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# APPG FOR ENTREPRENEURSHIP TAX REFORM



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**RT HON LIAM BYRNE MP**

Shadow Minister (Digital Economy)  
and Chair of the APPG for  
Entrepreneurship

The All-Party Parliamentary Group exists to encourage, support and promote entrepreneurship. Through events and research, it ensures Parliament is kept up-to-date on what is needed to create and sustain the most favourable conditions for those who take risks and strike out alone. An important part of what we do is working closely with experts and entrepreneurs to establish the barriers to starting and scaling up and examine how best they can be broken down.

In 2017/18, we approached two policy streams: Tax Reform and Women in Leadership. With our Secretariat, The Entrepreneurs Network, and our sponsors Octopus, we launched a Call for Evidence, asking the country's leading academics, relevant organisations and policy experts for their views on these specific issues.

Their responses, in addition to extensive research and a survey of over 500 entrepreneurs, formed the basis for these two short reports, which will be disseminated among politicians, the media and business owners. Currently, Britain sits in fourth place on the ranking of top countries for entrepreneurship. We hope that these reports will mark the start of new action by the government to ensure Britain becomes the best place in the world to start and grow a business.

**COLIN CLARK MP**

Officer, APPG for Entrepreneurship

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Modern entrepreneurs and founders of the future should be focused on new ideas that drive the economy and create jobs. The tax system can – and should – be designed to encourage enterprise. It must be simple, with a view to boosting startups and scale-ups.

I was 24 years old when I bought my first company in 1994, as part of a Management Buyout. Over a decade later, I sold the company, in part motivated by taper relief that encouraged investment.

Small companies drive research and development, but need support and direction to maximise the incentive of a well-designed tax system.

I have experienced the rapid growth and cash pressures of growing companies. Cash is king. Companies must be incentivised to take a long-term view and the tax system can relieve cash pressures while encouraging long-term investment.

I was fortunate to attract venture capital backing in 1994 and, with constructive tax policies, we can drive investment into established and budding entrepreneurs.

The Treasury and HMRC must play their part in ensuring policy has longevity and is not open to gaming. In my 28 years' experience in business, nothing is more sobering than an HMRC investigation. Instead of imposing flashy policies, the Treasury must applaud those willing to take risks.

Let's seize the day and back our entrepreneurs.

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**“Let's seize the day and back our entrepreneurs.”**



**CHRIS HULATT**  
Co-Founder, Octopus

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In order for businesses to start up, scale up, and succeed, it is critical that the tax environment in which they operate is fit for purpose. At Octopus, we see tax reform as getting the groundwork right – only then can the foundations be successfully laid and built upon.

As one of Europe's most active investors in young, innovative businesses, Octopus knows how tax affects a business at every stage of its growth.

We are therefore delighted to work with the All-Party Parliamentary Group (APPG) for Entrepreneurship to explore these issues, and how the Government can help entrepreneurs turn their idea into a success.

This report accurately highlights how the tax system directly impacts on the incentives of entrepreneurs to start up and grow their business – high taxes and a complex system actively discourages entrepreneurs. We therefore wholeheartedly support the report's call for regular public evaluations of key tax reliefs by the Treasury, and for measures to increase the awareness of business tax reliefs. These moves would ensure the country's tax code is able to keep pace with the changing economic landscape and innovative business models.

We also fully endorse the APPG's calls for a further reduction in the complexities associated with business taxation, with such measures as the transformation of Business Rates into a Commercial Land Tax. Octopus has invested in over 500 SMEs and encourages any opportunity to reduce the bureaucratic burdens they face. Of course, without capital, these businesses would not be able to get off the ground, and Octopus fully supports the recommendations to unlock investment by both exploring the option to launch an Unlisted Shares ISA, and to further expand EIS to a wider range of investors.

Octopus is keen to work with Parliament and Government to improve the policy environment and ensure a fair tax code that helps Britain's creative and driven entrepreneurs to reach their potential and thrive in global markets.

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**“High taxes and a complex system actively discourages entrepreneurs from starting a business.”**

# INTRODUCTION

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The tax system affects entrepreneurs at every stage of growth, from startup to exit. There are a numerous tax reliefs and incentives designed to support businesses each step of the way. They range from the Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS), and Venture Capital Trusts (VCT) to support early-stage businesses to the Annual Investment Allowance (AIA), R&D Tax Credits, and the Patent Box to encourage investment and research, all the way to Entrepreneurs' Relief to lower the tax burden for successful entrepreneurs. Yet, the tax code can also discourage entrepreneurship, create unnecessary barriers to growth, and increase administrative burdens. At a time when the public finances are under constant pressure, many will ask if existing support for entrepreneurs represents value for money.

The purpose of this report is limited. We are not designing an ideal tax code or proposing root and branch reform of the tax system. Our focus is on ensuring that the taxes, reliefs, and incentives that directly affect Britain's ambitious business-owners are fit for purpose. The report will focus on three key factors.

1. Effectiveness: Is the tax code supporting entrepreneurship in a cost-effective way and if not how can we change this?
2. Awareness: Are entrepreneurs aware of all the existing reliefs they can take advantage of?
3. Complexity: Where can we best reduce the administrative burden on business through tax simplification?

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 distributionally-neutral: where there are costs to the exchequer they are kept to a minimum.

