

Update on EIS and VCT schemes

(Lecture P1170 – 17.33 minutes)

Over recent years, restrictions on the tax reliefs for pension contributions have meant that more and more high net worth individuals have started looking at venture capital investments as an alternative to the hitherto conventional forms of provision for retirement. The main reliefs are:

- the Enterprise Investment Scheme (EIS);
- the Seed Enterprise Investment Scheme (SEIS); and
- Venture Capital Trusts (VCTs).

The EIS legislation, which has been available for many years, offers significant tax incentives to investors in the unquoted trading companies that qualify. These will typically be young high-risk businesses. It should be emphasised that there are stringent conditions associated with this and the other venture capital reliefs.

In summary, the principal EIS tax benefits are:

- income tax relief of up to 30% of the amount invested;
- no CGT if EIS shares are disposed of at a profit after three years;
- a form of CGT deferral which allows investors to hold over gains on any kind of chargeable asset against subscriptions in EIS shares;
- losses on EIS shares may be eligible for income tax relief under S131 ITA 2007; and
- EIS investments should attract 100% business relief under IHT after two years of ownership.

The SEIS regime was introduced in FA 2012 as a special relief to encourage investment in new start-up companies. The rules are largely based on the EIS and contain many of the same features. As far as the SEIS is concerned, the key differences in the reliefs available are:

- an income tax reduction of 50%, regardless of the investor's marginal tax rate; and
- gains arising on the disposal of any kind of chargeable asset can be exempted from CGT (up to a maximum of one half of the SEIS investment) by virtue of a targeted reinvestment relief.

This means that an investor could receive 50% income tax relief and 10% CGT relief (i.e. $\frac{1}{2} \times 20\%$) on a £100,000 SEIS investment, reducing his net cost to just £40,000. However, while the SEIS reliefs may appear to be more attractive in percentage terms, the overall amount of relief available is substantially less, given that the maximum SEIS investment in any one tax year is limited to £100,000.

On the other hand, with an annual limit of £1,000,000, which can rise to £2,000,000 for 2018/19 onwards if investments are made in 'knowledge-intensive' companies, £600,000 of relief is potentially available through the EIS.

The background rationale for the introduction of VCTs has been explained as follows:

'To overcome the expected difficulty of some investors meeting the conditions for relief under the EIS, an investment vehicle similar to an investment trust (known as a VCT) was devised in 1994. An individual investor can acquire shares in a VCT whose professional managers will use the funds to make and manage investments in a range of unquoted companies.'

A VCT is a quoted company that has been approved as such by HMRC. There are currently three forms of tax relief available to an investor in a VCT:

- an investment relief, given as a 30% income tax reduction, can be claimed on the amount subscribed for new shares in a VCT, up to £200,000 per tax year;
- a dividend relief provides an exemption from income tax on dividends received from shares in a VCT (it should be noted that this relief applies to shares acquired by purchase as well as by subscription, provided that the annual value limit of £200,000 was not exceeded); and
- disposals of shares in a VCT which qualified for investment relief are CGT exempt.

As a final point, it should be borne in mind that investment relief can be clawed back in whole or part if VCT shares are disposed of within five years.

The detailed conditions for EIS

The legislation lays down various conditions which must be met and over which periods. There are three periods which are relevant, all of which terminate at the third anniversary of the date the shares were issued (or if later, three years from when trade commenced). Period A starts with the incorporation of the company or two years before the share issue if later; Period B starts with the share issue and Period C starts 12 months before the share issue.

There is a recent concept for EIS which is that of knowledge-intensive companies. Such companies qualify for higher total investment limits; a longer initial investing period for the purposes of the permitted maximum age condition and a higher number of employees. This is discussed further below.

The definition was amended for shares issued on or after 6 April 2018 in cases where the issuing company began to carry on a trade less than three years before the date that the relevant shares are issued. In that case, the operating costs conditions have to be met in the three years after the date of the share issue so it will not be possible to tell if the conditions are met at the time of the issue.

