

Briefing Note

Enterprise Investment Schemes

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

Enterprise Investment Scheme

Income Tax Relief

Income tax relief, as explained below, on qualifying Enterprise Investment Scheme investments is available only to individuals. Other taxpayers who may be liable for income tax and who may invest in EIS shares, most notably trustees, are not eligible for the relief. In addition, relief is not available where the investor holds more than 30% of the shares in the company, including those held by their immediate family (which comprises their spouse/civil-partner, parents, grandparents, children and grandchildren, but not siblings). The investor cannot be an employee, director or partner of the company, although an exception to this is a director who is unpaid at the time of the issue (in which case relief is not withdrawn where “reasonable” remuneration is subsequently received for their duties).

A qualifying individual may invest as much as he wishes. 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. Income tax relief can be claimed in any one tax year on investments of up to £1,000,000 from 6th April 2012. For shares issued prior to 6th April 2006 the investment limit was £200,000; for shares issued between 6th April 2006 and 5th April 2008 the limit was £400,000; and between 6th April 2008 and 5th April 2012 the limit was £500,000.

Rate of income tax relief

Subject to a right of carry back, explained below, income tax relief is given at a rate of 30% (20% for tax years ending before 6th April 2011) by way of an income tax reduction for the tax year in which the shares are issued. The income tax reduction is limited to the lower of 30% of the qualifying investment (that is up to the investment limit of £1m) 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 as calculated for this purpose and invests £50,000 in a qualifying EIS investment, then income tax relief on the investment would be limited to £10,000, being lower than 30% of £50,000, which is £15,000.

Carry Back

The investor may claim to have some or all of the income tax relief given in the tax year immediately prior to the year in which the shares were issued. Although there is now no limit on the amount that can be carried back, the amount of tax relief will be subject to the investment limit prevailing for the earlier tax year. For example, if investments of £400,000 and £500,000 are made for shares issued in 2010/11 and 2011/12 respectively, a maximum of £100,000 of the 2011/12 year investment can be carried back. This is because the overriding investment limit for income tax relief for the earlier year is £500,000.

Investors should, however, act with caution when considering a carry back from 2011/12 to 2010/11 because the rate of relief on the amount carried back will be 20% rather than 30%.

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.

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

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) Relief

Where shares, subscribed for within the limit of £1m per tax year and on which some income tax relief was obtained, are disposed of more than three years after their issue (or more than five years for shares acquired on or before 6th April 2000), 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. Thus, for example, trustees (see above under income tax relief) will not be eligible for CGT exemption on EIS shares for which they subscribe.

Where income tax relief is not available on the whole investment because the investment exceeded the income tax limit applying at the time, 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. HMRC retains discretion to extend these time limits.
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> <ul style="list-style-type: none">• 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 ordinary 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.
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 relief is available for shares issued after 6th April 2012.

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. As SEIS relief did not exist in 2011/12, it will not be possible to carry back investments made before 6th April 2013.

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 applies only for the 2012/13 tax year and allows capital gains up to £100,000 to be exempted from CGT. Both the gains and the investment must take place in 2012/13, 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.

This note is intended as a brief summary of the taxation and legal position of Enterprise Investment Schemes as at October 2012. 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.

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