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## PRINCIPLES FOR TAX REFORM

Markets are effective at allocating resources and incentivising innovation. High profits in one market incentivise entrepreneurs to enter the market and compete, and high prices send a signal to entrepreneurs to find ways to reduce costs or produce new substitutes. In general, tax systems should be designed to minimise distortions that interfere with this process. Economists are typically critical of tax reliefs that give special treatment to favoured industries or interest groups.

But contrary to popular belief, economists do not subscribe to the view

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**“Tax systems should be designed to minimise distortions.”**

that we should simply “broaden bases and lower rates”, but rather that we should, as the Institute for Fiscal Studies’ Helen Miller puts it, “tax all income and deduct all costs of generating taxable income”.<sup>1</sup> This is because taxing intermediate goods (inputs) distorts production processes and penalises delayed consumption.

Deviations from broad-based taxes on income (minus the cost of income generating assets) should typically be avoided. But they can be justified when markets fail or are missing. For example, taxes on tobacco distort behaviour by design with the aim of pricing in the external costs of smoking. Similarly, the benefits of R&D are thought to “spill over” to other firms. As the firm is unable to capture the full benefits of investing in R&D they under-invest relative to the socially optimal level.

Another case of market failure is asymmetric information. For instance, there is an unequal access to information in the market for SME finance. Viable young businesses may struggle to access finance as they are unable to provide evidence of financial track record or offer collateral. The inability to provide this information means venture capital firms must carry out extensive due diligence on startups. This creates significant transaction costs (between £20,000 and £50,000) contributing to an equity funding gap for investments under £5m (higher for knowledge-intensive firms).<sup>2</sup>

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## UNDERSTANDING ENTREPRENEURS

Each year over 600,000 new businesses are formed. The entrepreneurs behind those startups will interact with the tax system in a number of ways as their companies mature. It is important to understand the specific needs of entrepreneurs at each stage of business growth.

Entrepreneurs tend to run losses as they experiment with business models. In the first 18 or so months, managing cashflow is vital.<sup>3</sup> Accessing finance is key and most entrepreneurs will rely upon tax incentives to attract equity investment initially through SEIS, EIS, and later through Venture Capital Trusts (VCTs). Once they develop a successful business model they may want to scale rapidly. This may involve hiring more workers, investing in new equipment, or renting larger office/retail space. They will need to pay Business Rates and Employers’ National Insurance Contributions. They may also take advantage of capital allowances, such as the Annual Investment Allowance (AIA) and First Year Allowances (FYAs), as well as R&D tax credits.

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1 Helen Miller (2018) “Tax reliefs: look for the tax design behind the big numbers” Institute for Fiscal Studies: <https://www.ifs.org.uk/publications/11692>

2 SME Access to External Finance (2012) BIS Economics Paper no. 16

3 Britain Unlocked: A Tax Code for Global Ambition, Institute of Directors/Grant Thornton (2016)

Policymakers should be especially interested in helping firms move from startup to scale-up. According to the Scale-Up Institute's Scale-Up Report, adding one per cent to the UK scale-up population could drive an additional 238,000 jobs and £38bn to Gross Value Added within three years. High-growth small businesses (scale-ups with annual turnovers of between £1m and £20m) are responsible for 20 per cent of all UK job growth and are more likely to invest in training.<sup>4</sup>

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**“Policymakers should be especially interested in helping firms move from startup to scale-up.”**

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<sup>4</sup> Defined as sustained (over three years) annualised growth (in turnover or employment) of 20 per cent

# RECOMMENDATIONS

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## THE TREASURY SHOULD REQUIRE REGULAR EVALUATIONS OF TAX RELIEFS

Tax reliefs are expensive. In 2015 the Resolution Foundation estimated that they cost the Treasury £108bn in lost revenue.<sup>5</sup> To put that into perspective, adjusting for inflation and growth, if tax reliefs were handled by a single department then it would be the third largest government department, ahead of education and defence.<sup>6</sup> This figure only includes reliefs designed to promote an economic and social objective, such as increasing the progressivity of the tax system (VAT Zero-Rating) or incentivising film production (Film Tax Relief). However, despite their relative fiscal importance, tax expenditures are rarely (with a few exceptions) evaluated by the Treasury or other relevant departments on whether they represent value for money.

Some tax reliefs are given proper scrutiny. The R&D Tax Credit is monitored by a specialist unit in the Treasury, and an HMRC evaluation published in 2015 assessed whether the R&D tax credit stimulated further R&D investment, finding “that for every pound spent on R&D tax credits, between £1.53 and £2.35 is additionally spent on R&D by UK companies”.<sup>7</sup>

Yet many tax reliefs go unanalysed and in some cases it is not clear what the underlying behavioural aim of the policy is. Helen Miller singles out Entrepreneurs’ Relief as an example of a tax relief with ill-defined objectives. In theory its function is to incentivise entrepreneurs to invest in their businesses, but the specific economic objective is poorly targeted. She states “it is not targeted at investment but at profits. It is available to many businesses that aren’t entrepreneurial but not available to entrepreneurs who cannot take their income in the form of capital gains. It distorts decisions over how income is received and incentivises tax motivated incorporation.”<sup>8</sup>

To improve our understanding of how entrepreneurs respond to tax reliefs, we surveyed 491 British entrepreneurs and asked them how beneficial they thought various tax breaks were. We found two fifths had not heard of the

