



HM TREASURY

# Tax-advantaged venture capital schemes: a consultation

July 2011





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<b>Subject of this consultation:</b>	Support for seed investment, and reforms to the Enterprise Investment Scheme and Venture Capital Trusts.
<b>Scope of this consultation:</b>	This consultation covers tax reliefs for investment in small, higher risk enterprises, including “seed” investment in start up enterprises. The aim is to gather views and evidence from stakeholders on a new scheme to support seed investment and on a number of reform options to improve the effectiveness of the existing Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT). The document is organised around three main themes (1) additional support for seed investment (2) simplification of the current schemes and (3) improved focusing of the schemes to ensure they remain appropriately targeted. The consultation also asks for additional supporting evidence from stakeholders on the use and impact of the current scheme.
<b>Who should read this:</b>	HM Treasury would like to hear from businesses, investors, representative bodies and others interested in tax-advantaged venture capital schemes in the UK.
<b>Duration:</b>	6 July – 28 September (12 weeks)
<b>Enquiries:</b>	Treasury Switchboard 020 7270 5000
<b>How to respond:</b>	Please send responses to:  Venture Capital Consultation Excise and Enterprise Team HM Treasury 1 Horse Guards Road SW1A 2HQ  Email address: <a href="mailto:ventureschemeconsultation@hmtreasury.gsi.gov.uk">ventureschemeconsultation@hmtreasury.gsi.gov.uk</a>
<b>Additional ways to be involved:</b>	Please indicate whether you are willing to discuss these issues with HMT. HMT will consider meeting interested parties to discuss the issues raised during this consultation. The timing, format and venue of these meetings will be informed by the expressions of interest received.
<b>After the consultation:</b>	A response document will be published. Responses will influence any legislative changes taken forward. The intention is to introduce legislation in the 2012 Finance Bill. Where appropriate the Government will seek State aid clearance for these changes.
<b>Getting to this stage:</b>	Budget 2011 announced consultation on how government could provide further support for seed investment, and on reforms to the existing schemes. This consultation also covers recommendations made by the Office of Tax Simplification (OTS) in March 2011. <sup>1</sup>

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<sup>1</sup> Office of Tax Simplification, *Review of Tax Reliefs Final Report* (March 2011) [http://www.hm-treasury.gov.uk/d/ots\\_review\\_tax\\_reliefs\\_final\\_report.pdf](http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_final_report.pdf)



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# Foreword

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The Government's *Plan for Growth*, published alongside the Budget in March 2011, set out measures to achieve four overarching ambitions for the British economy, including making the UK the best place in Europe to start, finance and grow a business. A vital part of this is ensuring that smaller businesses in particular have access to a wide range of sources of finance.

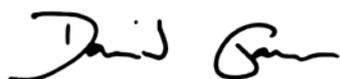
In February 2011, the Government agreed with the major UK banks that they will provide £76 billion of gross bank lending to SMEs in 2011, an increase of 15% on 2010. The Government has also committed to extend the Enterprise Finance Guarantee for the rest of this Parliament, supporting up to £2 billion of lending to businesses.

In addition, the Government has taken a number of steps to ensure the availability of equity finance. Government support for Enterprise Capital Funds will continue with a further £200 million over the next four years. At Budget 2011 the Government also announced proposals to encourage investment in businesses with high growth potential by reforming the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs).

Since their introduction in the 1990s, the EIS and VCTs have supported over £11.5bn of equity investment into UK businesses. The schemes incentivise investment in smaller, qualifying companies by offering a range of income and capital gains tax reliefs to individual investors who subscribe for new shares in a VCT or in a company qualifying under the EIS rules. The reforms announced at Budget are subject to State aid approval, and include:

- raising the rate of EIS income tax relief to 30 per cent from April 2011;
- increasing the annual EIS investment limit for individuals to £1 million from April 2012;
- increasing the qualifying company limits to 250 employees and gross assets of £15 million for both EIS and VCT from April 2012;
- increasing the annual investment limit for qualifying companies to £10 million for EIS and VCT from April 2012; and
- consulting on options to provide further support for early-stage ("seed") investment for start-up companies.

This document sets out proposals to ensure these schemes remain effective whilst supporting increased investment into companies that are essential for growth in the UK. I am pleased to publish the consultation paper and hope that businesses, investors, representative bodies and others interested in promoting growth in the UK will play a full part in the consultation process.



David Gauke  
Exchequer Secretary  
July 2011



# 1

# Introduction

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## Consultation outline

**1.1** The aim of this consultation is to gather views and evidence from stakeholders on a number of reform options to improve the effectiveness of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs). The document is organised around three main themes: (1) additional support for seed investment (2) simplification of the current schemes and (3) refocusing of the schemes to ensure they remain appropriately targeted.

**1.2** This document provides more detail on these proposals, asks for input on a number of aspects and sets out the timetable for change. The proposals set out in this document are at various stages of the Government's framework for tax consultation. Most are at stage 1 (setting out objectives and identifying options) or stage 2 (determining the best option and developing a framework for implementation including detailed policy design). The changes affecting feed-in tariff businesses (FITs) are at Stage 3 (draft legislation).

**1.3** The Government is seeking views on the impacts of the proposed changes (see Chapter 6).

**1.4** The Government is also asking for additional supporting evidence from stakeholders on the use and impact of the current schemes. More detail on the questions the Government would like to address is set out in Chapter 2 and Chapter 5.

**1.5** The consultation period runs to 28 September. Following this, legislation to implement any proposals to be taken forward in Finance Bill 2012, will be published in draft in the autumn and there will be scope then for further comment on the draft legislation.

## Support for early-stage investment

**1.6** The schemes are intended to address equity gaps that have been identified in relation to investment in small and medium sized (SMEs) enterprises and start-up enterprises. Evidence suggests that there are difficulties in accessing equity finance at two different sizes of investment.

**1.7** The levels currently in force which were introduced in 2006 and 2007 were designed to address the equity gap that has been found to exist between £250,000 and £2 million, where SMEs in particular find it hard to access equity investments.

**1.8** More recently, the review by Chris Rowlands, *The Provision of Growth Capital to UK Small and Medium Sized Enterprises* found that, in addition to the above, there is also an equity gap between £2 million and £10 million.<sup>1</sup> The announcements made at Budget and proposals set out in this document are an attempt to help address this problem.

**1.9** The schemes are designed to help address the market failures that exist in the equity investment market. The main source of market failure identified in the risk capital market in relation to access to risk capital by SMEs and early-stage companies is that of imperfect information.

**1.10** This can arise in a number of ways, for example:

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<sup>1</sup> Rowlands Review (2009) <http://www.bis.gov.uk/files/file53698.pdf>

- difficulties faced by investors in gathering sufficient information on the business prospects of a company, particularly those at the start-up stage;
- the disproportionate transaction costs in relation to size of investment when investing small amounts;
- risk aversion of investors towards smaller companies, in particular start-ups; and
- companies' lack of information or awareness of the benefits and contract terms of investment.

**1.11** The market failures outlined above are particularly acute for the smallest companies and start-ups that require seed investment. The Government recognises that there is a particular need for this investment. Entrepreneurs and start-up companies developing new ideas and products often require relatively small sums of investment. This can deter investors who may prefer to invest larger sums in larger companies. The Government therefore announced at Budget 2011 that it would consult on options to support seed investment through tax reliefs. The proposals for targeted seed investment support are set out in this document (Chapter 2).

### **Simplifying and refocusing the schemes**

**1.12** The Government is committed to simplifying the tax system and improving the ease with which taxpayers and businesses understand and interact with it. Following on from the recommendations made by the Office of Tax Simplification (OTS) in March 2011, this consultation document also sets out a number of proposals to simplify the schemes.<sup>2</sup> The proposals are for simplification of the EIS rules by removing restrictions on qualifying shares and types of investor.

