British Private Equity and Venture Capital Association response to the 'Consultation on Social Investment Tax Relief

The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK. Our aim is to aid understanding around the activities of our members, promote our industry to entrepreneurs and investors as well as to Government, the EU, trade unions, international media and the general public. We communicate the industry's impact and reinforce the crucial role our members play in the global economy as a catalyst for change and growth.

Our membership comprises more than 500 influential firms, including over 230 private equity and venture capital houses with an accumulated total of more than £200 billion funds under management, limited partners, professional advisers, service providers and international associations, working together to provide capital and expertise to growing businesses, to unlock potential and to deliver enhanced returns to the millions who directly and indirectly invest in our industry. Further details on the BVCA's activities can be found in our Annual Review.

Introduction and executive summary

The BVCA primarily represents private equity and venture capital firms, who raise and invest money on a commercial basis, to improve and grow businesses, and deliver returns to our investors, often pension funds and insurance companies. However we do count among our members, firms who invest in social enterprise, to deliver a social impact as well as a financial return. We also have conventional private equity houses who themselves invest in businesses in the social enterprise space. However it is a relatively small part of our membership operating in an underdeveloped market. There are many encouraging signs though that there is investor appetite that could be unleashed in the way this consultation advocates. We have seen the success that retail investors, providing funding through the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs), have had in unlocking investment via tax reliefs for deployment in innovative companies not suitable for bank loans. This is therefore a timely consultation, designed as it is to bring much needed capital to social enterprises doing vital work in our communities. In so doing it can create and normalise a market for investors, intermediaries and end users to support our existing social enterprises and encourage the creation of new ones.

We believe that the thrust of this consultation is in the right direction. Particularly in the way it defines eligible recipients of social investments. Structuring the tax relief in a similar way to EIS and, indeed, VCTs also has merit, and we believe that this certainly has the potential to set in a place a new regime that will raise more investment in this sector. However there are several areas where improvements are needed if we are to create a genuine marketplace, driven by intermediaries for social enterprise investment where none exists today. These are:

(i) **Size of permitted aggregate investment in a social enterprise must be increased from £200,000 to £5m.** We can understand the merits of a £200,000 pa limit to steer clear of the need to seek state aid approval, but this is simply unworkably small. Advisers and intermediaries will not be able to offer a share of such a small fund to their clients and thus an essential component for success will be lost.

(ii) **Permitted instruments should comprise debt rather than equity.** The structure of social enterprises lends itself far better to debt. Social enterprises are not suited to equity financing, as it is not in their nature (nor in their policy objective) that they should ultimately seek an exit.

(iii) **The vehicles for raising and delivering investment should be ever-green, transparent and diverse as possible.** Experience with VCTs shows the value of an evergreen, quoted vehicle, that can take a truly long-term investment view, recycle its investments, and provide investor liquidity through its quoted status.

(iv) **The size and nature of the relief should reflect the underlying policy objectives.** Longevity is the key, suggesting that Business Property Relief through the exclusion of the investment for Inheritance Tax purposes would be an important element**.**

Key Points

Increasing the size of the investment limit

The underlying aim of this consultation and any subsequent tax relief should be to catalyse as much investment into social enterprises as demand dictates. Estimates show that there is a capital shortfall in UK social enterprise in terms of both working capital and capital to fund innovation and growth. So it is certainly necessary for a state driven intervention to try and create the beginnings of a market. Offering tax relief, to retail investors and then marketing it aggressively to potential savers and investors would certainly help. But in order to maximise takeup and increase the amount of capital available for social enterprise, it is important that we strive to create a fully functioning market – this crucially means attracting advisors and intermediaries. Independent Financial Advisors (IFAs) offering these products to their clients is a necessary condition to create such a market. But for them to do this there has to be scale and this means the investment limits for individual social enterprises must be sufficiently large. The Government's starting point is for a limit of 200,000 Euros or around £150,000. This amount, per social enterprise, is so small as to make it both impractical and uneconomic for financial intermediaries to market to their clients.

However the reasoning cited in the consultation does not dispute these points by claiming that £150,000 limit is necessary and sufficient. The figure derives from what is the present limit to avoid triggering European Commission State Aid permissions. It also indicates that this is only the starting point to allow early implementation in Finance Bill 2014 as the evidence gathering required would take longer. Our view is that a scheme at this level, even if it is presented as a "pilot", will fail and the perception of failure will tarnish the scheme's future, possibly irretrievably.

State Aid clearance for such projects is very much a live issue. The Risk Finance Guidelines define a financial intermediary as '"Any financial intermediary, regardless of its form and ownership, including entrusted entities, fund of funds, private investment funds, public investment funds, banks, micro-finance institutions and guarantee societies."

The HMT consultation itself states

> "The Government recognises that social enterprise investment may be attractive to individuals who are willing to provide funding but do not want to have to make investment decisions personally, instead preferring decisions to be made by a fund manager operating a collective investment fund.
>
> The Government does not propose including a set of rules to facilitate and encourage social investments that are made indirectly via a separate legal entity such as an LLP. Instead, the Government believes that it would be simpler and more appropriate to use "nominee" arrangements to allow indirect investments to qualify for the social investment scheme"

This means that even if the social investment fund does not take the form of an LLP for example, the flexibility contained in the guidelines means that it can plausibly be claimed that any social investment, delivered through an intermediary which offers tax relief to its investors should be subject to the provisions of the Risk Finance Guidelines. There is clearly scope to apply for a higher limit and a reasonable basis to expect that application to be successful.

Permitted instruments should be debt not equity.

The consultation refers repeatedly to EIS, which is of course an equity only scheme, where individual investors can take equity stakes on a deal by deal basis in qualifying companies. But many social enterprises do not issue shares since they are companies limited by guarantee. The Consultation also rightly points out that social enterprises have few assets to secure loans against and only the profit can be 'captured' by the investor, not the second component, the social good. This suggests a greater focus is needed on differentiating between social enterprises and commercial businesses.

Profit making will be important from a sustainability perspective but we do not believe it should be the focus for generating returns to investors. Notions of 'exits' for investors seem inappropriate since the enterprises in question should surely be seen as evergreen. Services provided should never be disrupted by the possible need to transfer ownership. So 'gains on disposal' is simply not an appropriate term.

The consultation recognises that many current investments into social enterprises are the form of loans or quasi-equity. This being the case and given the sentiments above, we believe that debt instruments should be the main focus of the scheme. Unsecured debt is the most suitable for the investor as it is effectively subsidised by the tax relief and it will also suit the needs of the social enterprise as well.

There is scope for a minimum holding period for the investment that is reasonably long such as 8 years provided that long-term liquidity can be delivered either through debt amortisation or by allowing existing debt to be repaid out of a new issuance.

Quoted fund as most appropriate vehicle

VCTs form an example of how a quoted fund can provide an appropriate investment vehicle for unquoted companies. VCTs have the following characteristic; they invest in a portfolio of investments, thus spreading the risk; they are ever-green, thus being able both to take a very long-term view, and to recycle their investments on repayment / sale; they have strong corporate governance; they are absolutely transparent, with full audit and disclosure; and they provide a degree of liquidity through their quoted status. We would therefore recommend a similar structure for social enterprise funds but quoted on AIM to save on costs.

The size and nature of the relief should reflect the underlying policy objectives.

Social enterprises are long-term projects that require stability and continuity. Therefore, their underlying investors should also have similar aims. For retail investors, this is best achieved by making shares in the AIM quoted investment vehicle qualify for Business Property Relief, and thus be free from IHT for the investor. If this was the case, then the up-front income tax-relief could be much lower than for EIS / VCTs at say 10-15%.