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Looking to a better future

How the fiscal environment should help mend society going forward and encourage more innovation and entrepreneurship in the "new normal"

Some thoughts from aproposIP – specialists in advising on the exploitation of IP

Covid-19 will be a catalyst for the next wave of entrepreneurship and innovation. The world will need to adapt, with speed and agility: innovative entrepreneurship, thinking outside of the box, will provide a greater range of options for generating the "new normal". But the speed of response, and hence change, is vital. One of the boxes that previously has prevented many innovative changes to happen has been the fiscal environment. This is not a constraint peculiar to the UK, but some jurisdictions have made more effective attempts to encourage innovation and entrepreneurship than others. In this article we suggest ways in which the fiscal environment in the UK needs to change now, not at some time in the future, to ensure that one of the positives to come out of the pandemic is a vibrant, innovative and disruptive economy, where entrepreneurship is embraced and encouraged.

Where are we now?

With Covid-19, we are already seeing a major change in how businesses and consumers behave. Remote working and online shopping are probably the two most obvious examples. We no longer reach for the phone to call our bank, our utility suppliers, our insurers, our medical services; we go online instead. We've seen the impact on our high streets and shopping centres, and even the established online suppliers are seeing a shift in buying behaviours. One of the major clothing retailers has just announced that the rate of returns has fallen by over 30%. This means that their whole business model has to change and supply-chain dynamics become very different.

In our view, however, this is not innovation. It is change to adapt the existing business model to work, for better or worse, in the new environment. To use an economic term, it is a "push" response rather than a "pull" response. True innovation is changing the business model, concept or idea for the better, not as a reactive response, but as a disruptive force to change things for the better.

aproposIP is a specialist commercial consultancy, run by Dr Andrew Jupp (from Jupp Consulting – a specialist tax advisory firm) and Dr Pete Hotten (from NuAge Vision Ltd – a specialist IP exploitation consultancy), focused on IP rich early stage and fast-growth companies. Andrew, a chartered accountant, has deep tax expertise in the many areas that impact such organisations. Pete has spun out companies from universities and other IP rich organisations, he specialises in IP and IP strategy and has been a director and non-executive director for several companies. Both are PhD qualified life scientists who have been involved in commercializing science and technology for many years. They bring the ability to optimise the commercial prospects of their clients in a proactive and engaging manner.

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Inevitably, this means that risks have to be taken. Indeed, innovation and entrepreneurial activity (IdEA) inevitably involve risk; without risk there cannot be innovation. This risk needs to be managed, but if it's controlled too tightly, then innovation is stifled and no one will ever take that leap of faith. So there's a balance to be struck between managed risk-taking and recklessness. And so our suggestions later seek to encourage an appropriate level of risk, and reward it, whilst maintaining a degree of control and accountability.

We start with the premise that a civilised society/economy needs tax revenue to operate. There are then two questions that arise from this. They start with accepting that we need to tax individuals and organisations, so it's not "if" but "when", and secondly, do we need to use the tax system to incentivise initially ("reverse taxation") to tax more in the future?

In our view, the answers are very clear. We should tax the financial reward that comes from success, and in order to do that, we should use the tax system to create and encourage success. Doesn't it sound simple?...

1 Why is the fiscal environment so important?

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply. These two policies are used in various combinations to direct a country's economic goals.

When an economy slows, as it clearly has at the moment, unemployment levels are up, consumer spending is down, and businesses are not making substantial profits, government typically responds in one of two ways. A government may decide to fuel the economy's engine by decreasing taxation, which gives consumers more spending money while increasing government spending in the form of buying services from the market (such as building roads or schools). By paying for such services, the government creates jobs and wages that are in turn pumped into the economy. The alternative approach is to increase taxation, in the hope that increased tax revenues will enable debt to be repaid and create surpluses that can be invested to create jobs and in turn encourage consumer spending.

One of the biggest obstacles facing policymakers is deciding how much involvement the government should have in the economy. Indeed, there have been various degrees of interference by the government over the years. But for the most part, it is accepted that a degree of government involvement is necessary to sustain a vibrant economy, on which the economic well-being of the population depends.

2 Where does innovation come from?

Innovation can come from many sources, including:

- An individual in isolation;

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- An individual champion within some form of organisation (company, society, social network etc)
- Collectively from a group brainstorming issues and ideas
- Academia, industry, charities, regional and national government, local government.

Innovation typically springs from:

- Adversity (where we are now)
- Threat or challenge (again, where we are now)
- Observation of something better elsewhere
- Original thought driven by curiosity (often, but not always, from academia)

For any of these to flourish and move from the thought stage to the development/concept phase, they need to be first, activated, and secondly, encouraged/incentivised. And that's where the fiscal environment becomes important.

