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Emterprise Investment Schemes (EIS), Venture Capital Trusts (VCT) and Seed Enterprise Investment Schemes (SEIS)

The EIS and VCTs have traditionally been grouped together because they encourage investment in small unquoted trading companies and have certain legislative features in common. For these purposes, shares on the Alternative Investment Market (AIM) are considered unquoted. Most trades qualify, but some which are termed 'excluded activities' do not. For example, dealing in land or commodities; financial activities; and property development are all excluded activities. A company can carry on some excluded activities, but these must not be 'substantial' which HMRC take to mean as more than 20% of the company's activities.

The EIS is designed to help these small companies raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies.

The VCT scheme spreads the investment risk over a number of companies since individuals invest indirectly in a range of small companies. Investors subscribe for shares in VCTs which are companies listed on the London Stock Exchange and are similar to investment trusts. VCTs are run by fund managers who are usually members of larger investment groups. From time to time, VCTs realise investments and make new ones.

Comparison Table

	EIS 2012/13	VCT 2012/13	SEIS 2012/13
Income Tax			
Maximum invest-ment	£1,000,000	£200,000	£100,000
Tax relief	30%	30%	50%
Holding period	3 years	5 years	3 years
One year carry back	Yes	No	Yes
Dividends	Taxable	Exempt	Taxable
Capital Gains Tax	Gains exempt after 3 years	Gains exempt	Gains exempt after 3 years
Capital Gains Tax deferral relief	Yes	No	No
Capital Gains Tax holiday	No	No	Yes

EIS income tax relief

Income tax relief is covered in Part 5 Income Tax Act (ITA) 2007.

This is available to individuals only, who subscribe in cash for newly issued full-risk ordinary shares in a qualifying company. Investment can be directly into the company, or through an EIS Fund which will invest on behalf of the individual in a number of qualifying companies. The subtleties of EIS funds are not considered further but it should be noted that the individual is still the owner of the shares.

The minimum investment is £500 worth of shares in any one company in any one tax year. The maximum investment on which relief can be obtained is £1,000,000.

For shares issued from 6 April 2011 the relief is 30 per cent of the cost of the shares, to be set against the individual's income tax liability for the year of assessment in which the shares are issued. The maximum tax reduction in any one year is therefore £300,000 providing a sufficient income tax liability exists to cover it. The relief cannot be set off against dividend income, as the tax credit attached to the dividend is not recoverable.

Relief is also available in the case of joint subscriptions, Where shares are held jointly each of the owners is to be treated as having subscribed an equal amount even if all of the funds were provided by one of them.

There is a 'carry back' facility which allows all or part of the cost of shares acquired in one tax year, to be treated as if acquired in the preceding tax year with relief then given against the income tax liability of that preceding year.

Example:

Chris subscribes £750,000 for shares issued on 10 October 2011. He has already had relief of £100,000 in 2010/11, and the maximum relief available for that year is £500,000, so he elects to carry back £400,000 to 2010/11. He uses the balance of £350,000 in 2011/12.

Chris will be required to make two separate claims.

Income tax relief cannot be claimed if the individual is connected with the company in either of two ways. Firstly, by financial interest - for example the individual or an associate holding more than 30% of the share capital. Secondly, by employment - a partner, director (except for business angels) or an employee is deemed connected (an associate is so connected).

Example:

George subscribes for a 15% stake and obtains income tax relief. One year later he subscribes for an additional 20%. He is then deemed connected and his relief will be withdrawn.

Prior to claiming relief, an investor must receive from the company form EIS3 which certifies that the company has not, so far, breached any of the conditions for being a qualifying company. Form EIS3 cannot be issued unless the company has been trading for at least four months.

Income tax relief is then typically claimed on the self assessment tax return for the tax year in which the shares were issued. If the shares were issued in a previous year, and/or if the claim is for capital gains deferral relief, the claim part of the form EIS3 must also be completed and submitted to HMRC.

Investors who do not make returns under self assessment can use the claim section of form EIS3 to make their claim.