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**“Many tax reliefs go unanalysed and in some cases it is not clear what the underlying behavioural aim of the policy is.”**

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5 This figure only includes tax expenditures designed to promote economic or social objectives, it does not include tax reliefs created for other purposes such as simplicity

6 But not larger than health or welfare

7 Her Majesty’s Revenue and Customs (2015) “Evaluation of Research and Development Tax Credit” <https://www.gov.uk/government/publications/evaluation-of-research-and-development-tax-credit>

8 Helen Miller (2018) “Tax reliefs: look for the tax design behind the big numbers” Institute for Fiscal Studies: <https://www.ifs.org.uk/publications/11692>



Patent Box, with only 5 per cent of entrepreneurs believing the policy to be beneficial to their business (compared to 27 per cent believing R&D Tax Credit was beneficial to their business). Analysis by the Institute of Fiscal Studies suggests that the policy is poorly targeted and creates complexity within the tax system. They argue that by targeting the income stream not the research itself, it is unlikely to stimulate research activity.<sup>9</sup>

Policies such as Entrepreneurs' Relief and the Patent Box ought to be regularly reviewed by the Treasury to test whether or not they achieve their behavioural objectives in a cost-effective way. For instance, the Treasury should report on whether or not the Patent Box led to a large increase in patent activity and measure the increase in patent activity against the fiscal cost to assess value-for-money.

We should replicate Canada's approach to reviewing and reporting on tax expenditures. Each year, the government of Canada is required to publish an annual Tax Expenditure Statement.<sup>10</sup> Currently, HMRC does publish an estimated cost of certain tax reliefs but as the Public Accounts Committee has highlighted the list is "poorly defined, incomplete and inaccurate."<sup>11</sup> Canada also includes in-depth reports on one or two tax expenditures in each annual expenditure report.<sup>12</sup> When carrying out in-depth reports the Treasury should prioritise the largest tax expenditures. We should replicate Canada's approach to reviewing and reporting on tax expenditures.

- The Treasury should annually publish accurate tax expenditure reports, which highlight the intended aim and fiscal cost of each tax expenditure.
- The Treasury should carry out rolling in-depth reviews of the most expensive tax reliefs to be published alongside the annual tax expenditure report.

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## **ALLOW BUSINESSES TO DEDUCT THE FULL COSTS OF CAPITAL INVESTMENTS FROM THEIR ANNUAL TAXABLE INCOMES**

When entrepreneurs find a formula that works, they will seek to expand rapidly. The path from startup to scale-up will differ sector-by-sector. Firms that specialise in manufacturing will invest in plants and machinery to increase production. However, the tax treatment of capital expenditures can deter productivity-boosting investments. Unlike other business

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9 Helen Miller, Rachel Griffiths, and Martin O'Connell (2011) "Corporate Taxes and Intellectual Property: Simulating the Effect of Patent Boxes" IFS Briefing Note 111, Institute for Fiscal Studies

10 This is also the case in Australia and New Zealand

11 Public Accounts Committee, The effective management of tax reliefs, March 2015

12 For example in the 2018 Report on Federal Tax Expenditures, the Department of Finance evaluated the Non-Taxation of Capital Gains on Donations of Publicly Listed Securities

expenses, capital investments generate income over a number of years. This is reflected in the corporate tax system, with firms being able to write off ordinary expenses immediately and being forced to write off capital expenses gradually as the asset depreciates.

However, economic theory suggests that this differential treatment will discourage investment, reduce output, and lower wages.<sup>13</sup> All things being equal, a firm would rather have an immediate tax benefit than the same tax benefit in instalments over a number of years. This is because the value of the future tax benefit will be eroded by inflation and the opportunity cost of not having the money available immediately for reinvestment.

In recent years, the overall value of capital allowances has fallen. While the UK's Corporation Tax rate is lower than many of our trading partners, our treatment of investment expenses is not. Over the past eight years successive governments have reduced the statutory rate of Corporation Tax from 28 per cent to its current level of 19 per cent.<sup>14</sup> But despite the recent rate cuts, the Marginal Effective Tax Rate on new investment is relatively unchanged.<sup>15</sup>

SMEs are able to benefit from the Annual Investment Allowance, which allows firms to immediately write off up to £200,000 worth of capital expenditure. One justification for the limited allowance is that it allows SMEs who may face capital constraints to access cash-flow. However, research from the manufacturers trade body the EEF found that the 13/14 rate of £250,000 only covered 60 per cent of investment by SMEs, while the 14/15 rate of £500,000 covered 75 per cent of capital investment by SMEs. The lack of certainty over the rate of the Annual Investment Allowance makes it hard to plan out capital investments, some of which may take place over a period of 3-4 years. Paul Johnson of the IFS points to "an absurd degree of inconsistency in the setting of the Annual Investment Allowance".<sup>16</sup>

There is a growing body of research that finds similar policies, allowing firms to write off capital expenses immediately, have large positive impacts on investment.

