Enterprise Investment Scheme

Tax efficiency for investors
Introduction

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A bit about us

Keynotes is brought to you by Keystone Law, a leading London law firm which acts for a range of clients, from well-established companies to promising start-ups. We have created Keynotes to help your business grow and to show you how we think.

We do not claim to have reinvented the law firm, but we do think we have built a law firm to give our clients just what they need. Keystone uses technology and modern working practices to remove the need for junior lawyers and back office staff. Our lawyers work directly with you, our clients, and with their colleagues to deliver results. They have support when they need it, but they are not chained into standard processes and there is no big corporate machine in the background; the result is a solution that is built uniquely around you and feels very personal.

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If this is what you are looking for in a law firm, then please email us at keynotes@keystonelaw.co.uk. We would like to help solve any legal problem you are facing.

Disclaimer

We have written these materials to help you, but no article can address all the issues. The benefit of using an experienced lawyer is that they ask the right questions and build the solution around you. Please therefore note that these materials only provide you with general information and should not be regarded as a substitute for taking legal advice.
ENTERPRISE INVESTMENT SCHEME

Tax benefits of the Enterprise Investment Scheme (EIS)

Eligible individuals (e.g. business angels who satisfy relevant conditions) investing in new shares issued by a qualifying company can secure the following tax benefits:

- **capital gains tax (CGT) deferral relief** – tax realised on the disposal of another asset can be deferred by reinvesting the gain realised on that disposal in EIS eligible shares;

- **income tax relief** – income tax relief can be secured in respect of the amount invested in EIS eligible shares, subject to an annual limit on the amount invested of £500,000 – relief is given at the rate of 30% for shares issued on or after 6 April 2011 (an increase from the previous 20% rate announced in the 23 March 2011 Budget and indeed there is some speculation in the press of a further increase to 50% relief may be introduced in respect of the first £100,000 invested). The 23 March 2011 Budget also announced that the £500,000 limit will be increased to £1m from 6 April 2012;

- **CGT exemption** – an exemption from CGT in respect of any capital gain realised on the disposal of the EIS eligible shares.

Further information on the above reliefs and a summary of the main conditions to be satisfied in order to secure the reliefs is provided below. Reference is also made to further income tax relief which can often be secured in cases where the investor suffers a loss.

CGT Deferral Relief

- Deferral of tax arising on the disposal of any other asset is available if the EIS investment is made in the period beginning one year before and ending three years after the date the gain arose.

- There is no limit on the amount of the gain to be reinvested in the EIS shares which can attract the deferral relief.

- The conditions to be satisfied (relating to the company in which the reinvestment is made, the shares acquired and the application of the money reinvested) are set out in the Appendix to this Briefing. In addition the investor must be UK tax resident.

- The tax deferred by making the reinvestment becomes payable in prescribed circumstances, which include the following:
  - the investor disposes of the EIS shares (the subject of the reinvestment);
  - the investor becomes non-UK resident within three years of the investment; and
  - the EIS shares cease to be eligible shares (see the Appendix) during the period of three years after their issue.
• Deferment is not always advantageous. There can be circumstances in which the tax payable following the period of deferment will be greater than that which would have been payable on the original disposal, if no deferment had been sought.

Income Tax Relief

• 20% income tax relief (30% from 6 April 2011) is available on amounts invested in EIS eligible shares, subject to a minimum annual amount invested of £500 and a maximum amount of £500,000 (£1m from 6 April 2012).

• An election can be made to treat the shares as having been issued in the previous tax year, so that income tax relief can be claimed in that previous year (e.g. where the £500,000/£1m limitation was not utilised in the previous year).

• It is necessary to obtain an EIS certificate from the investee company and HMRC must authorise the company to issue this.

• The conditions to be satisfied (relating to the company in which the investment is made, the shares acquired and the application of the money reinvested) are set out in the Appendix to this Briefing. It is possible to obtain a provisional clearance from HMRC, in advance of an investment being made, that the relevant conditions will be satisfied.

• In addition the individual making the investment must not be “connected” with the company for a period from two years before the issue of the shares (or the date of incorporation, if later) and ending three years after the issue of the shares, or after the trade commences, if later. The individual will be treated as connected with the company, and so not eligible for income tax relief, if he/she:
  - has, or is entitled to acquire, more than 30% of the issued ordinary share capital and loan capital or of the voting power of the EIS company or any of its subsidiaries; or
  - is employed by, or is a director of, the company or any of its subsidiaries (or a partner of the company or any of its subsidiaries); or
  - is a partner of the company of a subsidiary.

• The individual can qualify for relief, even though he/she is “connected” with the company solely by reason of being a director, if, when the shares are issued, he has never before been connected with the company or involved in carrying on its trade. In such circumstances it is also possible for the director to receive reasonable remuneration for his duties as a director and the individual will not be disqualified if he also becomes an employee. This relaxation of the connected persons rule is aimed at business angels who are to make their expertise available to the company.

• Relief will be withdrawn if the shares are disposed of within the period ending three years after the issue of the shares, or after the trade commences, if later. Relief will also be withdrawn to the extent that the investor receives value from the company in the period starting twelve months before the date of acquisition and ending three years after that date, or after the trade commences, if later).
CGT Exemption

- An exemption from CGT on a disposal of the EIS shares made more than three years after their acquisition, or after the trade commences, if later.
- This exemption is only available for shares which have qualified for income tax relief.
- If income tax relief is not given on the full amount invested (e.g. because the amount exceeds the permitted maximum) the CGT exemption will be restricted to a proportion of the gain.

