

Venture Capital Schemes: Association of Investment Companies submission, part 2

The Association of Investment Companies (AIC) welcomes the opportunity to comment on HMRC's proposal to introduce a new investment condition for VCTs based on the EC Small Enterprise definition.

As noted in previous representations, we are opposed to the introduction of this new rule. Given our concerns, we wholeheartedly welcome the recent announcement that, if any new legislation is introduced in this area, it will be applied only to VCT funds raised after the announcement of the detail of any legislation. This will protect existing VCT funds from the negative outcomes we envisage will arise if the rule is introduced. Nevertheless, the AIC also **recommends** that the proposed change should be entirely withdrawn – and not applied to newly raised VCT funds – and that alternative measures are instead used to address any concerns HMRC may have with the targeting of VCT investment.

The AIC represents 92 VCTs which account for some 90% of the assets of the sector. These VCTs play an invaluable role in providing investment for UK small and growing companies, which traditionally struggle to secure development capital. This, in turn, supports employment and economic development within the UK. HMRC should not introduce changes to the VCT scheme which threaten these outcomes.

Problems for the investment process

Changing the definition of eligible investments by introducing the proposed 'size of business' rules based on the EC SME definition would create significant problems for VCTs investing under those conditions. These include problems:

At the time of the investment. The proposed definition would mean that calculations of assets, headcount etc would include contributions from entities which are separate from the investee company itself.

These separate entities could include 'partner enterprises' which are only linked with the company seeking investment because an existing shareholder owns a significant stake in another business. This might be a family concern or a business they are otherwise active in. VCT investment should facilitate serial entrepreneurs but this rule could prevent companies receiving investment where they have a shareholder with a variety of commercial interests. (This link with another company is likely to be primarily financial if a manager of the investee company is the shareholder in question as the VCT would expect such individuals to be actively involved in the potential investee business on a full-time basis.)

In theory the VCT could require that such shareholdings should be sold as a condition of providing capital. This would be a significant hurdle to securing a deal, if it was possible at all. In many cases there may not be ready purchasers for these shareholdings. Where a shareholding could not be sold, and a partner enterprise was created, a proportion of that business' staff and balance sheet total will be added to that of the investee company before an assessment of its eligibility as an investment was made. This could mean that a potential investee company fails to meet the required size thresholds, even where the relationship between it and another entity does not involve a substantive commercial link and raises no concerns from a public policy perspective.

It should be recognised that the existence of a partner enterprise created by virtue of a shareholding in another company does not raise questions over the effectiveness of the targeting of the VCT relief. That is, there should be no concern that the shareholder should be able to secure financing independently of the VCT. These interests will not necessarily provide security/collateral for loans to the potential investee company. They may be difficult to value. There may also be significant hurdles to be overcome before they could be liquidated (if that were required by the lender). Also, they may involve shareholder structures or agreements which would prevent shares being used in this way. All of these factors may make it difficult for these interests to be used as collateral, but even if this option were viable, it is far from clear that it would be desirable to tackle the finance gap by expecting financial liabilities to be shared between small companies in this way.

'Linked enterprises' can also influence the eligibility of an investee company. A number of commercial relationships could link an enterprise to an investee company for the purposes of the legislation.

Which relationships would create a linked enterprise is unclear, but we envisage this could include a contract for the supply of services. This creates difficulties as it is in the nature of potential VCT investee companies that they are immature. Consequently they may have only one, or very few, key clients or critical suppliers. These entities may have a significant influence over the operation of the company. Examples might be a small company supplying a major supermarket; a healthcare business providing services to the NHS, a bio-tech company working with a large pharmaceutical company, or a specialist firm selling into any highly concentrated market (e.g. a provider of accounting software seeking to deal with the 'big four' accounting firms). In all these circumstances the counterparty might be deemed to have a significant influence, even dominance, over the investee company. They may well have the ability to influence price, supply terms, quality, product features etc. Despite these relationships these enterprises should be suitable targets for public policy support through the VCT scheme. Indeed, they may be especially in need of VCT funding as businesses with concentrated operations may face more

difficultly securing finance from traditional sources, such as banks, than other companies with more diverse, and therefore less risky, customer bases.

