Changes to tax-advantaged venture capital schemes

OMB

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CIOT and ATT respond to the amendments in legislation

The CIOT and ATT have commented on the legislation that was issued as a consultation draft in March 2015 setting out amendments to the tax-advantaged venture capital schemes seed enterprise investment scheme (SEIS), enterprise investment scheme (EIS) and venture capital trusts (VCTs).

The CIOT raised concerns that the further qualifying conditions being introduced, in particular for EIS and SEIS, may not only restrict the number of potential investors who can qualify for the relief but the additional complexity may deter individual investors from taking advantage of the reliefs.

A new independence condition is proposed in draft ITA 2007 s 164A. Until now, an investor could have held up to 30% of a company’s share capital before making an EIS investment if, as a result of that investment, they did not go over the 30% mark and subject to meeting the other ‘no prior connection’ tests.

The condition would exclude investors who already held any number of shares in the investee company unless that equity is a ‘risk-based investment’ (ie had qualified for EIS, SEIS or SITR relief), or consisted of ‘subscriber shares’. Presumably one of the intentions of the draft s 164A is to exclude EIS relief for investors who already have a substantive active role in the business. But it would also catch family members who may have taken, or been gifted, a stake but have not claimed EIS relief (perhaps because the sums invested were very small) and were not original subscribers.

The CIOT has two suggestions to mitigate this. First, a carve-out could be included from this new rule, where existing shares were obtained by the prospective EIS investor as a result of personal, family or domestic relationships. This would mirror a similar carve-out from the employment related securities income tax provisions under ITEPA 2003 Pt 7, and in particular at s 421B(3). Second, a de minimis threshold could be included, so that EIS investors could still qualify if they held only up to a certain smaller percentage of the investee company, and were not founders and had not claimed a risk-scheme investment relief on those shares. A 5% amount, for example, would have a certain synergy with the current CGT entrepreneurs’ relief (ER) threshold for a ‘personal company’ (TCGA 1992 s 169S (3)) and also the threshold below which a selling shareholder is not caught by the anti-avoidance measures on rollover relief under TCGA 1992 s 137.

Increased investment caps for ‘knowledge intensive’ companies are proposed in draft ITA 2007 ss 173AA and 252A. Although the additional increase in the overall investment cap to £20 million is welcome, we are not sure why this should be restricted to ‘knowledge intensive’ companies. If the £20 million cap is eligible for state aid approval, why not extend it to companies that may not meet the ‘knowledge intensive’ test but which could have just as significant start-up and growth capital needs. This would include plant and machinery, sales or marketing and distribution logistics.

The ‘skilled employee’ condition (draft ITA 2007 s 252A) has what seems an unnecessarily detailed requirement for 20% of the workforce to have a higher education qualification of at least level seven. This equates to a master’s or PhD qualification, BTEC advanced professional award level seven or equivalent. A concern is that when tax legislation reaches this level of specificity, especially in the context of obtaining a relief, it runs the risk of becoming unworkable.

The amendments to ITA 2007 s 174 require that all investments under EIS are made for the purposes of promoting ‘business growth and development’. There has always been a restriction that investments must be for a qualifying business activity, but the draft definition of the new term ‘business growth and development’ in new s 174(2) adds little to our understanding of what the new restriction is aiming at compared with the existing legislation. Because HMRC tend to interpret such conditions narrowly, it could lead to record-keeping that is out of proportion to what is meant to be a relieving provision in order for the business to demonstrate that investment is being made to promote ‘business growth and development’.

Finally, the CIOT noted that the draft legislation includes new ITA 2007 s 251A for EIS and new ITA 2007 s 311 for VCTs, which give the Treasury the power to amend parts of the legislation by regulations under the draft affirmative procedure. We are concerned by this delegation to secondary from primary legislation since the reality is that scrutiny of secondary legislation can be cursory and can be done at any time outside the normal Finance Act cycle. The arbitrariness that that brings with it seriously risks damaging investor confidence in the regime as a whole. The justification for this change is not explained in the documents that were published alongside the draft legislation.

The ATT’s response comprised an endorsement of the CIOT response and a specific focus on the proposed ITA 2007 s 183A. This contains the 12-year test under which a company would be ineligible for EIS investment if its first commercial sale occurred more than 12 years before the relevant investment unless either: the prospective investment amounted to at least 50% of the *average turnover amount* of the prior five years; or there had been an EIS, SEIS or VCT investment in the intervening period. For more detail on the apparent thinking behind the 12-year test, see *Tax Adviser*, May 2015, pages 40 and 41.

The ATT’s first concern is that the 50% provision is not based on any logical connection between historic turnover and current capital requirement and that it would necessarily work unequally and arbitrarily given the potential diversity in the histories of different companies.

The second is that the proxy test displaces any other way of demonstrating the original objective of the change as set out in the Budget, namely to ensure that the proposed investment ‘will lead to a substantial change in the company’s activity’. The ATT suggested that a possible alternative condition for eligibility might require the production of a report from an independent expert – a concept used elsewhere in the proposed legislation.

As well as its specific comments on the proposed test conditions, the ATT proposed a *de minimis* exclusion from the 12-year test for smaller companies.

The draft legislation can be found here.

The CIOT’s response can be found here.

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