Response to:

HM Treasury Consultation on Tax Advantaged Venture Capital Schemes

September 2011

1. The Treasury's consultation of tax advantaged venture capital schemes comes at a very timely moment for the UK's commercial music industry and is of crucial importance to our sector. UK Music warmly welcomes Government's proposals for a new scheme to support seed investment and we offer comments on how the scheme can operate most effectively. We are concerned, however, with proposals relating to reform of the Enterprise Investment Scheme as we fear the proposed changes could have the unintended consequence of effectively barring investors in the music industry from participation in the scheme. We endorse the points relating to the qualifiying activities and the test of company size made by Ingenious Media in their submission.

2. A significant part of the UK's commercial music industry is characterised by the very high levels of investment required[1]. Businesses involved in the discovery of new talent, the production of new sound recordings and musical works, and the management and promotion of artists must typically frontload substantial amounts of investment in these activities while returns follow only after the lion's share of 'research and development' costs have been made. The risk and capital expenditure requirements are greatest at the start of each project.

3. It follows that availability of finance at these crucial stages is one of the most pressing issues facing the UK's commercial music industry. Many music entrepreneurs report acute difficulties in securing the finance they need to pursue their ambitions. Whilst accessing finance has always been difficult for the music industry, the difficulties appear to have become deeper and more entrenched over the past five years.

4. Several factors account for this. Following a decade of disruption and structural change, the music industry is now comprised of fewer mid-sized and large businesses, and more small and micro businesses, and these typically face greater challenges attracting external sources of finance. In addition, overall revenues across the sector as whole remain depressed.

[1] A&R investment in the UK music industry has traditionally invested around 20% or above of industry revenues in new talent.

Pressure on revenues inevitably will squeeze margins and reduce the levels of investment from the industry which negatively impacts the availability of internal financing arrangements that had previously sustained smaller SMEs in the sector's ecology. As a result, external sources of finance are more essential now than ever before, yet many investors appear wary of investing in the music industry. In addition to the inherently high risk of investing in a cultural or artistic 'product' in an economic downturn, investors are sensitive to challenges faced by the content industry in safeguarding itself against copyright infringement.

5. Without intervention, the lack of finance for investment will hamper the sector's potential for growth. Many dynamic, innovative music businesses are chronically undercapitalised and this greatly exacerbates their struggle to gain traction in a highly competitive and rapidly changing market.

6. Fiscal measures designed to stimulate greater levels of investment in research and development appear to be designed for the manufacturing process – whether the product is widgets, pharmaceuticals or high tech computer coding. Our colleagues in the technology sector describe how crucial the R&D tax credits they receive are for sustaining their business models. Meanwhile, our colleagues in other creative content sectors such as television and publishing describe similar frustrations that we experience in our inability to benefit fully from fiscal tools supposedly designed to encourage investment in the development of high value 'goods and services'. We would urge Treasury ministers to redress this historical imbalance between the manufacturing and creative content sectors when it comes to R&D tax incentives more generally.

7. Turning to specific questions in this consultation, UK Music welcomes proposals for a new stand-alone scheme for seed investment. However, great care must be taken in defining a seed stage company so that the definition does not exclude music companies. Many examples provided in the Treasury's consultation document for a seed stage company relate to activities leading to the manufacturing of a product. However, some music companies may never produce a physical product, particularly if they are primarily operating in the digital market.

8. Further, in our experience, there is a real and pressing 'investment gap' for companies that are already trading, but have not yet achieved the level of scale which would be appropriate for attracting investment through EIS. The new scheme should be flexible enough to enable investors to invest in fledging companies that have already embarked on their journey but whose investment needs have become more apparent after taking the first few steps. For example, a record company may have been created in order to promote and distribute one album by a promising young act, funded entirely from the directors' own savings. If the album enjoys success, the label owners might have ambitions to re-release the album to a wider market, sign another act or produce a second album. The type of investment required for this would amount to seed funding, yet the company would be unable to attract a potential investor through this new scheme because technically they are no longer in the pre-trading phase.

9. A requirement to utilise all monies raised in the scheme within a certain period of time would be reasonable so long as the period is set sensibly (years, not months). However, companies should never be incentivised to spend money just for the sake of meeting an arbitrary deadline, and besides, investors will put their own considerable demands and pressure on the company so we question the need for Government to create a requirement in the first place which will have to be monitored and enforced.