Relief is available in respect of an amount subscribed for shares in the issuing company where:

- 'relevant shares' are issued to the individual
 - Shares forming the OSC which throughout Period B do not carry any present or future preferential rights to dividends or assets on a winding up, nor any present or future rights to be redeemed
 - They are subscribed for wholly in cash and fully paid up at the time of issue
 - They are issued to raise money for the purposes of the qualifying business activity to be carried on by the company or a qualifying 90% subsidiary
 - They are issued for bona fide commercial reasons and not as part of any tax avoidance scheme
- the shares are issued before 6 April 2025
- the individual is a 'qualifying investor'
 - he is not connected with the issuing company
 - there are no linked loans in Period A
 - the existing shareholding requirement must be satisfied
- he must have subscribed for genuine commercial reasons and not as part of a scheme to avoid tax
- the issuing company is a 'qualifying company'
 - the company has a UK PE
 - it meets the trading company conditions in that it must exist only for a qualifying trade and the following are non-qualifying:
 - dealing in land, shares, securities or other financial instruments
 - dealing in goods otherwise than via a normal retail or wholesale trade
 - banking, insurance, money-lending, debt-factoring, HP or other financial activities
 - leasing
 - receiving royalties or licence fees
 - legal or accountancy services
 - property development
 - farming or market gardening
 - forestry or timber production

- shipbuilding, coal or steel production
 - operating or managing hotels or comparable establishments
 - operating or managing nursing or residential care homes
 - generating or exporting electricity or making electricity generating capacity available
 - generating heat
 - generating any other form of energy
 - producing gas or fuel
- it meets the financial health condition
- the qualifying business activity is being carried on by the company or a qualifying 90% subsidiary
- it is unquoted
- it meets the control and independence condition
- it meets the gross asset test
- it meets the company employee test
- the company's subsidiaries are all qualifying
- the general requirements are met in respect of the relevant shares:
 - the total amount of relevant investments must not exceed £12m or £20m if it is a knowledge intensive company with the annual amount being £5m
 - the money must be used for the purposes of the qualifying activity with the added proviso since 18 November 2015 that they are being issued to promote business growth and development, within 2 years of the issues
 - the shares are issued in the initial investing period (being 7 years or 10 years for a knowledge intensive company from the first commercial sale) unless special conditions are met
 - the relief must be claimed
 - there must be no pre-arranged exits
 - there must be no tax avoidance or disqualifying arrangements
- the 'risk-to-capital' condition is met which is that both of the following apply
 - it is reasonable to conclude that the issuing company has objectives to grow and develop its trade in the long-term and
 - it would be reasonable to conclude that there is a significant risk that there will be a loss of capital of an amount greater than the net investment return

Advance assurance

Companies that are seeking subscriptions under the SEIS or EIS may seek an assurance from HMRC that a prospective investment is likely to be eligible before issuing the shares. The service is discretionary and non-statutory. There is no requirement to obtain advance assurance and HMRC will not engage in protracted correspondence if there is a difference of opinion. There is no appeal process if HMRC will not give the assurance requested.

Assurance is given in respect of a particular issue of shares, in the circumstances set out in the application and will not apply if the circumstances change or there is a change in the legislation. It is not assurance as to the availability of relief to any particular investor. HMRC will not give assurance on speculative applications.

Knowledge intensive companies

1. Knowledge intensive companies are allowed to have more generous provision under EIS. They are companies which are carrying out significant levels of research and development. They can raise more finance (£10m in a 12 month period and £20m in a lifetime compared to £5m and £12m respectively for other companies), be up to 10 years old (rather than 7) and have up to 499 full time equivalent employees (rather than 249).

It is necessary that the company has prior accounting periods for which it is required to have filed statutory accounts with Companies House where it has sufficient levels of R&D expenditure.

The R&D expenditure must be:

- At least 15% of operating costs in one of the last three years or
- At least 10% of operating costs in each of the last three years.

The company must also then be able to show that either:

- The majority of its business will be derived from the IP being created or
- That its workforce has sufficient qualifications which are relevant to the R&D.

