Written evidence submitted by Association of Investment Companies (SBC0005)

Post-pandemic economic growth: State Aid and Post Brexit Competition Policy

Submission to the BEIS Select Committee from the Association of Investment Companies

The Association of Investment Companies (AIC) represents listed, closed-ended investment companies, including Venture Capital Trusts (VCTs). VCTs have some £6.4 billion of assets under management. VCTs provide funding and expertise to small, entrepreneurial businesses facing a 'finance gap'. That is to say, companies which face difficulties securing equity or long-term debt to grow their commercial activities.

The finance gap for smaller businesses is particularly acute when they are seeking sums too large for family and friends to invest, or which could be provided by business angel finance. The amount of capital being sought is also too small to attract the interest of traditional institutions. Making investments in this type of Small and Medium Sized Enterprises (SMEs) involves the investor undertaking detailed due diligence. This takes expertise, time and resources. Traditionally, banks do not seek to provide funds to SMEs on this basis. Other specialist institutions, such as private equity funds, offset the cost of making investments directly into businesses by undertaking large transactions. This strategy is impractical where the amount of capital sought by a business is relatively low and, therefore, the potential economies of scale available to the investor are limited.

Government support for VCTs

Tax incentives are used to encourage retail investment in VCTs. These incentives are intrinsic to the sector's capacity to raise capital for investment in SMEs.

The reliefs include an initial income tax relief of 30% when an investor purchases newly issued VCT shares plus ISA-type reliefs. That is to say, retail investors do not pay tax on any dividends received or if they make a capital gain when they sell their VCT shares. This tax treatment compensates for the higher risks of investing in small companies, and offsets the costs of the due diligence involved. Without these measures, VCTs would not be able to raise funds to support SME growth.

In return for this assistance from the Government, VCTs invest in a defined range of 'qualifying' small businesses. This ensures that taxpayer support is targeted according to the government's policy objectives to support SME growth.

Supporting small businesses in challenging times

VCTs have continued to provide capital throughout the difficult commercial environment created by Covid-19, and they can also play an important role in supporting the UK's post-crisis economic.

The AIC has recently published a report, 'Eager beavers: Enhancing the UK's commercial ecosystem' which examines VCT investment since the 2017 rule changes which directed VCTs towards higher-risk investment.

This report demonstrates the valuable role VCTs have played in supporting the UK's SMEs through the pandemic. As the UK looks to build back a more stable and competitive economy, VCTs have a vital part to play in the business ecosystem making significant investments in ambitious young companies. VCTs support a wide range of SMEs, from healthcare to technology and generate new jobs to help create a more resilient and responsive economy.

VCT sunset clause

The VCT scheme was approved by the European Commission as State aid under the Risk Finance Guidelines. In 2015, the Commission approved the existing EIS/VCT schemes until 5th April 2025. As a result of this, the VCT legislation in the Income Tax Act 2007 (as amended) contains a sunset clause so that VCT relief is only available to subscribers in the VCT for shares issued before 6 April 2025. We understand that this sunset clause only arose as a result of EU State aid approval. Such clauses are not typical of the UK's legislative approach in relation to tax matters. The finance gap is not a temporary feature of the UK's small business finance environment. It is a structural issue which governments of all political complexions have sought to address for many years. VCTs have been used to help bridge the finance gap since 1995.

The government has the power to extend or remove the sunset clause through secondary legislation. This would allow the VCT scheme to operate in its current form beyond the current expiry date of the scheme.

The AIC **recommends** that the government should provide an early signal of its intention to extend the VCT scheme beyond the sunset clause deadline. Ideally, this would involve removing the sunset clause. This would provide welcome certainty to VCTs and their investee companies that VCTs will continue to be reliable sources of growth capital.

Since January 2020, when Covid-19 reached the UK, VCTs have invested £695 million in small UK businesses including £219 million in follow-on investment. Follow-on investment has become increasingly important to investee companies. The fear that VCTs may no longer be able to make follow-on investment as a result of the sunset clause could affect sentiment as to whether VCTs are able to provide long term support as the business grows.

The AIC **recommends** that the Committee endorse its request that HM Treasury delete the VCT sunset clause. This would support broader market confidence in VCTs as a long-term investor in UK SMEs.

Subsidy control bill: enterprises in difficulty

The AIC has concerns about the draft Subsidy control bill's prohibition on subsidies restructuring an ailing or insolvent enterprise.

Under the current VCT scheme, "*enterprises in difficulty*" are not eligible for investment (section 286B, ITA 2007). This is a reasonable prohibition designed to ensure that tax advantaged funds are not used to prop up companies without a realistic chance of success. The problem arises in the details of how this concept is interpreted.

Her Majesty's Revenue and Customs (HMRC) currently determines whether an enterprise is in difficulty in accordance with the European Commission's Guidelines on state aid for rescuing and restructuring non-financial undertakings in difficulty" (2014/C 249/01). In general, HMRC will regard any company as being 'in difficulty' when it meets the criteria for insolvency under the Insolvency Act 1986, such as:

- the company is unable to pay its debts as they fall due

- the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (the "balance sheet test").

Additionally, where more than seven years have passed since a company's first commercial sale, it will also be regarded as being in difficulty if more than half of its subscribed share capital has disappeared as a result of accumulated losses.

These criteria can prevent investment in SMEs which are commercially viable. They can be problematic where the VCT already has an investment in the company and is prevented from making a follow-on investment which it otherwise would. This prohibition could undermine the viability of its initial investment. A VCT is a commercial entity seeking to secure a return for shareholders. It has strong commercial incentives to only invest in SMEs it expects to thrive. If a VCT is prepared (in the absence of restrictions created by this rule) to make a commercial decision to invest further, then it should not be prevented from doing so. A VCT would not make a follow-on investment in an investee company if it thought that the investee company had no prospect or was unlikely to succeed. Deficiencies in the EU approach should not be transposed into the UK's approach.

The Subsidy Control Bill uses different terminology to address the same policy objective (ensuring that aid is not wasted on failing enterprises). It identifies an enterprise as "ailing or insolvent" if:

(a) it would almost certainly go out of business in the short to medium term without subsidies;

(b) it is unable to pay its debts as they fall due; or

(c) the value of its assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

This definition suffers from similar problems to the EU approach. It is too restrictive and could prevent commercial decisions to make follow-on investments in SMEs. It should be amended so that an enterprise should not be regarded as being ailing or insolvent where existing shareholders or creditors are prepared to provide financial support on a commercial basis. The AIC **recommends** that, in line with earlier EU Guidelines, the definition of "a firm in difficulty" or an "ailing or insolvent enterprise" is one where it cannot recover through its own resources or with the funds it obtains from its owners/shareholders or from market sources.

This would enable a VCT, which is an existing investor, to make a follow-on investment in an investee company if it chooses to do so. I ask the Committee to support this recommendation in its final report.

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