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EIS & SEIS

Why they are the lifeblood of growing companies

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Introduction

Historically tax advisers tended to treat both the Seed Enterprise Investment Scheme and Enterprise Investment Scheme (SEIS and EIS) as an afterthought and merely something to claim once a client informed them that they had made a qualifying investment.

However, for start-ups and growing companies, raising money is fundamental to "kick starting" a business and achieving sustainable growth. SEIS and EIS are extremely powerful tools for entrepreneurs and growing businesses to attract investment; as well as being important for investors. Firstly, they make it far easier for a company to attract investment and secondly, they enable those investments to raise more money.

By virtue of the tax advantages to investors, a significant number of companies seek to obtain advance assurance from HMRC in order to attract investors. However, the rules surrounding SEIS and EIS can be complicated to understand and easy to fall foul of from a procedural perspective.

Set out below are some of the advantages of the schemes, together with the most common mistakes made by companies when dealing with SEIS and EIS.

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Overview of both schemes

The Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) are government initiatives offering some of the most attractive tax breaks available in the UK

Enterprise Investment Schemes (EIS) and Seed Enterprise Investment Schemes (SEIS) are both designed to encourage investment in small or medium sized companies. They achieve this by offering significant tax relief to individual investors who buy new shares in a qualifying company.

A. The Enterprise Investment Scheme (EIS)

The UK government set up the Enterprise Investment Scheme (EIS) in 1994 and through the scheme eligible investors can claim significant tax relief on investments up to £1 million per tax year.

In summary the main benefits of EIS tax relief are:

- 30% income tax relief can be claimed on investments up to £1 million per tax year.
- Any gain is Capital Gains Tax (CGT) free if the shares are held for at least three years
- Payment of CGT can be deferred when the gain is invested in shares of an EIS qualifying company.
- If the shares are disposed of at a loss an investor can elect that the amount of loss be set against any income tax of that year or of the previous year.

The tax reliefs available in a bit more detail are:

1. Income Tax Relief
   There is no minimum investment through EIS in any one company in any one tax year. Tax relief of 30% can be claimed on investments (up to £1,000,000 in one tax year) giving a maximum tax reduction in any one year of £300,000, provided you have sufficient Income Tax liability to cover it.

   EIS allowances are allocated individually; therefore a married couple could invest up to £2 million each tax year and be eligible for Income tax relief. The shares must be held for at least three years from the date of issue or the tax relief will be withdrawn.

   People connected with the company are not eligible for Income Tax Relief on their shares.

2. Capital Gains Tax exemption (CGT)
   Any gain is CGT free if the shares are held for at least three years and the income tax relief was claimed on them. Shares can be held for much longer and therefore potentially enable the investor to be accrue their CGT exemption over a long period of time which can be a great attraction.

3. Loss relief
   If shares are disposed of at a loss, the investor can elect that the amount of the loss, less Income Tax relief given, can be set against income of the year in which they were disposed or, on income of the previous year instead of being set of against any capital gains.

4. Capital Gains Tax deferral relief
   Payment of CGT can be deferred when the gain is invested in shares of an EIS qualifying company. The gain can be made from the disposal of any kind of asset but the Investment must be made one year before or three years after the gain arose - connection to company does not matter. Unconnected investors are eligible for relief from both Income tax and CGT referral relief.

5. Carry Back
   There is a 'carry back' facility which allows the all or part of the cost of shares acquired in one tax year, to be treated as though those shares had been acquired in the preceding tax year. Relief is then given against the Income Tax liability of that preceding year rather than against the tax year in which those shares were acquired. This is subject to the overriding limit for relief for each year.

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Restrictions on the scheme

To access the scheme, the investment must relate to the shares of a small, unlisted company. Small means 250 employees or less, and maximum gross assets of £15 million (before the investment). Unlisted means that the company is not quoted on a major stock market, although it can be quoted on a market for smaller companies like AIM or ISDX

B. The Seed Enterprise Investment Scheme (SEIS)

The Seed Enterprise Investment Scheme was established in 2012 is therefore much newer than its original parent initiative. The scheme is very similar to EIS but because it is designed for investing in even smaller companies, it offers even more generous tax breaks.

