

The Enterprise Investment Scheme

This note provides a summary of the Enterprise Investment Scheme and has been prepared based on the law up to and including the Finance (No 2) Act 2015.

The Enterprise Investment Scheme (EIS) encourages investment by individuals in small unquoted trading companies (or via EIS funds, which are see-through for tax purposes) by offering generous tax reliefs to such investors. The tax benefits are attractive but considerable care is needed to obtain them and a range of conditions must be fulfilled by both the company issuing the shares and the individual investor. While EIS relief is appealing, the “devil is in the detail”. For investments in new and very small companies, investors may also wish to consider the Seed Enterprise Investment Scheme.

Tax reliefs

Income tax relief

An individual investing in EIS shares can currently claim a reduction of his income tax liability in that tax year equal to 30% of the amount subscribed for the EIS shares. The relief is currently subject to a maximum investment limit of £1 million per annum. Where an investor is entitled to claim income tax relief in respect of a subscription for EIS shares made in any tax year, he may elect to carry back some or all of the income tax relief to the previous tax year.

Capital gains tax exemption

Provided income tax relief has not been withdrawn, and the EIS shares are held for at least three years from the date of their issue (or, if later, until at least three years after the date on which the relevant company begins to trade) (that is, until the “relevant third anniversary”), no capital gains tax charge arises on the sale of those shares.

Capital gains tax deferral relief

An investor can offset the amount subscribed for EIS shares (including subscriptions that exceed the maximum permitted for income tax relief) against his capital gains which arise in the period beginning three years before and one year after the date on which the investor subscribes for EIS shares. Any gain so offset is deferred until a disposal or other chargeable event occurs in relation to the EIS shares. At this point the earlier gain revives and the associated capital gains tax falls due. There is no limit on the amount of deferral relief which may be claimed.

Loss relief

If a capital loss is made on the sale of the EIS shares, in certain circumstances this loss (less any income tax relief already given) can be set against income or capital gains.

By way of illustration, for an investor who secures maximum tax relief, an investment of £1,000,000 can result in a tax reduction of £580,000 for the relevant year (made up of £300,000 of income tax relief and £280,000 of capital gains tax deferral).

Conditions for EIS relief

The company

Unquoted company: The company must be unquoted at the time of the investment with no arrangements in existence for its flotation. For EIS purposes, a company whose shares are traded on AIM is treated as unquoted.

Number of employees: The company must have fewer than 250 full time employees (or their equivalents) when the shares are issued or 500 for a knowledge-intensive company.

A knowledge-intensive company is a company whose costs of research and development or innovation are at least 15 per cent of the company's operating costs in at least one of the previous three years, or at least 10 per cent in each of the previous three years (the three years ending immediately before the company's last accounts); and either

- which is engaged in intellectual property creation from which within 10 years it is expected will derive the greater part of the company's or group's business; or
- which has employees with a relevant Masters or higher degree who are engaged in research and development or innovation and who comprise at least 20 per cent of the company's total full time equivalent workforce.

Annual and lifetime limit on money raised: The company may not raise more than £5 million in any 12-month period from risk capital investments, which includes the venture capital schemes (SEIS, EIS, SISR and venture capital trusts) and any other source which counts as aid under the EU guidelines on risk capital investments in SMEs. In addition, there is a lifetime limit of £12 million for such investments in any company (or £20 million for knowledge-intensive companies). In assessing both limits, account must be taken of money raised by subsidiaries, partnerships of which the company or its subsidiaries are members and businesses acquired by the company and its subsidiaries.

Business of company: The company may be either:

- a solitary company which exists wholly for the purpose of carrying on *qualifying trade(s)*; or
- the *parent company of a trading group*.

For this purpose, a trade is a *qualifying trade* provided that:

a) it is carried on in a commercial manner;

b) it does not include to a "substantial" extent any excluded trading activity including:

- dealing in land, shares or financial instruments
- providing finance or insurance
- leasing or receiving royalties or licence fees
- certain property-based trades such as property development, farming, market gardening, hotel management and operating or managing nursing homes or residential care homes
- subsidised generation or export of electricity.

In this context "substantial" is taken to mean 20 per cent but this could be measured in a number of ways;

c) the company carrying on the trade has a permanent establishment in the UK.

A company is a *parent company of a trading group* if:

- all its subsidiaries are qualifying subsidiaries (see below); and
- when the activities of the company and its subsidiaries are taken together and assessed as a whole, these do not include to a “substantial” extent *either* any excluded trading activity *and/or* any non-trading activity (eg investment activity or non-commercial activity).

Gross assets: The gross assets of the company (or the group if applicable) must not be more than £15 million before the issue of EIS shares and not more than £16 million immediately afterwards.

Independence: The company must be independent: it must not be a 51per cent or more subsidiary of another company; or under the control of another company (or another company and a person “connected” with that other company).

Qualifying subsidiaries: Any company under the “control” of the company seeking EIS funds must be a “qualifying subsidiary”, that is, a bona fide subsidiary. For this purpose “control” includes a right to more than 50 per cent of (a) the voting rights or (b) income of a company or (c) more than 50 per cent of the assets of a company on its winding up.

Financial Health: Enterprises which, under EU guidelines, are in “financial difficulty” are not eligible.