The Investor’s Net Exposure - Relief for Losses

If an investor suffers a loss on his investment greater than the amount on which income tax relief was obtained, further income tax relief can often be obtained at the individual’s marginal rate. This means that an individual who pays income tax at the top rate of 50% will often suffer a maximum overall effective loss of 35p in the pound, as illustrated below.

Example:

Investment of £100,000 in XYZ Co. – EIS income tax relief for the investor of £30,000.

Three years later XYZ Co. goes into insolvent liquidation - no return to shareholders.

Investor can claim relief against his income for a loss of £100,000 less the £30,000 on which EIS income tax relief was claimed, i.e. relief on £70,000, resulting in a tax benefit of £35,000 for a taxpayer who can utilise the full amount of the relief at 50%.

Total loss on an investment of £100,000 after tax relief: £35,000.

The extent to which this additional relief will be available (if at all) will be dependent on the facts of each case.

Further Advice

This Briefing summarises some of the main features of EIS rules, based on the law in force on 6 April 2011. It includes references to changes announced in the 23 March 2011 Budget, all of which are subject to State Aid approval. The relevant legislation is lengthy and detailed, and includes specific anti-avoidance rules not touched on in this Briefing. Specific advice should be sought in relation to the facts of any particular case.

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The main conditions to be satisfied, which are common to all three forms of relief (CGT deferral, income tax and CGT exemption), are as follows (defined terms being mentioned in italics):

- the shares must be **Eligible Shares**
- the shares must be issued by a **Qualifying Company**
- the shares must be acquired by subscription (i.e. new shares issued by the company and not a transfer of existing shares)
- the subscription must be wholly in cash
- the shares must be fully paid at the time of issue
- the shares must be issued to raise money for the purpose of a **Qualifying Business Activity** of the company of one of its 90% subsidiaries
- the money raised by the issue must be employed wholly for the **Qualifying Business Activity** within two years of the issue of the shares or, if later, within two years of commencement of the **Qualifying Business Activity**
- relief is not available if the total of the tax advantaged **Venture Capital Investments** made in the company in the year ending with the date on which the EIS shares are to be issued exceed £2m (expected to be increased to £10m from 6 April 2012, as announced in the 23 March 2011 Budget)

**Defined Terms:**

- **Eligible Shares**: New ordinary shares which carry no present or future preferential right to dividends or to the company’s assets on its winding up and no present or future right to redemption.
- **Qualifying Company**:
  - An unquoted company (AIM companies are treated as unquoted) which exists wholly for the purpose of carrying on one or more **Qualifying Trades**, or a parent of a trading group where the business of the group as a whole does not consist to any substantial extent of anything other than activities which fall within the definition of **Qualifying Trade**; and
  - the balance sheet value of the company’s/group’s gross assets must not exceed £7m immediately before the issue of the EIS shares and must not exceed £8m immediately afterwards; the 23 March 2011 Budget indicates that these limits will be replaced, with effect from 6 April 2012, by the more generous requirement that the gross assets must not exceed £15m immediately before the issue of the EIS shares; and
  - the company/group must not have 50 or more full-time of full-time equivalent employees; the 23 March 2011 Budget indicates that the 50 limit will increase to 250 from 6 April 2012.
o the company issuing the shares must not be in financial difficulties in accordance with European Community Guidelines for State Aid.

- **Qualifying Business Activity**: a Qualifying Trade which is carried on by the Qualifying Company or a 90% subsidiary of it; or research and development carried on by the Qualifying Company or a 90% subsidiary of it, from which it is intended that a Qualifying Trade will derive. The relevant activities must be carried on wholly or mainly in the UK; for shares issued on or after 6 April 2011 this test is replaced by a requirement that the company issuing the shares must have a UK permanent establishment.

- **Qualifying Trade**: Any trading activity will be a qualifying trade provided it does not consist to a substantial extent of one or more of the following;
  
  o dealing in land, commodities or futures, or in shares, securities or other financial instruments
  o dealing in goods otherwise than in an ordinary trade of wholesale or retail distribution
  o banking, insurance or any other financial activities
  o leasing or letting or receiving royalties or licence fees, other than from self-created intangible assets
  o providing legal or accountancy services
  o property development
  o farming or market gardening
  o holding, managing or occupying woodlands, any other forestry activities or timber production
  o shipbuilding
  o producing coal
  o producing steel
  o operating or managing hotels or comparable establishments or managing used as a hotel or comparable establishment
  o operating or managing nursing homes or residential care homes or managing properties used as such
  o providing services or facilities for any trade which consists to a substantial extent of the activities listed above and carried on by another person (other than a parent company) where one person has a controlling interest in both trades

The 23 March 2011 Budget announced that Finance Bill 2012 will also exclude any trade which consists wholly or substantially in the receipt of feed-in tariffs or similar subsidies, unless commercial electricity generation starts before 6 April 2012. This new rule will not affect shares issued before 23 March 2011.

- **Venture Capital Investments**: investments which attract EIS income tax relief, investments made by venture capital trusts and investments made under the corporate venturing scheme.

Would you like to know more?

Please get in touch with us at keynotes@keystonelaw.co.uk or call William Robins on 020 7152 6550. For more information about Keystone Law visit: www.keystonelaw.co.uk