While the maximum workforce and gross assets allowable under EIS are 250 staff and £15 million respectively, SEIS has lower limits of 50 staff and £200,000 gross assets. Businesses must also be less than two years old (there are no age restrictions under EIS).

Through the Seed Enterprise Investment Scheme (SEIS), investors, including directors, can receive initial tax relief of 50% on investments up to £100,000 and Capital Gains Tax (CGT) exemption for any gains on the SEIS shares.

The Seed Enterprise Investment Scheme, is therefore incredibly generous. If an investor paid tax at 45% and made an investment of £10,000 that completely failed, they would only lose £2,750 due to the tax relief. For this reason the Seed Enterprise Investment Scheme (SEIS) is extremely attractive to investors.

The main benefits of SEIS tax relief are:

- Investors can receive initial income tax relief of 50% on investments up to £100,000 per tax year in qualifying shares issued on or after 6 April 2012.
- A CGT exemption will offered in respect of gains realised on the disposal of assets in 2012-13, that are reinvested through SEIS in the same year.

Who is eligible to claim tax relief?

- The individual investor can be a director of the company, but not an employee
- An individual's stake in the company can be no more than 30%
- SEIS tax relief applies only to recently incorporated companies i.e. a new business that's under two years
- The company must have 25 or less employees and gross assets of up to £200,000
- For 2012-2013 only, a CGT exemption will be offered in respect of gains realised on the disposal of assets that are invested through SEIS in the same year.

Carry Back

As with EIS investments SEIS tax relief can be carried back to the previous tax year. An investor may elect under ITA07/S257AB(5) to have part or all of an issue of shares treated as though acquired in the tax year preceding that in which the shares were actually acquired. This is subject to the maximum annual investment limit for that earlier year (£100,000). The SEIS rate for the earlier year is then applied to the shares treated as acquired in the earlier year and relief given accordingly. As there is no SEIS rate for periods before 6 April 2012 an election under S257AB(5) will be effective only for shares acquired in 2013-14 and later tax years.

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Claiming your tax relief

The investor can only claim relief once the company sends through the applicable S/EIS3 form. Claims are made through the Self-Assessment tax return for the tax year in which the shares were issued.

Claims can be made up to five years after the investment after the first 31 January following tax year in which investment was made.

When the company invested in has been trading for four months or spent 70% of the total investment, the company must submit form SEIS1 to HMRC (or, more specifically, the Small Companies Enterprise Centre otherwise known as the SCEC).

Once SEIS1 has been reviewed and the requirements met, the SCEC will issue a copy of form SEIS3 for every investor. These are sent to the company and they can be passed on to each investor for them to complete and submit as part of their tax return.

Tax relief that is reduced or withdrawn

It is important to understand that tax relief will be withdrawn if an investor become connected to the company or if the company loses its qualifying status. The relief will also be either reduced or withdrawn if the Shares are disposed of, or if the investor receives "value" from the company such as a loan or an asset below market value.

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Interaction between SEIS and EIS

Although it's possible for an investor to invest in the same company and claim both SEIS and EIS relief, SEIS funds must be raised first. If a company mistakenly issues an EIS compliance statement, it cannot withdraw, revoke or replace it and SEIS relief will be denied.

It's therefore important that the company ensures its administration is in order or instructs suitably qualified professionals to deal with it for them.

Connection to the company

Should the investor be connected to the company, they will not be eligible for Income Tax Relief. Connections are defined through financial interest or employment.

Connection by financial interest

An individual is connected with the company if they control the company or hold more than 30% of the share capital or voting rights. These conditions apply for up to 2 years before and 3 years after the share issue. If during this time, the individual becomes connected, then the relief will be withdrawn. All relatives except brothers and sisters are included within these restrictions.

Connection by employment

For SEIS, an investor (or any associate) mustn't be an employee of the issuing company (or any subsidiary), at any time during the period from when the shares are issued to the third anniversary of issue. An investor (or associate) may, however, be a director (paid or unpaid).

For EIS, an investor mustn't be connected with the company at any point beginning two years before the issue of the shares and ending immediately before the third anniversary of the issue date. As set out above an individual will be 'connected' if they're an employee, a director, hold a material stake or subscribe for shares under reciprocal arrangements

The only exceptions are Business Angels – where the connection is as a director who receives no remuneration from the company.

