



By email: venturecapitalschemes.policy@HMRC.gsi.gov.uk

31 January 2017

Dear Sirs

Re: "Tax-advantaged venture capital schemes – Streamlining the advance assurance service"

This is the British Private Equity and Venture Capital Association's response to HMRC's consultation on streamlining the advance assurance service for the venture capital schemes, published in December 2016. The BVCA has a membership of over 600 firms, including 16 managing VCT or EIS funds, one managing an SITR fund, and their professional advisers. These firms rely heavily on the advance assurance service, as do the companies in which they invest. We are, therefore, grateful for HMRC's continued efforts to improve the service and reduce delays.

In our response below, we strongly oppose the withdrawal of the advance assurance service. This would produce a significant reduction in VCT, EIS and SITR investment, and would likely result in investment being directed towards better established, less-risky companies, contrary to the objectives of the venture capital schemes. Instead, HMRC should continue to focus on improving the operation of the service. Of the options presented, providing a service on discrete aspects of the rules could reduce the administrative burdens associated with the advance assurance service by reducing the number of repeat applications, provided it is introduced in addition to the current service.

Ultimately, however, our experience is that the primary cause of delays to advance assurance has been the additional complexity and ambiguity introduced to the schemes by the rule changes in the 2015 and 2016 Finance Acts, which were intended to secure EU state aid approval. Uncertainty in respect of the correct interpretation of the new rules has caused applications to be interrogated further by HMRC, producing delays and additional administrative burdens. We do not believe that significant improvements to the operation of the advance assurance service can be made without addressing this issue.

One of the opportunities that will arise from the UK's departure from the European Union will be to rationalise the rules, and better target the schemes towards instances of market failure. Until the point of departure, however, it is right that the UK continues to comply with its treaty obligations. In the meantime, considerable improvements could be achieved within the current EU state aid framework if HMRC were to adopt a more pragmatic approach to its interpretation of the existing legislation. Areas where such an approach would be beneficial are highlighted in the below response.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Tim Hames', with a horizontal line underneath.

Tim Hames
Director General, BVCA



Tax-advantaged venture capital schemes – streamlining the advance assurance service

BVCA Response – January 2017

Question 1. In what context are you responding to this consultation; e.g. investor, investee company, fund manager, industry body representative.

Question 2. Which tax-advantaged scheme or schemes have you used?

The British Private Equity and Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, including 16 managing VCT or EIS funds, and one SITR fund, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 385,000 people and 84% of UK investments in 2015 were directed at small and medium-sized businesses.

Question 3. What would be the impact of increasing response times, including any increase in costs and / or administrative burdens?

The rule changes to the Venture Capital Schemes in the 2015 and 2016 Finance Acts produced a significant increase in response times for applications for advance assurance. Improvements have been made in recent months, and we are grateful for the work that HMRC has done to speed up the service. These gains should not be lost.

If response times were to increase again, investment decisions by VCT, EIS and SITR funds would inevitably be delayed or cancelled entirely. This would stunt the growth of potential investee companies and would push some into cash crisis, resulting in delayed payments to staff, suppliers and possible job losses.

In the case of SITR funds, which are currently in their initial uptake and growth phase and only just beginning to build traction with investors, increased response times, subsequent delays in investment deployment and reduced investor returns could damage investor confidence disproportionately and severely halt the growth of SITR and the social investment space more widely.

Question 4. What would be the impact of withdrawing the advance assurance service?

If the advance assurance service were withdrawn, it is likely that investment arising from the venture capital schemes would grind to a halt, with negative consequences for UK SMEs and investors. The BVCA, therefore, strongly opposes the withdrawal of the advance assurance service.

VCTs in particular rely on the advance assurance service because they stand to lose their VCT status completely if they breach the terms of their VCT approval. This can occur as a result of a single erroneous investment in a non-qualifying holding. Where a VCT does accidentally breach the conditions of its approval, there is currently no provision in the legislation for VCT managers to retain their status by disposing of non-qualifying holdings. Thus, in the absence of advance assurance, VCT managers would be jeopardising their VCT status by investing in companies for which uncertainty exists about whether or not they qualify for tax relief.



The consultation paper suggests that seeking advance assurance is “often an unnecessary exercise” because fund managers can rely on professional advisors to give comfort. We do not agree with this assessment. The changes to the rules in the 2015 and 2016 Finance Acts—designed to secure EU state aid approval—introduced considerable complexity to the system, and there remains a debate over the correct interpretation of the new rules. It is not uncommon for companies to be turned down for advance assurance after seeking professional advice and submitting an application in good faith.

