Fiscal Studies (1994) vol. 15, no. 2, pp. 98–104

Venture Capital

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I. INTRODUCTION

The Conservative Government has been keen to stimulate investment in small businesses. In his November 1993 Budget, the Chancellor announced that the Business Expansion Scheme (BES), due to expire at the end of 1993, was to be replaced by the Enterprise Investment Scheme (EIS) and that a Consultative Document on venture capital trusts (VCTs) would be published.

This Consultative Document was published in March 1994 and outlined a PEP-like system for venture capital. An individual could put a sum of probably £100,000 each year into a segregated fund which would purchase shares in VCTs. The income and gains arising in the fund would be exempt from tax. A VCT would be a quoted investment trust investing in small unquoted companies. Eligibility of investee companies would be similar to BES/EIS relief and a maximum investment of £1 million in any one company would be allowed, of which at least 50 per cent would take the form of equity capital.

II. VENTURE CAPITAL

Venture capital is regarded as investing in unquoted business where the investor takes the risk that he may lose his capital. Capital can be provided as

(i) debt capital,
(ii) equity capital, or
(iii) a combination of (i) and (ii).

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The holders of debt capital are entitled to a prior charge of the profits and assets of the business, whilst the holders of equity capital are entitled to the residual interest in the profits and assets of the business. An instrument such as a convertible or profit-linked loan can combine the features of both debt and equity capital.

Although equity capital is normally provided in the form of ordinary share capital, debt capital can be provided in the form of either a loan or preference share capital. Whilst a loan differs from share capital in being a liability of the company, in risk terms there is little difference since if the company goes bankrupt there will normally be no money to pay the unsecured creditors anyway. Loan capital is, however, more tax efficient because the interest is deductible in computing profits for corporation tax purposes. A preference dividend is not deductible though the imputation system of tax reduces the effective rate of corporation tax on profits paid out as dividend from 33 per cent to 16.25 per cent. It will be noted that one of the effects of the reduction in the rate of tax credit from 25 per cent to 20 per cent announced in the March 1993 Budget has been to increase the effective rate of tax on profits paid out in dividend from 10.7 per cent to 16.25 per cent.

III. GOVERNMENT INCENTIVES

The Government's incentives on venture capital have been directed entirely at equity capital. BES relief, and now EIS relief, are only available in respect of ordinary share capital and the shares must not be entitled to any preferential right to dividends or to assets on a winding-up. Similar restrictions apply to reinvestment relief for capital gains under the Finance Act 1993. VCTs will be allowed to invest in debt capital, but this will be restricted to 50 per cent or less of the trust's assets.

The Government's incentives on venture capital have not been perceived as being very successful in providing risk capital to unquoted companies. Throughout its life, most BES investment has been in companies specially promoted to take advantage of the relief and designed to exist merely for the qualifying period of five years, and in the latter stages of BES, most of the money went into guaranteed exit housing schemes where the investors took no economic risk. Very little money has been raised by existing companies.

IV. UNSUITABILITY OF EQUITY CAPITAL

The underlying problem with the Government's schemes to encourage investment in small businesses is that they have been targeted at equity which is generally a most unsuitable form of capital for small unquoted companies. A company or entrepreneur is primarily looking for cash to finance the start or expansion of a business. Because the holders of equity are entitled to the residual profits, the owners/promoters of a business are effectively selling an interest in that business or prospective business by raising equity capital. As the promoters of the business or development that requires the capital, they will be more optimistic about the prospects and value of the business than outside investors and they may well not perceive the price that the outside investors pay for their equity as fair. Existing owners tend only to issue equity if they have no alternative ways of raising capital or the issue of equity is part of a package where debt is also provided.

By acquiring equity, the outside investors will become co-owners of the business with the existing shareholders who will generally be the managers of the company. Co-ownership inevitably creates potential conflicts of interest which will concern both managers/existing shareholders and outside investors. The outside investors will be concerned about how the business is run, what the managers are taking out in remuneration, dividend policy etc. The managers will be reluctant to cede voting powers to persons who know little about their business. The smaller the business the more dependent it will be on a few individuals, and the less easy it will be for outside investors to exert control. The Government seeks to encourage employees to own shares, and it should be noted that by encouraging outside investors to hold equity there is consequently less equity available for employees.

