Joseph Spencer
Enterprise and Property Tax
Business and International Tax
1/Yellow
HM Treasury
1 Horse Guards Road, London
SW1A 2HQ

By email: PCR.KI.Fund@HMTreasury.gsi.gov.uk

11 May 2018

Dear Sirs,

Financing growth in innovative firms: Enterprise Investment Scheme knowledge-intensive fund consultation

I am writing on behalf of the British Private Equity & Venture Capital Association (BVCA), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, the BVCA represents the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors.

We welcome the outcome of the Patient Capital Review and welcome the opportunity to comment on the questions posed in the consultation paper on the EIS knowledge-intensive fund. The BVCA believes that the creation of a new fund structure that provides attractive tax reliefs, facilitates portfolio investment, and is simple to invest in could increase the attractiveness of investing in a range of knowledge-intensive companies. As we outlined in our previous consultation responses, there is a gap in access to long-term and scale-up finance for knowledge-intensive companies that require long-term investment.

Although the focus of this consultation is on a fund with EIS-like incentives, which are directed to individuals, we believe it would be worth exploring extending this to fund structures that could facilitate institutional investment in scaling knowledge-intensive companies, which would provide the greater capital and longer timeframe required by many knowledge-intensive companies.

Our detailed feedback is set out in the attached response. We have previously met with representatives from HM Treasury to discuss the work of our industry and would be delighted to meet you again to discuss this response in further detail.

Yours faithfully,

Tim Hames
BVCA Director General

British Private Equity & Venture Capital Association
5th Floor East, Chancery House, 53-64 Chancery Lane, London WC2A 1QS
T +44 (0)20 7492 0400 bvca@bvca.co.uk www.bvca.co.uk

BVCA Response to the Consultation Paper on the Enterprise Investment Scheme knowledge-intensive fund consultation

Introduction

1. The impact of private equity and venture capital on the UK economy was set out in our response to the Government's Industrial Strategy Green Paper in April 2017[1]. This response covers Government interventions and schemes that encourage investment in UK businesses that are new, innovative and scaling up.

2. Independent research[2] conducted by Oxford Economics on behalf of the BVCA in 2017 has demonstrated the impact of venture capital on the UK economy. Taking account of all investment, including UK-managed funds, there are around 9,400 VC-backed companies in the UK, contributing over £10bn to GDP and employing more than 130,000 FTEs. When taking into account supply chain and employee spending impact, the sector contributes over £20bn to GDP, and supports 326,000 jobs.

3. EIS and SEIS programmes invest in the very early years of a small businesses growth cycle and a number levels in the growth and development market. Venture Capital Trusts (VCTs) have played a key role in improving the availability of finance to early stage companies. The combination of EIS, SEIS and VCTs show that many levels of the patient capital ecosystem are already in existence. SEIS allows for very early stage, EIS provides for a further advance in maturity and VCTs for further scale up. EIS and VCT funding plays a vital role for a whole range of smaller, entrepreneurial companies, not just those whose focus is on R&D.

4. We believe there is a need for a diversity of funding sources that are complementary, including both investment programmes and tax reliefs, as they target different needs, and have different investor bases. VCTs, EIS and SEIS allow the wider public to become a stakeholder in entrepreneurial Britain, and government investment programmes support venture and growth funds, and draw in private institutional investors.

5. The complimentary nature of these schemes must be preserved as they all serve an essential role in the development of early stage innovative companies. Any reduction in support would be very damaging for the UK's wider entrepreneurial ecosystem. A new knowledge-intensive EIS fund needs to focus investment on areas the Government wants, without upsetting the overall balance of the current tax advantage schemes.

Consultation questions

Q1. Why are some younger knowledge-intensive companies unable to obtain the levels of patient capital that they require?

6. The BVCA's response to the Patient Capital Review consultation described the challenges in

[1] BVCA response to the Industrial Strategy Green Paper, available here

[2] The contribution to the UK economy of firms using venture capital and business angel finance (Oxford Economics & BVCA, available here)

raising capital faced by companies that require long-term or "patient" investment.[3]

7. The lack of available funding is more nuanced than the consultation paper suggests. As we have demonstrated in previous consultation responses, the funding gap is increasingly problematic the further along the funding timeline that investee companies find themselves. SEIS has alleviated a number of the problems at the start-up/seed stage and the changes brought in after the 2017 Autumn budget will help to ensure that more money is focused on growth investing at the development capital/growth capital stage.

8. The problem is most acute at the scale-up capital stage, where funding rounds reach approximately £10mn. At this level, it is challenging for many companies to secure funding, especially in areas such as life sciences, because of the very long timescales and the perceived increase in risks. The problem for approved knowledge-intensive funds in addressing this need is the life time limit, which is quickly reached. More needs to done to ensure that the funding eco-system is better connected and able to support potential high growth businesses throughout their funding journey.

