## BRIEFING PAPER

# FUNDING TO FLOURISH: THE CASE FOR TAX RELIEF ON EARLY STAGE INVESTMENT

appg entrepreneurship

In partnership with

VCTA

Venture Capital Trust Association

# EXECUTIVE SUMMARY

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## Supporting growth investment

While the papers in the UK are preoccupied with stories of inflation, recessions, and slow productivity growth, there is one very happy economic story that is seldom reported on. Since the financial crisis, the UK start-up market has been growing at an impressive rate.

This rise in growth investment in the UK has been supported by a range of targeted tax reliefs, designed to compensate investors for the increased risk associated with investments in high-growth innovative start-ups at their earliest stages, when attracting investment to scale up can be most challenging.

However, despite the importance of the reliefs to the UK's start-ups and scale-ups, awareness and understanding among the UK's political class is relatively low. A poll commissioned by The Entrepreneurs Network in 2017 found that around half of MPs had not heard of the schemes, though support was high among engaged MPs.

This paper makes four recommendations to policymakers on supporting growth investment in the UK:

1. **Provide clarity about the future of the SEIS, EIS and VCT schemes and tweak to reflect the size of the modern start-up ecosystem.** The government has said that it is increasing the generosity of the SEIS scheme but the necessary legislation has not yet been passed.
2. **Update the financial health rules.** The current financial health rules do not make sense and can arbitrarily disqualify worthy companies. We should return to using financial health requirements that are more suitable to the nature of growth investment.
3. **HMRC should be more communicative with EIS start-ups and investors.** The EIS advance assurance team at HMRC should be given the resources it needs to communicate properly with start-ups and investors.
4. **SAFE Notes**. Government should make SAFE notes eligible for the same tax reliefs that more round-based growth finance are.

# INTRODUCTION

While the papers in the UK are preoccupied with stories of inflation, recessions, and slow productivity growth, there is one very happy economic story that is seldom reported on. Since the financial crisis, the UK start-up market has been growing at an impressive rate.

According to Beauhurst, the amount invested has increased by over seventeen times from £1.6 billion in 2011 to £27.7 billion in 2021.[1] At the same time, the number of deals being made has increased by more than fourteenfold, from 521 to 7,608. Despite having a smaller economy than countries like Japan and Germany, the UK is third, behind the US and China, for VC investment. That being said, the broader economic environment has punished growth investment too and investment in 2022 was lower than it was in 2021, with only £24.1 billion invested in 6,439 companies.[2] Mismanagement of our economy could reverse this growth and our lead could be stolen by other enterprising nations.

**Despite having a smaller economy than countries like Japan and Germany, the UK is third, behind the US and China, for VC investment**

Many British equity-backed businesses funded over the past decade are now household names, such as delivery app Deliveroo and challenger bank Monzo. Others have had a massive impact on global threats like Oxford Nanopore did during the pandemic.

The UK's growth investment success story has been uneven, however. Almost half (49%) of all growth investments are made in London, while just 2.9% are made in the North East, and the gap between London and the rest of the UK is growing. But despite London pulling further ahead, all parts of the UK have seen impressive growth.[3]

Governments of all stripes recognise that entrepreneurship is essential to a dynamic market economy, but while the APPG for Entrepreneurship exists to promote and support entrepreneurship in all forms, certain types inevitably attract more attention from policymakers. Venture-backed businesses have an outsized economic impact. In the US, average employment increases by 475% versus 230% and patent stock grows by 1,100% over ten years versus 440% when a business receives venture backing relative to similar companies that do not receive venture capital.[4]

1 The Deal 2021. (2022). Beauhurst. This refers only to announced deals, including unannounced deals (a harder to verify measure) suggest the level invested has increased to £26.5bn.

2 UK Equity Market Update Q3 2022. (2022). Beauhurst.

3 Ibid.

4 Penciakova, V. et al (2019). *Synergising ventures: The impact of venture capital-backed firms on the aggregate economy.*

This helps explain why policymakers across the world have developed numerous schemes designed to improve access to growth finance. These initiatives vary from co-investment funds to targeted tax reliefs. It is the latter which is the focus of this briefing paper.

