



Blue Sky Corporate Finance Ltd  
2nd Floor, 3 Brindley Place  
Birmingham B1 2JB

T: +44 (0) 845 BLUE SKY  
(2583 759)

F: +44 (0) 870 428 6594

[www.blueskycf.com](http://www.blueskycf.com)

Venture Capital Consultation  
Excise and Enterprise Team  
HM Treasury  
1 Horse Guards Road  
SW1A 2HQ

10 September 2011

Dear Sirs

**Re: Tax-advantaged venture capital schemes: a consultation**

Please find attached our submission in response to the consultation paper dated July 2011.

Blue Sky Corporate Finance Ltd is a West Midlands based firm of corporate finance consultants. We advise the owner/managers of small to medium sized businesses, who are looking to buy, sell or raise finance for their businesses. We employ a team of 8 staff, we have been providing the services outlined for 14 years, we complete between 20 and 30 deals per annum and we work exclusively in the SME sector of the market.

During 2009 Blue Sky Corporate Finance Ltd assisted the West Midlands RDA (Advantage West Midlands) with the development of their risk capital programme for 2009/13. This work included a study of the risk capital programmes operated by six regions outside of the West Midlands, a report/recommendations (fully adopted) on the way forward for the West Midlands programme, assistance with the development of the tender for the fund managements of the public backed equity funds in the region and assistance with the European grant application contribution.

The owner, founder of Blue Sky Corporate Finance and the main author of this response – Mr Paul Heaven is a Chartered Accountant and a member of the ICAEW Corporate Finance Faculty, a board member of the Greater Birmingham & Solihull LEP and a regular speaker at their events on the subject of finance for SME's. Paul is an active member of the West Midlands Regional Finance Forum (RFF) and its Risk Capital Sub-Group.

**Blue Sky Corporate Finance Ltd**

# Questions

## 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?

We acknowledge that the provision of evidence on this point is not easy. There are a number of prospective investors (institutional and angels) that will claim that they are willing to consider 'seed' investment but in reality few of them will actually complete a transaction at this stage of a business's development. Much of the evidence is anecdotal but this includes:-

- The only active institutional investor based in the West Midlands that is capable of investing at the pre-revenue/seed stage is the Early Advantage Fund. Significantly this is a fund sponsored by the RDA in the area (AWM) prior to its closure. This fund is mandated to co-invest alongside private investors (upon comparable terms) at the time of the investment. The fund was launched at the back end of 2009 and at the time of writing this report has made [13] investments. Of these investments [2] or [15%] would meet the definition of a seed investment set out in the HM Treasury report.
- Over the past 12 months the most active Business Angel Network in the West Midlands Region was the Minerva Network operating from premises on the Warwick Science Park. During this period the Minerva network has completed [10] investments of which [1] or 10% would meet the definition of a seed investment set out in the HM Treasury report.
- All investor types (institutional or angel) are seeking to maximise their return and minimise their risk. It follows that all investor types will inevitably migrate towards investment opportunities at the lower end of the risk spectrum. In this regard we would make the equally obvious observation that the changes in the Budget 2011 are bound to have the effect of encouraging EIS investors to chase investment opportunities in larger, more established post revenue funds. One of the corporate financiers in the West Midlands region was working on a seed investment opportunity with a well known EIS Fund when the Budget 2011 was announced. The investment manager of the EIS Fund concerned pulled out of the deal concerned and stated "that we are reviewing the whole focus of our investment strategy in the light of the budget changes.....this is a real game changer for us!"

#### What sort of support is needed?

For the record we do not subscribe to the view that this challenge can be solved by a tax incentive scheme alone.

In our opinion the support required is a mixture of locally managed seed investment funds and a local thriving, active and supported Business Angel market. There is considerable evidence (here in the West Midlands) that institutional co-investment seed funds promote, encourage and leverage business angel investment. For five years between 2004 and 2009 the AWM backed - Advantage Early Growth Fund (AEGF) - was one of the most active investors in the UK making 111 investments in 61 West Midlands based companies totalling £8.79m. Because it was a "co-investment fund" each

investment had to be at least matched by private investors at the same price per share so AEGF's capital was matched by £21.5m from 507 private investors and a further £7.6m of bank and other institutional loans.

In 2010 the role of the AEGF was largely replaced by the Early Advantage Fund (managed by Midven Ltd). The Early Advantage fund is a finance for business product, funded in part by the Solutions for Business portfolio of publicly funded business support. The £8m Early Advantage fund provides investment for small businesses within the West Midlands region. The fund can make an initial investment of up to £125,000 if matched by private money, and can invest a further £275,000 in later rounds. This fund is open to high growth start up, early-stage and medium-sized enterprises with or without revenues.

