BIA consultation submission: EIS knowledge-intensive fund

May 2018

Introduction

The BioIndustry Association (BIA) welcomes the opportunity to input into HM Treasury's consultation on a new Enterprise Innovation Scheme (EIS) Knowledge Intensive Fund.

The BIA is the trade association for innovative life sciences in the UK. Our goal is to secure the UK's position as a global hub and as the best location for innovative research and commercialisation, enabling our world-leading research base to deliver healthcare solutions that can truly make a difference to people's lives.

Our members include:

- Start-ups, biotechnology and innovative life science companies
- Pharmaceutical and technological companies
- Universities, research centres, tech transfer offices, incubators and accelerators
- A wide range of life science service providers: investors, lawyers, IP consultants, IR agencies

We promote an ecosystem that enables innovative life science companies to start and grow successfully and sustainably.

This consultation response has been informed by the BIA's Finance and Tax Advisory Committee and through consultation with fund managers (EIS and VCTS), independent financial advisors, and other intermediaries in the retail investment industry.

Overview of the BIA's submission

The BIA supports the creation of a new fund structure based on the successful EIS incentives and targeted to Knowledge-Intensive companies. We believe a new fund structure that provides attractive tax reliefs, facilitates portfolio investment, and is simple to invest in could increase the attractiveness of investing in a range of knowledge-intensive companies, including life sciences. Our full submission below sets out what features the fund should have to ensure it achieves this. In particular, the BIA proposes a new incentive of income relief applicable during years when fund shares are held, called Holding Relief, so as to reward longer holding periods; further details are given in the response.

As the Patient Capital Review rightly recognised, there is a current and particularly-acute gap in access to long-term and scale-up finance for life science companies. Whilst we welcome the new fund structure and believe it could increase investors' appetite for some life science companies, the structure and incentives are unlikely to favour companies developing new regulated medicines or other highly complex technologies. These have the longest Return on Investment (RoI) timelines, highest capital costs and can be higher-risk. As such, they often do not meet the investment requirements of most EIS investors.

Although the focus of this consultation is on a fund with EIS-like incentives, which are directed to individuals, it would be worth exploring what incentives and fund structures could facilitate institutional investment in scaling knowledge-intensive companies, which might provide the greater quantum of capital and longer timeframe required by some companies in the life sciences sector.

Answers to consultation questions

1. **Why are some younger knowledge-intensive companies unable to obtain the levels of patient capital that they require?**

   The BIA's submission to the Patient Capital Review consultation, *Financing growth in innovative firms,* described the challenges in raising capital faced by life science companies[1]. These can be summarised as: Return on Investment timeframes that far exceed other sectors due to R&D and regulatory hurdles; a shortage of specialist investors and others that feel they have the understanding to make investment decisions in science-based companies (including members of the public); and the high-risk nature of life science R&D, particularly in drug-development companies where outcomes can often be binary. Compounding these factors is the overall quantum of investment required to take a medical product to market, which is much higher than in other sectors.

   Even within the knowledge-intensive sectors, there is a wide variety of companies with different profiles of the above factors. Principally, many investors, especially individuals who use EIS, will naturally favour lower-risk, shorter-timeframe investments. Companies developing software or products subject to little regulation will therefore fit their requirements more easily than drug-development companies, even if the latter would provide a much greater return on investment in the long-term.

2. **What would be the best way(s) of further improving the flow of patient capital to knowledge-intensive companies, bearing in mind state aid constraints?**

   A variety of approaches is required, reflecting the variety of knowledge-intensive companies and their characteristics. The BIA supports the proposed fund approach, as the EIS brand is successful and well-recognised, and a fund structure facilitates a diversified investment strategy that helps spread risk, which is helpful for those investing in knowledge-intensive companies.

   To address the most acute patient capital gaps – largely faced by life science companies, as discussed above – more generous incentives may be required, as will tighter targeting to the specific types of companies. The BIA believes any State Aid implications of such an approach are manageable and is keen to discuss options with HM Treasury.