Growth investment is not right for every business, but it is often the best option for start-ups with uncertain future revenues, limited trading histories, or a lack of assets to secure a loan against. The latter problem is common for innovative businesses that generate intellectual property (IP) or other types of intangible capital that banks find hard to value and are difficult to sell to other businesses.[5] Equity-financed businesses tend to have higher growth ambitions relative to debt-financed businesses for multiple reasons. Due to a lack of trading histories or assets to secure the investment against, growth investors typically engage in higher levels of due diligence relative to other sources of finance. VCs typically invest in higher risk investments, where there is greater risk of business failure but also a greater chance of significant returns.[6]

As these growth investors have a direct stake in the success of the businesses they invest in, they often add extra value through mentoring or assisting in networking. When VCs develop a reputation for backing successful businesses, investment can be a powerful endorsement which opens doors for media opportunities and follow-on funding.

This rise in growth investment in the UK has been supported by a range of targeted tax reliefs, designed to compensate investors for the increased risk associated with investments in high-growth innovative start-ups at their earliest stages, when attracting investment to scale up can be most challenging.

For start-ups seeking their first investment, known in the industry as 'seed funding', there is the Seed Enterprise Investment Scheme (SEIS) which allows investors to claim 50% of their initial investment against their income tax and capital gains tax bills, and exempts the investment from capital gains tax on exit. Start-ups can receive the relief on a maximum of £150,000 in investment through the scheme, while individual investors can invest up to £100,000 through the scheme each year. SEIS is typically used by angel investors – ex-entrepreneurs who intend to pass on their wisdom and support the growth of early stage businesses. The scheme was announced in 2012 and was the last of three tax reliefs for growth investment to be implemented. As the relief is extremely generous, there are strict restrictions on the types of companies that can access the relief. The company must have fewer than 26 employees, have less than £200,000 in assets, and can only have been trading for up to two years.[7]

5 Haskel, J. and Westlake, S. (2017). *Capitalism without Capital.* Princeton University Press.

6 Mallaby, S. (2022). *The Power Law: Venture Capital and the Making of the New Future.* Penguin.

7 HM Revenue & Customs. (2017). *Use the Seed Enterprise Investment Scheme to raise money for your company*

In the September 2022 mini-budget, the SEIS scheme was updated. The updates stated that companies would be able to raise up to £250,000, the annual investor limit would be raised to £200,000, the gross asset limit raised to £350,000, and the age of company increased from two to three years. In the November Autumn Statement, the new government confirmed that they too were planning to increase the generosity of these schemes, saying: "As previously announced, the government is increasing the generosity and availability of the Seed Enterprise Investment Scheme."[8] But the new government has not yet passed the necessary legislation to make this so.

Early-stage businesses that are further on in their growth journey than those who would seek SEIS investment can use the Enterprise Investment Scheme (EIS). This scheme, which was introduced in 1994, offers slightly less generous tax relief with investors able to claim back 30% of their investment against their income tax bill. Investors are also able to defer capital gains from the sale of any asset if they use that gain to invest in an EIS qualifying business. More businesses qualify for investment under EIS but there are still a range of restrictions designed to ensure that the relief is targeted at innovative businesses where there is genuine risk to capital. To qualify, businesses must have no more than £15 million in gross assets, have fewer than 250 employees, and have been trading for no more than seven years since its first commercial sale. The government's Autumn Statement stated: "The government remains supportive of the Enterprise Investment Scheme and Venture Capital Trusts and sees the value of extending them in the future."[9]

Alongside EIS, Venture Capital Trusts (VCTs) are an option for more established, but still early-stage, high-growth businesses. If you invest in start-ups through a VCT fund, you can gain 30% upfront income tax relief on the amount you invest, provided you keep your VCT shares for at least five years. Additionally, any capital gains or dividends which arise from the VCT are untaxed. VCTs must be listed on a recognised UK stock exchange. VCTs are targeted at retail investors and can broaden the pool of investors into high-growth companies. VCTs are able to provide evergreen patient capital, which means they can enable individual investors to realise their investment without the need for fund managers to sell the underlying assets, enabling the funds to remain invested in companies over the long term. Because they are evergreen funds, the initial 30% income tax relief not only leverages the additional 70% of private capital, but this sum can grow and be re-invested multiple times by the fund into new eligible businesses across the UK.

For both EIS and VCTs, the qualifying criteria for businesses is somewhat relaxed in the case of knowledge intensive companies. Recognising the longer route to market and greater need for capital for knowledge intensive businesses, the seven year rule is extended to ten years and the maximum investment limit is £20 million (or £10 million per year).

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8 HM Government. (2022). *Autumn Statement 2022.*

9 Ibid.

Each year over £2 billion is invested through the schemes, supporting thousands of innovative start-ups to scale. The challenges of fundraising in periods of economic difficulty, such as the recent pandemic, can be especially acute for high-growth small businesses, many of which can struggle to access funding because they are high risk investments. Tax incentivised schemes such as VCTs address that market failure and help to close this gap in the funding landscape by attracting investors.