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EIS withdrawal or reduction of income tax relief

EIS shares must be held for three years from the date of issue or the start of trade if later, otherwise income tax relief will be withdrawn.

Relief will be **withdrawn**, if during that period,

- the investor or an associate become connected with the company.
- the company loses its qualifying status. Genuine commercial liquidation would not result in withdrawal of relief.

Relief will be **reduced or withdrawn if**, during that period,

- any of the shares are disposed of (**unless** the disposal is to a spouse or civil partner at a time when the couple are living together).
- the investor or an associate 'receives value' from the company (eg receives a loan or benefit from the company).

EIS disposal relief - capital gains tax exemption

If an investor has received income tax relief (which has not subsequently been withdrawn) on the cost of the shares, and the shares are disposed of after they have been held for the three year period, any gain is exempt from capital gains tax (S150A TCGA 1992). The exemption may be restricted if

- the investor has over subscribed.
- the investor has received value from the company and the income tax relief has been reduced accordingly

There is no restriction if the only reason full income tax relief cannot be given is because the claim reduces the investor's income tax liability to nil.

If income tax relief is not claimed, then any subsequent disposal of the shares will not qualify for exemption from capital gains.

An investor can claim a capital loss on the disposal of EIS shares (whenever disposed of) but in calculating this loss, the allowable cost is reduced by income tax relief not withdrawn.

Example:
An investor subscribes £100,000 for 50,000 shares in an EIS company. Income tax relief of £30,000 is given. Five years later these shares are sold for £65,000

The allowable loss is calculated as follows:

Disposal proceeds		£65,000
Less cost	£100,000	
Reduced by income tax relief	(£30,000)	£70,000
Allowable loss		**£5,000**

EIS disposal relief - income tax relief for capital losses

If the shares are disposed of at a loss, the investor can elect that the amount of the loss, less any income tax relief not withdrawn, can be set against income of the year in which the shares were disposed of, or any income of the previous year, instead of being set off against any capital gains (S131 ITA 2007).

EIS capital gains tax deferral relief

This relief is covered in Sch 5B Taxation of Chargeable Gains Act (TCGA) 1992.

Deferral relief can be claimed against any amount of chargeable gain arising on the disposal of any asset where the gain is invested in EIS shares. It can also be claimed when a gain previously deferred under the EIS (or VCT shares issued before 6 April 2004), is brought back into charge. The investor can claim deferral relief on only part of the gain if desired. The effect is to defer the tax liability until the EIS shares are sold or deemed sold. The investment must be made within the period one year before or three years after the gain arose.

To qualify, the investor must be an individual (or the trustees of a qualifying settlement) who is resident or ordinarily resident in the UK both at the time the gain accrued and at the time the shares are issued. Note however that EIS income tax relief and cgt disposal relief are not available to trustees.

The relief is claimed by the investor submitting part 2 of the EIS3 certificate from the company. The time limit for claiming is five years from 31 January following the end of the tax year in which the shares were issued.

The deferred gain becomes chargeable when there is a chargeable event. For example,

- a disposal of the EIS shares (except a disposal to a spouse or civil partner which is covered by the no gain/no loss rule).
- the investor becoming non-resident within the three year period (unless by reason of temporary overseas employment).
- the company ceases to be a qualifying company.

A disposal of some of the shares would trigger a proportion of the deferred gain becoming assessable.

A deferred gain is not triggered on the death of the investor or the spouse/civil partner who acquired the shares on a no gain/no loss transfer.

It does not matter whether the investor is connected with the company or not. It is therefore possible for an individual to invest in a company which he already owns or controls.

EIS and the company

For investors to be able to claim, and keep tax reliefs, the issuing company has to meet the qualifying rules as referred to in the introduction throughout the three year period. Note however that the company may subsequently become quoted without investors losing relief, but only if there were no arrangements for it to become quoted in existence when the shares were issued.

VCT tax reliefs available

Tax reliefs are only available to individuals aged 18 years or over and not to trustees, companies or others who invest in VCTs.

For individuals who subscribe for new ordinary VCT shares, three tax reliefs are available.

