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An introduction to EISs and SEISs - Part 1

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Introduction

This note is the first part of a two-part series on the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) regimes. This first part provides a brief summary of the two schemes and the criteria applicable to each in order to qualify for certain tax reliefs. The second part deals with the regulatory aspects of setting up and managing an EIS fund.

The Enterprise Investment Scheme is designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies. Investment in companies which are unlisted generally carries a higher risk than investment in listed companies and the tax reliefs are intended to offer some compensation for that risk. The EIS provides tax incentives in the form of income tax and capital gains tax reliefs to investors who subscribe for shares in qualifying companies, which benefits those companies by providing an opportunity for them to obtain funding which is not available from more traditional methods, such as banks.

The Finance Act 2012 introduced the Seed Enterprise Investment Scheme, which is an EIS scheme for start-ups.

Enterprise Investment Schemes

An investor can invest directly into a qualifying company and claim tax relief under the EIS or, alternatively, through an EIS fund, which invests in a number of qualifying companies on the investor's behalf. EIS funds can be approved by HM Revenue & Customs, or unapproved, but such approval relates only to the tax treatment of the fund and not to its commercial viability.

In order for an investment to benefit from the reliefs under the EIS, it must be:

1. a qualifying investment;
2. by a qualifying investor; and
3. in a qualifying company.

The following summarises each of these three components in turn:

(1) Qualifying investment

In order to qualify, an investment must have the following characteristics:

i. the investment must be made in cash;

ii. the shares should be fully paid at the time of issue;

iii. the shares must be issued in order to raise money for a qualifying business activity;

iv. the money raised must be used for the qualifying business activity within two years;

v. the shares must be ordinary shares and may not carry special voting rights, although they may carry limited rights to preferential dividends; and

vi. there should be no pre-arranged exit strategies in place.

(2) Qualifying investor

A qualifying investor must have the following characteristics:

i. the investor must not hold, either personally or in conjunction with their associates, more than 30% of the share capital of the company (and 'associates' for this purpose include spouse/civil partners, parents, children and grandchildren and business partners (but not siblings));

ii. the investor must not be a paid director or an employee of the company at the time of the investment;

iii. the investor must not receive a return of value for the investment e.g. the repayment by the company of a loan using the funds raised through the EIS share issue; and

iv. the shares must have been subscribed for wholly in cash and for genuine commercial reasons and not for the avoidance of tax.

Managers of the EIS are unlikely to be able to obtain EIS income tax relief or CGT exemption because relief is denied to any person who is connected with the qualifying company in the two years before subscription and the three years thereafter.

(3) Qualifying company

To qualify for the EIS scheme, a company must fulfil certain criteria, which can be briefly summarised as follows:

i. the company must be a trading company – most trades qualify, but there are a number of excluded activities, such as property development, coal and steel production, farming and market gardening and some financial activities: see the HMRC website for a complete listing;

ii. the company must be unquoted at the time of the share issue and cannot be listed on any recognised stock exchange. AIM and the PLUS Quoted and PLUS Traded Markets are not treated as recognised markets under EIS rules;

iii. the company's gross assets cannot exceed £15 million before the share issue or £16 million immediately after that issue;

iv. the company must employ fewer than 250 full-time employees at the time of the share issue;

v. the company must be carrying out the trade for which the money was raised for at least four months before an investor is eligible for EIS relief;

vi. the maximum amount that can be raised through an EIS by the company is £5 million in total in any 12 month period; and

vii. the company should not have been set up for the purpose of accessing and benefiting from venture capital reliefs.

Shares must be held for three years from the date of issue in order to secure the tax reliefs and should any of the above conditions cease to be met within that three-year period, relief can be withdrawn.

Available tax reliefs under EISs

Qualifying investors can claim income tax relief of 30% of their investment in a qualifying EIS company, subject to an annual investment limit of £1 million. Capital gains arising on disposal of EIS shares are exempt from capital gains tax and EIS shares fall outside an individual's estate for inheritance tax purposes if held for greater than two years. Losses on EIS shares can be offset against income or capital gains tax liabilities. As mentioned above, these tax reliefs are dependent on the investor holding an investment for at least three years.

In addition, EIS relief allows an investor to defer capital gains on the amount invested by reinvesting the gain into subscription for shares in an EIS qualifying company. The shares must be issued at any time beginning one year before and ending three years after the disposal of the original assets. This is no maximum limit for reinvestment relief.