**Each year over £2 billion is invested through the EIS and VCT schemes**

It is the complementary nature of the VCT scheme, the EIS and the SEIS together that makes the UK such a successful place to start and scale a business. SEIS allows for very early stage, whereas VCT and EIS work alongside each other – they can only invest in the same kinds of opportunities with the same maximum size and age limits. However, they typically appeal to different types of investors.

By virtue of the fact that a VCT operates like a fund, investors receive a share of all the investments held by the VCT when they invest. This provides a diversified investment (albeit focused on early-stage companies) from which a less volatile return might be expected.

EIS requires investors to invest directly into the shares of one or more early-stage companies which investors will then hold until there is an exit event. EIS tax reliefs are more generous overall, and in particular due to the availability of loss relief for non-performing investments, which recognises the fact that losses and growth will be offset within a VCT itself.

Both investments tend to be held over a long period by investors, but with EIS there is typically no option to remain invested after an exit event has occurred. VCTs typically appeal to slightly less experienced early stage investors because diversification can be achieved from lower investment values, and they have more straightforward administration.

Crucially, investors of early stage businesses provide business support and advice for their entrepreneurs. Experienced angels, funds, and VCT managers can help develop products, enter new markets, support exporting, and help develop effective sales and marketing strategies.

However, despite the importance of the reliefs to the UK's start-ups and scale-ups, awareness and understanding among the UK's political class is relatively low. A poll commissioned by The Entrepreneurs Network in 2017 found that around half of MPs had not heard of the schemes, though support was high among engaged MPs.[10]

This APPG for Entrepreneurship briefing paper aims to improve awareness and understanding of the reliefs so that Parliament is well informed ahead of the planned extension of the schemes beyond the 2025 Sunset Clause.

10 The Entrepreneurs Network. (2017). *Parliamentary Snapshot*.

This paper will be divided into three sections. The first section looks at the rationale for the tax reliefs, discussing and explaining market failures within the market for early-stage growth finance. The second section looks at the evidence on the impact of the various schemes, assessing whether or not they are delivering on their objectives and providing value for taxpayers. In the third section, we explore a range of current debates and issues around the relief, including eligibility, bureaucracy, and post-Brexit opportunities.

Case studies of entrepreneurs who have used the schemes also feature throughout the briefing paper.

# WHY SUPPORT GROWTH INVESTMENT?

What is the case for creating tax reliefs designed to support growth investments in innovative, but risky, businesses? This section considers the three commonly cited reasons about why a funding gap exists.

## Dealing with a lack of information

As young companies seeking growth finance do not have trading histories to lean on, investors often have little information about the business itself. This information asymmetry between investors and businesses requires time and money to solve, as investors have to expend resources on finding the right start-ups, negotiating terms, and then conducting extensive due diligence. As the government notes in a paper entitled *SME Access to External Finance*, these "transaction costs are generally fixed and do not vary greatly with the size of investment" and estimate they "cost between £20,000-£50,000 [per investment]."[11] As the costs do not vary with the size of the business or investment made in it, they represent a significant barrier to investment for the earliest stage businesses. They estimate that "for a small investment in a technically complex company, the costs can easily account for 10% or more of the investment."[12]

As a result, viable businesses with strong growth prospects find it harder to obtain finance when compared to larger, more established businesses, with extensive trading histories and assets for collateral. The presence of high due diligence costs is also particularly problematic for research intensive businesses where VCs are required to do extensive technical due diligence.

## Spillovers from intangible investments

Growth investment is typically sought by businesses which generate new IP or intangible assets, because these are hard to value and difficult to use as security for a loan.[13] This is important because new ideas create spillovers that benefit other businesses. For example, Just Eat's business model led to competition and follow-on innovation from businesses such as Deliveroo and Uber, which in turn prompted innovation from on-demand grocery businesses such as Getir and Gorillas.

11 BIS. (2012). *SME Access to External Finance.*

12 Ibid.

13 Haskel, Jonathan, and Stian Westlake. *Capitalism without Capital.* Princeton University Press, 2017.

This business model was not protectable by IP law, but, if the number of copycat 'Uber for X' businesses are anything to go by, it clearly had significant financial value.

There are, of course, major advantages in being first such as having the most established brand. For example, in technology, network effects, whereby a service is more valuable because others use it too, gives powerful benefits to the initial innovators. But, the fact that businesses are not compensated for the follow-on or copycat innovation they prompt will mean that we will see less of this kind of innovation than we want. As a result, measures designed to increase access to growth finance can be used as an indirect subsidy to this sort of activity.

