

Briefing Note

Enterprise Investment Schemes

Introduction

This note covers the tax treatment of investments qualifying for the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS.)

Enterprise Investment Scheme

The Enterprise Investment Scheme (EIS) is a UK government scheme designed to encourage investment in smaller higher-risk trading companies by offering tax reliefs to investors who purchase new shares in those companies. It is the responsibility of the company to apply to be an EIS qualifying company. The reliefs available are income tax relief, capital gains tax disposal relief and deferral relief.

Income Tax relief

The main features of income tax relief are set out as follows:

Type of relief	Income Tax Relief is given as a tax reducer.
Persons entitled to claim	Claims are limited to individuals. Other taxpayers may invest (e.g. Trustees) but are not entitled to income tax relief.
Restrictions to persons entitled to claim	Relief is not available where the investor holds more than 30% of the shares in the company (which includes shares held by immediate family). The investor cannot be an employee, director or partner of the company (although an exemption applies to directors who are unpaid at the time of the investment, and it is not withdrawn if at some point in future the director receives a 'reasonable' remuneration).
Limits to relief given	Relief is restricted to £1 million annually. Investments in excess of this will not be eligible for relief. The investment must be in cash for eligible shares which are fully paid-up. Eligible shares are new ordinary shares which carry no present or future preferential right to dividends or assets on winding up or to be redeemed, for at least three years after issue.
Rate of income tax relief	Income tax relief is given at a rate of 30% by way of an income tax reduction. The income tax reduction is limited to the lower of 30% of the qualifying investment (up to the investment limit of £1 million) and the amount which reduces the investor's income tax liability to nil. By way of example, if an individual has an income tax liability of £10,000 and invests £50,000 in a qualifying EIS investment, then income tax relief on the investment would be limited to £10,000, as this is lower than 30% of £50,000 (being £15,000).
When can relief be claimed	Relief is available in the tax year in which the investment is made. The investor may also claim to have some or all of the income tax relief given in the tax year prior to the year in which the shares were issued.

Knowledge-intensive businesses

From 6 April 2018 EIS relief has been extended to allow investors relief for up to £2 million of investment in 'knowledge-intensive' businesses. There are a number of strict conditions which HMRC have set in order for companies to meet the requirement to be considered 'knowledge-intensive'. Generally, this will be for businesses that are young and innovative, and they must spend at least 15% of their operating costs on research and development or innovation in at least 1 of the previous 3 years, or alternatively at least 10% of their operating costs on R&D or innovation in each of the previous 3 years.

Claiming relief

Income tax relief can be claimed via the submission of the income tax relief form to HMRC (which is provided by the company after investment is made) or alternatively via the investors self-assessment tax return. Either way, claims for EIS relief cannot be made until a certificate has been received from the company, issued on the authority of an Inspector of Taxes, stating that the relevant conditions have been satisfied. The company must have been carrying on a trade or qualifying business activity for at least four months. The overall time limit for claiming the relief is five years from 31st January following the tax year in which the shares are issued. The certificate should be retained as part of the taxpayer's tax records and exhibited to HM Revenue & Customs (HMRC) if requested.

Investment in EIS funds

It is also possible to invest through an EIS fund which may invest on the individual investor's behalf in a number of qualifying companies. The process for claiming relief is the same as explained above. However, income tax relief is given on the basis that the shares were subscribed for on the date the fund closed, rather than the date when they were actually purchased.

Withdrawal of relief

If the shares are disposed of at arm's length within three years from the share issue, and the price obtained at disposal exceeds the price at acquisition, the income tax relief is withdrawn in full. Otherwise, only part of the relief is withdrawn, based on an amount equal to the tax rate tax applicable for the year in which the relief was granted multiplied by the disposal proceeds. If the relief originally granted was restricted for any reason, the withdrawal of relief will be similarly restricted in proportion. If the shares are disposed of otherwise than at arm's length within the three year period, the relief is withdrawn entirely.

Income tax relief may also be withdrawn if in the three year period referred to above an individual receives value from the company, for example the company repurchases part of his shareholding or waives any liability he has to the company or pays him for cancelling a debt (other than an ordinary trade debt). The amount of relief withdrawn will depend on the amount of the value received, but the whole of any deferred capital gain (see below) will be brought back into charge. 'Insignificant' amounts of value received can be ignored, and in certain circumstances the relief will not be withdrawn if value received is repaid as soon as is practicable.

Where a husband and wife are living together, generally disposals can take place between them without withdrawal of relief.

The relevant legislation requires claimants of EIS relief to notify HMRC within 60 days of any event which causes the relief to be withdrawn.

Loss relief

If the shares are disposed of at a loss, the amount of the loss, less any Income Tax relief given, can be set against income of the year in which they were disposed of, or any income of the previous year, instead of being set off against any capital gains.

Capital Gains Tax (CGT) disposal relief

Where shares are disposed of more than three years after their issue, any gain is not a chargeable gain on the disposal for CGT purposes (i.e. it is CGT exempt) provided income tax relief has not been withdrawn during the first three or five years as appropriate. It should be noted that if income tax relief is not available on the investment, the CGT exemption does not apply. Income tax relief must be claimed in full to be able to obtain disposal relief. However, in some cases, there will be insufficient income to fully relieve the income tax relief due. Provided this is the only reason income tax relief is not given in full (as compared to limiting the claim made), there will be no restriction to the disposal relief available (assuming all other criteria is met).

Where income tax relief is not available on the whole investment because the investment exceeded the income tax limit, then on a subsequent disposal of the investment after three or five years as appropriate, a portion of any gain is exempt from capital gains tax. To arrive at the exempt gain, the full gain is restricted by multiplying it by a fraction of which the numerator is the amount of income tax relief received and the denominator the amount invested multiplied by the rate of tax relief.