The Oxford Centre for Business Taxation found that a change in the qualifying thresholds for first year allowances (a reform similar to the annual investment allowances for small and medium sized businesses) led to an 11 per cent average increase in investment by qualifying firms (compared to similar non-qualifying firms).<sup>17</sup> A further study from the US

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**“The tax treatment of capital expenditures can deter productivity-boosting investments.”**

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13 Robert Lucas (1990) "Supply-side economics: An analytical review." Oxford economic papers 42.2: 293-316

14 It's scheduled to fall to 17 per cent in 2020

15 Kyle Pomerleau (2017) What We Can Learn from the UK's Corporate Tax Cuts, The Tax Foundation

16 Paul Johnson (2014) Tax Without Design: Recent Developments in UK Tax Policy, Institute for Fiscal Studies

17 Giorgia Maffini, Xing Jing, and Michael P. Devereux (2016) The impact of investment incentives: evidence from UK corporation tax returns. No. 085. 2016

investigated the effect of state-level policies allowing firms to immediately write off capital expenditures. The paper's author found that the policy increased business investment by 17.5 per cent, led to 7.7 per cent higher employment levels and raised wages by 2.5 per cent.<sup>18</sup> A third paper published in the *American Economic Review* by Eric Zwick and James Mahon which analysed the effects of accelerated depreciation policies found that smaller firms were 95 per cent more likely to respond to accelerated depreciation policies than larger firms and that eligible firms increased investment levels by between 10.4 per cent and 16.9 per cent.<sup>19</sup>

Expanding the Annual Investment Allowance or replicating the recent US policy of allowing all firms to immediately write off the cost of investment in equipment and machinery for the next five years would significantly increase the incentive for firms to carry out productivity-boosting investments.

Moving to the latter system would come with large fiscal costs, at around an £18bn static annual cost. However, simultaneously eliminating the deductibility of corporate interest payments (to avoid a negative tax rate of debt-financed investments) would raise £12bn a year moving forward. The remaining £6bn could be raised by cancelling planned corporate tax reductions and increased tax receipts from growth in investment and wages. An alternative policy advocated in the Institute for Fiscal Studies' *Mirrlees Review* creates an Allowance for Corporate Equity (ACE) which generates a deduction for the opportunity cost of capital invested.<sup>20</sup> Provided the deduction is set at the right size, the policy would be economically equivalent to immediate write-offs, however it would provide the Treasury with a smaller upfront cost. The *Mirrlees Review* cites estimates that a revenue neutral shift to an ACE would increase GDP by 1.4 per cent, wages by 1.7 per cent, and investment by 6 per cent though this depends on where the additional revenue comes from.<sup>21</sup>

- The Treasury should expand the Annual Investment Allowance and increase the depreciation rate on capital allowances to incentivise investment.
- The Treasury should investigate moving towards a Corporate Tax system that either allows firms to immediately write off investment expenses or deduct the opportunity cost of capital over a number of years.

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18 Eric Ohrn (2018). *The Effect of Tax Incentives on US Manufacturing: Evidence from State Accelerated Depreciation Policies*. Grinnell College Working Paper

19 Eric Zwick and James Mahon. (2017) "Tax policy and heterogeneous investment behavior." *American Economic Review* 107.1 217-48

20 James Mirrlees, et al. (2011) "The Mirrlees review: Conclusions and recommendations for reform." *Fiscal Studies* 32.3: 331-359

21 Alan Auerbach, Michael Devereux and Helen Simpson (2010) "Taxing Corporate Income" in *Dimensions of Tax Design: the Mirrlees Review*, Institute for Fiscal Studies

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## TRANSFORM BUSINESS RATES INTO A BUSINESS LAND TAX LEVIED ON LANDOWNERS

When we surveyed entrepreneurs, over half thought Business Rates were quite or very damaging for entrepreneurship in the UK and 40 per cent believed Business Rates were harmful to the success of their own business. Business Rates can be best summed up by a quote from Nobel Prize winning economist William Vickrey: “Economically speaking, a combination of one of the worst taxes—the part that is assessed on real estate improvements ...—and one of the best taxes—the tax on land”.

Taxes may be paid by one group, but the ultimate burden may fall on another. As a result, economists distinguish between legal and economic incidence. Economic theory predicts that the true burden of a tax will fall upon the least-price responsive group. In the case of Business Rates that ought to be the commercial property owner. While businesses can respond to price increases by using less space, reducing production, or even closing altogether, commercial property owners have limited options as the supply of commercial property is relatively fixed due to planning restrictions. We wouldn't expect, except at the margin in the case of some new developments, the supply of commercial property to fall in response to a rate rise. As a result, theory makes the counter-intuitive prediction that rate rises will eventually lead to relative falls in commercial rents.

To test the theory, Nigel Medhi analysed data from six London boroughs in 1990 when the current Business Rates system was brought in to replace an array of local property taxes.<sup>22</sup> Medhi found that property values fell proportionately in boroughs where the rates burden increased and increased in boroughs where their rates burden fell. Medhi found that total occupancy costs (the total burden of commercial rents and Business Rates) were equalised in the long term. However, while the burden will eventually fall upon commercial property-owners as rents adjust, the process is not instantaneous.