## The market under invests in risk

Economic theory suggests that, as a whole, the market underinvests in risk relative to what would be socially optimal.[14]

When Jeff Bezos founded Amazon, he took $245,573 of his parents' money, and he thought there was a 70% chance that the business would fail and they would lose their investment.[15] This is normal for an early stage company. The reason to invest in them is because while many of them fail, some of them are Amazons and deliver exceptional returns. Bezos advises that others make similar high-risk investments, in a letter to the Wall Street Journal he says "Given a 10% chance of a 100 times payoff, you should take that bet every time. But you're still going to be wrong nine times out of 10."[16]

This advice is easier to follow the more money you have. A larger fund, with the capacity to make more investments, will be able to spread this risk over lots of companies, while smaller investors are likely to be more risk averse through fear of wiping out their entire fund. Bezos' parents, when giving him the start-up capital, were probably not betting all of their wealth and risking becoming homeless on just a 30% chance of success.

Similarly, if everyone in the UK pooled their savings to make one fund, they would be able to invest in more risky companies, and make more from our investments.

There are many reasons why it would be a bad idea to centralise all investments into a single fund, but this thought experiment can point to why the government may wish to nudge the market towards riskier investments and why the government may wish to make riskier investments itself.

14 K. J. Arrow and R. C. Lind, "Uncertainty and the Evaluation of Public Investment Decisions," Amer. Econ. Rev., June 1970, 60, 364-78.

15 CNBC. (2020, September, 3). *Jeff Bezos though there was a 30 per cent chance that Amazon would succeed.*

16 Forbes. (2016, April, 5). *Jeff Bezos Calls Amazon 'Best Place In The World To Fail' In Shareholder Letter*

The tax system also discourages risk taking, as the government taxes the upside to investments but fails to completely cushion the downside. The Institute for Fiscal Studies says: "Those who make substantial investments in a business for a modest return or who risk making a loss are penalised by the tax system. This is the group most likely to be deterred from investing by the tax system."[17]

The tax treatment of risk-taking is uneven because losses cannot be deducted immediately in many cases. This has two downsides. First, having to carry the relief into the future means the value of the relief is cut by the impact of inflation (a particularly relevant concern in the current economy). Second, smaller firms and investors may not have other profits to offset their losses against in the short term, so they may have no cushion at all.[18]

Because high-risk investments have the capacity to generate a lot of positive economic effects that benefit all of us, especially when you consider spillovers from intangibles, there is a case for the government to de-risk some investments by giving them a more generous tax treatment.

## CASE STUDY

### *Dr Nicholas Hawker — Co-Founder & CEO, FirstLight Fusion*

Dr Nicholas Hawker is the Founder and CEO of First Light Fusion – a company trying to solve the world's energy problems by commercialising a clean and abundant energy source as an alternative to fossil fuels. "We have an urgent, global need to decarbonise. Fusion can provide a clean, limitless baseload power source that doesn't have the drawbacks of conventional nuclear power."

First Light Fusion is now on its series D. As it was established in 2011, it is no longer eligible for SEIS or EIS relief. "We didn't use SEIS as we went straight into a more substantial funding round, but EIS was very important to us. We secured the backing of several high-net-worths and a specialist EIS investor and that was crucial for proving that the technology was viable and worth investing in future rounds. More than 50% of our seed funding came from EIS."

EIS lowered the risk profile for the early investors, which made the proposition easier to fund. "We're taking a new approach to inertial fusion. A lot of what we do challenges conventional wisdom, so we were a high-risk, and I think, high-reward bet. Without the cushion of EIS, raising money would definitely have been more challenging."

17 Adam, S, & Miller, H. (2021). *Tax system discourages employment, investment and risk-taking. It needs reform.*

18 Ibid.

# IMPACT OF SCHEMES TO SUPPORT GROWTH INVESTMENT

The UK's suite of tax reliefs targeted at growth investment have a large footprint in the UK's start-up ecosystem.

Research from the British Business Angels Association found that 86% of all angel investment was made through one of these schemes.[19] In certain sectors where the UK is world-leading, such as fintech, use of the schemes is widespread. A survey commissioned by the Independent Kalifa Review into Fintech found that 97% of equity-backed fintechs have utilised tax-incentivised investment schemes.[20]

**97% of equity-backed fintechs have utilised tax-incentivised investment schemes**

The schemes have been cited positively in independent reviews commissioned by the government such as the aforementioned Kalifa Review and the Patient Capital Review, which stated: "interventions such as the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) have helped develop a thriving start-up community."[21] The latter review noted the schemes were viewed 'highly favourably' by entrepreneurs and "many believe that at least one of the schemes has played a key role in their ability to start and begin to grow their businesses."