Any loss arising at any time will be an allowable loss for capital gains tax purposes or, if claimed, relieved against income (as noted above). In calculating the amount of the loss, the amount paid for the shares will be treated as being reduced by the amount of income tax relief granted.

Capital Gains Tax deferral relief

The main features of this relief are set out below. In particular it should be noted that trustees are entitled to deferral relief.

Type of relief	Deferral relief (distinct from “roll-over” relief) is available. This is given by deferring the gain and taxing it at some later date.
Persons entitled to claim	Claims are limited to individuals and trustees. Unlike income tax relief there are no restrictions to the proportion of the investor’s shareholding in the company or their connection with it.
Assets disposed of	For the purposes of CGT deferral relief, no restriction is placed on the nature of the asset which has been the subject of disposal.
Assets acquired	Only shares acquired in circumstances qualifying for income tax relief under EIS arrangements can be included. There is no requirement that income tax relief is actually secured; only that the share acquisition potentially qualified for relief.
Time limit for acquisition	EIS shares must be acquired within a period commencing 12 months before and ending 36 months following the time of disposal.

Limitation on amount eligible for relief	No limitation is placed on the amount of chargeable gains eligible for deferral relief. Note deferral relief may be available even though income tax relief is not available (e.g. the investor already owns 30% of the shares or reinvestment is by trustees of a trust which is not a bare trust).
Time limit for CGT deferral claims	Deferral claims must be made no later than the 31 st January falling five years after the end of the year of assessment in which disposal occurred.
Withdrawal of relief	<p>The deferred gains will be brought into charge to tax and tax payable will be calculated by reference to the legislation applicable at the time the disposal of the EIS shares or a prescribed event occurs. A deferred gain comes into charge when:</p> <p>the EIS shares are disposed of (otherwise than to a spouse); the investor becomes neither resident nor ordinarily resident in the UK within the three year period following issue of the shares unless it is because of working temporarily abroad and he resumes residence or ordinarily residence in the UK within three years of leaving the UK and still holds the shares on his return; The shares cease to be eligible shares.</p>
Death	On death of an investor, the deferred chargeable gain is not brought into charge to CGT.

It is important to note that the three foregoing reliefs will not be available if certain 'guarantee' arrangements exist before or when the shares are issued. These include any arrangements for the future disposal of the shares, or the disposal of the company's assets, or the ending of a company's trade, or the guarantee of a shareholder's investment.

Inheritance Tax

As EIS shares must be unquoted shares in a trading company they should qualify for 100% business property relief provided they have been owned by the transferor for at least two years prior to the transfer. For inheritance tax purposes unquoted shares include those which are traded on the Alternative Investment Market.

Seed Enterprise Investment Scheme

The SEIS is an extension to EIS that specifically applies to investment in small, unquoted start-up companies.

The companies in question must have issued the shares within two years of starting to trade and meet strict financial limits, which ensures that the scheme only applies to very small companies in their early stages. For example, the company cannot have more than £200,000 of gross assets and cannot raise more than £150,000 under the scheme. The rules closely follow those of the EIS scheme itself, particularly in respect of time limits and withdrawal of relief. However there are significant differences in respect of the tax relief themselves.

Income Tax relief

- Tax relief is available at a rate of 50% on a maximum investment of £100,000.
- There is an ability to carry back relief to an earlier year. However, as with EIS relief this is limited to the relief available in the earlier year.

You cannot be an employee of the company, but can be a director; you cannot, however, hold more than 30% of the company's share capital or voting rights at any time from the date of incorporation to the third anniversary of the date of issue of the SEIS shares.

Capital Gains relief

- As with EIS relief, capital gains realised on the disposal of shares qualifying for the income tax relief are not taxable, provided the shares have been held for three years.
- Losses (net of the amount of income tax relief) can still be claimed. Capital losses can be claimed against income of the tax year of disposal or the preceding year.
- Rather than the Deferral Relief offered by EIS there is a "Capital Gains Reinvestment Relief" available through SEIS investments. This relief allows capital gains up to £100,000 to be exempted from CGT. Both the gains and the investment must take place in the same tax year, but they can take place in either order, i.e. the investment can precede the disposals or vice versa.
- Unlike EIS Deferral Relief the exempted gains do not come back into charge when you dispose of the shares, provided the shares have been held for three years. The relief will be withdrawn in a similar way to income tax relief where there is a disposal of the shares or certain qualifying conditions are breached within that three year period.

The combination of income tax and Capital Gains Reinvestment Relief allows immediate tax relief of up to 78% on the investments, making this a highly tax efficient investment. However, the limits applying to the companies qualifying for the relief means it will only be available in a small number of cases and the investments will almost certainly carry a considerable amount of investment risk.

Key contacts

Please contact the tax team should you require any further advice on this.

This note is intended as a brief summary of the taxation and legal position of Enterprise Investment Schemes as at April 2019. Taxation is subject to change and depends on the individual circumstances of each client. Legislation is also subject to change. No responsibility can be accepted for any action taken in reliance of this note and specialist advice should be taken in every case.

Turcan Connell would be happy to provide such advice.

© Turcan Connell April 2019

EDINBURGH Princes Exchange, 1 Earl Grey Street, Edinburgh, EH3 9EE T 0131 228 8111 F 0131 228 8118 DX 723300 Edinburgh 43 LP1 Edinburgh 14
GLASGOW 180 St Vincent Street, Glasgow, G2 5SG T 0141 441 2111
LONDON 12 Stanhope Gate, London, W1K 1AW T 020 7491 8811

Turcan Connell is a Partnership of Scottish Solicitors regulated by The Law Society of Scotland.

www.turcanconnell.com