Nurturing growth

Personal tax

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Ben Powell provides a refresher of the rules and practicalities surrounding EIS and SEIS

Key Points

What is the issue?

A refresher of the limits, requirements, and practicalities on EIS and SEIS funding

What does it mean for me?

Failure to comply with the schemes can lead to loss of favourable tax treatment, resulting in very unhappy shareholders

What can I take away?

A consolidation of the rules for the EIS and SEIS schemes

While the Enterprise Investment Scheme (EIS) has been with us for 21 years and the Seed Enterprise Investment Scheme (SEIS) has been around since FA 2012, both schemes remain popular with small enterprises. Over the years there have been a number of changes, so this article acts as a refresher of the rules and practicalities surrounding the government’s ideas to promote small and start-up businesses to attract funding and nurture growth.

Qualifying company

To issue EIS/SEIS shares, a company must be a qualifying company. For this, it must be a trading company that is not carrying out an excluded activity. These activities include financial, accounting and legal services, as well as farming and property development. For SEIS, this qualifying activity must not be more than two years old, although this does not preclude the company from having undertaken a different activity before this period. The company also needs a UK permanent establishment.

The company must be unquoted, although AIM companies are classed as unquoted for this purpose. It must also meet the financial health requirement, which prevents companies in financial difficulties issuing EIS/SEIS shares. Finally, the company must not be a 51% subsidiary and any 51% subsidiaries of the company must also be qualifying for EIS/SEIS purposes.

For EIS, gross assets must not exceed £15 million before the share issue and £16 million after it. The company or group must not have 250 or more full-time equivalent employees. The limits are smaller for SEIS companies, with gross assets limited to £200,000 before the issue, and employee numbers limited to 25.

Qualifying shares

The equity issued must be ordinary shares, with no preferential rights to assets on winding up or to dividends, and must be paid up in full, in cash, when issued. A common reason for EIS investments failing is where the cash is not received on the same day as the shares are issued. To sidestep this problem, we recommend that solicitors hold cash raised in an escrow account until shares are issued. The investor must also be taking some real commercial risk, so any pre-arranged exit will cause EIS/SEIS investments to fail.

The cash must be raised for a qualifying business activity. This can cause problems with a cash-rich company because HMRC can argue that it does not need the money for a qualifying business activity. The cash raised from the share issue must also then be used for the qualifying business activity within two years of the date of the issue of the shares for EIS shares, and three years for SEIS equity. Shares can be issued before the trade begins, in which case the company has two years from the date of the start of the trade (three years for SEIS) to use the cash. The company must have carried on the trade for four months before an investor is eligible to claim EIS/SEIS relief. Paying dividends is not considered a qualifying business purpose.

For SEIS companies, the amount of cash raised through SEIS investment cannot exceed £150,000 in any three-year period. The company also cannot have previously raised funds through EIS or venture capital trust schemes.

Qualifying investor

Once the company complies, we must decide whether the investor is a qualifying investor in order to obtain income tax relief. This means he must not be connected to the company for two years before the issue and three years after it. To be connected, he or his associates must not be employed by the company; or must not own more than 30% of the ordinary shares, or voting rights in the company. His associates are spouses and linear descendants; but importantly, this does not extend to siblings.

For EIS companies, special provisions allow for a director of a company to be a qualifying investor, despite the directorship making the investor connected to the company. First, if the director is unpaid in the five-year period around the issue, he is still regarded as a qualifying investor. Second, if the director was not connected before the issue and becomes a paid director with reasonable remuneration for the services rendered immediately after the issue, he is still regarded to be a qualifying investor.

For SEIS companies, the rules on directors being connected are relaxed further still. A director is not treated as an employee of the company, and therefore is a qualifying investor unless they own more than 30% of the company or they are associated to an employee.