A key factor for an investor in taking an equity stake in an unquoted company is how the investment can ultimately be realised. There is little market for minority shareholdings in unquoted companies and where they are sold the price is generally very heavily discounted. Whilst flotation on the stock market is the preferred method of allowing investors to realise their holdings, it is unlikely to be economic these days to float a company much under a market capitalisation of £50 million. The smaller the business, the less likely it will be to grow to a size sufficiently large to be quoted on the stock market. Moreover, many managers do not want the pressures of running a public company. A sale to a third party will only be feasible if the managers want to sell their shares out also. Whilst a purchase by the managers or the company itself is possible, this is not a third-party sale and raises the issue of what is a fair price.

V. DEBT CAPITAL

Some form of debt capital which puts the interests of outside investors in priority to the interests of the managers/existing investors is likely to be much more attractive to both parties. It provides the investors with a quantified return which arises before the managers' entitlement and leaves the managers with full control over the business provided they deliver that return. Many companies would borrow from banks, but the difficulty is that banks are reluctant to lend where there is no security. Bankers generally require personal guarantees from the managers; as a result, if the business fails they could lose their homes and go personally bankrupt. The terms on which banks can call in their loans can be very onerous.

Entrepreneurs would be willing to pay high rates of interest for capital whose terms are less restrictive and do not involve personal bankruptcy if the venture fails. Many businesses actually only need small amounts of capital, often for relatively short periods of time, and therefore high rates of interest are not necessarily prohibitive. Whilst investors could lend at a straight rate of interest, investors and managers should be able to negotiate terms appropriate to the particular venture in question. These terms could, for example, include rolling up interest for a period of time, or linking interest to profits. In many cases, the capital might carry a guaranteed return plus some equity participation and represent a hybrid between debt and equity. If the investors are entitled to a guaranteed return they will only require a smaller percentage of the profits than would be the case if the capital was entirely equity, and this will create less tension between the investors and the managers.

If one looks at management buy-outs where most venture capital is currently provided, investments comprise a mixture of equity and debt finance, and usually by value debt finance is the largest element of the total investment. In the case of larger transactions, it is possible to divide up the capital provided between equity and one or more categories of debt. This is not so feasible in the case of smaller businesses because there are considerable transactional costs in monitoring unquoted investments and it will not normally be commercially sensible to have more than one category of capital.

VI. TAX PROBLEM

Where debt capital is provided, the return comes in the form of income for tax purposes and, moreover, any premium above the original issue price of the investment, whether paid at redemption or otherwise, will be characterised as income. In the case of venture capital there is a risk premium over and above the return earned on totally secure funds at a bank or building society and the more risky the investment the greater will be the premium. This premium compensates the investor for the losses that he will inevitably suffer if he has a portfolio of investments when a venture fails. Under longstanding tax principles, any loss on his investment will be regarded as capital and cannot be offset against income. The loss should (though not always) qualify as an allowable capital loss and can be offset when realised against capital gains. Whilst some investors may have capital gains and therefore can obtain tax relief, a portfolio that is geared towards income is unlikely to have capital gains. Only a bank or finance house which is regarded as a trader for tax purposes can offset losses against income. It is very difficult for a person other than a bank to be regarded as a trader where he is investing in securities intended to be held for the longer term.

An investor who provides debt finance can therefore be taxed on a much higher amount of income than he makes commercially. For example, an individual lends at the rate of 20 per cent per annum 50 to one company and 50 to another company. On the first loan over five years, he earns interest of 50 and receives back his capital of 50, but the other loan is a total write-off. The investor will, in overall terms, have broken even before tax and made neither a profit nor a loss, but for tax purposes, he will have earned income of 50 and will have a tax liability of 20, which will mean that out of his original investment of 100 he will get back only 80. Because venture capital investments are risky, it will make sense for an investor to diversify and invest in a portfolio of investments. This inevitably increases the chances that the investor will be taxed on a higher amount than his true economic income. Furthermore, the more risk the investor is prepared to take in his choice of investment the worse his problem. The position is no better if the investor invests through a collective investment vehicle, such as an investment or unit trust. Such vehicles would have to distribute their income in the form of interest or dividends, notwithstanding making losses on the investments themselves.

If an individual makes a single investment and he gets paid his interest, but the company subsequently goes bankrupt, he will be taxed on his high income, notwithstanding later losing all his capital or, moreover, will still be taxed if at the time the interest is received the company is in a doubtful financial position. A bank can make provisions for losses against its income and the measure of its income should be its economic profit.

Most individual investors have not looked to invest for income because the rates of tax on income have traditionally been so high. Since income is now taxed at below 50 per cent and at the same rate as capital gains, there is no advantage for investors in looking for capital gains and investors should be neutral between capital and income as long as the measure of that income is fair. With the recent steep decline in interest rates, many investors are seeking to maintain their income and if inflation rates remain low, debt investment should become more appealing.

