Enterprise Investment Scheme Association

Fuelling an Entrepreneur's Fire

A report produced in association with

The All Party Parliamentary Group for Entrepreneurship

March 2020

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How the Enterprise Investment Scheme helps fund Britain's next wave of high growth, entrepreneurial businesses.

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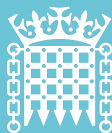

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Executive Summary

The Enterprise Investment Scheme (EIS) has been helping start and scale up businesses who struggle to gain access to funding for over 25 years. EIS (and in 2012, the Seed Enterprise Investment Scheme, SEIS) were introduced to incentivise private investors to risk funds by investing in smaller businesses and have helped over 27,000 SMEs raise over £20Bn in that time[1].

Start and scaleup businesses who receive funding through EIS & SEIS cover the broad spectrum of smaller company investment – mostly early stage or pre-profit investment - throughout the United Kingdom and cover a wide variety of sectors including healthcare, technology, AI & cybersecurity, life sciences, creative industries, environmental, leisure and hospitality, manufacturing and many more. EIS & SEIS investment has contributed to job creation, the launch of new products and services and increased competition.

Since their introduction, the schemes have created a compelling economic rationale and every subsequent Government has sought to maintain, embellish and focus the schemes recognising their value to the UK economy. But we believe more can be done.

This paper seeks to:

- identify the issues startups & scaleups face when seeking funding,
- recommendations as to how the EIS & SEIS schemes can play an even greater part in funding the UK's next generation of high growth businesses and
- the potential economic impact of the implementation of our recommendations.

1. Enterprise Investment Scheme Seed Enterprise Investment Scheme and Social Investment Tax Relief, May 2019, Statistics on Companies raising funds, HMRC *http://bit.ly/2HkyVnd*

Funding continues to be an issue for companies seeking to start and scale up, particularly at the point of significant scale up.

To address this, our primary recommendations are:

- **We believe that increasing the threshold for EIS & SEIS investment, and potentially removing it all together, will encourage follow-on investments, and could help smooth the transition into non-tax-incentivised investments. Additionally, a commitment from the Government that the schemes will continue beyond 2025 is needed.**

- **There is a compelling case for improving the administrative processes around authorising SEIS & EIS companies, and granting tax relief for investors.**

- **More can be done to raise the profile of EIS & SEIS both to companies seeking much needed equity finance including involving a far wider range of business support agencies such as LEPs, Universities and the IOD and to potential investors.**

- **We recommend that Britain should seek via negotiation with the EU to ideally be fully released from the EU State Aid and Risk Finance Guidelines limits as soon as practically possible. If full release is not immediately possible then a loosening of the limits should be sought to allow both for an increase in the levels of investment as well as liberalising the legislation thereby ending restrictions on investment, allowing faster deployment of capital and less administrative burden.**

Introduction

The UK is already a great place to start and grow a business. There are over 600,000 small businesses in the UK and they account for 99.9% of all businesses, 60% of employment and 52% of GDP[2].

Starting new businesses is important but scaling them up is equally important. They create jobs outside of the public sector, provide people with an income and generate tax revenue for the Government that funds for vital public services.

Instrumental in developing and funding a thriving UK start-up and scale up community are successful government policy interventions such as the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment scheme (SEIS). Over £20 Billion has been raised from retail investors through the schemes and they have played an important role in providing early stage funding for a wide range of innovative, productive companies who without the schemes would not have been able to start and scale their business.

2. Scale Up Institute, Annual Scale Up Review 2018 (p.72) *http://bit.ly/2HnytEJ*

The intention behind both schemes is to address an ongoing market failure where growing UK businesses are unable to access the capital they require to scale up.

Whilst this has been acknowledged by the European Commission in its 2015 amendment to the state aid clearance decision for EIS schemes, the full extent of this lack of capital continues to be underestimated, and growing UK businesses still struggle to secure investments of between £5m and £20m.

If the UK wishes to further strengthen its position as the best place to start and grow a business, as stated in all the major political party manifestos at the 2019 election, particular focus need to be given to not only funding early stage business start up businesses but also the transformational development of some of these start-ups into large-scale businesses.