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

We do not subscribe to the view that this challenge can be solved by a tax incentive scheme alone.

In our experience business angel activity (outside of London and the South East) needs active public support to stimulate, manage and encourage. The West Midland area has a history of public intervention to support business angel activity via the RDA. This support came to an end in March 2011 (although in practice very little support was provided after Dec 2010) and this coincides with comparably the poorest period of angel investment in the region for many years.

We are aware that some of the Business Angel Networks ('BANs') operating in London and the South East do not believe that public support/intervention is needed to stimulate the market. We believe that there are characteristics of the market for business angel activity in the London/SE that make their position true only for that region. The relative maturity of the business angel market in and the average size of an angel investment are unique to London/SE. It is for these reasons that public support for business angel activity is commonplace outside of London/SE.

In our opinion the challenge of stimulating investment in the start-up/pre revenue market must be met by a package of measures and whilst tax incentive will help it will not solve the problem on its own. The sort of measure that we believe are required (in addition to tax incentive):-

- Public sector support for Business Angel activity outside of London/SE
- Public sector support for co-investment funds to leverage Business Angel activity
- Corporate tax incentives to encourage Corporate Venturing

It is generally accepted that Business Angels prefer to invest in local businesses where they can keep an eye on their investment and add value where appropriate. It follows that activity to stimulate and support Business Angel activity should be delivered locally rather than nationally. For this reason we do not believe that programs designed to support Business Angel activity through public sector support or through co-investment funds should be deployed or managed on a nationwide basis. Instead we believe that the support of local Business Angel activity should be part of the Governments 'localisation' agenda and that any/all co-investment funds and BAN support should be delivered through the Local Enterprise Partnerships (LEPs).

Question 3: Would a new standalone scheme be an effective way of meeting the Government's objective of providing support for seed investment?

We do not believe that a standalone tax incentive scheme alone would meet the objective stated. We believe that such a scheme would be helpful and that it would encourage support for seed investment BUT we believe that such a scheme needs to be part of a number of wider measure to deliver the objective stated.

Question 4: Any 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?

A tax incentive of the nature outlined is bound to add complexity to the tax system and in that regard it would run counter to the Government aim of simplification. However we do not believe that this complexity would be a material barrier to the success of the incentive.

The extent to which the start-up company will be engaged in the process of claiming this tax relief will depend upon the definition of a 'seed stage' company; the more complex this definition the more likely that the owners/managers of the start-up company will become embroiled in the complexities of the relief. For the reasons set out below we believe that the definition of a seed stage company should be kept simple. This would have the additional benefit that the involvement of the owner/managers of the seed stage company in the claim process should be minimal or zero.

In our experience the majority of high net-worth individuals make use of 3<sup>rd</sup> part tax advisors and as such we do not believe that the potential additional complexity of a tax incentive is likely to act as a barrier to investors.

Definition of seed-stage companies?

We believe that the definition of a seed stage company should be objective, simple and easy to prove.

The suggestions set out in the consultation paper that the "*company that has not yet begun to receive income from its trade or intended trade*" meets these objectives and it would meet the objective of targeting the tax incentive at pre-revenue propositions. However the disadvantage of using this definition alone is that it would not cover the entire spectrum of the gap for seed capital. For example it is possible that a seed company that is post revenue may experience a challenge raising finance under the EFG scheme because the business is pre-profit (hence unable to demonstrate its ability to service a loan) or under the EIS scheme because it is early stage and thus at the riskier end of the investment spectrum (this is more likely in the light of the Budget 2011 changes).

The suggestion that the company has 'no un-conditional contracts/agreements' is complicated, difficult to prove and will engage the seed company owner/managers in a potentially complex legal issue. The 'gross assets test' is simple and objective but as the similar test for EIS illustrates it runs the risk of external pressure to raise the threshold and as a consequence thwart the very purpose of the incentive. The suggestions of using the definitions of 'R&D and/or prototyping' will, in our opinion, inevitably lead to complex interpretation rules and the suggestion of 'large scale

commercial manufacturing' would only apply to seed capital manufacturing companies and would lead to a potentially complex definition of what is large scale?