EIS income tax relief and capital gains tax (CGT) relief is available for individuals who make direct investments and for investments made through an EIS investment fund, but not for investments made through partnerships.

EIS relief can apply to investments in companies that have not yet started to trade and companies that carry on research and development. It should be noted that a new provision introduced for shares issued on or after 6 April 2012 prevents a company from qualifying for EIS relief simply by acquiring shares in another company. This new provision was aimed at avoiding companies using EIS money to acquire an existing trade or trading subsidiary and arguing that it was "preparing to trade".

Seed Enterprise Investment Schemes

The seed enterprise investment scheme (SEIS) is similar to the EIS scheme, but is designed to encourage individuals to invest in start-up trading companies to help alleviate the problems such companies have in raising finance. According to HMRC, SEIS is aimed at helping very early stage companies which would otherwise struggle to raise money even under EIS.

Available tax reliefs under SEISs

SEISs operate in a similar manner to the EIS, providing income tax reliefs for qualifying investors investing up to £100,000 in qualifying companies. It takes effect for shares issued on or after 6 April 2012 and before 6 April 2017 (although the time period for the availability of the relief could be extended by Treasury order).

Key limitations on relief, in addition to an annual investment limit of £100,000 as mentioned above, is a limit of £150,000 on funds that a company can raise under the SEIS and funds raised must be used in a qualifying business activity within three years of the investment. Further, no reliefs may be claimed by investors until at least 70% of the monies raised has been spent.

SEIS relief can apply to investments in companies that have not yet started to trade and companies that carry on research and development. Income tax relief on shares in qualifying companies is equal to 50% and any disposal is exempt from CGT. As with EISs, the shares must be held for at least three years to retain the SEIS reliefs.

Qualifying investor

The criteria applying to a qualifying investor are the same as for EISs, as set out above. However, although the investor may not be an employee, the investor (or any associate) may be a director (paid or unpaid). Thus, managers who are non-executive directors may qualify for the reliefs (subject to fulfilling the other conditions for relief) but those employed by the qualifying company will not qualify.

Qualifying Company

Most of the conditions are the same as for EISs above, but the main differences are:

i. the company must be a genuine new venture and no more than two years old;

ii. the company must have 25 or fewer employees (and if the company is the parent company of a group, that figure applies to the whole group); and

iii. the company must have assets of less than £200,000.

Interaction with EIS and venture capital trust regimes

Currently, a qualifying company will not be able to issue SEIS shares if it has previously raised funds under the EIS or VCT regime. However, it may raise EIS (or VCT) monies after it has raised capital through the SEIS, although the company must have spent at least 75% of the SEIS monies raised. This rule may change under the proposed changes announced in the 2015 Budget (as to which, please see the following paragraph).

Proposed changes to EIS and SEIS

The 2015 Budget announced a number of proposed changes to EIS and SEIS regime, as well as to VCT regime, with the aim of ensuring that they continue to be effective in supporting higher-risk small and growing businesses to access finance and that they are sustainable going forwards.

The proposed changes include the following:

i. a requirement that all investments are made for the purpose of business growth and development;

ii. a requirement that all EIS investors are independent from the qualifying company at the time of the first share issue;

iii. a new 12-year age limit on qualifying companies;

iv. a new cap on total EIS investment for qualifying companies of (a) £15 million for most companies and (b) £20 million for 'knowledge-intensive' companies;

v. an increased employee limit of 499 for 'knowledge-intensive' companies; and

vi. the removal of the barriers between SEISs and EIS/VCT funding.

Changes (i)-(v) are subject to State aid approval and for this reason, legislation was not published in the Finance Bill 2015. HMRC summarises a 'knowledge-intensive' company as a company:

- whose costs of research and development or innovation are at least 15% of the company's operating costs in at least one of the previous 3 years, or at least 10% of the company's operating costs in each of the previous 3 years, and either
- the company has created, is creating or is intending to create, intellectual property, or
- the company's employees with a relevant Masters or higher degree who are engaged in research and development or innovation comprise at least 20% of the company's total workforce.

HMRC is currently consulting on the proposed changes and the consultation closed to comments on 15 May 2015. A full response to the consultation will be published later in the year.

If you would like to discuss this further, please contact Claire Cummings at Claire.Cummings@cummingslaw.com or on 020 7585 1406.

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