**1.13** The Government also announced that it would consult on options to refocus both EIS and VCTs to ensure they are better targeted at genuine risk capital investments, and that feed-in tariffs businesses would be added to the excluded activities list from 6 April 2012. In accordance with the new tax policy making process, the Government is publishing draft legislation for comment. Annex B contains the draft legislation for FITs exclusion.

### **Principles for reform**

**1.14** In determining final proposals for reforms to the venture capital schemes, the Government will be guided by a number of principles of policy design. Any reform must be affordable to the Exchequer and therefore cost is an important factor. It must also be deliverable by HMRC and easy for the taxpayer to use. The policy must also be assessed to ensure it meets the Government's economic objectives to promote growth, encourage additional investment to support start-ups and enterprise, and to support job creation.

**1.15** In addition, both VCTs and EIS are State aids because they provide Government support that favours one class of enterprise over others. This means that any reforms to the schemes need to be agreed by the European Commission through the Notification process.

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<sup>2</sup> Office of Tax Simplification, *Review of Tax Reliefs Final Report* (March 2011) [http://www.hm-treasury.gov.uk/d/ots\\_review\\_tax\\_reliefs\\_final\\_report.pdf](http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_final_report.pdf)

**1.16** The Commission recognises that there is in general an insufficient level of risk capital available for start up and innovative young businesses, and therefore provides guidelines to governments who wish to provide support through grants or tax relief where there are market failures in the risk capital market.<sup>3</sup> In particular, the guidelines reflect the Commission's recognition that this problem is especially acute for seed investment, and of the additional benefits that angel investors can bring to start-up companies, in terms of investment, experience and expertise of developing a business.

### **How to respond**

Please send comments by 28 September, 2011 to: Venture Capital Consultation, Excise and Enterprise Team, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Email: [ventureschemeconsultation@hmtreasury.gsi.gov.uk](mailto:ventureschemeconsultation@hmtreasury.gsi.gov.uk)

Telephone (Treasury switchboard): 020 7270 5000

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<sup>3</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:194:0002:0021:EN:PDF>



# 2

## Support the seed for investment

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**2.1** From extensive discussions with stakeholders, the Government is aware that some start-up companies in the UK may have particular difficulties in accessing seed finance. In response, the Government is consulting here with two purposes. The first is to gain a clearer understanding and evidence on the exact nature and scale of the problem, and secondly to assess whether and how best the tax system might effectively support an increase in seed investment.

**2.2** Subject to agreeing a suitable design and State aid approval, the Government intends to bring forward support for seed investment from April 2012.

### History of tax-advantaged early stage investment

**2.3** The lack of seed investment is not a new problem. Successive governments have attempted to address it through the tax system, but with limited success.

**2.4** In 1981 the Government launched the Business Start-Up Scheme (or Relief for Investment in New Corporate Trades). According to the Chancellor at the time, the Business Start-Up Scheme was intended:

*“to attract individual investors to back new enterprises. It is designed for the outside or minority investor in certain new small trading companies, as distinct from the owner of the business, his close family and associates... Under the scheme an investor will be able to obtain relief ... There will be strict rules to ensure that it is not used for investment in financial or passive operations, or for tax avoidance.”<sup>1</sup>*

**2.5** The Scheme was intended to end in 1984, but in 1983 the Government announced an extension of the scheme through the new Business Expansion Scheme (BES), to include not only new companies but qualifying established unquoted trading companies as well. BES also offered more generous tax relief. BES was extended in 1986 to give exemption from Capital Gains Tax (CGT) in cases where BES relief had been given, and in 1988 to allow investment in companies specialising in letting residential property.

**2.6** BES was withdrawn in 1993 following widespread public criticism of the scheme. As a scheme that offered up-front tax relief at the investor’s marginal rate, it led to investment being made purely for tax reasons rather than sound business ones. In addition, the breadth of eligible investors and companies (most notably residential property) made the scheme highly attractive as a tax shelter. What had in its early years been a useful scheme attracting individuals to invest in unquoted trading companies, made only a modest contribution to such funding in its last five to six years.

**2.7** BES was replaced by the Enterprise Investment Scheme in 1993, which represented a revision and fine tuning of BES, and added to the income tax relief on subscriptions and CGT exemption, the facility of a CGT deferral relief, which was available for chargeable gains

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<sup>1</sup> <http://hansard.millbanksystems.com/commons/1981/mar/10/business-start-up-scheme>

reinvested in shares attracting the income tax relief. Since 1993, the EIS has continued to be reviewed and revisited to ensure it delivers the policy intent.

**2.8** The Government is keen not to repeat the mistakes of the past. Set out below are a number of questions inviting evidence on the problem any reforms would solve, views on the effective design of a scheme, and on the monitoring and controls required to assess effectiveness and prevent abuse.

## **Guiding principles of policy design**

**2.9** In considering how best to support business angel investment at the seed-stage, the Government will want to ensure that any reforms deliver real additional investment without distorting behaviour or adding undue complexity to the tax system. This will involve considering a number of factors, including:

- evidence to ensure that the nature of the problems is correctly understood and that a proposal will achieve the policy aims and deliver positive economic impact;
- costs to the Exchequer to ensure a proposal is both affordable and represents value for money for the taxpayer;
- complexity of the proposal, because the Government is committed to simplifying the tax system and any new proposal should not result in unnecessary administrative burdens;
- deliverability because HMRC must be able to operate the scheme effectively, including with a view to minimising abuse of the schemes; and
- adherence to the European Commission's State aid guidelines on risk capital, and to the Commission's processes and timescales for seeking State aid approval.

## **Evidence on the problem**

**2.10** The existing EIS and VCT schemes are aimed at smaller companies which find it harder, because of market failure, to raise equity investment. However this group is not homogeneous. The smallest companies, especially start-ups, face particular difficulties attracting investors to make early-stage investments.

**2.11** This can particularly affect high-tech and/ or innovative businesses, although it is not a problem peculiar to them. As part of a balanced package of changes that already extends the scope of the schemes to cover larger businesses, Government announced in the Budget that it also planned to consult on options to give additional support to these smallest companies.

**2.12** The Government recognises that the market failure leading to an undersupply of risk capital is particularly acute at this level of investment. Stronger incentives, for example a higher rate of tax relief, might be required to help make such investments commercially viable for investors and provide start-ups with the finance needed to succeed and grow.

**2.13** Related to this problem, is a need for support in the form of business advice and expertise for start-ups. It has been suggested that to be most effective, incentives should be targeted at business angel investors in companies which are in the pre-start-up or "seed" phase to ensure that this tax relief encourages those individuals with expertise to invest at the seed level, allowing pre-start up companies to benefit from both their investment and their expertise.

**2.14** Having a more focused scheme might also allow some use of debt instruments which is not possible under existing schemes.

**2.15** However, evidence also suggests that a significant barrier to investment at the seed stage is the high transaction costs relative to the size of investment. Even the most generous tax relief might not be enough to make seed investment worthwhile once transaction costs and risks have been factored in.

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

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

## Seed Investment

**2.16** In considering a scheme for seed investment, the Government has considered a number of alternative designs to meet the policy objectives of enhancing seed investment by business angels. Following assessment of the advantages and disadvantages of different designs, the Government is proposing to develop a new stand-alone scheme targeted more narrowly at the seed level and business angels, the Business Angel Seed Investment Scheme (BASIS)

**2.17** Though a new scheme could bring additional complexity to the tax system, by making it more narrowly focused than the existing reliefs, the proposal set out here aims to address more accurately the problems faced by start-ups who need seed investment, and to encourage Business Angels to invest in these enterprises. It should also help ensure that the relief is targeted at those it is intended to support, and therefore represents value for money for the taxpayer and supports the Government's ambitions for UK growth.

