Enterprise Investment Scheme

And Other Venture Capital Reliefs

Andrew Rainford

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Enterprise Investment Scheme

1. Introduction and background

1.1 History

The Enterprise Investment Scheme (EIS) as we know it today was first introduced in 1994, succeeding the Business Expansion Scheme (BES), which was devised in 1983. The EIS offers generous tax breaks to those who purchase shares which qualify for it.

Both the EIS and the BES before it were seen as a potential solution to the difficulty that entrepreneurs had in obtaining finance from traditional institutions, by offering tax incentives for outsiders investing in private companies, thereby providing much needed working capital. As Sir Geoffrey Howe said during his 1983 Budget:

> "These proposals will transform the position of unquoted trading companies seeking outside equity. It is a further move towards removing the bias in the tax system against the personal shareholder and a further measure to encourage wider share ownership. By concentrating help on those companies which do not have ready access to outside capital, the scheme will assist many more small or medium companies to realise their undoubted potential for growth."

The BES was, however, widely drawn – the range of potential investors and investee companies led to investments qualifying for the scheme being made mainly for tax sheltering, rather than genuine commercial reasons. The EIS was introduced in 1994 to bring things back into line with the original stated objectives. Speaking at the time, Michael Portillo said:

> "The purpose of Enterprise Investment Schemes [sic] is to recognise that unquoted trading companies can often face considerable difficulties in realising relatively small amounts of share capital. The new scheme is intended to provide a well-targeted means for some of those problems to be overcome."

1.2 Widening the scope

As mentioned above, the EIS tightened up many of the qualifying conditions that existed under the BES. This was in turn criticised as

excluding too many companies from qualifying, and so in 2012 several changes were announced relaxing some of these measures so as to be more inclusive. One announced measure was to increase the maximum amount a company could receive under EIS in any 12 month period from £2 million to £10 million. Unfortunately this change was rejected as excessive by the European Commission on State Aid. The annual limit was eventually increased to £5 million, where it remains at the time of writing, although FA 2018 increased the limit to £10 million for knowledge-intensive companies.

1.3 Reining in

At the March 2015 Budget, George Osborne – Chancellor of the then Coalition Government – announced that various changes, including a lifetime maximum limit on how much can be raised via the venture capital schemes to supplement the existing annual maximum, were required to the EIS (and other venture capital schemes) to ensure it continued to receive EU State aid approval. At the time of the announcement, the proposed new measures were restrictive, but more generous than the EU Guidelines suggested (subject to EU State aid approval).

Following the Conservative majority at the May 2015 General Election, an emergency budget was announced. On 8 July 2015, the Summer Budget confirmed that the previously announced changes would go ahead; however, they would now more or less follow the EU Guidelines directly, effective from the date of Royal Assent of *Finance (No. 2) Act* 2015 (18 November 2015).

Further changes were announced during the 2017 Autumn Budget that saw relief further restricted. A new qualifying condition now needs to be met for investments following the date of Royal Assent of *Finance Act* 2018*,* 15 March 2018 (the date specified in the original tax policy note) that will prevent relief where there is little or no real risk to the investor's capital.

Law: F(No.2)A 2015; FA 2018

1.4 EU approval

State aid is prohibited by the *Treaty on the Functioning of the EU* because it can distort competition and affect trade with other member states.

Using taxpayer-funded resources to assist one or more organisations in a way that gives an advantage over others may be State aid, and so is, generally, illegal. There are treaty exemptions for aid schemes which help to achieve the objectives of the community.

The EIS and VCT schemes constitute State aid because of the tax-advantaged investment in the target companies.

The schemes are permitted under treaty exemption, as long as the European Commission approves any changes or modifications to the member state's rules as coming within the parameters of the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises.

The guidelines dictate the type of investment that may be approved under the schemes, the size of companies that may benefit and the maximum amount that companies may raise annually.

There are further regulations governing State aid given to a single recipient when its value does not exceed €200,000 (known as *de minimis* aid). The SEIS (see **Chapter 12**) is an example of a scheme governed by these regulations.

1.5 Tax relief under the EIS

1.5.1 Overview

The EIS has four associated tax breaks:

- Income tax relief
- Capital gains tax (CGT) deferral
- CGT exemption
- Loss relief

Each is considered in detail in later chapters but a brief summary is provided below.

1.5.2 Income tax relief

For qualifying investments, relief is given as a tax reduction against the overall liability for the tax year of the investment (or the preceding year). This is therefore applied after other reliefs, such as

the personal allowance (if applicable) and personal pension contributions.

The current rate of relief is 30% on up to £1 million (generally) per tax year. Whilst the relief can lead to a refund – for example where tax has already been paid via PAYE – it cannot create a repayment (or further repayment) by reducing the overall tax liability below £nil. The 2017 Budget announced that this annual limit will increase to £2 million for investments into knowledge-intensive companies, and this was confirmed by the *Finance Act* 2018.

Where the relief available exceeds the tax liability for the year of the investment, the possibility of carrying back some or all of the claim into the preceding tax year should be explored.

Example – Alan

Alan makes a qualifying investment of £100,000 in 2018-19. His overall tax liability for the year is £20,000, of which £18,000 has been deducted via PAYE. Alan qualifies for £30,000 of EIS income tax relief, but this will be restricted to £20,000 because he does not have a sufficient tax liability to offset. He will receive a refund of £18,000 and will have no further tax to pay via his self-assessment return, but the additional £10,000 is effectively lost unless it can be carried back to 2017-18.

