AF4 2020/2021
Investment Products
Part 3: EIS, SEIS, VCT

These products are tested in AF1 as well as AF4. The former should just test the taxation of these products but sometimes this comes up in AF4. It would be wise to read the tax notes about these products in the AF1 section.

The milestones for this part are to understand:

- Why the government offers tax reliefs for these schemes.
- The main tax reliefs for investors in them.
- The qualifications that companies must meet to make use of these schemes
- The factors investors should consider in investing in these schemes.

The main capital markets operate both as a primary and secondary market. The majority of transactions on the London Stock Exchange are secondary market transactions. Buying shares is often described as "investing in business" but if an institution buys £500,000 of Tesco shares none of that money goes to Tesco, it is simply paid to the seller of those shares.

Only shares sold in the primary market raise capital for the business. Unfortunately, most new businesses are too small to use the capital markets. The government believes it is better for the economy if investors provide capital for new businesses rather than buying shares on the secondary market. To encourage this, it offers three tax incentivised schemes. These are:

- Enterprise Investment Scheme (EIS)
- Seed Enterprise Investment Scheme (EIS)
- Venture Capital Trust (VCT)

Enterprise Investment Schemes

If a business wishes to issue new shares that qualify for EIS tax benefits it must apply to HMRC. To qualify **the business** must:

- Be issuing **new** shares
- Be unlisted when the shares are issued and have made no arrangements to become a listed company.
- Be carrying on a qualifying trade, wholly or mainly in the UK.
- The shares must be issued within 7 years of its first commercial sale.
- The shares must be full risk ordinary shares that aren't redeemable and carry no rights to the company's assets
- Have assets below £15m before the share issue and no more than £16m after share issue.
- Have less than 250 full time employees.

It can raise up to £5m in any 12 months and £12m through the lifetime of the company.

There is also a knowledge intensive EIS with different qualifications that will be looked at later.

To qualify for the tax relief **the investor** must:

- Be unconnected with the business when applying for the shares.
- Not acquire more than 30% of the capital

The tax benefits for the investor are:

- Income tax relief at 30% on a maximum investment of £1,000,000. (£500 minimum investment) This is given as a tax reducer. Someone investing £200,000 would be able to reduce their income tax bill by £60,000. If their tax liability was £50,000, it would reduce this to zero but they could not claim a refund from HMRC.
- There is a carry back facility so that the purchased shares can be treated as being acquired in the previous tax year. The tax relief will then apply to the investor's income tax liability in the previous year.
- This relief is clawed back if the shares are disposed of within three years of purchase. There is no clawback if the investor dies or the shares are transferred to a spouse.
- The shares are free of CGT if held for three year
- CGT deferral relief is also available

Tom a higher rate tax payer makes a gain after annual exemption of £100,000. This would give a liability of £20,000. By reinvesting in an EIS this liability is deferred. Deferral can be applied for on any disposals made three years before and one year after the EIS purchase.

- They qualify for IHT Business Relief if held for two years,
- If the EIS shares are sold at a loss, the investor can elect to have the loss less any tax relief given when they were purchased to be set against their income for the year in which they were disposed rather than being treated as a loss for capital gains tax.

Knowledge Intensive EIS

If the business qualifies as "knowledge intensive", the annual limit increases to £2m.

A knowledge intensive company is defined as:

- The company has created or intended to create intellectual property
- OR at least 20% of the company's workforce engaged in research and development must have a relevant master's degree or higher.

AND

- It has spent at least 10% of their operating costs on R & D or innovation in each of the three years before investment

- OR have spent at least 10% of their operating costs on R & D or innovation in each of the three years before investment

If KIEIS status is given there are benefits to the company:

- It can receive up to £10m of funding per tax year.
- It can receive up to £20m funding rather than the normal £12m
- It can have up to 499 employees.
- It can be trading for up to 10 years rather than 7.
- The 10 year period starts when annual turnover exceeds £200,000

Practicalities of investing in an EIS

To qualify as an EIS the shares must be unlisted. This raises practical problems:

- How can new EIS investments be sourced?
- How can the investor value their holding?
- When they wish to sell their shares how can this be done?