**2.18** The BASIS scheme would be based on the current EIS but targeted more directly at Business Angels to incentivise their investing at the seed-stage of a company's development, with the possibility of more flexibility around the use of debt instruments.

**2.19** Under the current EIS and VCT schemes, there is no explicit restriction to a particular company stage. Instead, EIS and VCT qualification is based on company size, determined by the number of employees and gross assets. These are proxies for what is considered to be a small enterprise. A new scheme might enable the Government to more accurately target both investor and company, by identifying characteristics of an angel investor and seed-stage company.

**2.20** Access to the scheme would be restricted to a narrower category of investor and a narrower category of company than the current EIS, whilst allowing scope for investment via a wider range of financial instruments including some investment through debt instruments. This would be new territory for tax-advantaged venture capital schemes and legislation, and therefore any new proposal will need legal definitions to ensure it is workable in practice. The Government seeks views on whether a new standalone scheme would be an effective policy design for meeting the objective of supporting seed-investment and encouraging Business Angel support.

**Question 3:** Would a new stand alone scheme be an effective way of meeting the

Government's objective of providing support for seed investment?

**Question 4:** Any new 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?

**2.21** The remainder of this chapter discusses design issues raised by a new, targeted seed investment scheme.

#### *Definition of seed-stage companies*

**2.22** Relief under a new seed investment scheme would only be available for investment in seed stage businesses. Seed stage businesses could, for example, be companies in a pre-trading stage which intended using the funds raised to develop business concepts, perhaps involving the production of a business plan or the production of prototypes which require additional research, but prior to bringing a product to market and prior to commencing large scale commercial manufacturing. The definition might explicitly refer to "pre-trading" or it might refer to other factors.

**2.23** The scheme would not though be available to companies which are already trading but which intend raising money to develop a new product. Such companies would be able to use the existing EIS, subject to meeting the qualifying conditions.

**2.24** In order to create an effective scheme, the UK Government would need a definition that is workable in legislation, is also recognised in the UK investment industry and which is in line with State aid guidelines. The Government is therefore seeking views on how to define a seed-stage company which encompasses the intention described above.

**2.25** For example, a definition could include some of the following features:

- a company that has not yet begun to receive income from its trade or intended trade;
- a company that has no unconditional contracts or agreements in place to receive such income;
- a company that has gross assets of less than a specified amount;
- a company that is involved in developing a business plan, a prototype requiring further research, or development prior to bringing the product or service to market;
- a company that is not yet engaged in large scale commercial manufacturing.

**2.26** Recognising the particularly high-risk nature of this stage of company development, there will not be a requirement that the company must begin to trade within a specific period of time (as there is with the current EIS). However there will be a requirement that the monies raised under the scheme must all be used for the types of business activity envisaged as being carried on by a company in its "seed" stage.

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

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

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

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

**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?

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

### *Types of investment*

**2.27** Stakeholders have told us that seed investors in early stage businesses may prefer to provide finance through a mix of loan instruments and pure equity. Subject to a seed scheme obtaining State aid approval, it may be possible to offer relief for both equity and some debt instruments, which the current EIS does not (currently EIS requires that an investment is made through full-risk, ordinary shares). There would be a separate annual limit for the amount that an investor could invest under a new seed scheme. This would be lower than the current EIS limit of £500,000. There would also be a limit on the amount that a company could raise annually under a new seed scheme.

**2.28** The Government envisages a requirement that to comply with the EU guidelines, any individual seed investor in a qualifying company would have to have at least 70% of their investment in the form of equity or quasi-equity. The Commission guidelines define the different types of instruments as follows:

- **equity** means ownership interest in a company, represented by the shares issued to investors;
- **quasi-equity investment instruments** means instruments whose return for the holder (investor/lender) is predominantly based on the profits or losses of the underlying target company and are unsecured in the event of default. This definition is based on a substance over form approach;
- **debt investment instruments** means loans or other funding instruments which provide the holder with a predominant component of fixed minimum remuneration and are at least partly secured. This definition is based on a substance over form approach.

**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?

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

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

## *Definition of Business Angels*

**2.29** Under the new seed investment scheme, the Government would need an agreed definition of “Business Angel” that was effective in practice and included all those investors who could provide benefit to start-up companies. In order to do this the Government would need to identify specific characteristics that make an investor an ‘angel investor’.

**2.30** The EU Commission defines Business Angels as wealthy private individuals who invest directly in young new and growing unquoted businesses and provide them with advice, usually in return for an equity stake in the business, but may also provide other long-term finance.

**2.30.1** For example, a definition could be drafted to include some of the following features considered to reflect what a Business Angel is:

- has previously invested in four or more seed stage companies (to demonstrate experience);
- is or will be a director of the company, or provide other specified support or advice (for example, has expertise in a particular field, and will as a condition of the investment provide support to the company).

**2.31** However, the Government wishes to avoid the situation where, to obtain relief as a Business Angel, investors take up nominal positions on boards without making a real contribution, and it also wishes to avoid discouraging new investors who might bring valuable experience without having a record of previous EIS investment.

**2.32** The Government might require that the investor, to qualify under a seed investment scheme, must be participating in the governance of the company. Clearly this could be satisfied where the investor is a director of the company. However, there might also be other circumstances in which participating in the governance of a company could be regarded as being satisfied.

**2.33** Business Angels can come in the form of individuals acting alone, or quite commonly in syndicates where a group of angels make joint investments. The eligibility criteria should allow investment from both individual and syndicates of angels. Views are welcome on whether the definitions proposed would allow this practice.

**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?

**Question 15:** Should it be sufficient for an investor to be considered 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?

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

**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?

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

## Transition into EIS

**2.34** If a separate scheme were established, it is envisaged that companies would be able to transition from a seed-stage scheme into the existing EIS. To avoid breaking the EU rules on cumulation of aid, total investment under a new seed scheme and under EIS and VCT in a single year would need to be within the overriding annual investment limit, which currently limits investment received by a company to £2 million per annum.

**2.35** To ensure that the higher rate of relief available under a new seed investment scheme was justified, and to prevent the seed funding from supporting businesses moving into their start-up or expansion stage, it is envisaged the money raised under a seed scheme would have to be employed on the seed-stage activities for which the monies were raised before funding could be raised under either EIS or VCT.

**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?

## Claiming relief

**2.36** HMRC's PAYE coding system cannot readily accommodate EIS income tax relief at two rates. All EIS claimants are already being brought within the self-assessment (SA) system for 2011-12, as a result of the rate increase already announced for that year to ensure that relief is given at the appropriate rate.

**2.37** This will continue to apply under a new seed investment scheme, with the result that investors will only be able to claim relief after the end of the tax year.

## Monitoring the impact of changes

**2.38** It will be important that following any changes the schemes remain effective and properly targeted, to ensure available funding is not diverted away from intended beneficiaries of the scheme and that impacts can be measured and reviewed.

**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?

## Comparison of the EIS and a potential new seed scheme

**2.39** The following table summarises how the BASIS could potentially compare with the rules and conditions of the existing EIS.