Law: ITA 2007, s. 158; FA 2018

1.5.3 CGT deferral

Where a qualifying investment is made, the investor can match the amount invested to any capital gains realised in the period beginning three years prior to the EIS investment, and ending one year afterward, and defer the CGT arising on that part of the gain until the EIS shares are disposed of.

Example – Caroline

Caroline (a higher rate taxpayer) makes capital gains after the annual exemption of £250,000 in 2016-17, paying the tax of £70,000 in January 2016. In 2018-19 she makes a qualifying EIS investment of £250,000. If she chooses to, she can match the investment to the £250,000 gains from 2016-17. She would receive a refund of £70,000 and would only have to pay this tax back in the event of a later disposal or disqualifying event.

This relief is particularly valuable as it does not preclude investors who have a connection to the company from claiming it.

Gains which were deferred are brought back into charge at the prevailing rate(s) of tax – currently 10% or 20% depending on other income and gains. Since 3 December 2014, any gains made after that date which would qualify for entrepreneurs' relief at 10% which are deferred under EIS are brought back into charge at 10%. Prior to this the gain would be revived at the prevailing rate.

1.5.4 CGT exemption

Where a claim to EIS income tax relief has been made and not subsequently withdrawn, any gain arising on the EIS shares themselves will not be charged to CGT upon a disposal. It is often not appreciated that any gain deferred will come back into charge in the year of the disposal.

Example – Caroline (continued)

Caroline's investment qualifies for income tax relief which is not withdrawn. The shares are sold on 6 April 2024 for £750,000. The gain of £500,000 is exempt from CGT; however the original £250,000 gain deferred is brought back into charge, and the associated tax, calculated using the applicable rate of CGT (and allowing for any unused annual exemption), is now payable.

1.5.5 Loss relief

Where a qualifying investment is made, and the income tax relief is successfully claimed and not withdrawn, any losses (as adjusted for the income tax relief which is given and not withdrawn) arising on a disposal can be offset against capital gains in the same tax year as the investment (or carried forward against future gains). Alternatively, any such losses can benefit from "share loss relief" under ITA 2007, s. 131 and be offset against general income.

Example – Caroline (further continued)

Suppose, instead, that Caroline's investment only sells for £100,000. She would have a loss of £75,000 (the £150,000 loss less the £75,000 income tax relief not withdrawn) that she could choose to alleviate her other capital gains, or to offset against her general income of the year of disposal or the preceding year.

Ignoring any benefit of the capital gains deferral, it is clear that the risk to the investor (in monetary terms) is significantly reduced by the income tax and loss reliefs. For an additional rate tax payer who makes a failing investment of £100,000, the total relief is £30,000 plus £31,500 ([£100,000 – £30,000] × 45%), meaning that the downside risk of the investment – that is the "true" amount of money actually at stake – is only £38,500 in real cash terms.

In the following chapters we will look at qualifying conditions for the investor and for the investee company, as well as at the general conditions that must be met. We will then look at situations where relief is given but later clawed back.

Law: TCGA 1992, s. 150A; ITA 2007, s. 131

1.6 Claiming relief – process

The issuing company must first complete form EIS1 – the compliance statement – with the relevant details about itself, the nature of its business, and the investments to which EIS relief is intended to apply. HMRC will then consider the application, and provided the tax officer is happy that all qualifying conditions are satisfied HMRC will issue the company with authority to issue EIS certificates to each of the investors. It will enclose blank EIS3 certificates to enable this.

The company will then need to complete the certificates, and issue these to the relevant investors. The investors can then claim tax relief either on their individual tax returns, or by contacting the PAYE office to give effect to relief via their tax codes.

Note that relief cannot be claimed until the certificates are issued. The issuing company can be fined up to £3,000 if it issues certificates without the authority from HMRC, or if it makes a fraudulent or negligent compliance statement.

Advance assurance

It is also possible to request a non-binding opinion, known as advance assurance, from the Small Company Enterprise Centre (SCEC) before the shares are issued by providing them with all details pertinent to the potential investment.

HMRC have long felt that this facility was being strained by speculative enquiries (i.e. ones that are unlikely to lead to an actual investment). This might be done in order to test the boundaries of the legislation, in order to develop tax avoidance schemes for example. In response, in 2017 HMRC undertook a consultation on how to make the service more efficient, and the outcomes were announced in December 2017. In the future it is likely to become possible to submit requests online, which will cut delays owing to postage etc., but in addition, the following streamlining measures have been enacted:

- From 4 December 2017, no opinion will be given if it is apparent that the company is likely to fail to meet the new risk to capital condition (see **4.2.12**).
- From 2 January 2018, no opinion will be given in relation to speculative enquiries. In practice, this means that the company requesting the opinion will need to demonstrate that it has approached potential investors, and will need to provide the names of all individuals, fund managers or other promoters who are expected to invest.
- If a company is relying on a particular interpretation of the law in order to obtain relief, it will need to provide a full technical analysis demonstrating how the requirements of the law are met. HMRC will not issue an opinion unless it believes that the enquiry is seeking to allay genuine concerns (i.e. not simply testing the boundaries of the rules).

An illustration of how the third point might crop up in practice would be contrasting between a company seeking clarification on whether or not a potential investor is connected due to past involvement, and a company sending a number of slightly different scenarios to test the point at which connection is established.

This also applies for Seed EIS advance assurance applications.

Law: ITA 2007, s. 204-208
Guidance: VCM 14000-14210

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