In our opinion the challenge of seed capital applies to start-up and early stage businesses. The definition of a start-up businesses can be dealt with via the revenue test. An early stage business is more difficult to define but we believe that the key issue of seed funding is one of the length of time that the company has been trading and its profitability. If a company has been trading for more than (say) 5 years then it is no longer early stage and if the company has been trading profitably then it is no longer a seed capital candidate.

Our proposed definition of a seed stage company is therefore:-

- *A company that has not yet begun to receive income from its trade or intended trade*
- OR -
- *A company that has been trading for less than 5 years and has not yet generated a profit for corporation tax purposes.*

We believe that this definition meets the objective of being simple, objective and easy to prove (from HMRC Corporation Tax records) and it offers the additional advantage the involvement of the owner/manager of the seed company would be minimal/zero.

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

We believe that defining seed stage investment by ‘activity’ is potentially risky because it will open up the tax incentive to countless clarification notices and complicated definitions. An obvious illustration of this is the mind bogglingly complex definitions relating to scientific uncertainty of the activity of “R&D” (an obvious seed company activity) that are set out in the numerous HMRC papers relating to the R&D Tax Credit Scheme.

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

We believe that the need for seed investment ceases when a business is (or should be) capable of securing the funding it needs for expansion from other traditional sources. The most obvious point that this should be possible is when the business is *post-profit* when access to expansion finance should be available from a bank. Many (but not all) businesses should be able to access some of the more traditional equity markets when they are *post revenue*. However the use of ‘post revenue’ as the point at which a company would be disqualified from the incentive scheme would, in our opinion, be unnecessarily restrictive as many companies will be unable to attract equity interest at this stage.

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

We believe that any attempt to define the seed stage by relation to its activity is flawed and will lead to unnecessary complexity.

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

In principle the 'pre-trading' restriction is reasonable for a seed investment but the trick will be the issue of the definition of trading. We believe that a definition of pre trading that is restricted to sales income alone would be overly restrictive. The seed investment 'gap' exists for any start up company that is pre-profit rather. This is because bank debt even under the EFG scheme is not available to a company that cannot demonstrate a profitable track record. In the pre credit-crunch days of the SFLG scheme most of the banks would lend to a company that could show a track record of sales but in the present market the hurdle of 'viability' (or more accurately serviceability) set by the high street banks is that a company must show a history of being capable of repaying the loan out of profits. As a consequence one of the two stated reasons for the creation of the EFG scheme (.....to assist companies without a trading track record) is presently being frustrated. If the high street banks regard a viable trading track record as being a near recent history of profitable trading then so, we believe, should the seed investment tax incentive. It follows that we believe that the definition of pre-trading should be a history of recording profits (most logically) for corporation tax return purposes.

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?

We believe that it IS reasonable to incorporate a rule that the proceeds of investment monies raised under this scheme should be utilised within a certain period of time. That said we are not clear on the issue of why a company would raise investment under this scheme and then not use the proceeds and we are also not clear on what advantage has been gained by the company doing so. In our opinion this sounds like a rule for the sake of having a rule and in the interests of keeping the scheme simple then unnecessary rules should be avoided.

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

If the case for a rule on this issue prevails then we believe that a period of 3 to 5 years is reasonable.

### **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 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?

In our experience most high net-worth investors and certainly most of those that participate in private equity investment enjoy the services of a professional tax advisor and as such this condition would not represent an unduly onerous obligation. That said the best way around this challenge would be to permit HMRC pre-clearance of a proposed investment scheme in much the same way as already happens for the EIS scheme. Investors would then be entitled to ask if the planned investment scheme has been pre-cleared by HMRC and where appropriate a certificate of clearance provided.

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

No; please keep the restrictions to the minimum permissible under EEC regulations.

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

Again as few restrictions as possible should be the approach to the drafting of the rules on this issue. The banks and others will look after themselves when it comes to the ranking order of any security and the market will govern the coupon rate. The rules should permit (indeed encourage) the debt to be convertible but this objective will be achieved through the absence of unnecessary restrictions.

### 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?

In our opinion the objective of the drafting of the rules of this scheme should be to keep it simple and to avoid narrow definitions where at all possible. With these objectives in mind our recommendation would be to keep this definition simple and wide. If a definition is required at all then the EU Commission definition set out in the consultation paper would appear to be the best option.

- A restriction to an individual who has previously invested in a number of seed stage companies should be avoided since this will discourage first time investors.
- A restriction that imposes an obligation on the investor to become a director of the company should also be avoided (at all costs) since many Business Angel investors will NOT wish to become a director of the seed investment company into which they invest. The legal obligations of being a director of a company are onerous and this status is especially risky at the stage of a company's development when failure is more likely.