Research from the British Property Federation which analysed five revaluations between 1990 and 2010 found that even after three years rents will only have adjusted by 75 per cent.<sup>23</sup> For smaller firms who face cash-flow constraints this can be a painful transition. Measures to increase the frequency of revaluations from every five years to every three years will help as rents should adjust quicker in response to smaller rate changes. Businesses also find the appeals process for incorrect valuations complicated and the Federation of Small Businesses argues that the current system “places a huge administrative burden on small firms”.<sup>24</sup>

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**“Over half thought Business Rates were quite or very damaging for entrepreneurship in the UK.”**

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22 Nigel Medhi (2003) The capitalisation of business rates: An empirical study of tax incidence in six London boroughs. PhD thesis, London School of Economics and Political Science

23 Regeneris Consulting (2015) “Business Rates: Who Pays and Why it Matters”. [https://www.bpf.org.uk/sites/default/files/resources/Who%20pays%20business%20rates%20research%20\(BPF-BCO-BCSC\)%20Final.pdf](https://www.bpf.org.uk/sites/default/files/resources/Who%20pays%20business%20rates%20research%20(BPF-BCO-BCSC)%20Final.pdf)

24 Business rates appeals plummet as companies struggle to navigate new system, The Daily Telegraph. <https://www.telegraph.co.uk/business/2018/02/15/business-rates-appeals-plummet-companies-struggle-navigate-new/>

Beyond the incidence and administration aspects, Business Rates also deter investment in commercial property. For instance, installing a new blast furnace, steam boiler or building berth would increase a property's rateable value. This discourages manufacturers from investing in plants and machinery, making the UK a less attractive place to do business. According to the EEF, 50 per cent of manufacturers with annual turnovers of under £5m would be more likely to invest if plants and machinery were exempt from Business Rates.<sup>25</sup> But this aspect of Business Rates doesn't simply affect manufacturers; it can have a negative effect on high street shops and offices, as well as owners are also discouraged from carrying out renovations and improvements such as investments in energy efficiency.

To recap, in their current form, Business Rates discourage investment in commercial property, they impose a large administrative burden upon smaller business, and can create cash-flow constraints for smaller firms. To address these three flaws within the current system, we recommend two reforms.

First, Business Rates should be levied on commercial property-owners rather than occupiers. This would have two key benefits. It would alleviate cash-flow constraints as the adjustment period where the economic incidence shifts to property-owners would happen immediately. It will also reduce the administrative burden associated with Business Rates. As it stands, if a commercial property owner owns a business park then each individual occupier will have to separately make tax payments. By shifting the legal incidence to commercial property-owners the business park's owner would instead file a single claim. Likewise, if there were issues with the business park's valuation, then the owner would be able to file a single appeal, rather than multiple business owners being forced to make separate appeals.

Second, Business Rates should be assessed upon the land or site value of a commercial premise rather than on the value of the property itself. This would ensure that commercial property-owners are not deterred from investing in productivity-enhancing improvements. While there are clearly questions around feasibility, there are land value taxes in Denmark, Estonia, various US states, and Taiwan.

- The Government should reform Business Rates to reduce administrative burdens and cash-flow issues by levying the tax on commercial property-owners and not occupying businesses.
- In order to incentivise investment, the Government should assess rateable values upon the underlying land value of a commercial site rather than on the value of the property itself.

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25 Chris Richards (2017) "Business Rates - What are manufacturers calling for". EEF. <https://www.eef.org.uk/campaigning/news-blogs-and-publications/blogs/2017/mar/business-rates-what-are-manufacturers-calling-for>

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### **ALLOW TRADING LOSSES TO BE CARRIED FORWARD WITH AN INTEREST FACTOR THAT COMPENSATES BUSINESSES FOR INFLATION AND A REAL RETURN ON CAPITAL**

Startups often run large, up-front trading losses, as they search for a profitable business model. For example, it took five years for Facebook to turn a profit and Twitter only became profitable this year (its twelfth year of trading). The tax system should not penalise firms that prioritise revenue growth over short-term profitability. However, firms running trading losses face an unfavourable tax environment that can impede their access to finance.

Under the status quo, companies running trading losses are able to carry forward their taxable losses and deduct them from their taxable profits in future profitable years. This ensures firms with volatile profits do not face excessive burdens compared with firms turning smaller stable profits. However, the tax benefit is insufficient to compensate firms who may have to wait years to take advantage of the tax deduction.

The longer a firm must wait to take advantage of its tax deduction, the less it is worth to the firm. This incentivises investors to favour established profitable businesses and exacerbates the SME funding gap. If a firm could access the tax benefit immediately they would be able to re-invest it and generate a return.

The Government should correct this bias within the tax system by allowing firms to carry forward trading losses with an interest factor to compensate for the opportunity cost of capital. This would make investing in startups more attractive, helping close the SME funding gap by expanding access to finance.

- The Government should allow firms to carry forward trading losses with an interest factor that compensates businesses for a real return on capital.

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### **ALLOW NEW SMES GREATER FLEXIBILITY ON CASH-FLOW ISSUES BY MAKING EMPLOYMENT TAX COLLECTION QUARTERLY AND RAISE THRESHOLD FOR QUARTERLY CORPORATE TAX PAYMENTS**

For new businesses who face significant challenges accessing finance and volatile revenues, cash-flow is king. In the Institute of Directors (IoD) report Britain Unlocked: A Tax Code for Global Ambition, multiple business owners argue that the collection of Corporation Tax and National Insurance Contributions can create major cash-flow issues.<sup>26</sup> For firms, who may have difficulty accessing credit, additional flexibility to pay either of these taxes would smooth over cash-flow issues that can act as a constraint on hiring or expansion.