Concentrated contractual relationships, with the potential for a dominant influence, represent a normal phase in the development of many small businesses. Indeed, if an investee company has concentrated relationships of this kind, a priority identified by a VCT will often be to diversify the customer base and develop its internal arrangements to increase its commercial flexibility and autonomy. VCT investment will, therefore, help weaken relationships which create linked enterprises but this outcome will not arise if they are prevented from investing in the first place. Nevertheless, at the time of investment these relationships could create linked enterprises for the purposes of the envisaged test. This would mean that the entire headcount and balance sheet total would be included in the calculation of the size of the investee company/enterprise'. This could rule out a significant number of companies from securing VCT investment – despite the fact that these relationships are not inherently problematic from a public policy perspective and do not compromise the intentions of the VCT scheme.

The problems inherent in assessing an investment proposition where the enterprise test was in place would be raised repeatedly for VCTs as they often invest sequentially in a business. That is, they provide follow-on funding to support the ongoing development of the business.

The negative impact of the linked enterprise test is further increased because it is fundamentally uncertain. An assessment of dominance is not straightforward. The new test will make it extremely difficult for VCTs and their managers to take a view on the eligibility of potential investments. This will increase the cost and duration of due diligence. It will increase the likelihood that otherwise eligible deals will not secure HMRC approval. Each failure of this nature will increase the expense of investment. Also, the costs of HMRC's internal processes will increase and the guidance it provides may be less certain. It may take a prudent approach which would mean that businesses deserving of VCT support may fail to secure it. Given these difficulties it may be that HMRC will not be prepared to provide advance assurance of whether or not enterprises are linked. All these factors will make investment more difficult and undermine the ability of VCTs to provide funds when and where they are required.

By restricting the commercial development of the investee company. The proposals envisage that a 'relevant change' occurring within an investee company will require a reassessment of whether or not it remains a qualifying investment. The possibility that a shareholding might become non-qualifying after investment represents a threat to VCT status and substantially increases the risks of investment. It is unclear that this risk will be manageable without damaging the fundamental purpose of the scheme, that is, fostering the commercial development of smaller companies.

To protect against losing its qualifying status a VCT might require, as a condition of investment, that no relevant change is allowed which will make the company a non-qualifying holding. Unfortunately this would restrict the company's normal commercial development. It could prevent the acquisition of a business designed to enhance the company's market share, product offering or research and development capacity years after the original investment has been made. It might preclude the negotiation of contracts to supply the company's services to an important customer. This could involve, for example, a contract to supply a major distribution outlet such as a supermarket which would normally be a significant commercial coup for a growing company. The relevant change provision restricts commercial activity which would otherwise deliver benefits to the business but which could create a 'linked-enterprise'. These consequences threaten the public policy benefits provided by the VCT scheme.

Taken together these changes will create a massive upheaval for the investment prospects of VCT funds raised after the new rule was introduced and could substantially limit the range of companies which can secure development capital. This should not be an acceptable outcome and has not been justified in policy terms.

Policy concerns

Using the EC SME definition to determine whether or not companies are eligible investments changes the overall policy intention of the VCT scheme. It is not simply a matter of adjusting the targeting: it threatens to disrupt the entire policy impact.

Reducing funding options for smaller businesses: The new definition will narrow the range of investable businesses. It will exclude those with certain links to other commercial enterprises, even though there has been no discussion of whether or not these links have any influence on the existence of a finance gap affecting smaller growing companies.

For example, no evidence has been advanced as to whether or not such linkages have any meaningful influence on the ability of existing owners to secure finance from other sources. Our view (as expressed above) is that this is unlikely to be the case. A key factor influencing the finance gap in current market conditions is that banks have limited their exposure to the small business sector. Therefore even if shareholders in companies seeking funds could use these other interests as collateral, which we doubt, we are unclear that lenders would find this security attractive. After all, accepting these shareholdings as collateral would simply mean allocating their exposure to the small business sector in a different manner. It would not necessarily provide the basis for increasing their exposure. The ultimate outcome would not be the provision of more funding to smaller companies so the existing funding gap would persist.