What are the barriers that stop these original germs of ideas being progressed and developed? The innovation process needs time and resource. Time to sit down and think, to articulating the thoughts, to involve the relevant third parties and then to develop and implement the innovation. But the potential innovator/entrepreneur often doesn't have the time or the money to "take time out" and develop their creative thoughts. They are probably already working and undertaking activities to sustain normal living. Many potential great innovations may be lost and remain in the innovator's head and probably never even make it to being articulated in writing.

3 What do we have at the moment?

There's plenty of appetite/money available (both from the public and private sector) but in our view, not enough is channelled towards innovation. For early-stage companies seeking to raise funds, we have the Seed Enterprise Investment Scheme (SEIS) and the Enterprise Investment Scheme (EIS) which directly help the investors, but not bring immediate benefit to the innovator. These give income tax relief to the investor and tax-free gains if the investment is successful, but they are complex reliefs and many early-stage companies do not have the time nor the resources to implement them. Ultimately, they reward the investor who is already likely to be wealthy which is where, eventually, we want the innovators to be. The idea is laudable; the practicalities are fraught with hurdles and obstacles. Venture Capital Trusts (VCTs) have a similar aim, but the investment limits are relatively modest and again, only reward the investor. One could argue that without the investor being incentivised, then they won't "buy into the dream". This is, to an extent, true, but it doesn't help the entrepreneur who is taking the real risk (and also is likely to have "all his eggs in one basket", unlike the investor who will probably take more of a portfolio approach to managing risk).

Sadly, one relief which does directly benefit innovators, has been affected by recent changes which have made Business Asset Disposal Relief (BADR – formerly Entrepreneurs' Relief) far

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less attractive, such that now there is a lifetime limit of only £1million of capital gains being taxed at the lower rate of 10%. This was a valuable relief as it rewarded the founders of a business, not just follow-on investors. And there's much speculation that there will be changes in the next year or so to more closely align the rate of tax on capital gains with income tax rates, thus removing another incentive to take a risk with an idea or to invest in early-stage risky ventures.

For corporate investors, we have the valuable (but often over-looked) substantial shareholding exemption (SSE); the ability for corporates taking a 10% or greater stake in another company to realise the gain on a future sale of that shareholding tax-free.

So, there are incentives and reliefs available, but are they really working for the entrepreneur and main risk taker? We think not.

Many corporates (and other organisations) have sufficient cash that they are sitting on because of uncertainty; in other words, the worry that if they invest in something new that the endeavour may fail and leave the organisation in a financially poorer state. Some organisations are penalised if they invest in activities outside of their core objectives (eg charities).

So, what would we like to see change?

4 What changes would we like to see?

First and foremost, we want simplicity. Time and time again we are told that things are "just too complicated" and "we will spend more on professional fees than the benefit we gain". Simplicity is paramount for several reasons.

- The benefits must outweigh the cost.
- An idea needs to be acted upon quickly. Speed to market is often a key competitive advantages.
- Ongoing compliance (as, for example is the case with the current EIS regime) must be clear and easy to manage.
- It must be understandable by the entrepreneur/innovator (who is unlikely to be financially savvy), the investors and those within the organisation managing things.

Furthermore, a truly disruptive innovation which challenges the norm may by definition not be "investor friendly". There is a danger that the idea might be watered down to satisfy a risk-averse investor, and therefore not achieve its full potential. Investor reliefs therefore need to be more focused so as to encourage real risk-taking, not just by the entrepreneur, but by the investors as well.

So, here are some ideas. They are not costed (in terms of immediate loss of tax revenues, or actual upfront cost to the Exchequer) but are designed to set the creative juices flowing in the minds of policy-makers and influencers.

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Encouragement for the individual entrepreneur

As mentioned earlier, if the individual entrepreneur is not wealthy, they will need to spend their time and resources on activity which sustains their life/family. Many potential great ideas may be lost unless there is some form of almost instant support that allows the individual to use time to develop the innovation. Could the social service support network be used to drive innovation? For example, ‘universal credit’ is a system used to support the unemployed and others in trouble. But could the level of ‘universal credit’ be supplemented for those entrepreneurs actively trying to get innovative ideas implemented? Rather than this being seen as a “freebie”, it could potentially be structured as a loan which has to be paid out of the profits of success, with some form of write-off if the idea does not come to fruition. An analogy might be similar to a student loan whereby it is only repaid when the graduate earns above a certain amount in the future.

And could there be some form of mechanism that supports possible failure? It is generally acknowledged that an entrepreneur who has failed once is more likely to succeed when they try again. If an entrepreneurial / innovative company fails and leaves the entrepreneur in financial difficulty could there be a tax system that provides a safety net for the individual? This could, perhaps, be in the form of a preferential loan, or a convertible loan, or a grant for the innovative proposal which recognises that the entrepreneur already has a track record of ideas, even if they have not come to a successful commercial fruition.