The three schemes generate over £2 billion in investment to start-ups each year. SEIS, the smallest of the three schemes, supported £175 million in investment in 2020 to 2021 (the most recent year data is available for).[22] Forty-one percent of investment went to tech businesses and the investment was broadly concentrated in London and the South East, with over two thirds (68%) of investment being made there. VCTs are the second smallest scheme in terms of annual investment made each year, with £1.12 billion in new and follow-on investment being made in 2021-22.[23] The largest of three schemes is EIS. In 2020 to 2021, 3,755 companies raised a total of £1.66 billion through the scheme. Of the total invested, £358 million went to 1,370 new EIS companies.

19 UKBAA. (2020). *The UK Business Angel Market 2020*

20 HM Treasury. (2021). *The Kalifa Review of UK FinTech.*

21 HM Treasury. (2017). *Patient Capital Review.*

22 HMRC. (2022). *Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Social Investment Tax Relief statistics: 2022*

23 HMRC. (2022). *Venture Capital Trusts statistics: 2021*

The scheme had a similar geographic breakdown to SEIS, with two thirds (65%) going to businesses in London and the South East.[24]

Critics of the schemes typically focus on two main arguments:

### PROGRESSIVITY

Some critics are concerned by the progressivity of the schemes. Most recipients of tax relief are high-earners. After all, few low- or middle-earners can afford to invest thousands in high-risk, illiquid assets.

This criticism is slightly overstated however. VCTs are aimed at retail investors, and anyone who pays income tax can benefit from the relief. And though the legal incidence of the tax relief falls upon investors, by increasing the supply of venture capital they increase valuations and therefore the benefits also go to start-ups and scale-ups. If the investment leads the start-up or scale-up to employ workers at a higher wage, perhaps due to making productivity enhancing investments in new tech, then a proportion of the benefits will also flow to workers too. This highlights the difficulty in assessing progressivity without looking at the second- and third-order effects. Additionally, the relief exists to compensate investors for the extra risk they incur by putting money into innovative start-ups relative to more stable investments.

### GEOGRAPHIC SPREAD

Similar to the concerns around progressivity are concerns relating to regional biases in the relief. As London and the South East have the most mature markets for venture capital and angel investment, a large proportion of the relief will flow to businesses and investors based there.

The question for policymakers is what is the correct response to this regional bias. If the schemes are addressing genuine market failures then withdrawing them because they are utilised in the strongest start-up ecosystem would be counter-productive.

The regional issue may be related to demand. An analysis of regional data by the Venture Capital Trust Association (VCTA) found that the average age of businesses being invested in was higher outside of the South East.[25] This could be related to wider demand-side issues such as a lower proportion of family ownership in London (compared to the rest of the UK), local skill levels, and investment readiness.

The best way to address the disparity would not be withdrawing supply-side measures, but by creating additional demand-side measures to increase the number of growth-investable businesses.

24 Ibid.

25 Call for Evidence Submission, VCTA.

> There is a role for educating potential investors and start-ups outside of London about the schemes. This might involve collaborating with business schools and investment bodies to develop investment readiness programmes, investing in accelerators and incubators, and working to address skills shortages outside of London and the South East.

**Three quarters of companies that have received investment through the scheme say they innovated as a direct result of their EIS or VCT investment**

While the schemes are large and clearly impact investment decisions, the relative effectiveness of the schemes are hard to assess. As it stands, there is a lack of high quality econometric evidence showing additionality – in other words, investment that would otherwise not have been made if the reliefs did not exist. This may change with a forthcoming independent analysis commissioned by the government to evaluate the reliefs in response to a report from the National Audit Office, which found almost all tax reliefs were under-evaluated relative to similar spending.[26]

The strongest evidence for the additionality of the growth investment tax reliefs is a government commissioned Ipsos MORI survey of investors and investees. This survey found that 60% of investors either 'probably' or 'definitely' wouldn't have made the investment if the EIS or VCT relief was not available.[27] The research found that the upfront income tax relief was the key driver of the decision to utilise the scheme, rather than the back-end capital gains relief.