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**“The Government should allow firms to carry forward trading losses.”**

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<sup>26</sup> Britain Unlocked: A Tax Code for Global Ambition, Institute of Directors/Grant Thornton (2016)

Currently, SMEs with profits of £1.5m or more are required to forecast their taxable profits each quarter. Increasing this allowance to £5m per annum, as the Institute of Directors recommends, would have no long-term impact on the public finances (there would be an upfront cost), but it would allow medium-sized businesses to better manage their cash-flow and avoid making advance payment to HMRC when they have opportunities to expand their business.

SMEs in their first three years of operation should be granted additional flexibility to make quarterly rather than monthly Employers' National Insurance Contributions. This would also have no long-term impact on the public finances, but it will provide valuable support to businesses who struggle to access finance due to lacking a track record or collateral. The flexibility should be time-limited to recognise that once firms have a track record of successful operation, they are better able to access finance and require less flexibility.

- To alleviate cash-flow challenges for medium-sized business, the profits threshold for quarterly Corporate Tax payments should be raised from £1.5m per annum to £5m per annum.
- To support new businesses SMEs should be given the flexibility of paying Employers' National Insurance Contribution payments quarterly in their first three years of operation.

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#### **INVESTIGATE ALLOWING STOCKS AND SHARES ISAS TO INCLUDE UNLISTED SHARES TO ENCOURAGE GREATER INVESTMENT IN HIGH GROWTH SMALL BUSINESSES**

While the UK remains one of the best places in Europe to start a new business, with a well-developed ecosystem of VCs and angel investors, startups and scale-up still face difficulties in accessing finance. As Octopus' High Growth Small Business Report 2018 highlighted, if just 1 per cent of the capital invested in Stocks and Shares ISAs was invested in small, unlisted firms then it would unlock £3.15bn of extra investment for high growth small businesses. As investors rarely remove money from ISAs, this would effectively double the £3bn in existing patient capital identified in the Government's Patient Capital Review.<sup>27</sup>

The Government should continue the recent trend of increasing SME access to finance through expanding ISA treatment. Permitting existing Stocks and Shares ISAs to invest in the shares of smaller, unlisted companies would follow successful moves to expand ISA treatment to P2P lending and the AIM.

Provided anti-avoidance measures are sufficient to prevent abuse, this would provide an additional source of finance for firms who have reached

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<sup>27</sup> Patient Capital Review: Industry Panel Response (2017) HM Treasury [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/661397/PCR\\_Industry\\_panel\\_response.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661397/PCR_Industry_panel_response.pdf)

VCT investment limits and enable a wider proportion of the public to take advantage of the tax benefits of investing in early-stage businesses. In effect, this would democratise existing support for startups.

- The Government should investigate the feasibility of allowing existing Stocks and Shares ISAs to invest in unlisted companies.

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#### IMPROVE AWARENESS OF BUSINESS SUPPORT BY INCLUDING INFORMATION ABOUT TAX RELIEFS WITHIN HMRC CORRESPONDENCE

There is a wide range of support available through the tax system to help businesses grow, but many businesses fail to take full advantage of the support on offer. If awareness of the full range of support on offer was improved then it would enable more businesses to expand.

We asked nearly 500 business owners about their awareness of eight major tax reliefs (Annual Investment Allowance, R&D Tax Credit, Patent Box, EIS, SEIS, Entrepreneurs' Relief, Employment Allowance, and Business Rates Relief). Over a third of business owners hadn't heard of either the Employment Allowance or the Patent Box, while only one relief (R&D Tax Credit) had over 80 per cent awareness. MPs, those responsible for drafting, amending, and scrutinising the various reliefs, do worse.<sup>28</sup> Over half had not heard of Venture Capital Trusts, Annual Investment Allowance, Entrepreneurs' Relief, and SEIS.

Local Enterprise Partnerships (LEPs) should be a key source of information about business support, but IoD research found that nearly 60 per cent did not even know which LEP their business fell under in geographic terms. While reforms to improve the effectiveness of LEPs would be welcome, the government should start by leveraging its existing relationships with business.

As the IoD's Jamie Kerr put it in The Entrepreneurs Network's "A Boost for British Business": "It's rare that business leaders fail to open a message from the tax man".<sup>29</sup> Including detailed information on the range of reliefs available to support business growth within HMRC correspondence could dramatically raise awareness. Working with the British Business Bank HMRC could experiment with different marketing communications (e.g. one explaining a specific relief, another with a paragraph each on eight different reliefs) and track its effectiveness by measuring uptake against tax data.

The government should seek to replicate the widespread awareness of ISAs to stimulate the supply of finance into startups and scale-ups. Polling from YouGov found that 54 per cent of the public were aware the government had increased the ISA threshold in 2014 and over 3m invest with Stocks

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**"If awareness of the full range of support on offer was improved then it would enable more businesses to expand."**

28 The Entrepreneurs Network (2017) Parliamentary Snapshot "[https://www.tenentrepreneurs.org/s/SNAPSHOT\\_2017.pdf](https://www.tenentrepreneurs.org/s/SNAPSHOT_2017.pdf)

29 The Entrepreneurs Network (2017) "A Boost for British Business" <https://www.tenentrepreneurs.org/research/2017/6/5/a-boost-for-british-businesses>



and Shares ISAs.<sup>30</sup> In its report “Opening the Equity Economy” the IoD explains why ISAs have significantly higher awareness levels than other reliefs: “With ISAs, the government made a concerted effort to get buy-in from both the private sector (typically banks, who stood to make obvious gains in terms of new customers) and aggressively market them to the general public”.<sup>31</sup> To increase the supply of finance to startups, the government should consider including EIS/SEIS investments through the ISA wrapper. This would radically simplify the process from an investor’s perspective and may incentivise more higher-rate taxpayers to make relatively small investments in startups and scaleups.