**Table 2.A: Comparison of a new scheme with EIS**

	<b>BASIS</b>	<b>The current EIS</b>
<b>Investors</b>	Business Angels as defined, providing they do not have more than a 30% stake in the company	Anyone unconnected with the company (as defined)
<b>Company size</b>	Seed-stage companies. Will also have size limitations	All companies meeting the size requirements - currently, less than 50 employees and not more than £7m gross assets at time of investment
<b>Company activities</b>	Seed-stage (pre-trading) activities. Some restrictions on future activities, in line with EIS.	Trading companies or those preparing to trade where trade is commenced within two years of issue. Some restrictions on activities
<b>Amount of investment (company/investor)</b>	To be determined	Currently £500,000 per investor in one year, and £2m limit per company in one year
<b>CG deferral available</b>	To be determined	Yes
<b>CG disposal relief available</b>	Yes – but not on debt instrument investment	Yes

# 3

## Simplification

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**3.1** The Government announced in Budget 2011 that it would bring forward proposals for simplifying the two existing tax-advantaged venture capital schemes, concentrating in particular on the types of investment that can attract EIS relief and on which investors, who are connected with a company, can qualify.

**3.2** The Government recognises that the schemes can sometimes be complex for taxpayers. However, some of the complexity is necessary in order to protect the schemes from abuse and ensure they are targeted at those companies in need of the support.

**3.3** The following proposals are in relation to the existing EIS and VCT schemes, and will, where relevant, be applied to any new seed investment proposal.

### **Simplifications the Government will implement**

**3.4** The following simplifications have been subject to informal discussions with stakeholders. Set out here is an explanation of how the current schemes operate and how the Government is going to address the problems raised.

#### **Qualifying shares**

**3.5** Current EIS rules exclude shares which carry present or future preferential rights to dividends or to assets on a winding up, or which are redeemable.

**3.6** Potential EIS investors in early stage companies can currently be deterred by the prospect of being “crowded out” by later, non-EIS investors who are able to invest via a less restrictive range of financial instruments. The Government has been asked to consider allowing EIS investors to qualify for relief where investment is made via preference shares.

**3.7** The Government must adhere to the EC Guidelines on State aid for Risk Capital, which can present some difficulty in allowing preference shares generally to qualify because of the lack of certainty around whether some instruments might be accepted as constituting ‘equity or quasi-equity’. More fundamentally, the venture capital schemes are designed to recognise that investors put their capital at risk – where risk is lower (as with debt investment) there is less need for such an incentive.

**3.8** However, Finance (No 3) Act 2010 made changes to the definition of ‘eligible shares’ for the purpose of VCT investment, relaxing the restrictions on preferential rights to income and assets. The Government proposes replicating that definition for EIS.

**3.9** Using the same definition for both EIS and VCTs has the advantage that companies which receive investment via both schemes would not have to work with different definitions of qualifying shares.

**3.10** Applying that same definition, shares would qualify unless they carried:

- a present or future preferential right to the company’s assets on its winding up; or
- a present or future right to be redeemed; or
- a present or future preferential right to dividends where:

- the rights attaching to the share include scope for the amount of the dividend to be varied based on a decision taken by the company, the shareholder or any other person. (**Note:** this exclusion covers only those shares which carry preferential rights and does not therefore prevent the voting of dividends in respect of non-preferential shares, nor does it prevent shareholders from choosing to waive a dividend payment should they wish to do so);

or

- the right to receive dividends is “cumulative” – that is, where a dividend which has become payable is not in fact paid, but the company is obliged to pay it at a later time, normally once funds become available.

### Qualifying investors

**3.11** Neither income tax relief nor capital gains tax exemption is available to individuals who are ‘connected’ with the company, although existing capital gains may be deferred by connected individuals. An individual is considered to be connected with a company in either of two ways.

#### **Box 3.A: Company Connection**

##### *Connection via interest in the company*

Neither the investor nor an associate may separately or together have a level of interest in the company which amounts to:

- control of the company;
- holding more than 30% of a company’s issued share capital<sup>1</sup> (or share and loan capital taken together);
- holding more than 30% of the voting rights;
- or being entitled to more than 30% of the assets in the event of a winding up.

A person’s associates are defined as business partners, trustees of a settlement (where they are either a settlor or a beneficiary), and relatives (spouses or civil partners, parents and grandparents, children and grandchildren – but not brothers and sisters).

##### *Connection via employment*

Someone is connected with a company if they, or an associate, are a partner, director or employee of the company

**3.12** However, there is an exception for certain directors, intended to attract new investment from experienced business people who can also bring the benefit of their experience to the company. Where the investor’s only connection with the company is as a director who receives no remuneration (and is not entitled to such remuneration), and who has not previously been involved in carrying on the trade the company is carrying on at the time of investment, an investment may qualify for income tax relief.

<sup>1</sup> The tests relating to share capital operate by reference to the nominal value of the shares and not to the price paid for the shares. An investor who subscribes for shares at a premium can therefore have more than 30% of a company’s total share capital, providing that he does not hold more than 30% of the nominal value of the shares

**3.13** Income tax relief already given is not withdrawn if the investor subsequently becomes connected by becoming a paid director. Investors can still claim income tax relief on shares subscribed for after becoming a paid director (providing any remuneration is reasonable), if those shares are issued to them no more than three years after the original shares they subscribed for. If the company had not started to trade when the shares were issued to the investor as an unpaid director, relief can be claimed on further issues within three years of the company starting to trade.

**3.14** The policy rationale for not giving relief to existing directors and employees is that they typically do not suffer from the lack of information about the company which prevents the company from being able to raise money from unconnected investors. As explained above, an exception is made for directors previously unconnected with the business, to allow companies to bring in fresh expertise. The exception is limited to a period of three years from the date the new director is brought in, as after that period it is reasonable to assume that the information deficit has diminished.

**3.15** One area of the 'connection' rules which can cause problems is where a company needs short-term, emergency funding from its investors. Under the current rules investors are disqualified if the aggregate of their shareholding (in terms of nominal share capital) and any loans they have advanced to the company, exceeds 30% of the total company aggregate of those elements.

**3.16** In the interests of simplification, Government proposes removing that particular connection rule, except in respect of loans which carry the right of conversion into share capital or other instruments.

### Potential future simplifications

**3.17** The Government is aware of a number of other areas where the current rules are perceived to be complex, some highlighted by the recent OTS Review of Tax Reliefs.<sup>2</sup> Government would like to address these in future and would be interested in views both on the detail of any changes and on relative priority.

#### *Barriers to price-setting mechanisms*

**3.18** There can be difficulties in establishing an appropriate price for shares in very early stage companies, and seed investors may be disincentivised by the prospect of their investment being diluted by later stage investors who are better able to establish a realistic market value for the shares. Anti-dilution clauses inserted in shareholder agreements are likely to fall foul of EIS legislation designed to prevent the shareholders' capital from being protected.

**3.19** The Government welcomes views on the extent to which EIS rules on the use of anti-dilution clauses are deterring investment, and on how this might be addressed whilst still maintaining the principle that investors' monies should be genuinely at risk.

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<sup>2</sup> Office of Tax Simplification, *Review of Tax Reliefs Final Report* (March 2011) [http://www.hm-treasury.gov.uk/d/ots\\_review\\_tax\\_reliefs\\_final\\_report.pdf](http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_final_report.pdf)

**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?

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

**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?

### *Mergers of EIS companies*

**3.20** In a conventional merger between two or more companies involving a share-for-share exchange, investors are deemed to have disposed of their shares and can lose their EIS relief as a result. In principle, this could deter companies from obtaining the commercial benefits of such a merger, or, where they proceed and investors lose relief, deter those investors from future investment under EIS.

**3.21** The Government would welcome views on the extent to which this is a problem in practice. In order to maintain the integrity of the scheme, it is likely that any solution would require that companies would only be allowed to merge without loss of relief if the post-merger company or group would still qualify under the rules of the scheme.

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

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

### *Period of grace for payment for shares*

**3.22** Current rules for both EIS capital gains tax deferral and income tax relief require that shares must be fully paid up at time of issue. The legislation exists to ensure that investors cannot get relief without having put the full amount of money subscribed into the company, but the wording of the requirement means this is a common reason for investors failing to qualify for relief despite putting money into the company.