This paper therefore seeks to explore the opportunities that exist for improving access to funding across the ecosystem and the vital role that EIS & SEIS already play and can further play in helping small businesses to start, build and grow and bridge the gap between start up and scale up.

Deliberately, this report is limited in scope. Our focus is on ensuring that the reliefs already available that directly affect Britain's ambitious entrepreneurs are fit for purpose. The report will therefore focus on three key areas:

1. Effectiveness

Where do the funding gaps exist for startups and scaleups and what role are EIS & SEIS playing to address this and are they effective within the current legislation?

2. Simplifying the tax legislation

The EIS primary legislation is long, highly detailed, and contains many restrictions which are viewed as uncommercial. Is there potential to streamline the legislation to enable faster deployment of funds raised from individuals to provide greater support for SMEs?

3. Consciousness

What can be done to increase knowledge of EIS & SEIS schemes as funding options for entrepreneurs? How can inflows of investment from private individuals be increased?

We believe that there is the potential for broad cross-party agreement on the proposals set out in this report. The proposals put forward are designed to be revenue-neutral and geographically neutral. Where there are costs to the exchequer they are kept to a minimum.

Recommendation 1

Effectiveness

It is striking that, despite the UK's mature sector around 40% of scaleups still feel they currently do not have the right amount of funding in place for their current ambitions.[3]

And yet, the benefits to companies of taking an injection of equity are clear. Companies that receive equity investment are more likely to grow faster, particularly in terms of turnover. More of the companies with turnover growth of more than 100% each year have used equity financing than those growing less quickly. Similarly, more of the companies with employment growth of between 80% and 100% annually have taken an injection of equity.[4]

3. Scale Up Institute, Annual Scale Up Review 2018 (p.72) *http://bit.ly/2HnytEJ*
4. Scale Up Institute and Beauhurst, Scale Up Index 2019. *http://bit.ly/38qxJe4*

However, as is well known, the OECD ranks the UK as 3rd in terms of startups but 13th for scaleups and the proportion of UK start-ups which scale into large businesses lags significantly behind countries such as the US. This indicates that many UK-based businesses are unable to reach their full potential and either remain "stuck" in a stage of slow growth, accept a trade sale as the most convenient exit, or move abroad to access deeper pools of capital. All of which are ultimately to the detriment of the UK economy, tax receipts and job creation.

The Patient Capital Review did a good job in refocusing where EIS & SEIS investment should be focused. But both schemes remain subject to caps and rules which create two inefficiencies in the market as businesses transition into the scale-up stage:

- Early investors using EIS / SEIS are unable to provide follow-on tax-efficient investments;
- Pricing bubbles can develop around the cap, as it is easier to access smaller amounts of tax-incentivised capital than slightly larger amounts of non-tax incentivised capital just beyond the threshold.

In 2017/18, a total of c.£2.1bn was invested via EIS & SEIS. It is estimated that up to £1bn of additional capital could be raised annually through expanding or removing the cap on lifetime investment for EIS investments, especially given the enduring popularity of the schemes amongst investors.

For SMEs and investors, HMRC's own independently commissioned research highlights a number of positive outcomes that could be multiplied if increasing/removing existing limits.

- Three-quarters (74%) of investees had sought investment at least in part to start their business or to develop a new product or service, in line with the principal intentions of tax-advantaged venture capital schemes.
- 58% of investee companies said productivity had increased due to their investment.
- Just 11% felt that their proposed investment would have gone ahead without the schemes.
- Nine in ten (90%) of investee companies said their company had grown in terms of employee numbers since they first sought EIS investment. The median growth in employment since seeking venture capital was 33%,
- Nine in ten (90%) companies attributed at least part of their growth in employee numbers to EIS investment.