Companies receiving finance through the schemes were positive about them, with 93% agreeing with the statement: "The investment received from the tax-advantaged venture capital scheme was important to the growth and development of your company."[28]

The surveys revealed that the schemes were being used as intended, bridging funding gaps for innovative high-growth businesses. Three quarters (76%) of companies that have received investment through the scheme say they innovated as a direct result of their EIS or VCT investment, the most common form of which being the development of a new product or service, closely followed by radical (completely new to market) innovations. The vast majority of recipients (91%) said their company grew in terms of employee numbers as a result of using a scheme. Of those who added employees, nine in ten attributed the employment growth at least partially to their EIS or VCT investment. A majority (58%) said investments through the scheme led to increased productivity.[29]

Importantly, investments had non-financial benefits too for investees. More than two thirds (69%) agreed with the statement: "The skills and knowledge of the tax-advantaged venture capital scheme investor was important to the growth and development of your company." Of those who agreed, a large proportion (60%) strongly agreed.

26 National Audit Office. (2020). *The management of tax expenditures.*

27 Ipsos MORI. (2016). *The use and impact of venture capital schemes.*

28 Ibid.

29 Ibid.

Similar surveys, including a Deloitte report commissioned by the British Business Angels Association also found the reliefs were seen as a key factor in the decision to invest by three quarters (74%) of business angels, with 58% stating they would have invested less or not at all if the reliefs were not available.[30]

30 Deloitte and UK Business Angels Association (2015) Taking the Pulse of the UK Angel Market.

# ISSUES FOR TAX RELIEFS FOR GROWTH INVESTMENT

## Sunset Clause

As a condition for approval under the EU's State Aid regime, a Sunset Clause was imposed on both EIS and VCTs which restricts income tax relief only to shares issued before April 2025. The government has said it is supportive of these schemes and that they see the value of extending them, but if they are to continue, the necessary legislation needs to be passed. Until this is done, the lifespan of the schemes is finite.

There is a strong economic case for supporting growth investment through the tax system and many entrepreneurs, including some featured in this report, will testify to the value and importance of the schemes. The existing system, which is well-understood by investors and start-ups, is worth preserving. Any alternative system would not only have to be better, but would also have to be better enough to justify restructuring existing arrangements and starting from scratch in terms of marketing and investor education.

The uncertainty over the schemes' future post-2025 is not just a problem for companies in the future, but already causes issues. It is difficult for founders to plan fundraising rounds now without knowing if EIS is going to exist in the future, and investors may be less keen to invest if they think companies are going to fail to get further investment in the future. Similarly, VCTs suffer from future uncertainty, as part of the way they work is that they can provide evergreen patient capital because individual investors are able to realise their investments without the fund needing to sell off its underlying investment, which allows the fund to remain invested in start-ups over the long term. It also allows for the constant recycling of capital through the fund, which in turn enables VCTs to invest counter-cyclically when other sources of funding have dried up. However, if the scheme was closed to new investments, major problems would arise. If investors become sceptical that the Sunset Clause will be extended, then raising money into a VCT will become challenging due to the risk of bringing investors into an illiquid fund without the means to create liquidity or the ability to continue to invest and grow.

However, high-quality economic evidence for the reliefs remains limited. This is a general problem across governments with limited data collection on the effectiveness of targeted tax reliefs. The main exception is the evidence base for the R&D Tax Reliefs, where HMRC have commissioned multiple independent assessments designed to identify the reliefs additionality, that is to say, the share of new R&D expenditures that have taken place solely due to the relief.

In response to a National Audit Office report which criticised the failure of the government to have a "systematic approach to the evaluation of tax expenditures",[31] a tender was recently awarded for an evaluation of EIS, VCTs, and Social Investment Tax Relief which will be published later this year. This is a welcome step and regular evaluations should be made as the reliefs are changed going forward.

Unfortunately, we cannot wait for these evaluations. We have strong reasons to believe that these schemes are providing value that is undermined by the uncertainty of their future. The Sunset Clause for EIS and VCT in the 2015 Finance Bill should be removed and both schemes should be made evergreen to provide confidence to investors. The schemes should be evaluated regularly going forward.

## Administration

Due to the large tax relief available for investors through each scheme, there is a strong case for rules designed to avoid creating lucrative tax avoidance opportunities. This is particularly important in the case of relatively low-risk businesses which could function effectively as forms of capital preservation. In such cases, an investment that barely breaks-even or even makes a small loss could be worth it for the 30% upfront income tax relief. The need for strict rules to prevent abuse inevitably generates complexity and can inadvertently exclude businesses which do not neatly fit into traditional economic categories. For example, a past report from the APPG for Entrepreneurship found that restrictions on SEIS eligibility for asset-leasing businesses led to innovative eco-friendly sharing economy start-ups such as Bundlee being excluded from accessing the relief.[32]

For EIS, the size of the relief and the lack of clarity around what qualifies means that investors are reluctant to part with their money until they have confidence that the upfront income tax relief will not be withdrawn. As a result, almost all investors and start-ups use a service HMRC offers called 'advanced assurance', which certifies investments as qualifying before they are made. This is an important system, which investors and entrepreneurs both report as essential. However, the complexity involved with some cases and rising demand for the scheme have led to significant delays for start-ups and investors seeking advanced assurance.