The way in which the growth and development condition in particular is interpreted by HMRC introduces uncertainty into almost every investment under the schemes. Guidance suggests that EIS and VCT money is not allowed to fund existing expenditure. However, for a small company struggling to gain commercial traction, the distinction between existing spending and time spent on new projects is entirely artificial. The withdrawal of the advance assurance service would therefore produce considerable uncertainty in these cases, resulting in fund managers shying away from such investments.

Perversely, this would mean that investment would be more likely to flow to safer, better established companies, rather than the riskier investments the venture capital schemes are designed to support.

There is also considerable uncertainty about how to apply the exemption to the restriction on investments in companies older than 7 years that are entering a new product or geographic market. Withdrawing the advance assurance service would therefore be likely to reduce the amount of funding available for new product launches and entry into new markets, with negative consequences for innovation, exports and, ultimately, jobs and growth.

The difficulties and uncertainties of relying on professional advice notwithstanding, this would become a necessity if the advance assurance service were withdrawn. In this event, we would expect the cost of professional advice to increase significantly. This would disproportionately disadvantage smaller investors with fewer resources.

It would also disproportionately impact SITR investments, which typically generate more modest financial returns for investors, and more modest margins for fund managers in order to maximise social impact. They are unlikely to be able to absorb the increased costs of professional advice that would arise as a result of withdrawing the advance assurance service. The lack of available precedents in respect of SITR eligibility decisions on account of the relative youth of the scheme is also likely to prove challenging if firms are forced to rely on professional advisors.

Question 5. How could the advance assurance service be changed to focus on cases where there is greatest uncertainty? What would be the impact of such changes?

As indicated in our response to Question 4, the changes introduced in the 2015 and 2016 Finance Acts—particularly the growth and development condition as currently interpreted by HMRC—have introduced wide ranging uncertainty into the interpretation of the schemes’ rules, irrespective of the size of the investment or the investee company. As a result, the BVCA does not believe that the service can be narrowed considerably without producing the effects described in our response to the previous question—a considerable slowdown in investment and a significant increase in costs for fund managers—though some narrowing might be achievable if the growth and development condition is simplified.



We strongly oppose the proposal to limit advance assurance to the company's first one or two advance assurance applications only. The consultation paper makes reference to applications that are re-submitted multiple times in order to "test the boundaries" of the rules. In our view, such applications make up only a very small minority of repeat applications. Insofar as such cases exist, the May 2016 guidance already makes clear that in cases that attempt to exploit loopholes, or are contrary to the intentions of the schemes, it is at HMRC's discretion to withhold an opinion.

The overwhelming majority of applications that are resubmitted multiple times are made in good faith. The increase in these applications is largely a result of the ambiguity and uncertainty introduced into the schemes by the 2015 and 2016 Finance Acts. Withdrawing the advance assurance service from these applications after the first or second attempt would almost certainly lead to the abandonment of these investment opportunities as it is highly unlikely that firms would want to risk testing such cases in the courts after having already been given a negative determination by HMRC.

The proposal to limit advance assurance only to companies seeking their first investment under any of the tax-advantaged schemes is also unwelcome. The UK already lags substantially behind the US in terms of the frequency and size of follow-on funding rounds that venture capital funds can provide. This constrains the growth of UK companies and has caused many start-ups to establish elsewhere, such as Silicon Valley. Limiting the advance assurance service to the first investment under the schemes would exacerbate this problem.

Question 6. In what way could the advance assurance service be limited to discrete aspects of the rules? Please provide details of the impact on your business, particularly any increase in costs and / or administrative burdens.

The consultation notes that a service on discrete aspects of the rules could be introduced either alongside or in place of the current service. The BVCA would not support replacing the current service with one that opines only on discrete aspects of the rules. This would leave open the possibility that investments would fail to meet the requirements of the venture capital schemes as a result of aspects of the rules not covered by a narrower advance assurance service. As noted above, without the guarantee provided by the advance assurance service that an investment will qualify for tax relief, fund managers, particularly VCT managers, will be deterred from investing.

However, a service that opined on discrete aspects of the rules that operated *alongside* the "all or nothing" service has the potential to reduce delays and costs for fund managers as well as administrative burdens for HMRC.

At present, when applications are declined they are often altered based on the feedback received, and submitted again in the hope that the changes will satisfy HMRC's requirements. This means that applicants have to submit two separate applications in full—a costly and time consuming process—and HMRC has to assess two separate submissions in full. Providing a service that allowed applicants to seek HMRC's opinion on those parts of the rules where the greatest uncertainty lies would increase the likelihood that applicants 'get it right' first time, and therefore obviate the need for multiple applications to be prepared and considered in full. In the very simplest of cases it could obviate the need to seek full advance assurance altogether.



Under such a system, were an application to be submitted in full after some discrete elements had already been considered, HMRC need only consider those parts of the application that had not already been deemed to be compliant with the rules of the schemes.

The BVCA would therefore support the introduction of a service on discrete aspects of the rules, but only if this were provided alongside determinations on full applications.

Question 7. How would a standard set of approved documents assist you? Would you be prepared to cooperate in devising a standard set of documents?

Please provide details of any savings in costs and / or administrative burdens from using standard documents.

We do not believe that the introduction of standardised documents would improve the advance assurance service. Our experience has been that the majority of delays and costs have arisen as a result of contested interpretations of the rules stemming from the changes introduced in the 2015 and 2016 Finance Acts. The introduction of standardised forms and documents would do nothing to address this problem.

Question 8. Do you have any other suggestions to improve our advance assurance service?

Interpretation of the Rules

In the experience of our members, the primary cause of delays has been the additional complexity and ambiguity introduced into the schemes by the rule changes included in the 2015 and 2016 Finance Acts. These changes were intended to secure EU state aid approval. Until this has been addressed, it will be difficult to achieve significant improvements to the operation of the advance assurance service.

Over the longer term, it is clear that one of the opportunities arising from the UK's departure from the European Union will be to rationalise the rules, and better target the schemes towards instances of market failure. Until the point of exit, however, it is right that the UK continues to comply with its obligations under the EU treaties.

In the meantime, there is considerable scope to reduce the uncertainty and complexity within the current EU state aid framework if HMRC were to adopt a more pragmatic approach to its interpretation of the existing legislation. As noted in the response to question 4, a number of difficulties have been encountered in respect of HMRC's application of the permitted maximum age condition and the growth and development condition:

- In several cases, HMRC's approach has not been sensitive to commercial realities. For example, HMRC has refused or delayed applications because firms have undertaken limited sales in new markets in order to test the market prior to seeking investment. Such testing is a precondition of seeking funding—no professional investor would provide a significant amount of funding to enter a new market where the market had not been previously tested.
- A number of delays and rejections have resulted from HMRC appealing to a distinction between a firm entering a new product market and a firm merely developing or extending an existing product range. We regard such a distinction to be extremely unclear and, in some cases, largely artificial.

- One of the tests that HMRC frequently employs to determine whether or not a company is entering a new product market relates to whether or not the product in question is to be marketed to new customers. This test does not seem appropriate. Clearly, whether a product is marketed to existing clients has no bearing on whether it constitutes a “new product”. Indeed, when a firm does develop a new product, marketing it to existing customers will often be an essential plank of its marketing strategy.
- Where a firm is entering multiple new product or geographic markets, HMRC has made its approval conditional on all of proposed markets for expansion being demonstrated to be “new”, and has required the same minimum sum of money to be employed in each of the new markets. We believe that this goes beyond the requirements of the law.

Penalties for VCTs

As discussed in the answers to the questions above, the advance assurance service is particularly important for VCTs, which stand to lose their status if they breach the terms of their approval. This could arise as the result of a single investment. As a result, any scaling back or narrowing of the advance assurance service could have a disproportionately large impact on the appetite of VCTs to invest.

It may be possible to narrow the service, however, if the penalties for a VCT making an honest error were made less draconian; for example, by giving VCTs a period of grace during which they could dispose of erroneous investments that do not qualify for tax relief.

Partial Applications

We are disappointed that HMRC did not include the possibility of allowing partial applications, with final documents to follow. This is a minor procedural change that could result in the swifter approval of applications and a consequent reduction in the amount of time investee firms have to wait for funding.

From the point of view of the industry, this system worked well in the past. With the proper processes in place, there is no reason why it should result in HMRC officers reviewing incorrect applications, as the consultation papers suggests it has.

Introducing a Paid-for Service

Although introducing a payment for the use of the advance assurance service is not in the scope of this consultation, we would encourage HMRC to keep this possibility under consideration. As discussed above, advance assurance is essential in order to progress deals. Fund managers would be more than willing to pay for advance assurance if this resulted in the service being sufficiently resourced to provide accurate and timely decisions on a long-term basis.

The difficulty raised in the consultation paper that smaller companies could be disadvantaged by the introduction a charge for the service could be mitigated by ensuring that proportionality was built into any new fee structure. For example, fees could be charged on a sliding scale based on investment size—smaller investments might incur only a small fee to use the service, or no fee at all, while larger investments would attract a larger fee.