Maximum Age: First EIS investments must not be made in a company which is more than 7 years old (10 years old for a knowledge-intensive company). This age limit is calculated by reference to the date of the first commercial sale by the company. This age limit is waived where the relevant qualifying investments exceed 50 per cent of the company’s (or group’s) average annual turnover and are to be used to enter a new product or geographical market.

The shares

The shares issued must be ordinary shares and (with certain exceptions) not carry any present or future preferential rights to dividends, to the company’s assets on a winding-up, or to be redeemed. Subscription must be in cash and the shares must be fully paid up at the date of issue. In addition, no ‘arrangements’ for an exit route for the investor may exist.

Use of funds

The shares must be issued to raise funds for the growth and development of a qualifying business activity which will be undertaken by the company or a 90 per cent subsidiary. The use of the money for the acquisition of a company or a business, goodwill or certain intellectual property is specifically prohibited.

Existing shareholdings

If an individual subscribes for shares in a company and that individual already holds shares in that company (or a subsidiary), the new shares will not be eligible for EIS unless the existing shares are subscriber shares or were issued under the SEIS, EIS or SITR schemes.

The investor

The investor must be an individual (although investment via a nominee is possible). He/she must not be “connected” with the EIS company at any time during the period commencing two years prior to the issue of the EIS shares and ending on the relevant third anniversary. There are different types of connections:

Investor connections: An individual is “connected” with a company if he directly or indirectly owns over 30% of:

- the issued ordinary share capital of the company or any subsidiary;

- the loan capital and issued share capital of the company or any subsidiary; or
- the voting power in the company or any subsidiary.

For this purpose, an individual is treated as owning any asset which he is entitled to acquire (eg on exercise of an option) and which any of his “associates” owns or is entitled to acquire.

Work connections: An individual is connected with a company if he or any of his associates is an employee or director of the company or any subsidiary (unless the “*business angel*” exception applies (see below)) or a partner in a business partnership with the company or any subsidiary.

Business connections: An investor is connected with a company if he was at any time involved in carrying on the trade carried on by that company or a subsidiary whether as a sole trader, partner, director or employee.

Business angels

There are special rules for “business angel” investors. In general, a “business angel” is someone who has not previously been connected with the EIS company and only becomes a director of the company when the EIS shares are issued and is thereafter entitled to receive only reasonable remuneration for services provided to the EIS company. Occasionally, someone who is an unpaid director before making an investment might be eligible for business angel status but this will depend on all the circumstances. “Business angels” seeking EIS relief are, in particular, recommended to seek professional advice on their eligibility or otherwise for EIS relief.

If the investor is connected with the EIS company, most EIS reliefs will be unavailable but *capital gains tax deferral relief* would still be available provided that the other conditions are met.

Loan-linked investments

EIS relief will not be available if the investor receives a loan which would not have been advanced to him (or not on the same terms) but for his investment (or intended investment) in the shares issued by the EIS company.

Withdrawal of relief

Breach of EIS conditions

If the company, the shares or the investor fails to meet the required conditions relief will be withdrawn.

Income tax relief and capital gains tax exemption: withdrawn if any of the above conditions cease to be met before the relevant third anniversary.

Capital gains tax deferral relief: withdrawn on the occurrence of a chargeable event. Chargeable events include: the disposal of the shares (other than to a spouse or civil partner) at any time; the investor becoming non-resident; the company losing qualifying company status before the relevant third anniversary; the investor receiving “value” from the company; or the company buying in shares from any shareholder in the year prior to the investment or before the relevant third anniversary).

Loss relief: will cease to be available if at any time while the shares are held, any of the conditions which the company must fulfil for EIS relief cease to be met.

Receipt of value from the EIS company

If the investor or an “associate” receives value from the EIS company (or a “connected” company) then relief is reduced accordingly or, in the case of deferral relief, withdrawn. Detailed provisions outline the circumstances in which receipt of value occurs (including any repurchase of shares by the EIS company, non-arm’s length remuneration to the investor for services, or the transfer of an asset to the investor at an undervalue). Receipts of insignificant value are ignored where the total of all such receipts by the investor is less than £1,000 as are certain

“qualifying payments”. It is important to note that the “receipt of value” rules also apply where value has been received in the year prior to the EIS investment.

Mills & Reeve can advise you on all aspects of the Enterprise Investment Scheme. Please contact:



Christopher Townsend
Partner
+44(0)1223 222387
christopher.townsend@mills-reeve.com



Kevin Lowe
Partner
+44(0)121 456 8382
kevin.lowe@mills-reeve.com



Deborah Clark
Head of Private Tax & Trusts
+44(0)161 235 5432
deborah.clark@mills-reeve.com

www.mills-reeve.com T +44(0)344 880 2666

Mills & Reeve LLP is a limited liability partnership authorised and regulated by the Solicitors Regulation Authority and registered in England and Wales with registered number OC326165. Its registered office is at Monument Place, 24 Monument St, London EC3R 8AJ, which is the London office of Mills & Reeve LLP. A list of members may be inspected at any of the LLP's offices. The term "partner" is used to refer to a member of Mills & Reeve LLP.

The contents of this document are copyright © Mills & Reeve LLP. All rights reserved. This document contains general advice and comments only and therefore specific legal advice should be taken before reliance is placed upon it in any particular circumstances. Where hyperlinks are provided to third party websites, Mills & Reeve LLP is not responsible for the content of such sites.