   Beyond this, the government should explore tax-based incentives or other facilitating policies for institutional investors and corporate venture capital. These generally have the greatest capacity to be long-term, patient investors; although, the Patient Capital Review was right to point out that such an approach is not necessarily being taken by many. The BIA welcomes the commitments the government has made to work to unlock pension fund investment into long-term venture capital and is keen to work with HM Treasury, the British Business Bank, and regulators to support these efforts.

3. **What barriers are there to the development of investment funds that specifically target knowledge-intensive companies?**

   Fund managers the BIA has spoken to report investors can be off-put by the delay in being able to claim income tax relief and only being able to claim relief on the amount invested in the underlying company, which, due to management fees and other costs, is not 100% of their subscription to the fund. Under current rules, relief is given only after 90% of funds have been invested when most

[1] BIA (2017), *The BIA's submission to the Patient Capital Review: Financing growth in innovative firms*: https://goo.gl/F8CgQh

investors have already closed their tax affairs for the relevant tax year and paid the tax. They then have to make a backdated claim one to two years later.

There is also the challenge of the general lack of awareness and understanding within the retail investor base of the investment opportunities presented by life science companies and other knowledge-intensive sectors. As a result, funds may have struggled in the past to attract significant numbers of investors. EIS investors have traditionally been able to claim reliefs on investments into a wide range of companies, including pubs and crematoriums. Changes made to the schemes in 2015 and following the PCR have been successful in closing down such uses of the reliefs. It will take time for the retail investment industry and its investor base to adapt to this new environment and seize the opportunities. An attractive fund structure will help with this process but a wider communications campaign could expedite it.

In respect to the life science companies discussed in the previous questions, another significant challenge is the timeframe in which retail investors wish to see a return. The EIS holding period of three years generally means individuals using the scheme wish to see a return shortly after that time, which precludes investment in many life science companies. Exacerbating this is the fact that investors only see benefits at the beginning and end of the investment (as dividends are rarely paid). Funds therefor are setup with short-term investment strategies that do not work for knowledge-intensive companies.

4. Would a targeted knowledge-intensive EIS fund model help increase the supply of patient capital to knowledge-intensive companies?

Yes. The BIA supports the proposed fund approach, as the EIS brand is successful and well-recognised, and a fund structure facilitates a diversified investment strategy that helps spread risk, which is helpful for those investing in knowledge-intensive companies.

The fund structure also makes it easier for Independent Financial Advisors (IFAs) to recommend the product, as they can rarely advise on individual investments but can refer clients to fund managers.

P.T.O.

5. **Which of the options outlined above would most attract investors to knowledge-intensive funds? Please rank and critically compare the benefits and disadvantages of each.**

Option (ranked top to bottom in order of benefit)	**Benefit**	**Disadvantage**
Up-front tax relief. Income and GST relief could be claimed in the year of investment into the fund.	This would be of significant benefit, as investors wish to see relief immediately and with minimal bureaucracy. The investor should be able to claim relief on the **total invested in the fund** in the year of investment or fund close, or nominate the previous year, to reduce the bureaucracy of filing tax relief claims and provide surety in their tax position (reducing need for retrospective claims).	A restriction on the time the funds must be invested into a company, as proposed, would be a disadvantage on the administration of the fund and result in poor asset allocation; it takes time to identify high-quality companies and conduct due-diligence. Current time-limits are already too restrictive, so the proposed two-year window would not allow more money to be raised but could allow better allocation of funds of the same size.
Capital Gains Tax relief. CGT incurred from the disposal of assets (e.g. sale of a house) can be partially written-off if part or all of the proceeds are invested in the EIS fund.	Allowing a proportion of capital gains tax write-off if invested into a knowledge intensive fund would be a positive inducement to investment. CGT relief should also be given on gains from the fund investment. Tapered relief could provide an incentive to maintain investment in the fund over a longer period to gain greater relief; this would require CGT not being annually capped as it is currently.	Entrepreneurs with significant capital gains may not wish to use a fund structure to reinvest their gains; they may prefer to invest directly into a company (perhaps even their own next venture).
Extended carry-back. Investors can claim 30% relief on income tax in any nominated year within a defined period, say three or five years, prior to the fund's investment in an EIS company.	This may be of benefit to some investors but we do not believe it would be a significant incentive to invest, and certainly not more beneficial than providing up-front tax relief.	It could increase workload on HMRC, which would be required to assess retrospective tax claims on multiple years.

