friend

Briefing note

February 2015

ENTERPRISE INVESTMENT SCHEMES

Introduction

There are a number of provisions within the UK tax code which provide certain tax reliefs for taxpayers who invest in certain companies.

This Briefing Note deals with Enterprise Investment Schemes ("EIS") with two further Briefing Notes dealing with the Venture Capital Trust ("VCT") and Seed Enterprise Investment Scheme ("SEIS") legislation.

Income tax relief on investment/dividends

Individuals can currently get a tax credit of 30% on a maximum investment of £1m in cash for newly issued shares of a qualifying company in a single tax year. The maximum income tax relief is, therefore, £300,000. The credit is set off against the individual's tax liability but he/she must have an income tax liability sufficient to cover the credit in order to obtain the relief in full. The relief can only reduce the income tax liability to nil.

An individual may carry back any EIS income tax relief arising at any time in an income tax year, to the previous income tax year. This is subject to the overall cap per income tax year, and subject to the individual having sufficient income to offset the relief.

Income tax relief will be withdrawn if shares are disposed of within three years of acquisition or within three years of the company starting to trade if later, or if the investor or company ceases to qualify.

Income tax relief will not be withdrawn if the company becomes quoted within three years of the qualifying investment, so long as this was not part of the pre-arranged scheme.

Dividends from EIS companies are taxable in the normal way.

Capital Gains Tax ("CGT") relief on sale of shares

As long as income tax relief was given on the shares subscribed for and not withdrawn then those shares will be free of CGT when ultimately sold. The company must carry on its qualifying activity for three years from the date of acquisition of the shares, or three years from commencement of trading, if later. After that time it can carry on non-qualifying activities such as investment and the shares will still be free of CGT when sold.

In cases where a disposal of EIS shares does not meet the tests for CGT exemption (as EIS income tax relief has been withdrawn or not available in the first place), the EIS shares will be subject to CGT when sold.

The rates of CGT that apply to an individual are:

- 10% for gains qualifying for Entrepreneurs' Relief ("ER") within the lifetime allowance of £10 million (but see below for the interaction with CGT deferral relief);
- 18% to the extent that there is any income tax basic rate band not being used against income; and
- 28% for the remaining gains.

CGT deferral relief

Capital gains made on the disposal of any kind of asset can be deferred by reinvestment in shares in EIS companies. The investment must be in newly issued ordinary shares, subscribed for in cash.

Gains that can be deferred are those made on the disposal of a chargeable asset not more than three years before, nor more than one year after, the EIS investment is made.

The maximum gain that can be deferred is not limited to the £1m applicable to EIS income tax relief. It is possible to invest more than that and get deferral relief on the total investment. In addition, deferral relief is available where the investor does not meet the strict conditions of being unconnected with the EIS company. They can, for instance, be the sole shareholder. Deferral relief is not dependent on income tax relief.

The deferred gains will become taxable if:

1. The EIS shares are sold or disposed of other than to a spouse or civil partner.
2. The EIS shares are exchanged for non-qualifying shares.
3. The EIS shares cease to be eligible shares (e.g. conversion to deferred or preferred shares) within three years of issue or three years of commencement of trade, whichever is the later.
4. The investor becomes non-UK resident within three years of issue or three years of commencement of trade, whichever is the later, unless they are going to work full-time offshore for three years or less.
5. The EIS company ceases to qualify for any reason (e.g. starting a non-qualifying trade) in the three years following the issue of the shares, or in the three years from the commencement of trade, whichever is later.
6. The investor receives certain prohibited benefits in the period beginning one year before and ending three years after the issue of the shares or three years after the commencement of trade, whichever is the later. These can include directors' remuneration, rents, loans or interest which HMRC regards as excessive. Even a small amount of 'excessive' benefit can trigger the whole of the deferred gains although there are *de minimis* levels. Value can be repaid to the company if it has inadvertently been withdrawn.

The deferred gains will not be taxed on death, or if the shares are transferred to a spouse or civil partner. Death washes out the deferred gain completely.

An inter-spouse gift means that a later disposal by the donee spouse triggers the deferred gain, which is chargeable on the donee.

Gains which do crystallise can be deferred again by a further EIS investment. It is important to note that there is a risk that the EIS investment may turn out badly, involving loss of funds but still leaving tax to pay on the deferred gains. However, there may be CGT loss relief available on the EIS investment to soften the blow.

The interaction with ER

An EIS CGT deferral claim cannot be made with respect to a qualifying ER gain to the extent that the special 10% ER rate applies.