**3.23** Typically this happens for one of two reasons:

- because of the method of payment, investors do not have full control over the precise timing of the payment reaching the company's bank account and payment is sometimes delayed for a short time after issue of shares. The OTS identified this as a particular problem; and
- investors who are less experienced with the requirements of EIS set up the company themselves, and pay all of their intended investment in at the outset. However, that can mean that the shares remain unpaid for a number of weeks after issue because it takes that length of time to set up a bank account in the company's name.

**3.24** The Government would welcome views on how best to address this issue.

**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?

**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?

**3.25** It is worth clarifying that any payment to a company which is clearly intended and documented as an advance payment for shares does not fall foul of the legislation.

#### *Excluded activities*

**3.26** The list of activities excluded from the schemes has grown over the years, largely as activities were added in response to what were seen as particular abuses, and there are a number of inconsistencies – for example, nursing homes are excluded while nurseries are allowed, and hotels are excluded while restaurants are allowed (and may even be allowed if, as a side line, they have a small number of guest rooms).

**3.27** As a result of this, HMRC sometimes sees attempts to get around the exclusion of, especially, hotels, by fragmenting what is clearly a single business into a number of separate activities.

**3.28** The original reason for these exclusions was often a concern that the business might be property backed, meaning that there was less risk in investing.

**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)?



# 4

## Improving the focus of the schemes

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**4.1** Given the additional incentive offered by the increased EIS rate and higher EIS and VCT thresholds, the Government must ensure that the schemes continue to be targeted at genuine high risk capital investments. Informal discussions with stakeholders suggest they support this aim.

**4.2** With this in mind, the Government has a number of concerns about the operation of both schemes, which are set out below, with suggested solutions.

**4.3** In response to stakeholder requests, the discussion below covers the policy rationale underlying the schemes, to put in context the Government's concerns. This should remove some of the misunderstandings sometimes experienced by users of the schemes.

### **Companies established for the purposes of accessing relief**

**4.4** The venture capital schemes exist to incentivise investment in smaller, high risk companies which would otherwise experience difficulties in raising the finance needed to carry on their business.

**4.5** They are not intended to provide a tax-efficient investment solution for investors seeking to minimise their tax liability, nor are they intended to provide a mechanism to channel tax-advantaged finance into companies or projects other than those in the target sector.

**4.6** Government has some concerns about investment in companies which exist for a relatively short period of time during which they employ no staff, sub-contract all activities to other – often much larger – entities, and then cease activities. The companies appear to have been created solely for the purpose of allowing relief under the schemes to be accessed.

**4.7** In many cases, the economic substance, albeit not the legal form, of the transactions entered into by these companies, appears similar to a lending activity with the investee company receiving a pre-determined return not dissimilar to interest, and one or more other parties to the transactions receiving a benefit similar to a loan on advantageous terms.

**4.8** In most cases, the arrangements also substantially reduce or remove the financial risk to the investors for which the tax reliefs are intended to compensate.

**4.9** Money-lending and other financial activities are prohibited by the schemes, both because such activities are relatively low-risk, but also because they render redundant any other restrictions within the rules including the size restrictions, thus diminishing the extent to which the schemes can be said to be offering value for money and delivering their policy aim.

**4.10** One proposal to address the problem of determining whether a company is set up solely for the purpose of exploiting the reliefs is a test which considers a number of characteristics commonly displayed by such companies. The test would not be applied to companies which employ (or which will employ within 2 years of trade commencing) and continue to employ, 4 or more full time working employees or equivalent, including directors.

**4.11** It might be appropriate to precede the test with a statement of purpose, to the effect that the company would not qualify if on a reasonable view of the facts, its activities appeared to be primarily for the purpose of financing a company or project which would not itself qualify as an EIS or VCT investee company; with the indicators then being used as guidance to determine whether that was the case.

**4.12** Alternatively, the tests might stand on their own, with companies being disqualified if they displayed, 3 or more of the characteristics in the list. Suggested characteristics might be along the following lines:

- 50% or more of the activities required to fulfil obligations to customers will be carried out by persons not employed by the company;
- 50% or more of company's costs during the relevant period will be subcontract payments;
- 50% or more of the monies raised by the relevant share issue will be used to acquire intangible assets intended for resale;
- the company employs less than one full time unit of staff or part time equivalent, including directors, during the relevant period;
- 50% or less of the ordinary share capital is held by directors throughout the relevant period;
- the company employs at any time during the relevant period staff or directors who are also employees or directors of a party with whom it has contractual trading arrangements (or who have been seconded from that party);
- the company has only one customer;
- the company has only one supplier;
- the contractual arrangements entered into by the company viewed realistically, preclude the possibility of the company making a commercial loss.

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

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

**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?

**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?

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

## **Acquisition companies**

**4.13** The current legislation allows monies raised to be used not only by companies which are trading, but also by those which are 'preparing to trade', providing that the trade is commenced within two years of the share issue. HMRCs practice has been to accept that the company raising funds can use those funds wholly to acquire a subsidiary which is already carrying on a trade and that that will constitute 'preparing to trade'.

**4.14** HMRC is seeing cases where a company issues qualifying shares and shortly afterwards follows this by a larger issue of other equity or loan notes, (which do not themselves qualify). The aggregate money raised is then used to acquire an existing trade or trading company of a size which, taken together with the parent company issuing the shares, would exceed the size

restrictions of the schemes. It is doubtful whether such arrangements can be considered to be fulfilling the policy aims of the schemes, given that there appears to be no market failure.

**4.15** Government intends restricting the scope for this by stipulating that where monies are used by a company “preparing to trade” to acquire an existing trade or trading subsidiary, at the time that existing trade or trading company is brought into the group, the group still meets the size conditions of the schemes.

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

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

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

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

### **Exclusion of some feed-in tariffs businesses**

**4.16** The feed-in tariffs (FITs) scheme introduced by the Department of Energy and Climate Change provides a reliable source of income from the generation of electricity, intended to encourage the use of renewable energy sources by homes, small businesses and communities. The Government wishes to ensure that both EIS and VCT support is appropriately targeted at higher-risk businesses most in need of that support, across a range of industry sectors.

**4.17** It was announced at Budget 2011 that trades based substantially around the receipt of FITs would be excluded from eligibility for both schemes where shares are issued on or after April 2012 or commercial generation of electricity was not under way by that date. Shares issued before 23 March 2011 would not be affected by this announcement.

**4.18** Since that announcement HM Treasury and HM Revenue and Customs have discussed the detail of this proposal with interested stakeholders, and draft legislation taking into account those discussions is set out in Appendix B together with a draft Explanatory Note. Government welcomes views on the draft legislation.

**4.19** Based on the discussions with stakeholders, the legislation ensures that community interest companies, co-operative societies, community benefit societies and Northern Ireland industrial and provident societies will continue to qualify, as will trades generating electricity by hydro power or anaerobic digestion.

**4.20** Solar and wind generation will be excluded unless carried on by one of the above sorts of entity (the draft legislation uses the proposed new definitions in the Co-operative and Community Benefit Societies and Credit Unions Act 2010).

**4.21** Equivalent companies operating abroad (who can, in general, receive the benefit of EIS and VCT investment) must receive equal treatment. That could be done by saying that any foreign equivalent of the entities listed above would be treated in the same way, or it could be more specific. The best alternative to adopt depends on how likely this situation is to arise in practice. If it is very rare then rather than design perhaps complex provisions to address it, it would make more sense to deal with cases as and when they arise, for example by modifying the legislation, through regulations.

**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?

# 5

## Request for supporting evidence

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**5.1** The Government needs to ensure that future reforms to the schemes improve their effectiveness to increase the availability of risk capital to those SMEs that currently face difficulties in accessing investment finance. In order to help do this, evidence is required to build a detailed picture of how the schemes are currently used, by whom and to what effect.