The first route is to use "business angels." These are professional investors, possibly former senior executives who want to invest directly into new businesses. They use their contacts to find potential business opportunities.

A more common route is to use an aggregator or sponsor. This is a commercial organisation that acts as a "midwife" to potential EIS companies. They assist businesses to get EIS status and look for potential investors to invest in these. They will put a group of potential EIS companies together and invite investors to subscribe. This spreads the risk for investors by investing in more than one company. It may be referred to as an EIS fund but this isn't accurate as investors will own shares in each company. If sufficient investment cannot be raised, the floatation will not go ahead and the money returned.

The aggregator has a choice of offering investments in an approved or unapproved EIS. If the EIS is approved this means that HMRC has provided advanced assurance of its EIS status. This means that tax relief will be given in the year the EIS fund closes for subscriptions. The money must be invested within 12 months of the fund raising being closed.

If the scheme is unapproved, this means HMRC hasn't given advance assurance of its status. Tax relief will only be given when the money is invested in each company, not when the money is subscribed.

Once the shares have been issued, it is difficult to give them an accurate value as they are not listed on any exchange. Most investors will accept that they must remain invested for three years to avoid the tax being clawed back. After that there are no penalties when the shares are sold but what is a fair price and how can they be sold?

Most EIS sponsors will usually have some an exit strategy so that investors can get their money. This may be through:

- A sale to a larger company.
- Sale to a private equity company.
- A floatation on the Alternative Investment Market.

Most investors would recognise that EIS shares are high risk because they are investing in small developing companies but may underestimate the liquidity risk.

Seed Enterprise Investment Schemes (SEIS)

This extends the EIS regime to very small companies. There are similarities in that they must be held for three years to escape clawback of tax relief and to be exempt from CGT. There is no carry back facility but they qualify for loss relief and Business Relief.

To qualify for SEIS status the company must:

- Be unquoted on any recognised stock exchange when the shares are issued.
- The company must be less than two years old.
- The company must not have carried on any other trade before the new trade starts
- There must be less than 25 employees
- The company must have no more than £200,000 in gross assets.
- It must not receive more than £150,000 in total under the scheme

The tax relief for 2020/21 is:

- 50% on the cost of the shares on a maximum investment of £100,000 which is given as a tax reducer.
- If the investor has a CGT liability on disposal of another asset, 50% of this can be become exempt if invested into a SEIS. For example a higher rate tax payer has a £100,000 gain after annual exemption. This would give rise to a £20,000 liability. By investing into a SEIS he will only be liable for £10,000. This is in addition to the £50,000 income tax relief so effectively it costs £40,000 to make a £100,000 investment.
- Loss relief is available as within an EIS
- They qualify for BPR

It should be noted that any dividends paid from an EIS or SEIS company will be subject to income tax but this might be absorbed by the £2,000 dividend allowance.

The practical issues in investing in a SEIS are the same as with an EIS although the liquidity risk is probably higher since the business will be in its embryonic phase.

Venture Capital Trusts

A VCT is a company listed on the Stock Exchange that invests in the shares of other companies. Where it differs from a conventional investment trust is that at least 80% of the shares must be in qualifying unlisted trading companies.

As with an EIS, HMRC must give approval for the company to qualify as a VCT which enables investors to get tax relief. To be approved it must be **new company** which means that it will offer a prospectus setting out its investment aims to potential investors.

In practice the sponsor will set a subscription target (and a minimum individual investment). Once the target is met the fund is closed and no further subscriptions are accepted If the target isn't met the money will be returned.

In meeting the 80% target for unlisted companies the VCT must invest in **new** shares. Money invested by a VCT counts towards the maximum funding level of an EIS.