Increasing the risks of VCT investment: The attraction of the VCT investment proposition depends on a suitable balance between risk and return. Over the duration of the scheme the appetite for exposure to VCTs from retail investors has been influenced by changed perceptions of the risks. For example, when these risks have been offset to a greater extent by higher tax incentives, the scheme has seen higher applications for shares. When these tax incentives have been reduced, smaller amounts of capital have been allocated to this asset class. The market is, rightly, attuned to changes in the balance of risk and reward. Clearly many factors can change the balance of risks inherent in VCT investment, including changes to the scheme rules.

Rule changes in recent years have been driven by the demands of the State Aid approval process. The Government has rightly sought to limit these to maintain as far as possible the character of the VCT scheme. With the notable exception of the headcount test (which has cut off investment opportunities, particularly on the AIM market) it has largely achieved this. Unfortunately, the adjustments now proposed by HMRC threaten this record. Narrowing the pool of investable companies by seeking to take account of their links with other businesses is a fundamental change to the scope of the scheme. The same is true of making the eligibility of investments contingent on activities which may arise after the transaction is completed.

The relevant change condition is particularly egregious as it threatens the loss of a VCT's overall tax status in a period which has traditionally been without risk to this position. The failure of an investment to maintain its eligibility under the VCT rules, which then undermines the overall tax position of the VCT, would inevitably lead to its wind up and have significant knock on effects for other portfolio companies as well as the VCT's own shareholders. The proposed change creates fundamental changes to the balance of risk and reward within the VCT scheme in ways which the AIC is concerned have not been properly appreciated.

Proportionality: We understand that the targeting concerns which led to the proposed changes being advanced have arisen mainly in the EIS market and that these have been addressed through targeted changes to the EIS rules which govern investment in partnerships. Problems in the VCT market have been limited. One actual example of poorly targeted investment activity, albeit one worthy of concern, has been raised by HMRC in our discussions on this matter. However, given the problems that the proposals create in the VCT market and the limited extent of poorly targeted investment activity, introducing the rules for all newly raised funds is a disproportionate policy response.

This is particularly the case as the change creates problems for VCTs at a time when broader market conditions, including the withdrawal of banks from small business lending and persistently challenging trading conditions, make the need for an alternative source of development capital more acute.

Evidence-based policy making: At the heart of our concern is the lack of evidence on 1) the need for a change, 2) the impact it would have on the number of potentially investable companies, 3) how the risk profile of the VCT scheme would be altered and 4) the overall implications for the ability of VCTs to address the finance gap.

In the absence of evidence on these issues we **recommend** HMRC should consider if their concerns about targeting could be addressed in a different and less potentially disruptive way.

An alternative approach

The example of poorly targeted VCT investment cited by HMRC in our informal discussions on these proposals involved arrangements which used contracts between a VCT portfolio company and a larger business to allow the larger company to gain the benefits of lower-cost capital (because it was supported by the VCT scheme). The concern was that the larger company should not have been able to benefit in this way and that the arrangement did not create any additional economic activity. The AIC believes that this matter could be addressed by using mechanisms which already exist within the VCT rules.

In particular, the VCT rules already include a requirement that a company eligible for investment must be engaged in a qualifying trade which is carried out on a commercial basis. The AIC **recommends** that rigorous application of the current 'commerciality' criteria offers the best means of ensuring the proper targeting of VCT investment without undermining the broader operation of the scheme. In practice, VCT investment will only be carried out with prior approval from HMRC. This gives HMRC the ability to assess potentially problematic arrangements – and reject them if necessary. Certainly, arrangements such as those described above should be caught by such an assessment in the future now that HMRC has identified this area as a concern.

To assist in this process of assessing commerciality, the AIC also **recommends** that HMRC should consult on, and publish, guidance on arrangements which create concerns. This would set out details of the questions which would have to be satisfactorily addressed by a VCT about the structure of a portfolio company's operations for approval to be granted. This will ensure that HMRC's targeting concerns are addressed in a proportionate manner which does not disrupt the wider operation of the VCT scheme. The AIC would be pleased to work with HMRC to assist in the preparation of such guidance.

11 March 2010

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