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Applications for HMRC advance assurance

HMRC provide advance assurance through their specialist Venture Capital Reliefs (VCR) Team. Any application for advance assurance is made through the submission of HMRC's prescribed VCSAA form and comprehensive supporting documentation. The documentation is required to demonstrate how the company meets each requirement or condition of the scheme.

It is important to bear in mind that:

- The advance assurance service is a non-statutory, discretionary, service.
- A company does not have to apply for an advance assurance before receiving an investment.
- An advance assurance has no legal force; it is only HMRC's opinion as to whether a company is likely to meet the qualifying conditions if it receives an investment under the circumstances set out in the application.
- An advance assurance applies to a specific investment. It won't apply if:
  - there are any material changes to the proposed investment approved, or any of the supporting facts or documents used as part of the application.
  - there was not full disclosure of relevant information during the application process. This includes where areas of doubt were not fully highlighted, or relevant information was omitted
  - the law changes between the date the advance assurance was given and the date of the investment.
- The advance assurance service is not a registration scheme; HMRC will only consider applications if a company is actively seeking funding and the terms and amounts are agreed.
- The company must have a Unique Tax Reference (UTR) number issued by HMRC before applying.

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Other things to remember in order to qualify

According to HMRC, there are a number of common failures by companies. Firstly, the shares must be fully paid up in cash when they are issued. Accordingly, shares must not be issued at a time when the company hasn't received payment for them in full. An agreement or 'undertaking' to pay at a future date isn't sufficient. Secondly, shares must be full-risk ordinary shares and mustn't be redeemable or carry preferential rights to a company's assets on a winding-up, even a very small preference will infringe this requirement, even if it is unintentional. Further, the shares mustn't carry preferential rights to dividends if the right depends (to any extent) on a decision of the company, a shareholder or any other person, or where the right to receive a dividend is cumulative.

Care must be taken when drafting the articles of association and any shareholders' agreement, and professional advice should be taken to ensure they do not conflict with the requirements of either scheme.

Potential pitfalls:

HMRC have limited patience dealing with corrections and it is alarmingly easy to fall foul of the rules. Great care is needed to ensure the EIS 1 and EIS 3 (and corresponding SEIS forms) are completed correctly. Simple errors like the date of issue of the shares, shares being issued fully paid, or preferential rights attaching where there are multiple share classes can mean investors don't get the tax reliefs.

Although it's is sometime tempting for clients do deal with these issues themselves for the reasons set out above there is an inherent danger because of the procedural complexities associated with both schemes.

We therefore advise clients that wherever possible they work with professionals who are familiar with the intricacies and idiosyncrasies of both of the schemes.

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Conclusions

External investors are often reluctant to invest in a business unless they understand the consequences of doing so, including the taxation impact of the investment.

Both the Enterprise Investment Scheme ("**EIS**") and the Seed Enterprise Investment Scheme ("**SEIS**") are tax-efficient government-backed schemes which allow qualifying businesses to fundraise from investors who are tax-resident in the UK. We encourage all entrepreneurs to seek advance assurance from HMRC prior to raising funds to see if they are eligible for EIS or SEIS. Having advance assurance can make businesses a far more attractive opportunity for UK investors.

Both schemes do have a number of technical requirements and ensuring available tax relief can be tricky to get right as there are many pitfalls for the unwary. It is therefore important that professional advice is sought to ensure that the investment scheme is right for your business and also that the appropriate company framework is in place to ensure compatibility with the scheme.

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How Aquitas can help you.

Aquitas Law work alongside specialist accountants and our team can provide access to comprehensive advice to assist companies with EIS/SEIS issues and Advance Assurance applications.

Our specialist Corporate & Commercial Law team can review your investment strategy and assist you to structure your business to make you attractive to investors.

Call us on 020 7099 4444 or email us @ enquiries@aquitaslaw.com for a free consultation

Please note:

The availability of any tax relief, including EIS and SEIS, depends on the individual circumstances of each investor and of the company concerned, and may be subject to change in the future.

If you are in any doubt about the availability of any tax reliefs, or the tax treatment of your investment, you should obtain independent tax advice from a suitably qualified professional before proceeding with your investment.

Please visit the HMRC website for further information on EIS/SEIS tax relief.

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