The Heisenberg VCT invests £3m in Fantastic App Ltd which has EIS status. In the current year it can only accept a further £2m using the EIS scheme.

A VCT can also invest in new issues on the Alternative Investment market. This will also count towards the 80% limit.

Some VCTs will already have purchased the fund's underlying shares whilst others will only start to invest once the subscription is closed. In the latter case at least 30% of the funds raised must be invested within 12 months of raising the money. The remainder must be invested within three years of raising the money otherwise the VCT status may be withdrawn.

The full qualification rules are:

- At least 80% of its investments by value must be in qualifying unlisted trading companies
- No more than 15% must be invested in any single company or group.
- The remaining 30% by value of the fund can be in ordinary shares (listed on the stock exchange) or debt. Any debt must have at least a five year term.
- At least 10% of a VCT's investment of the 30% must be held in ordinary shares.
- A VCT cannot invest more than £5m in any one company.
- It must not retain more than 15% of the income it derives from shares or securities

The tax benefits for investors are:

- Income tax relief is given at 30% of the investment up to £200,000. This is a tax reducer and is clawed back if the shares are not held for five years.
- They are free from CGT on disposal. (no minimum holding period)
- Dividends from the VCT shares are free from income tax.

They don't qualify for income tax loss relief or Business Property Relief

The risks of investing in a VCT

One advantage of a VCT over an EIS or SEIS is that its shares are listed. This means the shares will have a published price and can be encashed on demand. However, there are other factors that need to be considered.

- Selling VCT shares within 5 years of purchase would mean a clawback of the tax relief. The exceptions are a disposal following death of the investor and transfer to a spouse.
- The underling qualifying assets, unless they are AIM shares, are unlisted so are difficult to price.
- Being an investment trust, the shares may trade at a premium or discount. Because the market in AIM shares is quite small they tend to trade at a discount.

Assessing suitability of EIS, SEIS and VCT

These three products are some of the most tax efficient ones available to UK investors but there is a saying that, "don't let the tax tail wag the investment dog". In other words, just because a product offers great tax incentives does not mean it will be appropriate for the client. Potential investors should first use their ISA and Pension Allowances before considering these products.

There is a large capital risk because they are based on new small companies but with an EIS or SEIS this can be mitigated by using loss relief.

Josh invested £200,000 in an EIS. Tax relief of £60,000 was given so the net cost was £140,000.

Unfortunately, the company collapses four years later and the shares are worthless.

Assuming Josh is an additional rate taxpayer he can offset £140,000 as an income tax loss which reduces his tax bill by £63,000.

This means his maximum possible loss is £77,000 (£140,000 less £63,000)

Loss relief is not available with a VCT but losses can be offset against CGT liabilities.

Risk can also be reduced by diversification. A VCT will always offer a diversified portfolio but investors in EIS/SEIS can diversify by spreading their money across different companies. There could be an argument that EIS/SEIS investors have direct control over which companies to invest in whereas in a VCT that decision is made by the manager.

They are medium to long term investments. They are investing in small unlisted companies which means it will take longer to see whether the company will be successful.

Liquidity risk is a significant factor in all three products. Shares in an EIS or SEIS are unlisted and therefore illiquid. Being able to encash an investment is only likely if the business is taken over by a larger one.

VCT shares are tradeable but will be priced at a large discount to net asset value. In all three cases the buyer of existing shares will get no tax relief which will be a factor in determining the price.

That concludes this part so you should now understand:

- Why the government offers tax reliefs for these schemes.
- The main tax reliefs for investors in them.
- The qualifications that companies must meet to make use of these schemes
- The factors investors should consider in investing in these schemes.

Further Reading

https://www.crowdcube.com/pg/eis-tax-relief-for-investors-44

https://www.seedrs.com/learn/guides/seis-tax-relief

https://www.theaic.co.uk/guide-to-investment-companies/venture-capital-trusts-vcts