Most popular definitions of a Business Angel investor include a provision that the person making the investment must have been unconnected with the company before he/she makes the investment. This principle is a fundamental rule of the EIS scheme. In our opinion this restriction is not only unnecessary it is also at odds with the way that the investment market works. Most equity investors (and pretty much all of the banks) will be looking carefully at the participation of the owner/managers in any given investment round. This is commonly referred to as the principle of 'skin in the game' and it follows that the market is very keen that owner/managers are seen to participate in a given investment round. In our experience this issue can be the difference between the success and failure of an investment round.

The obvious and popular rebuttal to this point is that the tax incentive for an owner/managers participation in a given investment round is dealt with by Entrepreneurs Relief. However in our opinion this argument ignores at least 3 important issues:-

- Entrepreneurs Relief is only available against Capital Gains whereas the relief anticipated by this scheme (and EIS) is also available against income tax.
- Entrepreneurs Relief is only available for Equity investments and this scheme is clearly anticipating relief in respect of both quasi equity and debt.

- Entrepreneurs Relief only applies when the proportion of the equity involved in a transaction exceeds 5% of the enlarged share capital. In our experience an owner/manager may be called upon to make an investment of very much less than 5% of the total equity as a prerequisite to the completion of a seed capital investment round.

For the above reasons we would strongly recommend that any seed capital tax incentive is made available to ALL participants in a qualifying investment round.

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?

We can envisage NO benefit in this restriction and furthermore we fear that such a restriction would thwart the very purpose of the tax incentive. For reasons already stated many Business Angel investors will NOT wish to participate in the company as a director or indeed in any capacity that might cause them to be regarded as shadow directors of the company.

The purpose of the scheme should be to encourage Business Angel investment into seed stage investments. Any rule that would seek to force the angel to participate in the governance of the company is likely to have precisely the opposite effect.

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

YES very much so. If we have not already made it clear in our earlier responses then it is worth repeating that we do believe that investors who are not directors should be able to qualify for the scheme. Indeed we regard this as being imperative. As for the question of 'circumstances'; then our response to this point would be 'in any circumstances'. The whole purpose of this scheme is to seek to encourage Business Angel investment into seed stage companies. The very fact that the scheme is being considered indicates that the Government recognises (correctly in our view) that this is a problem area. Any rule which seeks to force an investor to assume the legal obligations of assuming the role of an officer of the company will almost certainly have the effect of discouraging participation.

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?

We can see no benefit of complicating the rules of this scheme by such a requirement. At the very least such a rule will discourage first time investors.

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

None; the purpose of the scheme is to encourage investment into seed stage companies. We fail to see what purpose would be gained by making the qualification factors more complex than the very minimum that are needed/required.

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?

The obvious complication of this ruling is that of 'timing' since it would serve no one's interest for the company to run out of money before it can then undertake an EIS/VCT investment round. Given that an EIS/VCT round is likely to follow a seed capital round then clarification of this issue would need to be resolved. We note with interest that the cumulation rule does not state that the seed money must be 'fully' employed. Would it not be sufficient for the owner/managers to provide a declaration that the balance of any seed capital (if any) left at the time of an EIS/VCT investment round will continue to be used for the purpose set out in the seed capital application/clearance?

### **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?

In our opinion monitoring should be 'light touch' and if possible it should impose the bare minimum of additional red tape on the owner/managers of the business. The regulatory onus should be upon the initial application for clearance when checks should be undertaken to ensure that the company concerned qualifies for relief under the scheme. Where possible any additional checks should be restricted to returns and submissions that the company is already obliged to make (e.g. Annual Returns and Corporation Tax Returns).

## **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?

In our opinion the use of anti-dilution provisions can be counterproductive since they may act as a barrier to subsequent investment rounds. There may be a rational and perfectly justifiable reason for dilution taking place at the second or subsequent rounds and the seed investors are perfectly entitled to avoid this dilution by participating in their pre-emption rights. In our experience the most common issue here is that the second or subsequent investment round was not anticipated by the seed investor at the time of their initial investment and as a consequence he/she is either unwilling/unable to participate in the investment round and feels disadvantaged by the dilution that results.

