R02 2020/2021
Enterprise Investment Schemes, Seed Enterprise Investment Schemes, Venture Capital Trusts

These three products offer significant tax breaks for investments in new smaller companies. Unfortunately, these tax reliefs are not included in the tax tables.

Whilst the tax reliefs are different for all three products they focus on:

- Tax relief and limit on contributions in a tax year
- Whether gains are exempt from CGT
- The tax treatment of dividends
- Whether they qualify for Business Relief

These reliefs are only available on new issues. Investors who purchase shares in the secondary market will get no tax relief.

Whilst the majority of questions will probably be on the tax reliefs, there could be some on the qualifying rules.

Enterprise Investment Schemes

An EIS offers significant tax breaks for **new** investments in qualifying companies.

To qualify for EIS status the business must:

- Be unlisted when the shares are issued and must have made no arrangements to become a listed company.
- Be carrying on a qualifying trade, wholly or mainly in the UK.
- Be issuing new shares
- Have assets not exceeding £15m before share issue and £16m after share issue.
- Have less than 250 full time employees

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 are:

- Income tax relief is given at **30% on a maximum investment of £1,000,000**. (£500 minimum investment) This is given as a **tax reducer**. Someone investing £1 million would be able to reduce their income tax bill by £300,000. If their tax liability was £50,000, it would reduce to zero but they could not claim a refund from HMRC.
- There is a carry back facility so that the shares purchased 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 sold within three years of purchase.
- The shares are **free of CGT if held for three years**
- If the investor has disposed of another asset which has given rise to a CGT liability, the gain can be invested into an EIS and the liability on the original gain can be deferred until the EIS is sold/disposed. For example, 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 is deferred. Deferral can be applied for on any disposals made three years before and one year after the EIS purchase.
- 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.
- They are eligible for **Business Relief** so if held for more than two years they are effectively excluded from the deceased's estate

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

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. They also qualify for loss relief and Business Relief.

The definition of a qualifying company is different and there are more generous tax breaks. 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 reliefs for 2020/2021 are:

- **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 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 the gain into a SEIS the CGT liability is reduced to £10,000. This is in addition to the £50,000 income tax relief so effectively it cost £40,000 to make a £100,000 investment.
- Loss relief is also available so if the company failed and the shares were worthless an investor who was a 45% tax payer could offset £50,000 (loss after tax relief) against income so saving £22,500. Put another way a £100,000 investment carries a maximum loss of £17,500. (£50,000 less £22,500 less £10,000)

Any dividends paid from an EIS or SEIS will be subject to income tax.

Venture Capital Trusts

A VCT is somewhat similar to an investment trust so unlike an EIS the investor has a spread of investments. The VCT must be listed on the Stock Exchange although most its income must come from unlisted securities.

VCT status is given by HMRC. The qualification rules are:

- At least 70% 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.
- At least 30% by value of the fund must be in ordinary shares in qualifying companies.

- At least 10% of a VCT's investment in any qualifying investment must be held in ordinary shares.
- Balance can be in shares or debt. Any debt must have at least a five year term..
- A VCT cannot invest more than £5m in any one company.

The tax benefits 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.
- It must be a new subscription to qualify for the tax relief. Purchases on the secondary market do not get this relief.
- They are free from CGT on disposal. (no minimum holding period)
- Dividends from the VCT shares are free from income tax.

All three products offer a good example of the phrase, “Don’t let the tax tail wag the investment dog”. Whilst all offer excellent tax breaks they all invest in smaller start-up companies so the risk of loss is high.