For investors, loss aversion was a particularly important factor in decision making. The reliefs meant that the value of their investment could effectively fall by a substantial amount before investors would start to lose money, which made them more willing to invest. Additionally, certain investors said they would have invested regardless of the tax reliefs but pointed out that they were able to afford to invest a higher amount due to the reliefs. Similarly, certain investors said they had made more risky investments than they normally would due to the tax reliefs, which is in line with the policy intent of the schemes.[5]

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5. HMRC Research Report 355 - The use and impact of venture capital schemes February 2016 http://bit.ly/2UR8T2P

Finally, the Government should leave the market to decide investments are made. Governments *"need to learn that when it comes to innovative initiatives, it's usually impossible to pick the big winners from the losers early on…. to drive significant long-term growth, they need to invest in a large number of innovation initiatives, and fail in most of them, to be able to find the few that pay for the rest – with interest."*[6]

Expanding or removing the EIS & SEIS investment caps would require additional government funding to be made available and will require further revision of the European Commission's state aid clearance decision for the EIS schemes. Further economic modelling will be required to evaluate the most effective way to raise this additional investment through tax incentives, considering also the returns available from other tax incentivised investment opportunities such as pension funds and ISAs. However, there is clear evidence that tax advantaged schemes help offset the risk of taking an equity position for an individual investor and and they are an important pool of privately funded investment relieving funding pressure from central government agencies.

We believe that increasing the threshold for EIS & SEIS investment, and potentially removing it all together, will encourage follow-on investments, and could help smooth the transition into non-tax-incentivised investments. Additionally, a commitment from the Government that the schemes will continue beyond 2025 is needed.

Fuller, more detailed recommendations to improve the scope of the schemes can be found in the Appendices.

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6. Alexander Osterwalder, Why Can't Nestle Produce Another Nespresso? *http://bit.ly/2UOKM4R*

Recommendation 2

Simplifying the tax legislation

The EIS legislation is intended to be enabling legislation and should be applied as such. However, our view is that HMRC is applying the rules as though the EIS is anti-avoidance legislation.

We have received representations that HMRC is placing restrictions on investment which are not contained in the legislation, itself. We fully understand that, whilst the UK is under EU Treaty obligations, the EIS needs to meet the requirements of the Risk Finance Guidelines, but where the legislation allows for appropriate discretion in it is interpretation and application, it is our view that it should be interpreted and applied in the way that is beneficial to the investee company and to the UK economy. We do not believe this is the case currently. Within the Appendix, we set out some specific instances.

In short, there is a case for improving the administrative processes around authorising EIS & SEIS companies, and granting tax relief for investors. As the Office of Tax Simplification noted:

"The OTS is aware that legislative changes about the nature of companies in which investments can be made is expected to streamline the processes, which is to be welcomed. However, digitisation and relaxation of legislative inflexibilities could also contribute to faster turn-arounds, which in turn would better enable companies to attract venture capital.

Complexities built into the SEIS/EIS legislation often catch out unwary companies, either at the time of application or after SEIS/EIS status has been granted. This can cause good businesses to lose necessary venture capital, or result in relief being denied or withdrawn some time after the investors have made their investments. Some of the rules may be necessary to properly target the reliefs, but a review of these complexities to remove unnecessary ones, or to build in de minimis thresholds (for small companies) would be useful."[7]

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7. Office of Tax Simplification, Business Lifecycle Report: Simplifying the taxation of key events in the life of a business http://bit.ly/2vu1jAQ

Recommendation 3

Consciousness

Awareness of alternatives to traditional finance for small businesses has continued to grow, with 52% of small businesses aware of peer to peer lending, 70% aware of crowdfunding platforms and 69% aware of Venture Capital (up from 47%, 60% and 62% respectively in the previous year)[8]. But more can be done.

In 2017, the Business, Energy and Industrial Strategy Committee recommended that “the Government directs resources towards promoting the SEIS, EIS and VCT schemes. This includes the British Business Bank working with HMRC to consider how to improve promotion of the scheme.[9] Whilst the British Business Bank and the Government committed to explore ways to raise awareness of the schemes, we believe more can be done to raise the profile of EIS & SEIS both to companies seeking much needed equity finance including involving a far wider range of business support agencies such as LEPs, Universities and the IOD and to investors.

8. British Business Bank, Small Business Finance Survey 2019 http://bit.ly/2HnSjjs

9. Business, Energy and Industrial Strategy Committee, Small businesses and productivity, Fifteenth Report of Session 2017 http://bit.ly/2Ssn11b

Recommendation

Conclusions

All political parties have recognised that Britain has the potential to be the best country in the world to start and grow a business – a place where entrepreneurs know they can build on their ideas and find success. Our hope is that by acting upon our recommendations, every great entrepreneurial management team will be able to obtain the finance it needs in the UK to develop their ideas into major global businesses.