Where the issue of dilution arises due to the aggressive stance of an institutional investor (typically a VC) taking part in the second/subsequent round then the pre-existence of anti-dilution provisions is likely to make no difference. We acknowledge that we have seen many instances where a VC type investor will stipulate aggressive conditions for an investment round in which they are proposing to

participate. A stance of “we will have x%, management will have y% and all of the previous external investors can be left with z%” is not uncommon. Whilst we acknowledge that this is a challenge we feel that it is unlikely that anti-dilution provisions will have any impact upon this stance. Moreover if the rules of the tax incentive scheme are drafted to the effect that the Business Angel might retroactively lose the tax benefit if the anti-dilution rules are ignored then this could give rise to potentially dangerous consequences. Imagine a scenario where the VC investor is the ‘only show in town’ and they are proposing investment terms which trample all over the anti-dilution provisions. The Business Angel may be put in the impossible situation of being forced to choose between the options of forcing the company to go bust (by rejecting the offer) or retrospectively losing the tax relief.

If so, how might this best be addressed?

The fact that the anticipated scheme allows for some element of debt and quasi equity will certainly help this issue.

During the preparation stage of their 2009/13 Risk Capital Programme; Advantage West Midlands (AWM) commissioned some research of public backed equity programs being managed around the UK. This research work was undertaken by Blue Sky Corporate Finance (Midlands) Ltd and is publicly available. Amongst the schemes reviewed was a seed equity/mezzanine programme operated by London & South East. This scheme permitted the seed investment to be made in the form of convertible debt (they called this mezzanine). The debt finance attracted (accumulated) interest and was repayable at a rate that was linked to sales (typically 1.5% of sales subject to variation). However the important feature of this scheme was the debt was convertible to equity at the price per share of the next investment round. This approach did not prevent the issue of dilution as such but, in our opinion, it did deal with a number of risks/challenges associated with a seed stage investment:-

- It is universally accepted that the valuation of the business is almost impossible at the seed investment stage. The LSE mezzanine scheme approach avoided the need to determine a valuation for equity purposes by making the investment in the form of debt.
- Allowing the conversion of the debt to equity at the price per share of the second/subsequent rounds defers the valuation issue to a point where this is hopefully more practical. This approach also fixes the price at which the seed investors can be ‘bought-out’ by repayment of the debt (+ interest) if the incoming investor would prefer this option. Whilst it would be right to argue that the seed investors participated at an earlier and riskier stage of the business development there is no reason why this fact could not be factored into the coupon (interest) rate.
- This approach also deals with the whole range of outcomes that a Business Angel investor might anticipate (whereas the equity only option only deals with two of these). When a Business Angel makes an investment there are 3 possible outcomes that he/she will contemplate:-
  - The Company Fails – In this scenario it will make very little difference what form the investment takes (equity, quasi-equity or debt) since the Business Angel is likely to lose his/her investment.

- The Company Succeeds – In this scenario a second/subsequent investment rounds is likely and the Business Angel will be forced to consider the options of participating in that round (pre-emption) or suffer the consequences of dilution. However under the terms of the LSA Mezzanine scheme the Angel would have the option of converting his/her debt at the same valuation as the incoming investors. This is not perfect but it is fair.
- The Company Flat lines – This refers to a not uncommon scenario where the company survives but it does not grow quickly enough to ‘exit’ at a profitable valuation. In this situation a Business Angel can find themselves an uncomfortable bed fellow of the owner/managers with the Angel wanting the owner to exit at more or less any price and the owner not wishing to do so. The advantage of the LSE Mezzanine scheme in this situation is that it allows the owner/managers to buy-out the Business Angel by repaying the debt (+ interest) on the basis agreed.

We believe that the LSE Mezzanine Scheme is an interesting approach and lesson learned. The fact that the loan repayment is linked to sales should (and we emphasise the word “should”) meet the EU Commission definition of quasi-equity. If this is the case then this approach would appear to meet all of the key requirements of this incentive and it will also deal with the challenge of dilution.

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

We believe that dilution is a fact of life and that the existence of an anti-dilution provision will only serve to complicate, rather than resolve, this issue. Legislation to avoid dilution is likely to add complexity to the scheme and should therefore be regarded as a low priority.

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?

As previously described the scope to invest in the form of debt will go some way to mitigate the challenge of dilution.

### **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?

In our experience this rule does deter the merger of EIS companies and for no obvious purpose. We can see no reason why either of the sets of shareholders of merged EIS entities should lose their EIS status. The Budget 2011 materially increased the definitions of the size of a company that would qualify for EIS purposes. This change was presumably designed to lead to greater use of the EIS scheme. We believe that **as a minimum** the rules should be changed to the effect that if the entity

created out of the merger of two (or more) EIS Companies would itself qualify, within the EIS rules, then both (or all) sets of shareholders should retain their EIS status.