Tax relief

For EIS share issues, the investor receives income tax relief to the value of 30% of the amount invested up to a maximum £1 million. For SEIS share issues, the investor receives tax relief at a generous 50% of the amount invested up to £100,000. These reliefs are given as a tax reducer and are deducted from the investor’s tax liability for the year. The amount can be used only to reduce the tax liability to zero, although tax deducted at source can be refunded. It is possible for an investor to use both reliefs in the same year.

The EIS/SEIS tax reducer can be carried back one tax year as long as the limit in the preceding year was not exceeded, so that, if the tax liability of the investor is not sufficient in one year to use the maximum relief, he can take advantage of setting this relief against two tax liabilities.

If the investor sells his shares within three years of the issue, some of the income tax relief originally given will be clawed back. The amount of the clawback is the sales proceeds of the shares multiplied by the original rate of the relief given, up to a maximum of the full amount of the relief originally given.

If shares are sold at a profit after three years, the gain is fully exempt from capital gains tax for the investor. Shares sold before then are chargeable as normal and they must have originally qualified for income tax relief to qualify for capital gains tax exemptions. Capital losses on the shares are fully allowable whenever they are sold. An election can also be made to offset any capital loss that may arise on EIS/SEIS shares against net income, which will be attractive to higher and additional rate taxpayers who can shield themselves from much of the financial risk of the investment through significant tax savings. This election is also not subject to the £50,000/25% loss relief restriction applicable to most losses offset against total income.

Reinvestment relief

As well as these tax reliefs, investors can also claim EIS reinvestment relief that defers gains on any assets sold in a similar way to rollover relief. There is no maximum investment for this relief and the amount claimable is based on the gain reinvested rather than the proceeds. Investors can also choose to claim a specified amount to take advantage of the annual exemption and any brought forward losses. The gain is deferred until there is a later chargeable event, at which point it crystallises and is charged to capital gains tax.

The investor must be UK-resident and invest in the EIS shares 12 months before, or 36 months after, the original asset is disposed. The connected party rules do not apply to EIS reinvestment relief and hence, as long as all other conditions are met, the capital gains tax deferral can be claimed even where the investor does not get income tax relief.

Examples of chargeable events include the sale of the shares, becoming non-UK resident in three years, or the shares ceasing to be eligible such as through the cessation of trade. However, flotation of the company on the London Stock Exchange does not crystallise the gain.

For SEIS reinvestment relief, 50% of the gain reinvested is exempted instead of deferred as with EIS reinvestment relief. However, the maximum eligible for relief through this mechanism is £100,000. You will not receive reinvestment relief on a gain or the capital gains tax exemption on the eventual sale of the SEIS shares unless you have claimed SEIS income tax relief on them.

Advance assurance

Practically, the company can apply for advance assurance for EIS/SEIS investment rounds by completing form EIS/SEIS(AA). It is often advisable to draft an accompanying letter with more detail on the company’s ownership structure and trade. Also provide a pointer to find more information, such as the company’s website. It is useful to provide HMRC with copies of the articles of association, prospectuses and shareholder agreements for them to review and ensure nothing falls foul of the EIS/SEIS rules. HMRC usually take about 30 days to respond. Although the advanced assurance procedure is not mandatory, we have found it to be useful for these reasons:

- EIS certificates can be issued more promptly after the share issue;
- potential investors may request to see the advanced assurance for their own comfort; and
- problem areas that might exist can be flushed out before the funding round begins – we have found HMRC to be helpful on this.

When the shares are issued, a compliance statement EIS1/SEIS1 must be filed. This confirms the exact amount and timing of the share issues to HMRC and the company’s fulfilment of EIS/SEIS requirements. At this point, HMRC will confirm that the business has met the requirements and give the issuing company the authority to issue EIS3/SEIS3 certificates to the investors. It is not until the investors receive this that they can claim the reliefs.

The schemes continue to drive investment and growth in SMEs and the real success is demonstrated by the legislation remaining relatively static in recent years. At the smaller end of the corporate world, the schemes have helped to breed innovation and success.