VII. POSSIBLE SOLUTIONS

Rather than provide incentives to a particular form of finance which is not appropriate for most small businesses, the Government would be better advised to remove the tax difficulties that discourage debt finance from the non-bank sector. There is no obvious reason why the provision of debt finance should be restricted to banks and it would be desirable that individuals and collective investment vehicles should be encouraged to lend to the small business sector. High-risk lending is more appropriate for investors who are staking their own money than for banks which are ultimately staking their depositors' money.

- Provision could simply be made that losses on venture capital investments are offset against income. There is precedence for this in the form of relief under Section 574 Income and Corporation Taxes Act 1988 which allows income tax relief for losses on ordinary shares in unquoted trading companies.
- This relief is not available in respect of debt capital and is only available when the investment is realised. Any system of offset should allow relief for provisions as this otherwise encourages investors to push unsuccessful investments into bankruptcy. Provisioning, however, is inevitably subjective and creates scope for disagreement between investors and the Inland Revenue. The cost to the Exchequer might be reduced by restricting the deductibility of losses or provisions to income from other unquoted investments or investment income generally.
- If the Government wanted positively to encourage venture capital it could remove some of the subjectivity of provisioning by a system of allowances. To reduce the cost to the Exchequer, allowances might be given over a period of years with claw-back of the allowances when the investment is sold. As part of the quid pro quo for allowing relief for losses, any gains on the investment could be brought into charge to income tax.
- The tax difficulty with venture capital finance arises because investors receive a high rate of return for taking risk. An alternative approach would be to allow investors to exclude their income for tax purposes and roll it forward as a reserve against future losses. A reserve along these lines has recently been introduced for Lloyds underwriters. In the case of venture capital, the whole amount of income could be rolled forward or, less generously, the income in excess of a normal rate of return, say 5 per cent.
- An extension of this approach might be to allow investors to set up tax-segregated funds along the lines of PEPs and what is proposed for VCTs. Rather than exempt the income and gains of such funds altogether, which perhaps would be too generous and would encourage avoidance, the income and gains could be taxed when they are extracted from the fund.
- The Government could confer exemption in return for a fee or a special tax. Investments could be put into a tax-free fund if the investor paid a fee of, say, 2 per cent to the Government. The level of the fee might be based on the income tax that would be payable if the income was placed on deposit. At current interest rates of around 5 per cent and a top income tax of 40 per cent, a 2 per cent fee should more than compensate the Revenue for the loss of the tax. The purchase of such exemption would mean that if the investments were successful, investors would be better off, but if the investments were not successful, investors would be worse off.
- Since many investors would wish to invest through collective investment vehicles which can spread risk and provide specialist management, attention should be given to the tax position of such vehicles.

VIII. OTHER ISSUES

- Tax relief is usually available for interest on borrowings to finance an investment in an unquoted company where the borrower has more than 5 per cent of the share capital of the company. If investors are looking to invest for income, there is no reason why investors should be denied tax relief for their borrowing costs. To reduce the cost to the Exchequer, tax relief might be restricted to income derived from unquoted investments in the same way that interest relief on borrowings to acquire investment property is restricted to the rents received.
- Where interest payable by a company is to any extent linked to profits, the interest is not deductible for corporation tax purposes and it is treated as a dividend. This restriction does not apply where the lender is a bank or company. In order not to discourage the linking of interest payments to profits, it would be desirable to remove this restriction in respect of all loans.
- Unquoted investments are more difficult and expensive to manage. It would be appropriate that tax relief is given for such management expenses, as it is currently available to companies.

IX. CONCLUSION

To a Conservative Government, tax incentives are more attractive than government expenditure in stimulating economic development. However, tax incentives, just as much as government subsidies, need to be carefully targeted and run the risk of distorting economic activity. If taxpayers are being encouraged by tax incentives to do something which they would not naturally wish to do, larger tax benefits must be given to have any effect. The greater the benefit on offer, the more it will encourage artificial schemes to claim the relief without in substance doing what the Government intended should happen, and this leads to loss of revenue.

In seeking to encourage investment in smaller businesses, the Government has mistakenly targeted equity capital. Pure equity capital is not attractive either to most small businesses or to investors. Debt capital is much more suitable and achieves the desired purpose of providing cash to small businesses to finance expansion. Rather than seeking to introduce tax incentives which of themselves distort the tax system, the Government would be better advised to remove distortions already present in the tax system. One significant distortion as regards venture capital is that the tax system discourages high-risk lending by the non-bank sector.