For qualifying ER disposals where a gain meets the conditions, and there is unused ER lifetime allowance, a taxpayer has a choice between:

- Making the ER claim:
    - To benefit from the special 10% tax rate the tax is not deferred meaning it must be paid by 31 January following the tax year during which the qualifying ER disposal takes place; or
- Making the EIS CGT deferral claim:
    - Where the gain is deferred but when the gain does become chargeable it cannot benefit from the special 10% rate meaning that it will generally be taxed at 28% as it is unlikely that such an individual will have unused basic rate band.

Deferred gains and tax rate changes

Where a gain has been deferred or rolled over it will be subject to tax at the CGT rates prevailing when it comes into charge. This means that for a higher rate taxpayer, if current rates remain the same, gains will be subject to tax at 28%.

Where a deferral claim has already been made, consideration should be given to withdrawing the claim if ER is relevant. It should be noted that where claims are made within a self-assessment tax return, the timeframe for withdrawing the claim is the same as for any other amendment to a tax return - that is one year after 31 January following the end of the tax year for which the return was prepared.

Losses

If EIS shares are sold at arm's length at a loss, or the company goes into liquidation, a capital loss will accrue. This is calculated in the normal way less any income tax relief given and not withdrawn. This capital loss can also be set against income in the year it arises and/or the previous tax year. For a 45% taxpayer, this currently limits the maximum economic loss to 38.5%.

Qualifying individuals

Investors must be individuals to qualify for income tax relief. In addition, they must be resident in the UK if they are to qualify for CGT deferral relief.

The individual must not be connected (in a period beginning two years before the share issue and ending three years after the later of the issue of the shares or commencement of trade) with the company in which they invest, which means:

- The investor and their associates must not own more than 30% of: the ordinary shares, or the voting rights, or the total issued share capital, or the assets on a winding up.
- They must not be a paid director of the company except in limited circumstances.
- They must not receive value from the company e.g. repayment of certain loans, excessive dividends, assets transferred at an under/over value, repayment of share capital.
- They must not be an employee of the company or any of its 51% subsidiaries.

Note that if only CGT deferral is being claimed not all of the above conditions apply.

Qualifying companies

The value of the gross assets of the company (or group if appropriate) must not exceed £15 million immediately before the investment takes place and £16 million immediately thereafter.

The company must not be "in difficulty" to qualify.

The investment must be in new ordinary shares. Where the company has previously issued shares qualifying for SEIS relief, it will only be possible to issue shares qualifying for EIS relief if at least 70% of the SEIS funds have been spent on the qualifying business activity for which they were raised.

The company must be unquoted (AIM qualifies as unquoted) although it could become quoted in the relevant period (three years from the later of the share issue or commencement of trade) without loss of relief, if no prior arrangements for a quotation were in place at the date the shares were issued.

The company issuing the eligible shares must have a "permanent establishment" in the UK. The funds raised must be used in qualifying activities within 24 months of the later of the share issue and the commencement of trade.

Certain trades are specifically excluded:

- Dealing in property, shares, commodities and other financial instruments;
- Property investment and development;
- Insurance and banking (though not insurance broking);
- Leasing;
- Legal and accounting services;
- Farming, market gardening and forestry activities;
- Hotels and nursing homes;
- Exploitation of intellectual property rights (not created by the company);
- Ship building; and
- Coal and steel production.

In addition the company must be independent and not under the control of another company.

Practical issues

None of the EIS reliefs can be obtained until the company supplies a form EIS 3 to the investor. The company can only submit this when it has been trading for at least four months. Therefore there may be a significant delay in obtaining relief when a company is not already trading and needs time to prepare for the trade. There are further requirements as to how quickly the cash raised must be invested in the qualifying trade.

If an EIS 3 is not available when the tax return is submitted, then the taxpayer must pay the tax and subsequently amend the return and get a repayment of the tax overpaid.

The company must submit an EIS 1 form within two years of the end of the year of assessment in which the shares are subscribed for or, if the company completed the first four months of trading in a later year of assessment, within two years of the end of that four month period.

The investor must claim relief within five years from the 31 January following the tax year in which the subscription is made.

Inheritance tax considerations

EIS shares cannot normally be quoted and must be in trading companies. They should therefore normally attract IHT business property relief ("BPR"). Holdings of any size attract relief. A holding of less than 30% in an EIS company is therefore potentially very useful since it could attract one or more of the following:

- Income tax relief at 30%
- CGT exemption on disposal at a gain but relief on a loss
- 100% IHT relief on a gift or on death

The IHT relief for EIS shares should be contrasted with the position of many private assets which may be sold to release the funds to invest; these are normally fully liable to IHT, so by reinvestment a considerable IHT advantage can be obtained. Normally however, the new shares must be owned for two years prior to the IHT event for BPR is due, so life insurance cover may be advisable in the meantime.

Further advice

The rules are complex and only the main points have been set out in this Briefing Note. Please contact us if you require any more information or specific advice.

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