**5.2** As with all policy development the Government would welcome submissions of evidence from stakeholders in support of the further reforms to the schemes announced at Budget 2011, and on their current effectiveness in attracting investment to meet the equity gap in the risk capital market, and contributing to UK growth.

**5.3** In particular, evidence would be welcome on the following points.

### Areas for supporting evidence

- The presence of an equity gap above the existing limits of the EIS and VCT schemes. In particular, we would welcome evidence in relation to:
  - companies requiring investment above the current £2 million threshold (but cannot access through normal lending) – is this a problem specific to any particular sector, type of company or situation;
  - size of the company (assets and employees) and where this is a trend specific to certain sectors.
- The schemes currently use the number of employees and gross assets of the company as proxies for determining what an early-stage company is. Are there any other features that would more accurately identify these sorts of companies?
- The barriers start-up companies face when requiring seed investment. For example, is it a lack of awareness of the sources of finance available, is it a lack of lending, preference for equity over debt, contractual terms of equity investment?
- The demand from companies at seed stage for the support, expertise and experience of angel investors.
- The barriers that currently put investors off providing seed-investment.
- The loss to the economy from underinvestment in new start-up enterprises.



# 6

## Impact assessment

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**6.1** An impact assessment for the changes announced in Budget 2012 was published in the Tax Information and Impact Note as part of the Budget documentation (see <http://www.hmrc.gov.uk/budget2011/tiin6261.pdf>). This consultation document sets out three further proposals, for additional support for “seed” investment; for simplifications to the existing schemes; and for better focussing of these schemes, and more detail on the proposed restrictions to FIT based trades, and invites views on the impacts of these.

**6.2** Elsewhere in this document, questions focus on particular aspects of the proposed changes including design issues and tradeoffs, as well as aspects of their overall impact. This chapter brings together the Government’s thinking on a range of impacts, seeking further views on these and input to help refine its view.

### Exchequer Impact

**6.3** This consultation sets out a number of different policy options each with their own variations. It is therefore not possible at this point to provide costs because this relies on future policy decisions which are dependent on the outcome of the consultation.

### Economic Impact

**6.4** Smaller companies tend to face barriers in raising equity finance. This is due to a number of factors, in particular lack of publicly available information about companies’ prospects.

**6.5** Tax relief is therefore given to incentivise such investment. The enhancements to the schemes, including the introduction of a higher rate of relief for seed investment, will improve incentives to invest in small companies, helping new businesses to be established and established businesses to expand, become more productive and increase employment.

**6.6** Excluding companies whose trade consists wholly or substantially of the receipt of FITs will reduce the incentive to individuals to invest in lower risk investments which receive other forms of subsidy.

### Impact on individuals and households

**6.7** Individuals and households investing in companies under the new seed investment scheme will benefit by being able to claim increased income tax relief.

**6.8** Individuals investing under both existing schemes will benefit from simplifications to the rules of the schemes.

**6.9** Around 10,000 individuals invested through EIS in 2008-09, the last year for which figures are available and around 6,300 through VCTs.

### Equalities impacts

**6.10** Compared to the self-assessment population, EIS and VCT investors tend to be male, located in the South of England and have higher overall income levels. The changes to the schemes are not likely to alter that position. We have no data to suggest that there will be

impacts on other groups. From the data available therefore do not think these changes will have a disproportionate impact.

## Impact on businesses and civil society organisations

### *Support for seed investment*

**6.11** Most of the rules of a new seed investment scheme would be similar to the existing EIS, which is of long standing and is familiar to many companies, investors and advisers. Moreover it would be delivered through the existing Small Company Enterprise Centre (SCEC) with the same facility as currently exists for companies to receive advance assurances. Government therefore believes that the regulatory impact of this change would be minimal while the additional incentive for investment will aid businesses, including some social enterprises.

### *Simplification proposals*

**6.12** The Government believes that the simplification proposals set out here are deregulatory overall, but would welcome any feedback to inform the impact assessment that will be published with draft Finance Bill clauses in the autumn.

### *Simplification – Qualifying shares*

**6.13** The Government's view is that aligning the definitions of qualifying shares across EIS and VCTs will simplify matters for companies issuing shares under both schemes. Moreover, the new definition will, for EIS companies, be slightly wider.

### *Simplification – Qualifying investors*

**6.14** The Government's view is that relaxing the rules to allow emergency funding from existing investors will be a simplification that benefits companies and investors.

### *Improving the focus of the schemes*

**6.15** The changes proposed will exclude certain companies and activities from the benefit of the reliefs. Government has sought to do this in a way that has the least unintended impact and would welcome views on how well this has been achieved, and whether the changes, as proposed, are likely to be effective.

**6.16** The draft legislation excluding investment in FITs subsidised trades sets out that certain classes of company which are established with public or social benefit in mind will be able to continue to receive investment under the venture capital schemes.

## Small Businesses

The seed investment proposal is designed to improve access to very early stage finance, and should therefore if successful, have a beneficial effect for certain small, new businesses. It should have no impact on longer established businesses. The questions in chapter 2 are designed to draw out the extent to which the Government's proposals achieve this, and in particular, whether the additional complexity necessary to target the additional relief is justifiable.

## Environmental impacts

**6.17** The draft legislation excluding investment in FITs subsidised trades will mean less support for certain low carbon electricity technologies, in particular solar photovoltaic and wind turbines.

**6.18** Other technologies will not be affected, including hydroelectricity and anaerobic digestion. The overall environmental impact of these changes therefore depends on whether, and to what extent, investment is diverted between technologies, and whether it reduces overall.

**6.19** The Government welcomes views on the likely impact of these changes.

The Government would welcome comments or evidence to support the assessment of the impacts of the changes under consultation.



# 7

## Summary of consultation questions

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### 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?

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

#### *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?

**Question 4:** Any proposal would potentially add to the complexity of the tax system and 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?

#### *Definition of seed-stage companies*

**Question 5:** How best might Government define "seed-stage" activities?

**Question 6:** At what point does the need for "seed" investment cease?

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

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

**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?

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

### *Types of Investment*

Subject to State aid approval of the BASIS scheme, it may be possible to offer relief for both equity and some debt instruments. The government envisages a requirement that to comply with EU guidelines, any individual BASIS investor in a qualifying company would have to have at least 70% of their investment in the form of equity or quasi-equity.

**Question 10:** 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?

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

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

### *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?

**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?

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

**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?

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

To avoid breaking EU rules on cumulation of aid it is envisaged the money raised under a seed scheme would have to be employed on the seed-stage activities for which the money was raised before funding could be raised under EIS or VCT.

**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?

### *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?

## 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?

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

**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?

### *Mergers of EIS companies*

In a conventional merger between companies involving a share-for-share exchange, investors are deemed to have disposed of their shares and can lose EIS relief. This could deter companies obtaining the commercial benefits of such a merger or deter investors from future investments under EIS.

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

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

### *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?

**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?

### *Excluded Activities*

The list of excluded activities from the schemes has grown over the years, as activities were added in response to what were seen as particular abuses. This has led to a number of inconsistencies.

**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)?

## Improving the Focus of the Schemes

### *Companies established for the purposes of accessing relief*

The Government has concerns over companies that appear to have been created solely for the purpose of allowing relief under the schemes to be accessed. One proposal to tackle this problem is a test which would consider a number of characteristics commonly displayed by such companies. Companies found to be displaying a certain amount of these characteristics would be disqualified from the scheme.

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

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

**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?

**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?

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

### *Acquisition Companies*

Government intends to tackle concerns around acquisition companies by stipulating that where monies are used by a company “preparing to trade” to acquire an existing trade or trading subsidiary, at the time that existing trade or trading company is brought into the group, the group still meets the size conditions of the schemes.