10. One feature of a new scheme to support seed companies should be to enable investors to convert a loan into an investment and still have the tax benefit, as there are many occasions when it would be in the best interest of the company to keep the cash in the business. This would not mitigate investors' exposure to risk, which would remain very high, but it would create greater flexibility for the seed company. For example, an investor may already have a £100,000 equity stake in a company, and if the company requires another cash injection, the investor should be able to loan a further £100,000 to the company, and benefit from tax relief, with the option of converting the loan into equity in the future.
11. We strongly urge Government against trying to define a 'business angel' or to specify the type of individual who can benefit from this tax relief. This effort is unlikely to lead to the outcome Government seeks. Having previously invested in 4 (or more) seed stage companies is not a reliable indicator that

the investor will be able to provide 'good' advice to the company in which s/he is investing, particularly if the company is embarking on a highly innovative or specialised venture. Equally, many potential investors will absolutely not want to become a director of the company. What pre-trade seed companies need first and foremost is investment. The overriding objective of Government must be to stimulate and lubricate the flow of investment, not to select 'smart' investors from those with more money than sense. To try to force the dispersal of good business advice from potential investors as a condition for investment relief is mistaken and is likely to benefit no one. Any definition settled upon will either be side-stepped, or will have the effect of deterring potential investors. We very strongly urge Government to disentangle investment relief for seed funding from the provision of business support and mentoring.

12. We suggest instead that companies in receipt of tax advantaged venture capital schemes be advised of specialist business support schemes such as the Princes Trust or the relevant industry trade associations as a better route to achieve the Government's objective. Schemes such as the Prince's Trust Enterprise Programme have a strong track record[2] of providing business advice and guidance to young people who show entrepreneurial promise. The music industry remains a very attractive sector for young people and with the right combination of investment incentives and business support services the music industry can be a positive contributor not only to enterprise but to employment and social inclusion.

13. We now turn to the EIS scheme. Neither income tax relief nor capital gains tax exemption is available to individuals who are 'connected' to the company in which they are investing. Why? The EIS is "designed to help smaller, higher risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies." Those investors with a connection to the company will not be any less exposed to risk than those without a connection to the company, and in sectors where risks are perceived to be particularly elevated, the need for incentives are most acute.

[2] Over the past year, more than 5,500 young people joined the Enterprise Programme for people interested in self employment. A further 7,188 young people with their own businesses were provided with ongoing mentoring support. The Princes Trust has helped 77,000 young people set up business since 1983.

Just as we strongly urge against a requirement in the seed stage funding that there must be a connection, we would urge that there should be no bar under the EIS scheme to having a connection to the company. It seems nonsensical that Government would set so many barriers to investors having a connection to the company under EIS scheme when Government is at the same time searching for ways to force a connection under the seed funding. The only connection restriction that makes sense would be if an investor were also employed full-time by the company. We urge Government to remove all other connection rules.

14. Excluded activities: "*receiving royalties or licence fees (though if these arise from the exploitation of an intangible asset which the company itself has created, that is not an excluded activity)*" All music publishers are excluded from EIS as music publishers technically take an assignment of copyright rather than create it. This is an anomaly and must be addressed as it remains a very blatant discrimination to parts of the music industry. The activities carried out by many music publishers with respect to the development of songwriters and the promotion of musical works are increasingly akin to the activities carried out by record labels in their support of their artists, who are eligible for EIS, in recognition of the very high risk involved. Please see our annex for further details.

15. This rule also prohibits small record companies or any other music company which has bought an existing catalogue, even if the investment would be used for developing new IPR and therefore is unquestionably legitimate risk capital. Music industry representatives would like to work with Treasury officials to find a way of amending the excluded activities rules so that they are not unjustifiably excluded from the EIS. This has been an area of contention for many years and we urge Government to take this opportunity to fix this issue, which need not be controversial or unduly difficult. We refer the Treasury to the submission of Edge Investment Management which sets out these concerns as they affect other creative content sectors. We fully endorse Edge Investment Management's submission as it relates to excluded activities.

16. Chapter 4 of the consultation document, covering questions 29 to 37, cause us great alarm. Government propose to set a test for companies which

employ less than 4 full time employees in order to address concerns that some companies appear to be established only for the purposes of accessing tax relief. The vast majority (81%[3]) of music industry businesses employ fewer than 5 people. By way of example, a recent survey of the 850 companies that comprise the membership of the Association of Independent Music showed that the average employee headcount was two people per company. If company size were the only trigger for a test, virtually the whole of the music sector would be subjected to such a test and have to prove their legitimacy before participation in the EIS. This feels like a presumption of guilt and seems blatantly wrong and disproportionate.

17. An alternative proposal put forth by Government is for the tests to stand on their own, with companies disqualified if they display 3 or more of the 9 characteristics listed in section 4.12. Again, this gives us cause for concern. Many existing, legitimate music companies would display 3 (or more) of those 9 characteristics and this is a reflection of the music sector ecology where few companies are vertically integrated and it is increasingly the norm for specific functions to be contracted out to specialists (often freelancers) on a project by project basis, for example, 46% of those employed in the music industry are classified as freelancers. In our view, the list of "characteristics" is not framed appositely enough and will cast too wide a net over companies in the creative industries.

