Proposed refocusing of the enterprise investment scheme

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The Budget speech in March 2015 included the announcement of: 'Changes to the enterprise investment schemes and venture capital trusts to ensure they are compliant with the latest state aid rules and increasing support to high growth companies.'

Although the proposals were not included in FA 2015, the dependence of the venture capital schemes on EU-wide state aid approval rules means that they are likely to be included in an early Finance Bill after the general election, regardless of the outcome.

On 24 March 2015, the Treasury and HMRC jointly published a consultation titled *Tax-advantaged venture capital schemes: draft legislation and explanatory notes*. The principles behind the proposed changes to both EIS and VCT are broadly similar, but there are differences in the detailed provisions. Space constraints mean that this article focuses on the main changes proposed for EIS.

The consultation document summarises the Budget announcements as follows:

'The Government will, subject to state aid approval:

- Require that all investments are made for the purpose of business growth and development.
- Require that all EIS investors are independent from the company at the time of the first share issue (excluding founder shares).
- Introduce new qualifying criteria to limit relief to companies whose first commercial sale took place within the previous 12 years unless the company has received a previous investment under SEIS/EIS/VCT (follow-on funding is not restricted). This rule will apply except where the total investment represents more than 50% of annual turnover averaged over the preceding five years.
- Cap the total investment a company may receive at £20 million for companies that meet certain conditions demonstrating that they are "knowledge intensive" and £15 million for other qualifying companies.
- Increase the employee limit for knowledge-intensive companies to 499 employees.

'The Government will, with effect from 6 April 2015:

- remove the requirement that 70% of SEIS money must be spent before EIS or VCT funding can be raised.'

In our comments below, we follow the order of these bullet points.

The proposed *growth and development* condition appears to be designed to remind companies and investors of the purpose of the tax-privileged investments. It might be used to deny relief if the qualifying purpose is insufficiently apparent. The term *growth and development* is not defined in the legislation.

The proposed *independence* condition denies relief where a prospective investor already holds shares in the company unless their existing shares are either a 'risk-scheme investment' (shares subscribed for under the EIS, SEIS or social investment tax relief rules) or qualifying subscriber shares (referred to in the explanatory note as founder shares).

The 12-year test appears to be designed to satisfy the new state aid rules in a practical way. The *Red Book* published on Budget day had indicated that the proposal would mean that companies must be less than 12 years old when receiving their first EIS or VCT investment ‘except where the investment will lead to a substantial change in the company’s activity’.

Stated in those terms, the condition sounded as if it would require complex definitions and a lot of monitoring throughout the 12-year period. Readers will therefore be pleased to note that the draft legislation avoids those complexities by the use of a proxy test. If the relevant shares are issued more than 12 years after the issuing company’s first commercial sale (and there has not been a relevant investment in the intervening period that enables the proposed investment to qualify as follow-on funding), the proposed investment will be eligible for relief as long as the total of relevant investments made in the company in a period of 30 consecutive days which includes the day on which the relevant shares are issued is at least 50% of the ‘average turnover amount’. The latter term is defined as the average of the company’s (or group’s) turnovers for each of five consecutive years ending on a defined date. Using such an objective numbers-based test is not, however, without its own problems. It will tend to discriminate against low-margin high turnover companies (including any that were genuinely about to embark on making a substantial change in their activities) and it could also put pressure on companies to identify other investors simply to achieve the required ratio of investment to turnover.

The higher caps for total investment and employee numbers for ‘knowledge intensive companies’ involve the introduction of detailed definitions and the possibility in one context of the requirement for a written evaluation by an independent expert on the prospect of relevant intellectual property being created.

The removal of the requirement that 70% of any SEIS money must be spent before EIS or VCT funding can be raised by a company is simply accomplished by the proposed omission of the current condition.

This note can only give a flavour of the implications for companies and prospective investors if the proposed changes are implemented. The Treasury has invited responses to the proposals by 14 May 2015.

The consultation document is available on the GOV.UK website.