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

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

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

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

### *Exclusion of some Feed-in Tariff Business*

At Budget 2011 it was announced that trades based substantially on the receipt of feed-in tariffs would be excluded from eligibility for both of the schemes. The legislation sets out certain companies that will continue to qualify for the scheme.

**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?



# 8

## Consultation process

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**8.1** This consultation is being conducted in line with the principles outlined in the document "[Tax policy making - a new approach](#)" published at Budget June 2010. This sets out three stages for policy development:

Stage 1 - set out objectives and identify options

Stage 2 - determine the best option and develop a framework for implementation, including detailed policy design

Stage 3 - draft legislation to effect the proposed change.

**8.2** This document provides more detail on these proposals, asks for input on a number of aspects and sets out the timetable for change. The proposals set out in this document are at various stages of the Government's framework for tax consultation. Most are at stage 1 (setting out objectives and identifying options) or stage 2 (determining the best option and developing a framework for implementation including detailed policy design). The changes to FITs businesses are at Stage 3 (draft legislation).

### How to respond

Responses should be sent by 28 September 2011 -

By e-mail to [ventureschemeconsultation@hmtreasury.gsi.gov.uk](mailto:ventureschemeconsultation@hmtreasury.gsi.gov.uk)

By post to: **Venture Capital Scheme Consultation, Excise and Enterprise Team, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ**

**8.3** All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

**8.4** When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

### Confidentiality

**8.5** 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.

**8.6** 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 (HMT).

**8.7** HMT 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.

### **The Consultation Code of Practice**

**8.8** This consultation is being conducted in accordance with the Code of Practice on Consultation. A copy of the Code of Practice criteria and a contact for any comments on the consultation process can be found in Annex A.

# 9

## Timeline for reform

**Table 9.A: Timeline for reform**

Budget 2011	The Government announced increase of the EIS tax relief rate from 20% to 30%. This change was included in Finance Bill 2011, and will, subject to Parliamentary approval and State aid approval, take effect from April 2011.
July through to September	Publication of the consultation and consultation period, which will involve a number of stakeholder events.
Autumn 2011	Government will confirm which changes are to be introduced in Finance Bill 2012, and publish draft legislation for these.
Spring 2012	Subject to State aid approval, legislation will then be taken forward in Finance Bill 2012. Finance Bill 2012 will also include legislation on restricting feed-in tariffs.
April 2012	Subject to State aid approval, the increases in investment thresholds and company size and the introduction of the new seed investment scheme take effect.
Future years	The Government will seek to introduce further simplifications (as set out in this document) in future Finance Bill, where Parliamentary time allows.
Throughout 2011	Seeking State aid approval for the reforms from the European Commission.



# A

## The code of practice on consultation

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**A.1** This consultation is being conducted in accordance with the Code of Practice on Consultation.

**A.2** The consultation criteria:

- 1 When to consult - Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- 2 Duration of consultation exercises - Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- 3 Clarity of scope and impact - Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- 4 Accessibility of consultation exercise - Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- 5 The burden of consultation - Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- 6 Responsiveness of consultation exercises - Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- 7 Capacity to consult - Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Consultation Coordinator, HMRC Better Regulation and Policy Team 020 7147 0062 or email [hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk](mailto:hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk)



**B**

## **Feed-in tariffs draft legislation**

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## **1 Venture capital schemes**

Schedule 1 contains provision about the enterprise investment scheme and venture capital trusts.

## SCHEDULE 1

Section 1

## VENTURE CAPITAL SCHEMES

## PART 1

## ENTERPRISE INVESTMENT SCHEME

*Amendments of Chapter 4 of Part 5 of ITA 2007*

- 1 Chapter 4 of Part 5 of ITA 2007 (enterprise investment scheme: the issuing company) is amended as follows.
- 2 (1) Section 192 (meaning of “excluded activities”) is amended as follows.
  - (2) In subsection (1), omit “and” at the end of paragraph (k) and after that paragraph insert –
    - “(ka) the subsidised generation or export of electricity, and”.
  - (3) In subsection (2), omit the “and” at the end of paragraph (e) and after paragraph (f) insert “, and
    - (g) section 198A (subsidised generation or export of electricity).”
- 3 After section 198 insert –
 

**“198A Excluded activities: subsidised generation or export of electricity**

  - (1) This section supplements section 192(1)(ka).
  - (2) Electricity is exported if it is exported onto a distribution system or transmission system (within the meaning of section 4 of the Electricity Act 1989).
  - (3) The generation of electricity is “subsidised” if a person receives a FIT subsidy in respect of the electricity generated.
  - (4) The export of electricity is “subsidised” if a person receives a FIT subsidy in respect of the electricity exported.
  - (5) But the generation or export of electricity is not to be taken to fall within section 192(1)(ka) if Condition A, B or C is met.
  - (6) Condition A is that the generation or export is carried on by –
    - (a) a community interest company,
    - (b) a co-operative society,
    - (c) a community benefit society, or
    - (d) a NI industrial and provident society.
  - (7) Condition B is that the plant used for the generation of the electricity relies wholly or mainly on anaerobic digestion.
  - (8) Condition C is that the electricity is hydroelectric power.
  - (9) For the purposes of this section –

“anaerobic digestion” means the bacterial fermentation of organic material in the absence of free oxygen (excluding anaerobic digestion of sewage or material in a landfill);

“community benefit society” means –

- (a) a society registered under the Co-operative and Community Benefit Societies and Credit Unions Act 1965 as a community benefit society, or
- (b) a pre-2010 Act society (as defined at section 4A(1) of that Act) which meets the condition in section 1(3) of that Act;

“co-operative society” means –

- (a) a society registered under the Co-operative and Community Benefit Societies and Credit Unions Act 1965 as a co-operative society, or
- (b) a pre-2010 Act society (as defined at section 4A(1) of that Act) which meets the condition in section 1(2) of that Act;

“FIT subsidy” means –

- (a) a financial incentive under a scheme established by virtue of section 41 of the Energy Act 2008 (powers to amend licence conditions etc: feed-in tariffs) to encourage small-scale low-carbon generation of electricity, or
- (b) a financial incentive under a similar scheme established in a territory outside the United Kingdom to encourage small-scale low-carbon generation of electricity;

“NI industrial and provident society” means a society registered under the Industrial and Provident Societies Act (Northern Ireland) 1969 (c. 24 (N.I.));

“small-scale low-carbon generation” has the meaning given by section 41(4) of the Energy Act 2008.”

4 In section 199 (excluded activities: provision of services or facilities for another business), in subsection (1)(a), for “(k)” substitute “(ka)”.

5 In section 200 (power to amend by Treasury order), the existing provision becomes subsection (1) and after that subsection insert –

“(2) An order under this section may –

- (a) make different provision for different cases or purposes, or
- (b) include such transitional provision as the Treasury consider appropriate.”

#### *Application of paragraphs 2 to 4*

6 (1) Subject to sub-paragraph (2), the amendments made by paragraphs 2 to 4 have effect in relation to shares issued or treated as issued on or after 23 March 2011.

(2) Those amendments do not have effect in relation to shares issued before 6 April 2012 if the issuing company, or a qualifying 90% subsidiary of that company, first began to carry on activities of the kind mentioned in section 192(1)(ka) of ITA 2007 before that day.

*Transitional provision*

- 7 Until such time as section 1 of the Co-operative and Community Benefit Societies and Credit Unions Act 2010 comes into force, section 198A(6) of ITA 2007 has effect as if for paragraphs (b) and (c) there were substituted –
- “(b) a society registered under the Industrial and Provident Societies Act 1965,”.