- HMRC should experiment by carrying out randomised controlled trials into the effect of including detailed advice about tax reliefs alongside other correspondence with business.
- Investigate using the ISA wrapper for additional tax reliefs to increase awareness on the supply side.

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#### **ALLOW INVESTMENTS BY FAMILY MEMBERS TO QUALIFY FOR EIS AND SEIS AND SUPPORT GROWTH OF SCALE-UPS BY CREATING A SCALE-UP EIS WITH A HIGHER CAP AND A REDUCED RATE OF TAX RELIEF**

The Enterprise Investment Scheme (EIS) was introduced under John Major in 1994 to increase private investment into viable early-stage businesses which may otherwise struggle to attract equity finance because they lack collateral and trading histories. If the cost of due diligence cannot be justified by the size of the investment, then viable firms will go unfunded. The problem is exacerbated for Knowledge Intensive industries which tend to have highly variable returns.

The scheme allows qualifying investors to obtain income tax relief of 30 per cent of the value of their investment up to an annual maximum of £2,000,000 (£600,000 tax relief). Investments are exempt from Capital Gains Tax on the disposal of shares, provided they have been held for three years. Qualifying businesses can raise up to £5m a year through the scheme and £12m over their lifetime. Knowledge Intensive companies can receive up to £5m per year and £20m over their lifetime.

Polling carried out by Ipsos Mori found that 4 in 10 companies that received funding through a tax-advantaged venture capital scheme (EIS, SEIS, VCT) would have not received the investment if the scheme was not in place. 9 in 10 investees attributed at least part of their growth in employee numbers to investments received through EIS or VCTs.

In order to prevent fraudulent incorporation and money laundering, parents and relatives are currently prohibited from investing in a company through the EIS and SEIS. These rules should be revised to encourage the

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30 Andrew Farmer (2014) “One in ten want a NISA the action” YouGov

31 Jimmy McLoughlin (2015) “Opening the equity economy” Institute of Directors

Bank of Mum and Dad to invest in their child's business rather than a deposit for a new house. Existing policies to prevent funds from flowing to "low-risk investments" by excluding certain business activities (property development, farming and market gardening, coal and steel production, hotel and nursing home operation and management, and some financial activities) should help ensure that the schemes are used to support legitimate new companies. One option would allow family members to invest provided that the criteria for firms more than 7 years old is met (raise money amounting to at least 50 per cent of its 5 year average turnover, and spend that money on entering a new product or geographic market). This would ensure that investments were not flowing to low-risk propositions such as a new branch of an existing family business.

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.

The Patient Capital Review argued that the full scale of the problem of access to capital is underestimated, finding that "growing UK businesses still struggle to secure investments of between £5m and £20m." While medium-sized companies seeking larger investments are better able to demonstrate viability to investors, some (in particular knowledge-intensive companies) still struggle. We recommend the creation of a Growth or Scale-up EIS as proposed by the Patient Capital Review's Industry Panel. This would raise the lifetime investment cap while offering a lower level of tax relief to minimise revenue loss.

The Government should reconsider rules that require companies seeking investment to include investor names and addresses when they apply for Advanced Assurance. As Anthony Rose of SeedLegal highlight this "creates an unhelpful Catch-22: the startup needs to know who their investors will be before they can obtain Advance Assurance, and investors will often only commit to investing after the company has obtained their Advance Assurance!" While the ambition of reducing the Advanced Assurance backlog (it currently takes HMRC 8 weeks to process a claim) is welcome, a better approach would to be increase funding for Advanced Assurance processing and allow firms to pay for guaranteed expedited processed.

- The Government should allow Family Members to Invest in EIS/SEIS, introduce a Scale-up EIS at a reduced rate but higher cap, and improve the Advanced Assurance process.

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**"The Government should investigate implementing the recommendation of the Patient Capital Review's Industry Panel to remove the 'Controlling Party' restriction."**

# CONCLUSION

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It is vital that, as Britain leaves the European Union, we are one of the best places in the world to start and grow a business. Getting tax policy right is key to creating a business environment that fosters entrepreneurship. Tax reform can deliver faster economic growth, boost employment and raise wages.

The APPG for Entrepreneurship will continue to work closely with entrepreneurs, experts, and policymakers to ensure our tax code does not discourage entrepreneurship.

The APPG for Entrepreneurship would like to thank the following organisations for their contributions towards the Call for Evidence and helping ensure that the tax system helps, rather than hinders, business growth.

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Institute for Fiscal Studies (Oral Evidence), Resolution Foundation (Oral Evidence), The Tax Foundation, Institute for Family Business, WTT Consulting, IPSE, Institute of Directors, Aldermore, ISBE SIG for Entrepreneur Finance, Enterprise Investment Scheme Association.