Encouragement for early-stage investment individuals and teams

A key problem under the current regime is the lack of liquidity in early-stage investments[1]. Both early-stage investment funds and individuals become locked into their investments, often having to wait a decade or more to secure any return.

If Government were to intervene to address this market failure, it would be to enable a mechanism, i.e. making available money under specified conditions, to reward both early stage investors and associated management teams for taking what is a disproportionate risk for the reward that they might receive. Equally the same mechanism could be used to enable early high-risk investors / management to follow on their investment as an alternative. Ultimately this would allow early investors / management to exit the commitment that they have made should they want to or continue as part of the overall team on an equal footing to new investors.

Most entrepreneurs, as we have alluded to already, are rubbish as financial management, administration and the management of a business. They are great with coming up with ideas but they are unlikely to be the right person to drive this forward. We suggest that there needs to be some form of “catalytic fund” which exists to buy out these innovators at an early stage, and to free them up (with some security behind them) to create more ideas and take more risks in the future. As experience shows time and time again, it is better to create a portfolio of new innovative enterprises than to place all bets on one or two. Enterprises

[1] We would like to acknowledge Gerry Ronan and Mark Bowman as contributors to this concept.

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succeed or fail for a great many reasons, and it is almost impossible to predict if one new enterprise will become the next "unicorn". But the probability of creating a winner rises dramatically if there are several runners in the race.

To an extent, the recently introduced Future Fund (launched in response to COVID-19) has sought to address some of these issues. The Future Fund provides convertible loans to UK companies in amounts ranging from £125,000 to £5million, subject to third party investors matching the amount. The fund aims to support UK start-ups that rely on equity investment but are unable to access the Coronavirus Business Interruption Loan Scheme. This is a start, but is time-limited, and doesn't go anywhere near far enough.

Here is a further suggested solution. We suggest that a government-backed fund be established to incentivise early stage activity and which would also create a return to government over the long term. The fund would acquire an equity position but at a discounted value, i.e. it could buy early investor / management equity at a discount or, in the event the fund enabled an early investor to follow their investment the same discounting mechanism would be obtained by the supported investors / management agreeing to pass on a % of the economic value of any equity they dispose of in the future.

Encouragement for corporates to invest

As mentioned earlier, the SSE relief allows corporates to dispose of investments, subject to certain conditions, tax-free. However, there are currently no upfront incentives to encourage corporates to invest. Here are a few thoughts on what might be considered.

- Immediate relief for corporation tax purposes on equity investments in any business which satisfies the normal SME criteria and has been established for less than three years. Any gains on the investment would be entirely free from corporation tax (akin to the SME) but without the minimum 10% shareholding requirement. In some ways this would be a form of extending EIS relief (for individuals) to corporates.
- A tax credit system (similar to R&D tax credits) to encourage corporates to invest in businesses which operate in an entirely different field of expertise to the investing company's core business.
- Maybe a "stick" rather than a "carrot" approach could be introduced. Maybe corporates should be penalised if they have substantial cash piles but do not put aside, say, 5%, into a fund ring-fenced for supporting earl-stage high-risk innovations. There is an analogous position here with the requirement for public companies to comply with certain Corporate and Social Responsibility (CSR) regulations. Whilst initially introduced as a stick, it has now become a matter of pride for companies to publish their CSR policy and to be seen to be leading the way.
- Evolution of the Public Private Partnership (PPP) model. This was a model that initially was welcomes and lauded but became to be despised. Could this be re-launched with the object of creating an "innovation support PPP" where grants are provided to support innovative commercial projects? Structured correctly, along the lines of a matching 50:50 public:private funding, for example, this could catalyse industrial growth. Possibly central government could make funds available to local

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councils by increasing the budget they give to them by say 50% (ie on a matching basis) for every investment they make in an IdEA.

5 And in the long-term?...

One of the biggest disincentives to take risk is uncertainty. We always have to advise our clients that the advice we are giving now is based on current legislation and practice, which may change. So what might look like an attractive proposition now may not look so attractive next month or next year. Take, for example, BADR. Many entrepreneurs were working on the basis that at least £10 million of their gain on the successful exploitation of their idea would be taxed at 10% capital gains tax. Overnight they were told that only £1 million of gain would now attract the lower rate. And if rumours/expectations are correct, potentially a massive amount of their gain could be taxed in the future at a much higher rate.

So, we are calling for:

- Certainty over the sustainability/ longevity of tax reliefs and incentives
- Simplicity in implementation and ongoing compliance
- Creativity by politicians and civil servants in devising and setting policy: talk to the interested parties, involve entrepreneurs, academics and corporates in the decision-making
- Incentives which are aimed directly at the entrepreneur/innovator, as opposed to the investor (recognising, of course, that today's innovators may become tomorrow's serial investors)

And if we can get all this right, we will have created a culture that embraces innovation, risk-taking and entrepreneurship, and an environment that plays it part in creating the "new normal" post-Covid.

END

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