

Amendments to the main venture capital reliefs

(Lecture B1062 – 23.37 minutes)

Following the consultation issued by the Government in response to the Patient Capital Review, it was acknowledged that high-growth innovative businesses require significant levels of upfront capital and come with the downside that the risk of loss to the investor is proportionately greater than it is for most other investments.

Knowledge-intensive companies

Legislation has been introduced by Cl 16 and Sch 4 F(No2)B 2017 further to encourage investment in knowledge-intensive companies (see S331A ITA 2007 for a detailed definition of this term) via the EIS and VCT regimes. With effect from 6 April 2018:

- the maximum amount which an individual may invest under the EIS in any tax year is being doubled from £1,000,000 to £2,000,000 as long as at least £1,000,000 is invested in one or more knowledge-intensive companies (if less than £1,000,000 is invested in knowledge-intensive companies, the EIS limit for that year becomes £1,000,000 plus the actual amount invested in knowledge-intensive companies);
- the annual limit for knowledge-intensive companies receiving money under the EIS and from VCTs will be raised from £5,000,000 to £10,000,000 (note, however, that the lifetime limit is unchanged at £20,000,000); and
- if knowledge-intensive companies so elect, they are to be allowed to use the date when their annual turnover first exceeds £200,000 – this will normally be the last day of the relevant accounting period – in determining the start of the initial investing period under the 10-year maximum age test instead of the date of their first commercial sale.

These add to the incentives already available for knowledge-intensive companies.

Risk-to-capital condition

Encouraging more investment in knowledge-intensive companies seeks to redirect capital away from low-risk qualifying investments. The Government intend to legislate to ensure that all the main venture capital reliefs are targeted at growth companies. In the words of HMRC:

‘Relief under the schemes will be focused on companies where there is a real risk to the capital being invested and will exclude companies and arrangements intended to provide “capital preservation”.’

For investments made on or after 6 April 2018, a new condition set out in Cl 14 F(No2)B 2017 will become part of the EIS, SEIS and VCT rules (the ‘risk-to-capital condition’). Tax-motivated investments will henceforth be excluded where the tax relief provides most of the return for an investor and where there is only a limited risk to his original investment.

This risk-to-capital condition has two parts:

1. whether the company has objectives to grow and develop over the long term (which broadly mirrors an existing test); and
2. whether there is a significant possibility that the investor could suffer a loss of capital of an amount greater than his net investment return.

As already mentioned, the Government want the main venture capital schemes to be focused on support for companies with high growth potential. There is clear evidence that a significant subset of recent EIS investments concentrated on capital preservation. The risk-to-capital condition is described as 'a principled approach that enables the Government to avoid excluding certain specific types of activity, which (could) risk excluding genuine entrepreneurial businesses, whilst reducing the opportunity to use the schemes for tax-motivated investment'.

On 4 December 2017, HMRC published draft guidance in connection with the risk-to-capital condition. This can be found in Paras VCM8500 – VCM8560 of the Venture Capital Schemes Manual. When considering whether both parts of the condition above are met, HMRC will take into account all factors which are relevant to the company at the time when the investment is made. The following is a non-exhaustive list of such factors:

- the extent to which the company's objectives include increasing the number of its employees or the turnover of its trade;
- the nature of the company's sources of income, including the extent to which there is a significant risk of the company not receiving some or all of the income;
- the extent to which the company has, or is likely to have, assets which could be used to secure financing from any person;
- the extent to which the activities of the company are subcontracted to persons who are not connected with it;
- the nature of the company's ownership structure or management structure, including the extent to which others participate in or devise the structure;
- how any opportunity for investment in the company is marketed; and
- the extent to which arrangements are in place under which opportunities for investments in the company are, or may be, marketed alongside opportunities for investments in other companies or entities.

The guidance includes various practical illustrations of how HMRC will apply the new risk-to-capital rules.

Illustration

Pembroke Research Ltd is a company set up by Cambridge postgraduate students to exploit their research which they expect will eventually have wide commercial value. They have hitherto been using university facilities, but they now need their own laboratory.

The directors prepare a business plan, but, as the project is high-risk and long-term and as Pembroke Research Ltd has no track record, the company is unable to attract investment from the market. Fortunately, the company manages to secure initial investment under the EIS from members of an angel syndicate and a fund manager acting as nominee for a number of individual investors. A schedule of follow-up funding is agreed for the next five years. The directors maintain a majority interest in the company. The company uses the money to build and equip a small laboratory and to employ a technician. It expects to expand the laboratory and employ more technical and administrative staff over the course of the next five years.

How the risk-to-capital condition might apply:

- Taking the above information into account, it looks as though Pembroke Research Ltd will meet the risk-to-capital condition provided that all other eligibility requirements are satisfied.
- The directors are entrepreneurs who have established a company to carry on their own business. The angel syndicate, fund manager and any other promoters have not been involved in setting up the company – they have merely been approached by the entrepreneurs to consider putting money in as independent minority investors.
- The company intends to increase its employee numbers and in due course to launch a product on the market. This suggests long-term plans to grow and develop the company's business.
- There is significant risk for the EIS investors as, at the time of their investment, there is no certainty that a commercial product can be developed or will be successful.
- When making a decision about whether the investment meets the risk-to-capital condition, other relevant factors may have to be considered along with those above.

HMRC have stated that they will decline to provide any advance assurance in connection with investments which, taking into account all the facts available to them, appear likely to fail the risk-to-capital condition.

Further VCT measures

Additional measures specific to VCTs have been introduced by Cl 17 and Sch 5 F(No2)B 2017, to include the following:

VCTs will be required to invest 30% of funds raised in an accounting period beginning on or after 6 April 2018 in qualifying holdings within 12 months from the end of the relevant accounting period.

With effect from 6 April 2019, the time limit for VCTs to reinvest their investment gains will double from six months to 12 months.

With effect from 6 April 2019, the proportion of VCT funds that must be held in qualifying holdings will increase from 70% to 80%.

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