Survey Partners: Accelerator Network, EISA, Enterprise Nation, Entrepreneurs Forum, FSB, Guild of Entrepreneurs, ICE, Innovation Forum, IPSE, Nacue, Nesta, peak b, Platform, Runway East, Small Awards, Supper Club, Tech UK, Tech London Advocates, Tech Nation, The Leap, The Entrepreneurs Network, Toucan Ventures.



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### SAM DUMITRIU

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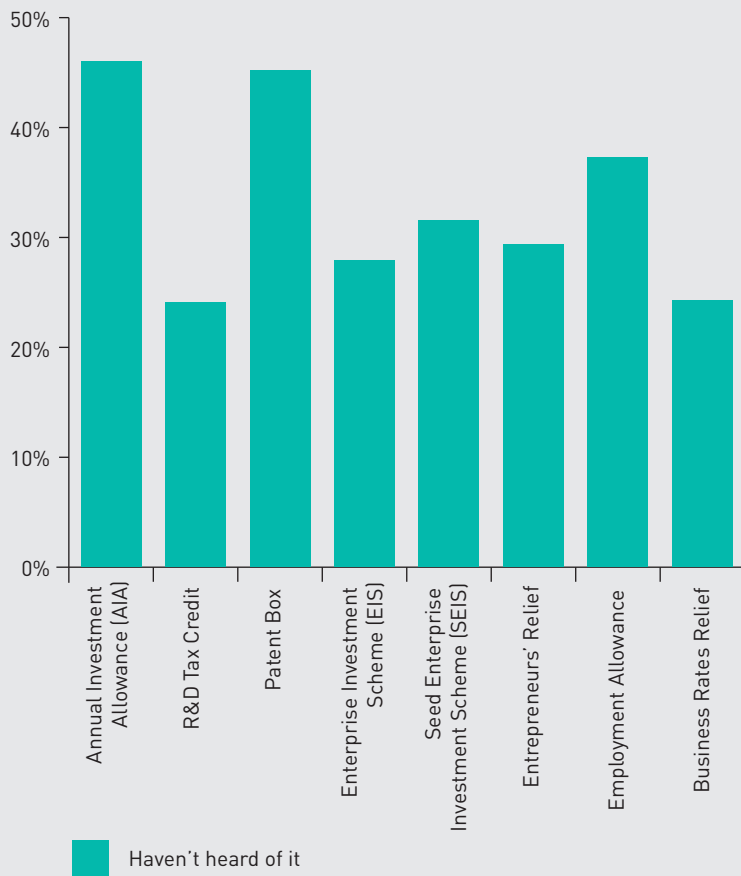
Head of Research, the Adam Smith Institute

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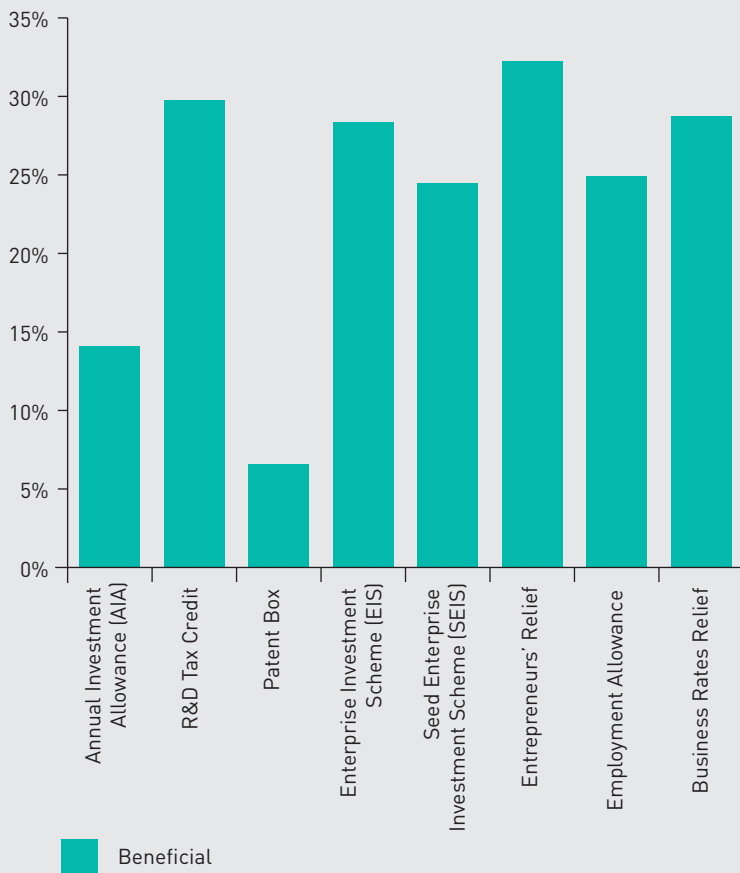
**“It is vital that, as Britain leaves the European Union, we are one of the best places in the world to start and grow a business.”**

# SURVEY CHARTS

How beneficial have the following tax breaks been for the success of entrepreneurship in the UK?



**How beneficial have the following tax breaks been for the success of your business?**



# octopus

A brighter way

Octopus is a group of companies investing in the people, ideas and industries that will make the world a better place to live. The group has nearly 300,000 customers across six businesses, and their investments have put more than £7.8 billion into the UK economy. Octopus was founded in 2000 by Simon Rogerson and Chris Hulatt, who have taken the spirit of entrepreneurship and applied it to sectors like financial services and energy, where innovation and optimism can help create something better.