1. 'front-end' income tax relief.
2. exemption from cgt on disposals.
3. exemption from income tax on dividends.

For individuals who do not subscribe but acquire by other means (eg purchase from someone else) then tax reliefs 2. and 3. are available.

CGT deferral relief, previously available, was abolished in respect of shares issued after 5 April 2004.

VCT income tax reliefs

Income tax relief is covered in Part 6 of ITA 2007.
'Front-end' tax relief is available at 30% of the cost of new ordinary shares subscribed for up to the 'permitted maximum' of £200,000 to be set against the individual's income tax liability for the year of assessment in which the shares are issued. The annual limit applies to all the taxpayer's acquisitions in VCTs in the tax year concerned, and shares acquired earlier in the tax year count towards the permitted maximum first.

The maximum tax reduction in an individual's income tax liability in any one year is therefore £60,000 providing a sufficient income tax liability exists to cover it.

> **Example:**
>
> If Jonny subscribed £20,000 for shares issued in the tax year 2011-12 his maximum income tax relief would be £6,000. If his actual liability in that year before any VCT tax relief is £5,000, then that is the relief he will receive. The difference of £1,000 cannot be set off against the income tax liability of any other year.

The shares must be held for at least five years and throughout this time carry no present or future preferential rights to dividends or to the VCT's assets on winding up and no present or future rights to be redeemed.

Tax relief can be claimed either with the tax return (see page Ai 2) or as a stand alone claim. There is no set form for a stand alone claim.

Dividends received from VCT shares are exempt from income tax ('dividend relief') in respect of shares acquired within the 'permitted maximum' of £200,000. These dividends do not have to be included in the tax return.

VCT withdrawal of 'front-end' income tax relief

'Front-end' income tax relief will be withdrawn, in whole or in part, if the shares are disposed of within five years of issue. A disposal between spouses or civil partners who are living together does not give a rise to a withdrawal.

> **Example:**
> Ed subscribes £100,000 for 100,000 VCT shares. He claims 'front-end' income tax relief of £100,000 x 30% = £30,000. Within five years he sells 10,000 shares at arms length for £2,000.
> The 'front-end' income tax relief to be withdrawn is the smaller of:
> a. relief given on shares disposed of £30,000 x 10,000 / 100,000 = £3,000, and
> b. consideration £2,000 x 30% = £600.
>
> The relief to be withdrawn is therefore £600.

'Front-end' relief may also be withdrawn where a VCT loses its approval. Death does not give rise to a withdrawal of 'front-end' income tax relief.

VCT capital gains tax exemption

There will be no chargeable gain (or allowable loss) for cgt purposes on selling ordinary shares in a VCT provided

- the shares were acquired within the permitted maximum for the tax year in question.

- the VCT was a approved as a VCT both when the shares were acquired and when they were sold.

There is no minimum period for which the shares must be held.
As for 'dividend relief', cgt relief is available for both newly issued shares and second-hand shares.

VCT conditions for HMRC approval

The conditions a company must satisfy for it to be approved as a VCT include the following

- income is wholly or mainly from shares or securities
- at least 70 per cent, by value, of its investments comprise holdings in qualifying companies (see introduction).
- the holding in any company must not represent more than 15 per cent (by value) of its investments.
- its ordinary shares are listed on the London Stock Exchange
- it must not retain more than 15 per cent of the income it derives from shares or securities.

SEIS

This scheme will:

- apply to companies with 25 or fewer employees; assets of up to £200,000, and which are carrying on or preparing to carry on a new business.
- give income tax relief worth 50% of the amount subscribed by individual investors with an investment of less than 30%, including directors who invest in their companies.
- have an annual investment limit of £100,000 per investor, with unused annual amounts able to be carried back to the previous year, as under the EIS.
- have an overall tax favoured investment limit of £150,000 for the company. This will be a cumulative limit, not an annual limit. exempt cgt on gains on SEIS shares.
- exempt cgt on gains realised from disposals of assets in 2012-13, where the gains are reinvested through the new SEIS in the same year.