Financing growth in innovative firms: Enterprise Investment Scheme knowledge intensive funds

OMB **Personal tax**

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The CIOT recently responded to the Treasury’s consultation on the introduction of a new approved fund structure within the Enterprise Investment Scheme (EIS), with the possibility of additional incentives to attract investment. Such a fund structure would be focused on mainly investing in knowledge intensive companies.

Our response was based on feedback from members in practice providing advice to clients on the EIS rules and qualifying conditions. One of the main issues they raised is that the complexity and number of EIS qualifying conditions is a material barrier to younger companies seeking EIS (and SEIS) investment. For knowledge intensive companies at an early or start-up stage, this is a time when they need seed capital investment, will need professional advice on the qualifying conditions, and usually assistance in applying for an advance assurance and completing the EIS1 (or SEIS1) forms. The amount of professional advice which a company would need to be 100% sure that these reliefs will apply is usually well beyond the cash flow of these companies.

We also pointed out that often knowledge intensive companies need far greater levels of capital investment than those permitted under the EIS rules and in a much more flexible format than the traditional ordinary share capital model offered by EIS, and this aspect does not seem open for change. We suggested this area is consulted on.

As the consultation noted, there is already a current EIS approved funding model but very few funds seek HMRC approval. We think this is largely because the legislation contains a number of strict conditions, and on top of that any fund has to comply with financial services regulatory issues. In our view, simply introducing a new fund structure is not the answer unless it can be designed in a way that means the marrying of tax and financial regulations is not overly onerous.

The consultation outlined four options to attract investors to knowledge intensive funds, and asked respondents to rank and compare the benefits and disadvantages of each. We ranked them in order of preference as follows:

1. Dividend tax exemption: this could be attractive but would need to take effect before the 5 to 7 years suggested in the consultation. If left for that long before applying, we think it will have little incentive. A suggestion would be to have staggered thresholds for a dividend tax exemption, which may be quite attractive now that the general exemption for dividend income has come down to £2,000 per annum.
2. Extended carry back of income tax: this sounds appealing and, even better if it could be extended to a carry forward ability as well.
3. CGT write off: we are not sure how much of a significant additional incentive this would be on top of the existing CGT deferral, especially if only part of a capital gain can be written off, but it could be attractive for very wealthy investors.
4. Up front tax relief: this sounds attractive, but the concern is around the additional compliance burden and cost going forward to monitor when and whether the investments were actually made by the fund, and a clawback of tax relief if the investments were not made.

Our full response can be found on the CIOT website.