We recommend that Britain should seek via negotiation with the EU to ideally be fully released from the EU State Aid and Risk Finance Guidelines limits as soon as practically possible. If full release is not immediately possible then a loosening of the limits should be sought to allow both for an increase in the levels of investment as well as liberalising the legislation thereby ending restrictions on investment, allowing faster deployment of capital and less administrative burden.

The EIS & SEIS schemes have delivered a 25 year track record of success in delivering much needed equity funding to entrepreneurial, small businesses and by broadening and widening the schemes as outlined above, economic growth, productivity, employment and tax revenue can all be boosted.

Understanding the early stage access to finance environment

Many SMEs would never be financed by larger funds because they are too small, too niche, too high risk, etc. yet many of these businesses are launched or grow on the back of angels, friends and family and individual investors or small funds using EIS.

Other capital sources struggle to or don't have the appetite to reach these areas or do not do so effectively and yet these areas are often the areas where funding is most needed and where high growth is often achieved. A main root cause holding back effective deployment of and demand for patient capital is the inability to recycle capital efficiently as a growth company grows and develops.

As a generalisation, a seed investor may invest in multiple rounds but not usually beyond a series A round, preferring to exit at this stage if possible so that his capital can be reinvested in more seed investments rather than washed out in later rounds of the original investment. By contrast, very large investment funds take little interest in seed investments because their performance, however good, is unlikely to make much impact on the overall performance of the very large investment funds.

An efficient market needs both types of funds (and intermediates) so that capital can be recycled and employed efficiently according to the expertise of the investor; and that expertise differs very widely from the investor working with his local university and the manager who orchestrates international global fund raisings to support the global expansion of the next unicorns. Without the seed investors, the global investors might never find worthwhile 'new to market' investments. Without the very large investors the seed investors might be trapped and washed out. Both are needed for the ecosystem to work at its best.

Detailed Recommendation 1

Amending the EU's State Aid & Risk Finance Guidelines

The tax reliefs received by investors under the EIS are deemed to represent State aid. When the Risk Finance Guidelines were adopted in 2014 to replace the Risk Capital Guidelines, the Commission recognised that the previous Guidelines *"proved to be too restrictive both in terms of eligible SMEs, forms of financing, aid instruments and funding structures."*

The modernisation of State aid rules launched by the Commission in 2012 had three main, closely linked objectives:

1. Foster growth in a strengthened, dynamic and competitive internal market;
2. Focus enforcement on cases with the biggest impact on the internal market;
3. Streamlined rules and faster decisions.

The Competition Policy Brief published in January 2014 at the time of the introduction of the Risk Finance Guidelines stated:

"Following extensive consultations with Member States and stakeholders, the Commission is now taking a bold step by setting up a simpler, more flexible and generous state aid framework for the provision of risk finance to SMEs and midcaps. The new rules should attract and channel private financing to support the public policy goals of economic growth and job creation, which is particularly important in times of economic crisis."

The Competition Policy Brief continues:

"SMEs are by and large still heavily dependent on traditional bank lending. Lending is, however, still limited by the refinancing capacity, risk appetite and capital adequacy of banks. The financial crisis has exacerbated problems flowing from such overreliance on bank lending - approximately one third of SMEs were unable to receive the necessary finance in recent years. Such a failure in finance markets translates into a "funding gap", which hinders companies during the seed and start-up stages, and later during their development and growth stages. The Commission is boldly reacting to changing market realities. New State aid rules will permit a more rapid and generous distribution of risk finance aid to SMEs and mid-caps. This is an important contribution to the European Union's efforts to re-launch economic growth during difficult times for many SMEs."

However, since the publication of the Competition Policy Brief in 2014 Europe remains in difficult economic times and the funding gap for SMEs and mid-caps persists.

The EIS primary legislation is very long and highly detailed, and contains many restrictions which are viewed as uncommercial, but we are advised that they are necessary to meet State aid Risk Finance Guidelines. The complexity of the EIS legislation illustrates the potential to streamline further the State aid Risk Finance Guidelines.

