit negotiations.

3.9 Draft legislation and draft rules for the new approved fund structure will be published alongside the draft legislation for Finance Bill 2019-20. HMRC will also publish and consult on draft guidance for the new approved fund.

3.10 The objective of providing these additional flexibilities for EIS funds through the new approved structure is to ensure additional patient capital reaches knowledge-intensive companies. The government also encourages new fund managers and angel groups to enter and develop expertise in knowledge-intensive sectors. This new approved fund structure is intended to work alongside the other changes announced as part of the government response to the PCR. As outlined in that response, the government will continue to monitor the market and will take action against behaviour not in the spirit of the Venture Capital Schemes where necessary. As with all tax policy, the new approved fund structure will be kept under review.

3.11 Finally, as it does for all financial services firms, the government strongly encourages all EIS fund providers to sign the Women in Finance charter.

HM Treasury contacts

This document can be downloaded from
www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk