HM Treasury
By email: emiconsultation@hmtreasury.gov.uk

Date: 26 May 2021

Dear Sir, Madam

Re: BVCA response to the HMT call for evidence on Enterprise Management Incentives (EMI)

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital ("PE/VC") industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

Introduction

The BVCA welcomes the review of the current Enterprise Management Incentives ("EMI") scheme and its dedication to ensuring SMEs have the necessary tools to remain competitive with more established companies. The UK hosts the most important PE/VC ecosystem outside the USA, which generates significant numbers of highly skilled jobs and adds a significant dimension to the country's global importance as a financial services hub. The EMI regime's benefits would be attractive to PE/VC backed companies as approximately 80% of companies invested in by BVCA members each year are SMEs. HMRC's evaluation report on published in 2018 concluded that EMI are only being used by a small number of the high risk, high growth, small companies that the regime was specifically designed for. The regime should help these companies to compete more effectively with larger firms to hire and retain highly skilled employees through share incentivisation.

BVCA Recommendations

The EMI regime is currently unavailable to companies that are backed by PE/VC because of the way the independence requirement (paragraph 9(2)(b), Schedule 5 ITEPA 2003) interacts with the control aggregation rules (sections 993 and 995 ITA 2007) that apply to the partnership structures that are commonly used by PE/VC funds. This is unfortunate as the EMI rules were designed specifically to benefit high risk, high growth, small companies, and this describes many PE/VC-backed companies perfectly.

The BVCA recommendation is to amend the legislation so that EMI options can be used by more of the companies the regime was originally targeted at. This is a recommendation we have made in many BVCA Budget submissions. This could be achieved by amending the independence requirement and in particular by providing that the independence test will still be met where the control condition under paragraph 9(2)(b), Schedule 5 ITEPA 2003 is failed because a company which would otherwise be treated as having control is a partner in a CIS limited partnership (as defined by section 376(5) CTA 2009) or is the operator or a partner in the operator of a CIS limited partnership.

British Private Equity & Venture Capital Association
T +44 (0)20 7492 0400 F +44 (0)20 7492 0401 bvca@bvca.co.uk www.bvca.co.uk

Based on feedback from some members, EMI is available in some deals depending on the structure and level of holding in the company.

We have only answered certain questions based on the feedback we have received from members. We will follow up with further feedback as it arises.

Detailed feedback on consultation questions

Question 5: If you are responding on behalf of a representative body or think tank, please describe briefly the body, its objectives and its members.

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. Further information on the memberships is included above.

EMI's effect on recruitment and retention of key employees in high-growth companies

Question 6: To what extent do you agree/disagree that the EMI scheme is fulfilling its policy objective of helping SMEs recruit employees? Please explain your answer.
Question 7: To what extent do you agree/disagree that the EMI scheme is fulfilling its policy objective of helping SMEs retain employees? Please explain your answer.
Question 8: To what extent do you agree/disagree that the EMI scheme is fulfilling its policy objective of helping SMEs grow and develop? Please explain your answer.

Our members have informed us that the EMI scheme can be useful when recruiting employees for companies at the seed and pre-series A stages of venture capital investment. The ability to offer EMI options is an important component of attracting the required talent to work in these early stage companies and stay competitive with market rates payable in larger, more established, companies (including in the tech sector).

Often EMI is the preferred method of equity incentive for qualifying companies which suggests it is well understood and favoured by those companies that can operate it. However, currently the EMI regime is unavailable to many companies that are backed by PE/VC funds. Most PE/VC funds are structured as limited partnerships. Investors will join as limited partners, making a financial commitment but having no rights to be involved in running the partnership business. There will be a general partner, which is responsible for running the partnership business but which will generally not be entitled to significant economics from the fund. For regulatory reasons, the general partner's role will normally be to appoint an entity to act as operator/manager of the fund partnership to the exclusion of the general partner and the general partner will not be allowed to operate/manage the fund partnership (as opposed to finding someone else to do that) unless it first becomes FCA authorised. The operator/manager of the fund will be a FCA authorised entity (a company or LLP) which is the parent of the general partner.

The independence requirement (in paragraph 9, schedule 5, ITEPA) is that the company granting the EMI options is neither a 51% subsidiary of another company nor under the control of another company or of another company and any other person connected with that company. "Control" is a reference to directional control; s 995 ITA 2007. A person who is a partner in a partnership is treated as connected with the other partners; s 993 ITA 2007.

If we apply that test to a company which is wholly-owned by a PE/VC fund limited partnership, it might be thought that the company would fail the independence test if any of the partners in the fund partnership (not just the general partner) was a company. That is a concern we have highlighted on many previous occasions. This may not be the case if the general partner is not allowed to run the fund partnership business unless it is FCA authorised and is required to appoint an external manager/operator to do so. In such a case, the partnership (and therefore none of the partners) will have directional control of portfolio companies. That control will rest with the manager/operator. If the manager/operator is a company, the independence test will be failed. If, however, the manager/operator is a LLP, it will only be failed if a company is a member of the LLP. This is because a LLP is treated as a partnership and references in the Income Tax Acts to a company do not include a LLP (s 863 ITTOIA 2005). So, the operator/manager LLP cannot be a controlling company. However, as the LLP has control of portfolio companies, any company which is a member of the LLP will be treated as controlling fund portfolio companies, because those companies will be controlled by the corporate member together with the other members, with whom it is connected.

We are aware anecdotally of HMRC approving the grant of EMI options by PE/VC fund portfolio companies where the fund is managed by a LLP manager/operator which does not have a corporate member. This seems to us to be a wholly random outcome which cannot reflect any meaningful policy objective.

As far as policy objectives are concerned, if the aim is to prevent a controlling company artificially flooding value into a company that issued EMI options, that could be addressed by adapting concepts such as the rules in Chapter 3D, Part 7 ITEPA to prevent the benefits of EMI options being available where values have been artificially manipulated.

Fund portfolio companies are operationally independent; their businesses will typically be quite disparate. The size tests (paragraphs 12 and 12A Schedule 5 ITEPA) are operated separately by reference to each portfolio company and its own subsidiaries. But the current independence test means that, even though portfolio companies may pass the size and other qualifying tests, they cannot grant EMI options. There does not seem to us to be any policy rationale why the benefits of granting EMI options should be denied to a large part of the constituency for which they were designed.

To our mind there is no reason to treat a fund portfolio company as failing the independence test just because a company which controls it is (a) a (limited or general) partner in a fund partnership, (b) the operator/manager of the fund partnership, or (c) a partner/member of a partnership or LLP which is the manager/operator of the fund.

BVCA members are long-term investors, typically investing in unlisted companies for around three to seven years, and are committed to building lasting and sustainable value in the businesses they invest in. By amending the independence requirement under current rules to allow EMI options to be granted by companies controlled by partnership structures commonly found in PE/VC funds, the EMI scheme would benefit more SMEs and the wider economy, as highlighted below:

- **Supporting jobs:** Our members currently back around 5,400 companies, employing close to 1.9 million people across the world, including 972,000 people in the UK.

- **Significant investment:** Over the five-year period 2015-2019, BVCA members invested over £43bn into nearly 3,230 companies based in the UK. Of the UK companies invested in during 2019, around 60% were small companies and 27% medium-sized companies.[1]

- **Innovation Nation:** Conducted by Oxford Economics, research[2] published by the BVCA in March 2020 illustrates how important it is to keep the UK as a centre for entrepreneurship and investment as the country embraces its new global position. Employees at companies backed by angel investment and venture capital are 60% more productive than the total UK private sector average, and once supply-chain impact is factored in, these businesses contribute a total of £37.7 billion of GDP to the UK economy.

Further feedback on how the PE/VC industry supports government priorities, is included in the BVCA's 'New Horizons' report.

Question 9: In your views, what aspect of the EMI scheme is most valuable in helping SMEs with their recruitment and retention objectives? Please explain your answer.

Broadly speaking, the EMI scheme allows a company to give employees the same value and tax treatment as direct share ownership, but without requiring them to pay for shares up front or the company to issue shares. This clearly makes equity participation affordable and attractive for staff and they give the company a powerful recruitment/retention tool. In saddition, an EMI scheme is attractive to a company as compared with issuing shares, as it keeps its share capital smaller and simpler until the options are exercised.

Question 10: Is there evidence to suggest that high growth companies that are no longer eligible for EMI are finding it difficult to recruit or retain employees? Please explain your answer. If your answer is yes, what in your view causes these difficulties and which jobs and kinds of companies are affected?

The BVCA does not have any specific evidence of this. However, feedback from our members suggests that there are cases which the loss of EMI qualifying status has led to less attractive equity incentives being offered to their teams and can lead to misalighnment between those employees that can access EMI, and those who cannot.

Question 11: If your answer to the previous question is yes, in your view, would expanding EMI help with these issues? Please explain your answer. If your answer is yes, do you think that other forms of remuneration or employee benefits could achieve similar results?

Yes, expanding EMI (e.g. relaxing qualifying conditions around, for example, employee numbers or gross assets) would allow companies to participate in EMI schemes for longer which would prevent immediate difficulties faced by those companies who breach these limits. A 'phased' withdrawal could potentially be used to reduce the current 'cliff edge' for companies. We don't believe that other forms of remuneration / employee benefits currently achieve similar results – the most closely aligned is CSOP which is a much more restrictive regime. We do however consider that CSOP should be reviewed in order to assess whether this could be used as a more effective next step for growing companies.

[1] BVCA Reports on Investment Activity – available here.

[2] Further information on *Innovation Nation* is available here.

Question 12: Are you aware of the other tax-advantaged employee share schemes offered by the Government (CSOP, SIP, SAYE)? Do you use or have you previously used any of these schemes?If the answer is no, please explain why.

Whilst SAYE and SIP are 'all employee' plans, we consider that the CSOP regime should be reviewed and could be a very effective 'next step' for companies who do not qualify for EMI. In particular, if adjustments were made such as, for example, allowing discounted options to be granted, removing the three year holding period and increasing the £30k limit, it would offer a useful alternative to EMI.

Question 16: In your view, should the EMI scheme criteria be extended to include more companies? Please explain your answer. If your answer is yes, which eligibility criteria would you change and why?

Yes. Our primary concern, is the how the rules will apply to PE/VC fund partnerships and the portfolio companies that they own; see our answers to questions 6-8 above.

Additionally, **we suggest that the government considers extending the circumstances in which the independence requirement will be *treated* as met to other appropriate circumstances** (currently this is done only in relation to companies that are under the control of an Employee Ownership Trust).

Q17: In your views, do the current EMI scheme criteria have a distorting effect on companies' growth insofar as the companies try to remain within the scheme's limits? If your answer is yes, could you provide examples or quantitative data to support your views?

None that we are aware of.

Q18: In your view could widening the current eligibility criteria to support larger companies affect smaller companies' ab ability to recruit and retain employees? Please explain your answer.

Potentially, yes, although not all highly talented individuals wish to work for large/multi-national corporations. We propose that revision in this area focus on deferring the point at which SMEs cease to qualify and allowing those companies that fail to qualify for what appear to be 'technical' reasons to qualify.

We would be very keen to discuss the contents of this letter with you and look forward to hearing from you.

Yours faithfully,

Mark Baldwin
Chair
BVCA Taxation Committee