Further liberalisation of the State aid rules could be a precursor to Member States applying the regime with fewer unnecessary restrictions on investment and with a reduced administrative burden. This would lead to faster deployment of funds raised from individuals to provide greater support for SMEs and knowledge-intensive mid-caps. This would enhance the effectiveness of the Risk Finance Guidelines to deliver development capital to SMEs and innovative mid-caps.

Detailed Recommendation 2

Replace the age limit

The EISA recommends that the Commission replace the "age restriction" on eligible recipients of State aid with a different threshold.

Instead we propose a gross assets test, of say £20 million, be used instead to determine eligibility for the recipients of State aid Risk finance. The EIS scheme, for which Commission approval has been given, has an existing gross assets limit. This has the advantage of facilitating a clear assessment of eligibility. Deciding what level of gross assets to apply (within a threshold set by an updated Risk Finance Guidelines) in relation to individual applications for State aid approval, would, of course, be subject to a full market failure analysis. The size of the investee company or group would be a suitable measure for rapidly directing investment where the funding gap is most significant.

We note that the EU SME definition, according the European Commission's user guide to the SME definition published in 2016 stated:

"SMEs are the engine of the European economy. They drive job creation and economic growth and ensure social stability. In 2013, over 21 million SMEs provided 88.8 million jobs throughout the EU. Nine out of every 10 enterprises is an SME, and SMEs generate two out of every three jobs. SMEs also stimulate an entrepreneurial spirit and innovation throughout the EU and are thus crucial for fostering competitiveness and employment. Given their importance to Europe's economy, SMEs are a major focus of EU policy. The European Commission aims to promote entrepreneurship and improve the business environment for SMEs, thereby allowing them to realise their full potential in today's global economy."

The User Guide to the SME definition quotes from Jean-Claude Juncker, President of the European Commission:

"Jobs, growth and investment will only return to Europe if we create the right regulatory environment and promote a climate of entrepreneurship and job creation. We must not stifle innovation and competitiveness with too prescriptive and too detailed regulations, particularly when it comes to small and medium-sized enterprises (SMEs). SMEs are the backbone of our economy, creating more than 85 % of new jobs in Europe and we have to free them from burdensome regulation."

The User Guide continues:

"SMEs require assistance that other enterprises do not. Compared with other enterprises, SMEs are confronted with a unique set of issues.

Market failures: *real SMEs often face market failures that make the environment in which they operate and compete with other players more challenging. Market failures may occur in areas such as finance (especially venture capital), research, innovation or environmental regulations; SMEs may be unable to access finance or invest in research and innovation or they may lack the resources to comply with environmental regulations.*

Structural barriers: *SMEs often must also overcome structural barriers such as a lack of management and technical skills, rigidities in labour markets and a limited knowledge of opportunities for international expansion."*

SMEs are less likely to trade across borders. They are, by definition, less likely to be significant participants in specific EU geographic or product markets. Their capacity to distort the internal market is, by definition, minimal.

The EISA believes that the reforms in the Risk Finance Guidelines did not achieve a streamlined system because of this focus on the “age” of the investment instead of its size.

The age of company test, as implemented by the UK, where the investee company is a group imposes an onerous obligation to ascertain when the first commercial sale of the investee group took place. This task is complicated because subsidiaries, which themselves may have acquired businesses, have either joined or left the investee company group. The test also takes into account a line of business which may have ceased long ago. This requires extensive due diligence and is a barrier to receiving investment.

Establishing the age of a business can be particularly difficult where companies or businesses may have been disposed of by the investee group prior to the State aided investment and the investee company no longer has access to the relevant information or staff members.

The guidance issued by HMRC in relation to this aspect of the test illustrates the difficulties:

“The rules look at all the businesses of every company that has ever been a member of the investee company’s group including businesses or parts of businesses acquired by any of the companies and take the earliest possible date of all those companies and businesses as the date of the first commercial sale. In determining a company’s first commercial sale, it does not matter that it or its subsidiaries may be, or may have been, carrying on different activities.”