## PART 2

## VENTURE CAPITAL TRUSTS

*Amendments of Chapter 4 of Part 6 of ITA 2007*

- 8 Chapter 4 of Part 6 to ITA 2007 (venture capital trusts: qualifying holdings) is amended as follows.
- 9 (1) Section 303 (meaning of “excluded activities”) is amended as follows.
- (2) In subsection (1), omit “and” at the end of paragraph (k) and after that paragraph insert –
- “(ka) the subsidised generation or export of electricity, and”.
- (3) In subsection (2), omit the “and” at the end of paragraph (e) and after paragraph (f) insert “, and
- (g) section 309A (subsidised generation or export of electricity).”
- 10 After section 309 insert –

**“309A Excluded activities: subsidised generation or export of electricity**

- (1) This section supplements section 303(1)(ka).
- (2) Electricity is exported if it is exported onto a distribution system or transmission system (within the meaning of section 4 of the Electricity Act 1989).
- (3) The generation of electricity is “subsidised” if a person receives a FIT subsidy in respect of the electricity generated.
- (4) The export of electricity is “subsidised” if a person receives a FIT subsidy in respect of the electricity exported.
- (5) But the generation or export of electricity is not to be taken to fall within section 303(1)(ka) if Condition A, B or C is met.
- (6) Condition A is that the generation or export is carried on by –
- (a) a community interest company,
- (b) a co-operative society,
- (c) a community benefit society, or
- (d) a NI industrial and provident society.
- (7) Condition B is that the plant used to generate the electricity relies wholly or mainly on anaerobic digestion.
- (8) Condition C is that the electricity is hydroelectric power.
- (9) For the purposes of this section –

“anaerobic digestion” means the bacterial fermentation of organic material in the absence of free oxygen (excluding anaerobic digestion of sewage or material in a landfill);

“community benefit society” means –

- (a) a society registered under the Co-operative and Community Benefit Societies and Credit Unions Act 1965 as a community benefit society, or
- (b) a pre-2010 Act society (as defined at section 4A(1) of that Act) which meets the condition in section 1(3) of that Act;

“co-operative society” means –

- (a) a society registered under the Co-operative and Community Benefit Societies and Credit Unions Act 1965 as a co-operative society, or
- (b) a pre-2010 Act society (as defined at section 4A(1) of that Act) which meets the condition in section 1(2) of that Act;

“FIT subsidy” means –

- (a) a financial incentive under a scheme established by virtue of section 41 of the Energy Act 2008 (powers to amend licence conditions etc: feed-in tariffs) to encourage small-scale low-carbon generation of electricity, or
- (b) a financial incentive under a similar scheme established in a territory outside the United Kingdom to encourage small-scale low-carbon generation of electricity;

“NI industrial and provident society” means a society registered under the Industrial and Provident Societies Act (Northern Ireland) 1969 (c. 24 (N.I.));

“small-scale low-carbon generation” has the meaning given by section 41(4) of the Energy Act 2008.”

- 11 In section 310 (excluded activities: provision of services or facilities for another business), in subsection (1)(a), for “(k)” substitute “(ka)”.
- 12 In section 311 (power to amend Chapter by Treasury order), the existing provision becomes subsection (1) and after that subsection insert –
  - “(2) An order under this section may –
    - (a) make different provision for different cases or purposes, or
    - (b) include such transitional provision as the Treasury consider appropriate.”

#### *Application of paragraphs 9 to 11*

- 13 (1) Subject to sub-paragraph (2), the amendments made by paragraphs 9 to 11 have effect in relation to a relevant holding issued on or after 23 March 2011.
- (2) Those amendments do not have effect in relation to any relevant holding issued before 6 April 2012 if the relevant company, or a qualifying 90% subsidiary of that company, first began to carry on activities of the kind mentioned in section 303(1)(ka) of ITA 2007 before that day.

*Transitional provision*

- 14      Until such time as section 1 of the Co-operative and Community Benefit Societies and Credit Unions Act 2010 comes into force, section 309A(6) of ITA 2007 has effect as if for paragraphs (b) and (c) there were substituted –
- “(b) a society registered under the Industrial and Provident Societies Act 1965,”.





# **Explanatory Notes for feed-in tariffs draft legislation**

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## EXPLANATORY NOTE

### SECTION [1] SCHEDULE [1]: VENTURE CAPITAL SCHEMES

#### SUMMARY

1. Section [1] introduces Schedule 1. This Schedule excludes from relief under both the Enterprise Investment and Venture Capital Trust schemes investments in a company whose business consists wholly or as to a substantial part of the generation of electricity which attracts Feed-in Tariffs (FITs). The exclusion does not apply where the energy is hydroelectricity or based on anaerobic digestion, or where the company is one of a number of specified types of social enterprise.

#### DETAILS OF THE SCHEDULE

2. Paragraphs 1 to 7 of Schedule 1 make changes to the list of excluded activities for the Enterprise Investment Scheme.
3. Paragraph 2 adds a new item to the list of excluded activities in Section 192 of the Income Tax Act 2007 (ITA 2007) - the subsidised generation or export of electricity.
4. Paragraph 3 inserts a new section 198A in ITA 2007, defining the subsidised generation or export of electricity.
5. Subsection (2) of new Section 198A defines when electricity is “exported”.
6. Subsections (3) and (4) specify that electricity is “subsidised” if a FIT payment is received either for its generation or export to a distribution or transmission system.
7. Subsection (5) overrides subsections (3) and (4), providing that electricity is not subsidised, in three specified circumstances. Condition A is where it is generated or exported by a community interest company, a co-operative society, a community benefit society or a NI industrial and provident society (subsection (6)), Condition B is where the electricity is derived from anaerobic digestion (subsection (7)) or, Condition C, hydro power (subsection (8)).
8. Subsection (9) defines a number of terms used elsewhere in the new Section. In particular, “FIT subsidy” is defined to include not only financial incentives under schemes established under section 41 of the Energy Act 2008 but also a financial incentive under a similar foreign scheme.

9. Paragraph 5 amends the existing power which allows the Treasury, by regulations, to amend the list and definitions of excluded activities, so that such regulations may make different provisions for different cases and purposes and include transitional provisions. This will make it easier for the definitions to be kept up to date without needing primary legislation.
10. Paragraph 6 provides that the exclusion of FITs based trades only applies to shares issued on or after 23 March 2011, and nor do they affect shares issued before 6 April 2012 if the generation or export of electricity has commenced before then.
11. Paragraphs 8 to 14 make similar changes to the excluded activities for Venture Capital Trusts.

### **BACKGROUND NOTE**

12. The feed-in tariffs (FITs) scheme introduced by the Department of Energy and Climate Change provides a reliable source of income from the generation of electricity, intended to encourage the use of renewable energy sources by homes, small businesses and communities.
13. The Government wishes to ensure that both EIS and VCT support is appropriately targeted at higher-risk businesses most in need of that support, across a range of industry sectors.
14. It was announced at Budget 2011 that trades based substantially around the receipt of FITs would be excluded from eligibility for both schemes where shares are issued on or after 6 April 2012 or commercial generation of electricity was not under way by that date. Shares issued before 23 March 2011 would not be affected by this announcement.
15. Since the announcement, Government has consulted with interested parties and the draft legislation accompanying this Note includes further exceptions to address concerns which have been raised. In particular, it exempts from the measure certain types of community-based company. It also exempts generation of electricity using hydro power or anaerobic digestion.
16. In addition, the legislation does not use the concept of “commercial” generation focussing instead on when the subsidised activity commenced.

### HM Treasury contacts

This document can be found in full on our website at:  
[hm-treasury.gov.uk](http://hm-treasury.gov.uk)

If you require this information in another language, 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 4558

Fax: 020 7270 4861

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)

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