Growth and development and the risk-to-capital condition

These are new requirements designed to focus away from lower risk investments. These are gateway tests and are arguably highly subjective. Money must be being raised for growth and development and the investment must carry a significant risk that the investor will lose more capital than they gain as a return.

Growth and development is not defined in the legislation and HMRC take the following as generic indicators of growth:

- Increasing revenues over time
- Increasing a company's customer base
- Increasing the number of employees

The money may not be used primarily to cover pre-existing day to day expenditure.

The risk-to-capital condition is a principles-based condition that depends on taking a reasonable view as to whether an investment has been structured to provide a low-risk return for investors. The condition is designed to deter tax planning. The problem lies in the fact that HMRC are challenging a number of cases, often picking on phrases in business plans and shareholders agreements.

Pitfalls

There are many reasons why SEIS or EIS relief may not be available. They include:

- Shares must be paid up in cash at the time of issue (since the purpose is to raise funds for the business). Shares issued on the conversion of loans will not qualify.
- Companies can raise funds from both SEIS and EIS but SEIS shares must be issued at least one day before any EIS shares
- In order that the investors bear risk, there are a number of anti-avoidance measures one of which is the pre-arranged exit rules. These are not only about exits but care needs to be taken that at the time of the share issue there are no arrangements:
 - For the disposal of any shares in the company;
 - For the disposal of a substantial part of the assets of the company; and
 - For the protection against the risks of making the investment.

HMRC have for the last six years or so considered that the anti-dilution rights are a protection

- The age requirement (7 or 10 years) is linked to the earliest first commercial sale of the company or a subsidiary or any person who has carried on the business although there are two other possibilities
 - It has previously raised State aid risk capital and is raising further funds for the same business activities (although HMRC have been known to challenge this)
 - The company is raising funds of at least half the average turnover of the last five years and will employ those funds solely to enter a new product or geographic market
- Ceasing to trade causes loss of EIS status unless the reason for cessation is as a result of administration or liquidation for bona fide commercial reasons
- Shares issued must remain eligible shares
- The company cannot repurchase any of its share capital

Abingdon Health Ltd [2016] TC05525

In this case, the question being considered was whether the EIS shares had preferential rights as there was a type of growth shares issued to management which meant they could only receive capital above a hurdle. It was found that the fact that a winding up which would trigger the preferential rights associated with the EIS shares was highly unlikely but that this was irrelevant since a preferential right is either present or absent. The legislation simply requires the shares to carry preferential rights, not that they are likely to be exercised.

Flix Innovations Ltd v Revenue and Customs [2016] BTC512

This was a similar case to the Abingdon case but in this case there were deferred shares. The EIS shares ranked about the deferred shares for repayment capital on a winding up so they had a preferential rate. In this case, the irrelevant point is that the deferred shares were issued for commercial reasons.

GDR Food Technology Ltd [2016] TC05219

This case involves a more esoteric point which is not covered above. A company must claim SEIS before EIS (i.e. once an EIS claim has been made, you cannot claim for SEIS). Shares were issued in this company but the agents erroneously issued an EIS1 compliance certificate and not an SEIS1 form. This was found to be determinative in identifying the type of shares issued.

Bell [2016] TC04969

This case highlights the need to be careful about meeting of the relevant conditions. You cannot get EIS relief if you are a director, unless it is within three years within a previous issue of shares which qualified. They got the dates wrong and it was outside the relevant period so EIS relief was not available.

Robert Ames v HMRC [2018] UKUT 0190

Robert Ames did not claim income tax relief on his EIS shares as he had no taxable income so there was no benefit to be derived from doing this. However, he wanted to claim the corresponding CGT disposal relief when the shares were sold for a considerable profit. HMRC refused to allow the disposal relief due to the failure to make the IT claim. An important point to note!

Oxbotica Ltd [2018] TC06538

This company only issued £316 of share capital – it was a spin out tech company from Oxford University. HMRC argued that this was not meaningful enough to be of any use in the business. But the FTT found no minimum investment is required.

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