9. The lack of availability and visibility of expansion finance constrains the growth of UK companies as the focus shifts to survival rather than further investment, which has clear implications for the UK economy in terms of jobs, growth and productivity. It also reduces returns for their venture capital backers, making the asset class less attractive to investors. A knowledge-intensive EIS fund would go some way to addressing this, but it is only part of the solution.

Q2. 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?

10. The rule changes to the Venture Capital Schemes in the 2015 and 2016 Finance Acts produced a significant increase in response times for applications for advance assurance. This has lengthened the time it takes for eligible companies to receive investment, and we are aware of some companies being pushed into cash crisis and shedding jobs as a result. In some cases, HMRC has also gold-plated some of the EU requirements.

11. Whilst we welcome the creation of a new fund, we would also look to clarify other areas to provide further certainty. Changes to the current reliefs are not the main concern of BVCA members who run VCTs or EIS portfolios funds. Consistency in the administration of these funds by regulators would provide more certainty and a better environment for investors. This would reduce the time it takes to get cash into companies, and would reduce the resources that HMRC would need to dedicate to the service.

12. The greatest source of uncertainty in the rules at present is the restriction on investment in companies seven years after their first commercial sale. Both the General Block Exemption Regulation (GBER) and HMRC envisage that companies may make limited test sales without beginning the seven year clock. As we have outlined in our response to the Patient Capital Review, many fund managers will not consider investment in companies older than seven

[3] BVCA response to the Patient Capital Review, available here.

years, irrespective of the circumstances. As a result, many deserving targets, and which would meet the GBER requirements for state aid, are not receiving the support they need. Providing firms with certainty on the application of the seven year rule would encourage additional investment into firms entering new markets, and firms developing new products or products with particularly long development phases. It would also reduce the burdens on the advance assurance service, and the length of time it takes companies to receive investment.

Q3. What barriers are there to the development of investment funds that specifically target knowledge-intensive companies?

13. BVCA members have found that investors can be off-put by the delay in being able to claim income tax relief when investing through EIS approved and unapproved funds and only being able to claim relief on the amount invested in the underlying company, which, due to management fees and other costs, is not 100% of their subscription to the fund. Under current rules, relief for EIS investment through an EIS approved fund is given only after 90% of funds have been invested, when most investors have already closed their tax affairs for the relevant tax year and paid the tax. They then have to make a backdated claim one to two years later.

Q4. Would a targeted knowledge-intensive EIS fund model help increase the supply of patient capital to knowledge-intensive companies?

14. The BVCA would support the creation of a new EIS fund for knowledge-intensive companies if it is given the right structure that is administratively simple and has similar incentives to EIS. The EIS brand is a successful, well-established scheme, and a new fund structure would help facilitate a diversified investment strategy that helps spread risk, which is helpful for those investing in knowledge-intensive companies. The fund structure also makes it easier for Independent Financial Advisors to recommend the product, as they can rarely advise on individual investments but can refer clients to fund managers.

Q5. 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.

15. We have placed each option from most attractive to least attractive.

(i) ***Up-front tax relief.*** *Income and CGT relief could be claimed in the year of investment into the fund.*

16. This would be of significant benefit, as investors wish to see relief immediately and with minimal administrative burden. Investors should be able to claim relief on the total amount invested in the fund in the year of investment or at the date of the fund closing to reduce the bureaucracy of filing tax relief claims and provide certainty in their tax position.

17. A restriction on the period which money must be invested by the fund into a company would be a disadvantage and could result in poor asset allocation. It takes additional time to identify

BVCA

knowledge-intensive companies and conduct due-diligence, and to seek HMRC confirmation of knowledge-intensive status – something that is critical to ensure investments are made in knowledge-intensive companies. Currently HMRC do not consider the knowledge-intensive criteria unless a company needs to be knowledge-intensive to receive EIS or VCT investment; in order for a fund to be designated as knowledge-intensive HMRC would need to provide an opinion in advance on all investments made through the fund.

18. Current time-limits for approved EIS funds are already too restrictive, so a proposed two-year window would not only allow more money to be raised but could allow better allocation of funds of the same size.

(ii) ***Capital Gains Tax relief.*** *CGT incurred from the disposal of assets (e.g. sale of a house) can be partially written-off if part or all of the proceeds are invested in the EIS fund.*

19. Allowing a proportion of capital gains tax write-off if invested into a knowledge-intensive fund would be a positive inducement to investment. Reinvestment relief which provides an exemption similar to that available for SEIS investment would be preferred to CGT deferral relief, which can require keeping detailed records for many years.