31 National Audit Office. (2020). *The Management of Tax Expenditure*

32 Dumitriu, S. (2021). *Sharing Economy.*

This can be a major issue for start-ups in knowledge intensive fields. These delays are not just inconvenient, they can create real cashflow issues and delay plans to expand. This is a problem in a sector as fast-moving as tech where speed of execution is often vital.

One measure designed to reduce wait-times for advanced assurance was a ban on 'speculative applications' without a named investor. Prior to 2018, businesses were able to apply for advanced assurance without naming an investor. After receiving advanced assurance, start-ups would then go to investors seeking compliant investors. This reform reduced wait-times relative to the alternative but it also creates significant challenges for early-stage businesses seeking to raise capital. Some have described it as a 'chicken-and-egg problem' where angel investors will only talk to a company if they are confident the business qualifies, but start-ups cannot provide that assurance without first having an investor on-board.[33]

Action on wait-times is necessary, and prior to this change, as many as half of the start-ups that went through the HMRC process never received any investment. We cannot simply avoid the problem by moving angel investors over to the self-certification model that works well for VCTs, as angels often lack the resources and specialist legal advice that VCTs have.

Instead, HMRC should work more responsively with start-ups and their investors. Currently, when a start-up applies for advanced assurance, they hear nothing from the regulator until a decision has been reached. The system would be easier for HMRC, investors, and start-ups alike if all parties were able to communicate with each other. Start-ups should be told about the progress of their application, and HMRC should be able to pick up the phone to the applicants and ask them further clarifying questions should their application require it.

## The Northern Ireland Protocol

When the SEIS, EIS, and VCT tax reliefs were brought in, the UK was part of the European Union. At the time, the schemes were viewed as State Aid and were, as a result, limited by the EU's state aid rules. As we are no longer in the EU, there is some confusion about whether the EU's State Aid rules apply.

Some believe that a consequence of the Northern Ireland Protocol is that these growth investment tax reliefs cannot apply to any businesses based in Northern Ireland that are planning to export goods to Ireland without the UK renegotiating the precise terms of these reliefs with the EU.

These growth investment tax reliefs do not favour any particular industry or business, as a result, it is not clear that they should count as State Aid. Instead, as we argue above, they behave more like a general tax cut.

33 Dumitriu, S and Salter, P. (2020). *Unlocking Growth.*

If cuts to capital gains tax or income tax are not deemed to be State Aid, it follows that it is not State Aid to make adjustments to these tax rates to correct for the distortions that they create.

As a result, there is a clear case for the UK, now outside of the EU, to press ahead with any of the government's desired changes to the growth investment tax breaks.

**There is a clear case for the UK, now outside of the EU, to press ahead with any of the government's desired changes to the growth investment tax breaks**

## Eligibility

As it stands, the amount any single company can receive in investment through the scheme is capped. Research from Beauhurst and SFC Capital has noted a drop-off in the number of first time seed-stage investments. Their findings suggest that the eligibility threshold for SEIS may be a factor in this fall.[34] For the last three years, the median first-time seed stage investment has hovered around £150,000, the current SEIS threshold. The market has developed significantly over this period with average deal size rises and the mean first-time seed-stage deal is £400,000. This divergence highlights the influence of SEIS on early-stage investment decisions.

The maximum investment cap for SEIS has not changed since the scheme was introduced almost 10 years ago. Since then, the market for VC finance has changed significantly. Outside of the European Union, the UK has a new subsidy control regime which would permit SEIS to be raised to £200,000 for investors and £250,000. Such a change would ensure that the relief remains in line with where the market is.

Additionally, the new subsidy control regime would make it possible to extend the trade-based eligibility period for SEIS from two to three years. This would allow businesses to spend more time working on business models before seeking external investment at more favourable terms.

## SAFE Notes and Convertible Loans

Often start-ups raise funds outside of a standard investment round in order to access the capital they need quickly before finding other investors to participate in the full round. The initial investor will give the start-up a SAFE note, which is essentially money in return for equity at a future date. Currently these SAFE notes are not compatible with SEIS or EIS unless they are converted to equity within six months.