If an investment is made in a company which subsequently turns out to have failed the age limit test, for example, because at one time the investee company had a subsidiary, which it subsequently disposed of, which had acquired a business with an earlier date of first commercial sale, then means that the investment is non-qualifying. The potential severity of the consequences of making a non-qualifying investment can deter individuals from making the investment.

The age of a company, in itself, is not a robust indicator of whether or not it has the capacity or knowledge to scale up its production and therefore may not act as a proxy for its ability to secure bank financing. Indeed, market changes may create the opportunities for expansion for companies that have previously been operating for a number of years which require external finance. This is confirmed by paragraph 73 of the Risk Finance Guidelines which states:

"The General Block Exemption Regulation covers SMEs which receive the initial investment under the risk finance measure before their first commercial sale on a market or within seven years following their first commercial sale. Only follow-on investments are covered by the block exemption beyond this seven-year period. However, certain types of undertakings may be regarded as still being in their expansion/early growth stages if, even after this seven-year period, they have not yet sufficiently proven their potential to generate returns and/or do not have a sufficiently robust track record and collaterals. This may be the case in high-risk sectors, such as the biotech, cultural and creative industries, and more in general for innovative SMEs. Moreover, undertakings that have sufficient internal equity to finance their initial activities may require external financing only at a later stage, for instance to increase their capacities from a small-scale to a larger scale business. This may require a higher amount of investment than they can meet from their own resources." [Emphasis added]

Consequently, the EISA recommends that the age of company test should be replaced with a test based on size of the investee company. The EISA recommends that that size should be the gross assets of the investee company.

The EISA also recommends that size should not be determined by reference to employment, since the focus of risk finance investment should be on creating employment regardless of the age of company, in line with EU employment targets.

Detailed Recommendation 3

Reduce the admin burden

Focusing on the administration and paperwork involved in EIS investments would be a good place to start. The scheme is far too complicated for most private investors to understand and can leave a negative impression after making an EIS investment.

EIS investors have experienced delays in being able to claim income tax relief when investing through EIS approved and unapproved funds and only being able to claim relief on the amount invested in the underlying company, which, due to management fees and other costs, is not 100% of their subscription to the fund. Under current rules, relief for EIS investment through an EIS approved fund is given only after 90% of funds have been invested when most investors have already closed their tax affairs for the relevant tax year and paid the tax. They then have to make a backdated claim one to two years later. Again as the OTS notes:

"Although HMRC approve straightforward cases quickly, initial investors in SEIS, EIS and VCT schemes often have to wait a long time to receive the documentation needed to claim the relief on their tax returns. There are a number of stages in the process of obtaining this documentation, and the OTS considers that this area would benefit from an in-depth review with a view to identifying options to streamline the process. As a result of the lengthy process, individuals' tax returns sometimes have to be submitted before the documentation has been received to meet filling deadlines. This means that the tax relief cannot be claimed at that point. Investors may have to amend their tax returns later and submit additional forms to claim the relief once they receive the relevant documentation."

Introducing a simplified fund investment process where tax relief is received far quicker and with only one certificate required. Consistency in the administration of these funds by regulators would provide more certainty and a better environment for investors. This would reduce the time it takes to get cash into companies, and would reduce the resources HMRC has to dedicate to the service. Consideration of a vehicle that provides upfront tax relief that helps investors with the timing of their investment and more certainty over when they can expect to receive tax relief.

Detailed Recommendation 4

Requirement for a business plan

Under the risk finance aid provisions of GBER, an exception to the basic age limit is granted so that that risk finance aid may also cover follow-on investments made in eligible undertakings, including after the 7-year period if the possibility of follow-on investments was foreseen in the original business plan.

This is unduly restrictive. A business plan may evolve over time and the needs of the business may not have been foreseen at the time the original business plan was drawn up. If the age limit test is retained, the AIC recommends that the requirement for the follow-on investment to be envisaged in the business plan be deleted.

Detailed Recommendation 5

Lifetime limit

The Risk Finance Guidelines impose restrictions on the total State aided investment that may be received depending on whether it is a SME or innovative mid-cap. This total limit is too restrictive and complex to assess. It can inappropriately prevent further investment to scale up the business.