Furthermore we believe that the whole rationale for this rule should be reviewed. Even if the merged entity does not qualify under the new EIS limits it is unclear to us why a merger should automatically disqualify one set of shareholders.

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

In our opinion the EIS merger issue is important and should be addressed as soon as possible but this issue is not as great a priority as the seed investment challenge.

### **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?**

Better guidance material is always helpful and if this is a common problem with EIS (this is not an issue that we have experienced) then better guidance on the specific issue of the timing of the payments for shares would be helpful.

**If so, how and where should that be made available to ensure it was seen by those most in need?**

In our experience some sort of web-based (downloadable) guidelines would be the best way of reaching the greatest audience.

**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?**

In our opinion there should be a grace period for the shares to be fully paid up. This grace period is required for 2 reasons:-

- The company seeking the investment is often urgently in need of the funding and a grace period to allow the investment to be made ahead of the legal/tax paperwork would permit the investment to be made quickly and then the legal/tax paperwork to follow.
- The process to develop and complete the legal investment paperwork (investment agreement/articles of association) is often time consuming and expensive. In some cases the investment process can falter during this time period and/or the owner/managers may struggle to afford the legal representation that they need during this phase of the investment process. Allowing a grace period would permit the legal documents to be negotiated and agreed at a sensible pace while the business is continuing. This would also provide the owner/managers with some funding to afford proper legal advice during this process.

In our opinion a sensible grace period between the timing of the cash payment and the proper completion of the paperwork for legal/tax purposes is six (6) months.

## **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?

In our opinion a review of the excluded activity list would be helpful and welcome.

If so, what priority should be given to this (relative to other issues raised in chapter 3)?

In our opinion this is a relatively low priority compared to other issues set out in this response.

## **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?

We are in favour of keeping the rules of the scheme as simple as possible. With this objective in mind we are cautious about any proposal that will complicate the administration of the scheme and any proposal that might give rise to a retrospective withdrawal of the tax relief (other than in cases of deliberate fraud).

As previously set out we favour the approach of HMRC pre-clearance of each scheme (as is presently possible for EIS).

Of the various tests outlined in the consultation paper we would favour the 'employment' test although it should be borne in mind that this scheme is intended to cover pre-revenue investment cases. As such there is a risk that the owner/manager INTENDED to employ 4 full time employees at the time of the investment but for whatever reason the project failed (the R&D did not yield the hoped for outcome, the prototype was built but failed to find a customer etc.). In these circumstances it would be unfair for the investor to lose the tax relief retrospectively and equally unfair for the company to lose the benefit of an investment scheme that was designed for the purpose intended.

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

As previously stated we would favour an approach whereby applicants would submit a pre-clearance application to HMRC including a business plan/executive summary. If HMRC are not entirely satisfied with the purpose for which the investment is being sought then they would a) be entitled to ask additional questions, seek clarification or seek assurances and b) reject the pre-clearance application where appropriate. Only where the application was made fraudulently would it be appropriate to retrospectively deny the tax benefit obtained.

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?

Of the tests set out in section 4.12 our responses would be as follows:-

50% of activities carried out by non employees	No: The use of sub-contractors is a common and legitimate way of keeping costs down during the seed development stage
50% of costs sub-contracted	No: Ditto
50% of money raised used to purchase intangible assets intended for resale	Yes: This is not a typical activity of a seed stage development and if the intangible asset has a real value then non-seed funding should be available to cover the cost.
50% or less of ordinary shares held by directors through the relevant period	No: This could happen for all sorts of perfectly legitimate reasons.
Trading with Connected parties	No: This could happen for all sorts of perfectly legitimate reasons.
One Customer Only	No: For most seed stage investments this would be good news.
One Supplier Only	No: This is not proof that the business does not have 'risk'.
Losses Precluded	Yes: This would clearly be a non seed stage and non risk based investment.

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?

Of these options we favour the precursor purpose statement and a list of positive (intended purpose) indicators.

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

We do not favour the disqualification list.

### **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?

None of which we are aware

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

They are

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

We believe that the proposed solutions will be effective but that they will need to part of a wider strategy to deal with the key challenge of seed capital investment.

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

In our opinion this is unlikely and whilst they will help to deal with this challenge they are unlikely to solve it alone.

#### **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?

None of which we are aware.

Question 39: Will the definitions included in paragraph (9) of new clause 198A in the draft legislation give the right result in practice?

We believe that it will.

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?

Yes

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?

Yes