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Dear Joseph,

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

We welcome the opportunity to respond to the government's consultation on Enterprise Investment Scheme knowledge-intensive funds.

The Quoted Companies Alliance Tax Expert Group has examined your proposals and advised on this response. A list of members of the Expert Group is at Appendix A.

Our key recommendation to improve the flow of patient capital to knowledge-intensive companies is to increase the limit for SEIS from £150,000 to £250,000 per company.

We have responded below in more detail to the specific amendments from the point of view of our members, small and mid-size quoted companies.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

Response

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

Younger knowledge-intensive companies can face obstacles when approaching investors. In particular, there are the disadvantages of competition. More established businesses often have a trading history of one or two years; those companies have already received seed capital, hired technical staff and are on the second stage of investment. They therefore have a viable prototype or idea that will attract a wider range of investors, including individual retail investors and fund providers which offer a portfolio of tax efficient investments.

With other investments still indicating a healthy return and perhaps a lower overall risk profile either through a spread of investments within an offered portfolio or with a company that can demonstrate a longer history, the young knowledge-intensive company is at a distinct disadvantage.

Q2 What would be the best way(s) of further improving the flow of patient capital to knowledge-intensive companies, bearing in mind state aid constraints?

We believe that one way of improving the flow of patient capital to knowledge-intensive companies would be to revise the limits for SEIS. The current limit of £150,000 per company is restrictive and should be increased to £250,000. This would form alignment with the maximum amount of Enterprise Management Incentive options that can be issued to an individual. We think that this should be able to work within state aid constraints.

For SEIS, the possibility of an investor through the various reliefs putting 27.5% of their capital at risk is a powerful incentive so there is benefit in increasing the threshold.

We also believe that there should be a greater number of varied funds available to investors which hold EIS and SEIS shares; this would enable investors to spread their risk.

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

The most significant potential barrier to the development of investment funds that specifically target knowledge-intensive companies is the market demand for such a fund. Investment funds in this area would have to compete with high risk funds, such as those in the emerging markets sector. Those funds are larger and generally invest in larger companies, and demonstrate high income and gain yields. New target knowledge-intensive companies rarely generate any income and usually present more risk than current investment products.

Similarly, although there are dedicated technology funds, these are based around larger companies. It is questionable whether investors would seek to invest in a group of small unproven companies. The uptake would likely be guided by the uptake in venture capital trust schemes in the UK.

A further potential barrier concerning market interest is that the funds will be narrow in composition across sectors; most tax efficient investment funds invest in a wide range of sectors to spread risk. The managers of the new funds would need to demonstrate due the particular conditions of the new EIS for target knowledge-intensive companies, how the investment is worthwhile.

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

Although we have reservations as detailed above regarding the funds, their existence would promote more investment in target knowledge-intensive companies. Greater investment – even to a small degree – may stimulate job creation and promote the growth of young companies through the innovation carried out.

Q5 Which of the options outlined above would most attract investors to knowledge-intensive funds? Please rank and critically compare the benefits and disadvantages of each.

1. *Up-front tax relief*

Our experience has shown that the tax relief is the most important component of the scheme to investors. The immediate effect on an investor's tax liability is of great benefit and encourages serial investment.

However, a disadvantage of this option is that if funds are invested at the two year limit and the three year qualifying period is added to this, investors must wait five years from the date of investment until they can be certain that the EIS relief received is still valid.

We would like further information as to the effect on investors if individual EIS investments within the fund failed, no longer qualified for EIS, or were sold within the qualifying period. There would be additional compliance and information provision required here and some indication of the format for this would be appreciated even at this early stage in the consultation.

2. *Extended carry-back of income tax or CGT deferral*

Although not to the extent of a change in the upfront tax relief, this option would be very helpful to some investors. Often, the income received in the current or previous year is not sufficient to take full advantage of the tax relief on an investment. If there is an extended carry-back, there is a greater chance of larger investments being made if previous, more bounteous years can be accessed. This may also encourage recently retired individuals to invest if they can use part of their pension lump sums and obtain relief for tax years where they were still high income earners. Greater investment and greater flexibility can only be beneficial for the scheme and for the companies who are part of it.