The EISA recommends that this restriction be removed. Instead, the size of the investee company at the time of investment, i.e. the gross assets of the investee company or whether the investee company is an SME or innovative mid-cap at the time of investment, be the determining criterion.

Detailed Recommendation 6

Requirement for new or geographic market

Under the risk finance aid provisions of GBER, an exception to the basic age limit is also granted to companies entering a new product or geographic market which require a risk finance investment which, based on a business plan, is higher than 50% of their average annual turnover in the preceding 5 years. This exception is unduly restrictive.

If the age condition is retained, the EISA recommends that no financial hurdle be imposed on the entry into the new product or geographic market. Further, the EISA recommends that the “new product” and “new geographic” market be interpreted in accordance with general concepts of competition law, such as market definition assessments.

Detailed Recommendation 7

Replacement capital

The GBER recognises that as businesses scale up, there is a need for replacement capital. The European Commission recognised within their review of risk finance state aid that allowing replacement capital combined with an injection of development capital would better reflect market practices. The European Commission also recognised that by making it easier for investors to exit would in turn give them a bigger incentive to invest at an earlier stage. The EISA recommends that the State aid Risk finance guidelines include a similar provision allowing replacement capital in moderation which complies with state aid rules objectives.

Detailed Recommendation 8

Committing to EIS & SEIS beyond 2025

A provision in each of the 2015 Summer Finance Bill schedules (a condition for state-aid approval) introduced the inclusion of a sunset clause, intended to restrict tax relief to shares issued before 6 April 2025. There is a provision which allows that date to be amended by Treasury order.

We seek ministerial assurances that every effort will be made to ensure the continuation of both reliefs and provide maximum advance publicity to any enforced shortening of the life expectancy of the two reliefs. Tax incentive design should recognise that governments rarely, if ever, have the necessary resources and information to successfully target support to specific firms, sectors or technologies. Instead, tax incentive design should target entrepreneurial firms based on a number of criteria, such as age and size (financial and headcount)[4]. EIS & SEIS fulfils this aim as recognised by the EU who studied 46 tax incentive schemes across Europe. The benchmarking component of this study ranked all tax incentives observed in the country sample according to good practice in their design in order to inform policy discussion on best practice. The two highest ranked schemes are United Kingdom's Seed Enterprise Investment Scheme and Enterprise Investment Scheme.[5]

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4. Scale Up Institute and Beauhurst, Scale Up Index 2019. *http://bit.ly/38qxJe4*
5. HMRC Research Report 355 - The Use And Impact Of Venture Capital Schemes - February 2016 *http://bit.ly/2UR8T2P*

Detailed Recommendation 9

Remove investor restrictions

To further expand the pool of investment, the Government should investigate implementing the recommendation of Patient Capital Review's Industry Panel to remove the "Controlling Party" restriction that investors cannot hold or control more than 30 per cent of the shares or by receive paid employment as directors or employees. Consideration should also be given to relaxing the rules preventing the parents and family members of small business owners from investing in their businesses. This would open a new avenue of retail capital.

As the OTS note *"The absence of any immediate tax relief for the capital contributed by the start-up owner contrasts sharply with the plethora of tax reliefs that are available to subsequent investors".*

Detailed Recommendation 10

Raising consciousness amongst entrepreneurs and investors of EIS & SEIS

The British Business Bank's Small Business Finance Survey 2019[8] shows encouraging signs that awareness amongst SMEs of external forms of finance increasing as is awareness of who to approach for specific funding but there is still work to do to ensure entrepreneurs are properly educated about all the available funding options open to them.

In 2017, the Business, Energy and Industrial Strategy Committee recommended that *"the Government directs resources towards promoting the SEIS, EIS and VCT schemes. This includes the British Business Bank working with HMRC to consider how to improve promotion of the schemes."* Whilst the British Business Bank and the Government committed to explore ways to raise awareness of the schemes, we believe more can be done to raise the profile of EIS & SEIS to companies seeking much needed equity finance including involving a far wider range of business support agencies such as LEPs, Universities and the IOD.