Dividend tax exemption. This may be applied to dividends for shares held for a defined period, say five or seven years.	We see no benefit in this feature. Investors in early-stage companies generally look for significant accumulative capital growth.	This would encourage investment into companies paying dividends, or close to paying dividends, which is a behaviour we see in VCTs currently and one of the reasons they do not invest into early-stage knowledge-intensive companies, which typically invest all revenue into R&D. The policy under consideration should be targeted to companies that will not be paying dividends for ten or more years, generally.

P.T.O.

6. **What other features would a knowledge-intensive EIS fund need in order to address the funding gap for knowledge-intensive companies, keeping in mind the constraints within which such a structure would be created?**

The fund should have the following characteristics:

- **True pooling of capital**. The funds should be setup similar to unit trusts (like VCTs), so that investors own shares in the fund not directly in the underlying companies as they do with current EIS approved funds. It should also be possible to issue new shares (which provide reliefs) to raise additional capital. This will reduce constraints on the fund manager's strategy and reduce the need for managers to seek premature exits from companies as a result of investors withdrawing funds
- **At least 30% up-front income tax relief** with a minimal-bureaucracy system for claiming, subject to a three-year holding period of fund shares. Relief should be provided for the total subscription to the fund to reduce bureaucracy (caused by linking relief to individual investments in companies) and to maximise the attractiveness of the fund to prospective investors, who could be put off by not receiving 100% of their relief
- **Further income tax relief in years when invested in the fund to promote longer holding periods ("Holding Relief").** Shareholders could claim relief on their income in the current tax year as long as they hold shares for their original investment in full. Further analysis would be required to determine the relief rate required to provide sufficient incentive, however, 30% would be recommended so that holding shares is as beneficial as withdrawing and reinvesting into a new fund/company. We appreciate that this would be highly generous and potentially costly, although initial cost could be outweighed by increased economic activity. An alternative could be 10% upfront income tax relief and recurring Holding Relief also at a 10% rate.

  This feature could kick in after shares have been held for three years, and the relief could be awarded each subsequent year or at milestones, such as three, five, seven and ten years.
- **Disposal Relief** on capital gains as provided through current EIS rules
- **Loss Relief** as provided through current EIS rules
- **Deferral Relief** on capital gains as provided through current EIS rules. To encourage longer holding periods, a proportion of deferred taxable gains could receive Disposal Relief, whereby the longer the holding period the greater the Disposal Relief. However, as an incentive for longer holding, this would be less preferable to the further income relief proposed above, due to the added complexity.
- **Shares not subject to Inheritance Tax,** even if the fund is listed, to encourage long-term holdings. EIS shares are currently subject to Business Property Relief (BPR) but this is only applied if the funds are invested into another BPR eligible asset, reducing its attractiveness. A post-inheritance holding period, say three years, would need to be introduced to prevent recipients selling the shares immediately after inheriting them
- **Evergreen, preferably listed,** to enable a long-term investment strategy and promote transparency. Crucially, evergreen funds can follow their money in successive fundraising rounds but this may require investments to be made in non-ordinary shares, which will require new flexibility in the EIS rules. Moreover, listed structures are audited and information is publicly available, which will improve transparency and thus trust in the funds.

- **80% of funds should be committed within three years** of being invested into the fund to allow efficient allocation of capital
- **Allow secondary share purchasers to benefit from reliefs** to create a secondary market for shares in evergreen funds, this would improve liquidity, and thus value and sustainability, of knowledge intensive funds. The BIA supported Treasury proposals for EIS/VCT relief for replacement capital in 2016 but they were never brought forward (see annex 1). Allowing this for only knowledge intensive funds would increase the attractiveness of this asset class. As with VCTs, up-front relief would not be given but other benefits would, such as Holding, Disposal, and Deferral Reliefs
- **Permit portfolio company restructuring**, which is currently constrained in EIS-funded companies. This can result in inefficient business models and loss of reliefs when the rules are inadvertently broken

It is envisaged that this fund structure would require approval by HMRC.