18. <u>It would seem likely that the consequential outcome of sections 4.1 to 4.12 would exclude almost the entirety of the music industry from the EIS, counter to ministerial statement and objectives.</u>[4] We refer the Treasury to the submission of Ingenious Media which sets out these concerns in detail. We fully endorse Ingenious' submission.

19. UK Music hopes that Government will be persuaded of the pressing need for intervention to encourage a more enterprising economy in the UK. The United States has a very different investment culture that encourages risk-

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[3] *Music impact and footprint* published by Creative & Cultural Skills 2008-2009.

Hansard 16th June, column 907: Mr Vaizey: "I want to continue to work with the banks to try to educate them on how the enterprise finance guarantee scheme can be used to support the music industry. Important changes in the Budget, such as the enterprise investment scheme, will also help our creative industries. "

taking, and is the single most important factor in supporting the development of innovative new products, services and processes. At this juncture, the Government should put a greater priority on stimulating private investment in innovation than on trying to set definitions and narrow the scheme's parameters. The benefits to the economy will be far greater if the ultimate prize is higher levels of investment, more innovation, and greater growth.

ENDS

UK Music would be willing to be contacted regarding this consultation.

Please contact:

Cathy Koester
Senior Policy Adviser
UK Music
020 7306 4442

ANNEX

MUSIC PUBLISHING AND THE EIS SCHEME

What businesses can presently avail of the scheme?

Qualifying business activities comprise not only trade but also research and development which are intended to lead to a qualifying trade.

Businesses are excluded which receive royalties or licence fees other than those attributable, broadly, to intangible assets/copyrights owned and created by the business.

Why to date have publishers been excluded from the Scheme? Music publishing has been excluded because:

Copyright and therefore ownership in a musical work normally originates in the composer of the musical work, not the publisher to whom rights in the musical work are assigned or licensed. Therefore the publisher is not the first owner and creator of the intangible copyright asset in the musical work.

Two exceptions to the general principle of ownership of a musical work are set out in the Copyright Act:

- If a musical work is created by an employee in the course of his employment then his employer will be the first owner of the copyright unless otherwise agreed

- If a musical work is computer generated then the creator shall be the person by whom the arrangements necessary for the creation of the work are undertaken.

Publishers are perceived to be carrying out a passive reactive function merely collecting fees and royalties and distributing them to composers after deduction of a commission whereas we see the music publishing profession as dynamic and risk taking in the development of composers and their work and the promotion and exploitation of works.

We consider that the place of creation of the musical work (original composer or publisher) should not be the determining factor in assessing whether a shareholder in a music publishing company should be entitled to relief. What should be significant is the symbiotic relationship between a composer and his publisher whereby the latter gives significant undertakings to the former (both financial and otherwise) to develop the career and promote and exploit the musical works of the composer.

Earning royalties from the use of copyright is not a passive pastime. There is nothing passive about finding ways to generate revenue from the use of music in a modern digital environment.

The traditional primary source of revenue for a publisher of popular music from the licensing of music for use on records and being paid per record sold is rapidly eroding to be replaced by an uncertain environment where business models reflect the constantly changing digital environment - subscription, download, share of revenue (including advertising revenue).

Our mission statement for a good music publisher:

"*A good publisher seeks out great music and great composers and songwriters, supports composers and songwriters in the creative process, promotes their catalogues across a variety of platforms, manages the business exploitation of the catalogues and generally seeks to protect and enhance the value of their works with passion and professional commitment.*"

Over the last 50 years the investment risk in new musical popular talent has more publicly been shouldered by the recorded music industry (a branch thrusting out from the trunk of the traditional music publishing business). Now, often publishers are discovering and nurturing talent, providing space and time for the talent to develop, funding studio time and gigs and possibly an initial record release, encouraging creative collaborative partnerships, and in the case of a performer songwriter developing the act to a stage – song quality, performance quality and image whereby the "act" is ready for the next phase and this may be deal with a major record label.

We have used the word "popular" because we want to draw a distinction from so-called classical or serious music. The classical sector has never had the luxury of a strong classical record industry and the burden of talent development – the support for the composer in the composition of a classical work, the production of intricate performance parts, the promotion of the work not to record labels but to concert promoters and broadcasters in the UK and abroad falls squarely on the shoulders of classical music publishers. It is no surprise that the most recent player to enter this market was Faber Music (part of the Faber publishing group) in the 1960s.

There is and will be great music and there are and will be great composers in Britain and it is a publisher's job to find, develop and bring this talent into the light.

Music Publishers Association Ltd
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