Additionally, 37,350 individuals invested in EIS in 2017/18[9] . Yet there are estimated to be a quarter of million taxpayers earning in excess of a quarter of a million pounds a year and almost 350,000 earning more than £150,000 per annum. Because tax incentives reduce the effective marginal cost of investing in smaller companies, in theory, more individuals should be willing to invest more capital to smaller companies through EIS & SEIS thereby benefitting from tax incentives, and at lower before-tax expected rates of return if they are aware of the schemes. The potential therefore for more individuals' capital to be deployed in EIS & SEIS is huge and represents a significant, untapped source of investment. More should be done to promote the schemes to High Net Worth individuals and Independent Financial Planners.

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8. British Business Bank, Small Business Finance Survey 2019 *http://bit.ly/2HnSjjs*

9. Business, Energy and Industrial Strategy Committee, Small businesses and productivity, Fifteenth Report of Session 2017 *http://bit.ly/2Ssn11b*

Appendix
EIS & SEIS The Details

Appendix

EIS for Investors

Investors can invest up to £1M (£2M in a knowledge intensive company) a tax year in new shares in EIS-qualifying companies to benefit from income tax relief at 30% of the amount invested.

- In order to retain income tax relief, you must hold the shares for a qualifying period of at least 3 years, starting from the date of the investment or the date the company begins trade if later.
- After the qualifying period you may benefit from capital gains tax disposal relief on any shares disposed of at a profit.
- You may also offset any losses on disposal of the shares, either against capital gains or (in some cases) against income, net of any income tax relied retained.
- You can also defer an existing capital gains tax charge if you re-invest the gain in EIS-qualifying shares.

Appendix

EIS for Companies

To be eligible for EIS investment, a company must meet all of the conditions, including:

- It must have fewer than 250 employees at the time of investment (or fewer than 500 for a ‘knowledge intensive’ company).
- It must have no more than £15m in gross assets at the time of the investment.
- It must not be quoted on a recognised stock exchange.
- It must not be controlled by another company.
- Generally its trade must not be more than seven years old at the time of the first EIS investment (ten years for a ‘knowledge intensive’ company).

The above rules apply to the group if the company is part of a larger group.

Shares issued under EIS must be ordinary non-redeemable shares, with no preferential rights to assets in a winding up and limitations on preferential rights to income. Additionally, a company must not raise more than £5m finance in any 12 month period (unless it is a ‘knowledge-intensive company which, from 6 April 2018, can raise £10m in a 12 month period) or a total of £12m through any combination of EIS and Venture Capital Trust investment (and certain other publicly funded support). For a ‘knowledge intensive’ company, the total lifetime funding cannot exceed £20m.

Appendix

SEIS for Investors

Investors can invest up to £100,000 a tax year in new shares in SEIS-qualifying companies to benefit from income tax relief at 50% of the amount invested.

- In order to retain income tax relief you must hold the shares for a qualifying period of at least 3 years.
- After the qualifying period you may benefit from capital gains tax disposal relief on any shares disposed of at a profit.
- You may also offset losses on disposal of the shares, either against capital gains or (in some cases) income, net of any income tax relief retained.
- You and your associates must not be connected with the company by employment (although directors may qualify), or have more than a 30% stake in the company. The relief is also subject to some anti-avoidance rules.
- You can also write off up to half of an existing capital gains tax charge if you re-invest the gain in SEIS-qualifying shares.

Appendix

SEIS for Companies

To be eligible for SEIS investment, a company must meet all the conditions, including:

- It must carry on a 'new qualifying trade', being one which has not been carried on by either the company or by any other person for longer than two years at the date of issue of the shares; and where neither the company nor any qualifying subsidiary had carried on any other trade before the company in question began to carry on the new trade
- It must have fewer than 25 employees.
- It must have no more than £200,000 in gross assets.
- It must not be quoted on a recognised stock exchange.
- It must never have been controlled by another company.

The above rules apply to the group if the company is part of a larger group.

Shares issued under SEIS must be ordinary non-redeemable shares, with no preferential rights to assets in a winding up and limitations on preferential rights to income. Additionally, a company cannot raise more than £150,000 finance in total through SEIS (and certain other publicly funded support also has to be taken into account). Additional later fundraising may qualify EIS.

eisa.org.uk

If any members would like to organise events with the support of EISA please contact Member Services on **info@eisa.org.uk**