SAFE notes are often popular with US investors. Y-Combinator, for example, is a world-class accelerator which has helped with the creation of well known start-ups, including Twitch, Airbnb, and Dropbox. They issue a SAFE note with no time-limit to US start-ups that it incubates.[35]

34 Beauhurst. (2021). *Seeding to Succeed.*

35 Y Combinator. *Safe Financing Documents.*

Giving SAFE notes unequal tax treatment discourages foreign, especially American, investment into UK companies and ignores the often unpredictable funding requirements that early-stage companies have.

## CASE STUDY

### *Dave Ward — CEO, ClubSpark Group*

Dave Ward co-founded ClubSpark Group in 2012, a B2B software business for sports providers. The Clubspark platform helps businesses and national governing bodies manage registrations, memberships, resource access, competitions, coaching and more. Clubspark's aim is to get people healthier and more active. "We believe in the power of sport to provide better mental and physical wellbeing"

In 2012 online bookings systems were not as ubiquitous as they are now. Tennis courts and football pitches were often booked over the phone or in person, and records were kept on paper. Dave saw there was a gap in the market for an easy to use, cloud-based booking system to help sports clubs manage their businesses and improve the experience for players. Clubspark now works with over 15,000 sports businesses worldwide.

They started out using their own money and debt financing the business but when they won a big contract in the US and needed to scale the businesses quickly, they decided to look at equity investment. Clubspark has had two fundraising rounds, both of which were VCT backed.

Dave says the first round was the toughest. "We didn't know where to go or who to speak to. If the schemes didn't exist, we would have had to go where there was funding, especially as our business is pretty international, it would have made sense for us to pivot there if the opportunities didn't exist at home."

# TOPLINE RECOMMENDATIONS

## Provide clarity about the future of the SEIS, EIS and VCT schemes and tweak to reflect the size of the modern start-up ecosystem

The government should provide more clarity about what it is going to do with respect to the SEIS, EIS and VCT schemes.

The government has said that it is increasing the generosity of the SEIS scheme – this will probably be in line with what was initially outlined in the mini-budget (increasing the amount that companies can raise to £250,000, the amount that investors can put in to £200,000, and the gross asset limit to £350,000), but the necessary legislation has not yet been passed.

On EIS and VCTs, the government has said that they support the existence of the schemes, but have not taken the necessary steps to ensure that the schemes don't lapse after the Sunset Clause. Here too they should act to make the schemes evergreen, thus providing the clarity that the start-up ecosystem needs.

The UK Patient Capital review also noted that there is a venture funding gap that exists at the boundary of the existing EIS and VCT threshold. It suggested that we should extend the schemes to cover this cap, either by increasing the thresholds or by tapering the limit.[36]

## Update the financial health rules

The current financial health rules do not make sense and can arbitrarily disqualify worthy companies. When the schemes were first introduced, they used the 2004 EU requirements for financial health but, when the financial health requirements were updated by the EU in 2014, they began to cause issues.

The new financial health rules require a company to have more assets than liabilities and, if it is raising funds outside of its initial investment period, to still have more than half of its invested capital.

36 HM Treasury. (2017). *Patient Capital Review: Industry Panel Response.*

As the rationale behind growth investment is to give money to currently unprofitable companies based on the prediction that they would become profitable in the future, these financial health tests make little sense.

These rules were updated somewhat in December 2022 to extend the amount of time that knowledge intensive companies can be in their initial investment period up from seven to ten years. This limits some of the damage caused by these rules but it is still an inferior system to the 2004 rules.[37]

We should return to using financial health requirements that are more suitable to the nature of growth investment.

## HMRC should be more communicative with EIS start-ups and investors

The EIS advance assurance team at HMRC should be given the resources it needs. If it is unable to accept applications from companies without investors, then it must be more communicative with start-ups and investors to make sure that good companies do not fall through the cracks. They should give companies a timeline and respond to their questions. HMRC should also be able to contact start-ups and investors with clarifying questions about their Advanced Assurance applications, which ought to speed up the process.

## SAFE Notes

There is no reason for the SAFE note longstop to be as short as six months, and it ignores the fact that funding does not actually happen in discrete rounds. Government should make SAFE notes eligible for the same tax reliefs that more round-based growth finance are.

37 HM Revenue & Customs (2022). *VCM13040 - EIS: income tax relief: the issuing company: financial health requirement*

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## About the APPG for Entrepreneurship

The All Party Parliamentary Group for Entrepreneurship was set up to encourage, support and promote entrepreneurship. It also ensures that Parliament is kept up-to-date on what is needed to create and sustain the most favourable conditions for entrepreneurship.

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