We believe that a disadvantage would be the complexity for the investors making a Self-Assessment. There would be another change to the tax return, leading to uncertainty relating to investments that qualified for the enhanced relief. Detailed records would need to be held in case of a failure of the EIS investment.

3. *Capital Gains Tax relief*

Another important incentive for investors is the deferral of capital gains by EIS investment. Writing off a proportion of the gain would increase this incentive. The measure would attract larger investments from entrepreneurs making gains on their businesses, since the final tax burden on their gain would be reduced below 10%. These larger investments would bring about a considerable benefit.

The only disadvantage for this additional relief is again the added complexity to personal tax compliance.

4. Dividend tax exemption

This option would not be appealing to investors since few investments in EIS reach the point where companies pay regular dividends. Much investment in EIS companies is derived from those with a particular interest in the success of a business or a connection with the founders. In these cases, an additional relief for the company dividends would likely not provide more incentive for investment. Other investors would be looking for an exit from a successful EIS company to repay capital once the initial growth phase is completed. The small tax free return on the results of successful trading would not seem to be a rationale that would be considered by these investors.

The disadvantage of the pressure on a business to pay dividends to loyal shareholders highlighted in the consultation would be the only considerable disadvantage.

Q6 What other features would a knowledge-intensive EIS fund need in order to address the funding gap for knowledge-intensive companies, keeping in mind the constraints within which such a structure would be created?

When investors are subscribing for shares in EIS companies, it is the knowledge of the company's activities and the information contained in the prospectus that attracts the investor. Investing in a fund, blindly, means that the investor knows little of the companies that he/she will be investing in. Effectively, they are investing in the fund manager. The fund would need to issue a prospectus that would give information relating to the success of the fund manager and the companies contained within the fund. Benchmarking information would also be required.

Q7 Would a 'patient' dividend tax exemption provide the right incentive to both attract investors in the fund structure, and encourage longer term approaches to investment?

We do not believe that the financial benefit on this additional exemption is sufficient in comparison with the long period that shareholders are required to keep their shares. This is unlikely therefore to be a factor that garners greater investment in knowledge-intensive companies. It is not only the early tax relief in the investment which attracts investors, but also a perceived lowering of risk of their capital.

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

We believe an investor chooses EIS because of the range of tax reliefs available against his/her income and gains and of course the attractiveness of the company's offering in terms of subject matter and prediction of future results. These investors are usually sophisticated and rely on qualified trusted advisers to advise them and deal with their tax compliance and would not be concerned with the inner complexities of a fund. The complexity within a fund will also not concern the company seeking investment if the additional costs are far outweighed by the additional investment received due to improved reliefs.

The key to getting investment in the fund is not related to a lack of complexity since the detail required presently for applying EIS conditions is considerable and this scheme is very popular with both investor and new company alike.

APPENDIX A

Quoted Companies Alliance Tax Expert Group

Paul Fay (Chair)	**Crowe Clark Whitehill LLP**
Paul Attridge	Beavis Morgan LLP
Ray Smith	Clyde & Co LLP
Sam Dames Nick Burt Mark Joscelyne	CMS
Daniel Hawthorne	Decher**t**
Hannah Jones	Deloitte LLP
Emma Bailey	Fox Williams LLP
Holly Edwards	Frontier Developments PLC
Douglas Tailby	Grant Thornton UK LLP
Mark Allwood	haysmacintyre
Peter Vertannes	KPMG
Matthew Rowbotham	Lewis Silkin
Catherine Hall	Mazars LLP
Alex Barnes	Memery Crystal LLP
Tom Gareze	PKF Littlejohn LLP
Emma Locken	PricewaterhouseCoopers LLP
Dan Robertson	RSM
Vijay Thakrar	Unattached