In addition to the above incentives, the success of the fund for the life sciences sector will require buy-in to the proposition from the IFA industry, who will ultimately be the gatekeeper for many potential investors. Similarities to existing EIS products will aid understanding and acceptance of the fund structure but the asset class – life sciences VC – is one that few IFAs feel confident advising on, and the potential risks may be beyond their insurance cover. Critically, the fund structure will need to be classed as a retail investment product by the Financial Conduct Authority (FCA). Treasury should also explore with the FCA any regulatory barriers that might prevent investment through the new fund.

There will be a need to upskill the IFA community to understand the investment opportunities of the VC asset class; the BIA is keen to explore with Treasury how this could be achieved through a government-industry partnership.

7. **Would a 'patient' dividend tax exemption provide the right incentive to both attract investors in the fund structure, and encourage longer-term approaches to investment?**

It is our opinion that a dividend tax exemption will not provide a great enough incentive as the timeframe to profitability is too long for the types of companies that this fund should be looking to support. Locking money into illiquid assets for five, ten, or more years carries a significant premium, which the savings from such a relief would not be able to compensate for. A greater incentive would be further income tax relief in years when invested in the fund (Holding Relief) as described above.

8. **To what extent would relief at the level of the fund be attractive when weighed against the additional complexity that would be necessary?**

The BIA believes that reliefs at the level of the fund would be significantly more attractive to potential investors, largely as it would reduce the complexity for them, and, according to fund managers that we have spoken to, would not introduce an unmanageable compliance burden. It should also be noted that, whilst administration can be a distraction to fund managers, it is never going to be the most intellectually-challenging aspect of investing in knowledge-intensive companies.

For any further information on the contents of this submission please contact Dr Martin Turner, Policy and Projects Manager, by emailing mturner@bioindustry.org

Annex 1 – BIA submission to Treasury on replacement capital

Venture capital schemes - replacement capital
BioIndustry Association submission to HM Treasury – April 2016

The following statement was prepared by the BIA's Finance and Tax Advisory Committee in response to a request for comment from the HM Treasury Enterprise and Property Tax team.

Venture Capital Schemes – Replacement Capital

We welcome the interest of HM Treasury in considering a replacement capital measure for the venture capital schemes of SEIS, EIS and VCT relief.

We understand that replacement capital is considered to be "the purchase of existing shares in a company from an earlier investor or shareholder". This type of secondary sale would benefit knowledge-based companies. They usually have long development periods which act as a disincentive to many investors, so a tax relief to encourage a more active market in the shares should bring more private investment into the sector.

However, we also consider that any such measure needs to be targeted in order to avoid abuse and avoidance in the absence of furthering the development of the business.

We therefore consider that any replacement capital measure should contain the following elements:

i. The earlier investor should have held the shares for at least three years, consistent with the existing reliefs.
ii. The company should be knowledge-intensive, as these types of company require patient, long-term capital.

If these two conditions are met, then the earlier investor should be able to sell their shares as a capital gains tax exempt disposal. The new investor would then acquire the shares and similarly have the ability to sell then capital gains tax free if they hold them for at least three years.

For further information, please contact Dr Martin Turner, Policy and Projects Manager, BIA, on 020 7630 2192 or mturner@bioindustry.org.

The BioIndustry Association (BIA) is a United Kingdom trade association of over 300 member organizations working in research and development (R&D) and manufacturing in the bioscience sector. BIA members include emerging and established biotechnology companies, pharmaceutical companies, academic research and philanthropic organizations. BIA members are responsible for over ninety per cent of biotechnology-based medicines currently in clinical development in the UK. They are at the forefront of innovative scientific developments targeting areas of unmet medical need.