20. CGT relief should also be given on gains from the fund investment. Tapered relief could provide an incentive to maintain investment in the fund over a longer period to gain greater relief; this would require CGT relief not being annually capped as it is currently.

(iii) ***Extended carry-back.*** *Investors can claim 30% relief on income tax in any nominated year within a defined period, say three or five years, prior to the fund's investment in an EIS company.*

21. This is a potentially useful benefit for individual investors but we do not believe it would be a significant incentive to increase investment capital overall.

(iv) ***Dividend tax exemption.*** *This may be applied to dividends for shares held for a defined period, say five or seven years.*

22. We see little benefit in this exemption, as few existing EIS companies pay a dividend and few investors invest in EIS in the expectation of a dividend.

Q6. 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?

23. The BVCA favours an approved fund structure, which have some features similar to that of a VCT, predominantly because of the administrative ease and only require one share certificate and one tax relief claim. A vehicle which is an approved fund, in theory, should provide simplicity. However the method for claiming EIS relief under the current approved fund model is hindered because of the speed of deployment and the possibility that if one investment becomes disqualifying the whole EIS would fail creating a "cliff edge" scenario. A completely new EIS vehicle would be more attractive alongside further tax reliefs.

24. The new fund should be similar to unit trusts so that investors own shares in the fund, rather than owning shares directly in the underlying companies as they do with current EIS approved funds. It should also be possible to issue new shares in the fund (which qualify for EIS tax reliefs) after it has begun making investments, to allow additional capital to be raised. This will reduce constraints on the fund manager's strategy.

25. This fund should also be non-cyclical so that there is greater certainty over the ability of the fund to make follow-on investments, and so be better suited to providing capital to knowledge-intensive companies which usually require multiple rounds of funding. This provides investors with access to liquidity without the need for the fund manager to sell the underlying assets, enabling the funds to remain invested in companies over the long-term. It also has the advantage from a cost-effectiveness standpoint that the proceeds of asset sales are recycled within the fund and reinvested into additional companies.

26. We recommend that the fund should have the ability to follow on any of its investments for the same business activities, even if the limit on gross assets of £15m are exceeded. Many EIS funds and VCTs have not been able to follow their successful investments in life sciences businesses, and this is a barrier to early stage investment in such companies. This would provide scale-up capital, a need particularly identified in the Patient Capital Review.

27. An up-front income tax relief of at least 30% with a minimal amount of bureaucracy for claiming is also desirable, subject to a three-year holding period of fund shares. Relief should be provided for the total subscription to the fund to reduce bureaucracy (caused by linking relief to individual investments in companies) and to maximise the attractiveness of the fund to prospective investors, who could be put off by not receiving relief for 100% of their investment.

28. Further income tax relief in the years when investors continue to hold their investments in the fund would also help to promote longer holding periods. Shareholders should be able to claim further income tax relief in a future tax year as long as they continue to hold their original investment in full. Further analysis would be required to determine the rate of relief required to provide a sufficient incentive, however, 30% would be recommended so that holding shares is as beneficial as withdrawing and reinvesting into a new fund/company. This feature could kick in after shares have been held for three years, and the relief could be awarded either in each subsequent year or at certain milestones, such as every three years.

29. We also recommend an increase of the 12 month investment period to 24 months to provide greater flexibility for fund managers to find and make investments. As explained above, many of our members find 12 months to deploy funds in an EIS approved fund is too short a timeframe as due diligence procedures can take several months leaving a limited timescale to deploy capital.

30. Up-front relief on 100% of the total investment, to be reclaimed at a later point would provide the most certainty and ease for fund managers and investors, so attracting additional investment and potentially new managers to this space.

31. The fund would need to retain some liquid funds to enable follow on investment in the underlying companies (most knowledge intensive companies do require further funding) and also to meet running costs of the fund. We suggest this should be 20% of the fund.

Q7. 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?

32. The dividend tax exemption was thought to make no difference given that very few knowledge-intensive EIS companies pay dividends. Providing further income tax relief for a longer holding period in the fund or the CGT exemption listed above would be more effective than dividend relief in providing additional funding for knowledge-intensive companies. We would also highlight that by far the biggest attraction would be the easing of administration burdens and access at a much earlier stage to tax relief.

Q8. To what extent would relief at the level of the fund be attractive when weighed against the additional complexity that would be necessary?

33. We believe that reliefs at the level of the fund would be more attractive to potential investors. This would be less complex and easier to administer than providing relief for each separate underlying investment. However, the simplifying of the administration and claiming of the current reliefs would make the overall proposition more attractive to investors.