AF1: Taxation of Investments 2023/2024
Part 4: Enterprise Investment Schemes/Seed enterprise Investment Schemes/Venture Capital Trusts

These three products are a favourite topic for AF1 examiners. Questions should focus on their taxation rather than their structure or suitability which is more the realm of AF4. It is useful though to understand the basics of their structure. If you want more details on the construction of these products go to this subject on the AF4 section

The milestones for this part are to understand:

- The basic structure of the three schemes
- How the initial tax relief works and how it can be clawed back.
- The CGT and IHT benefits of these schemes
- How loss relief operates.

The background to these schemes

A stock exchange enables companies to raise capital by issuing shares. Once shares are issued they are traded on the secondary market but these trades don't provide any additional capital for the company.

Start-up companies need capital to grow their business but their size makes it impossible to access the main capital markets. The government sees raising capital for small companies in the primary market as more beneficial for the economy than trading shares in established businesses on the secondary market. These three products are designed to encourage direct investment in new businesses by giving investors generous tax breaks.

A company wishing to raise capital using either an **EIS or SEIS** applies to HMRC to be given this status. Once granted a business can offer **new** shares to individual investors who benefit from the tax breaks that come from this status.

A **VCT** is an investment trust that buys shares in qualifying companies. Tax relief is only available on purchase of **new shares** issued by the VCT.

To summarise the key differences:

- EIS and SEIS Investors are direct shareholders in the company.
- VCT investors own shares in the VCT so it is a form of collective investment.
- EIS and SEIS shares are unlisted.
- VCT shares are listed on a recognised market.

A company can raise up to £12m from a combination of EIS and SEIS investors and Venture Capital Trusts over their lifetime but cannot raise more than £5m in any one 12 month period.

Companies that have been trading for more than 7 years (measured from its first commercial sale) cannot raise capital through this route with one exception. It can raise money through EIS/VCT provided it raises at least 50% of its 5 year average turnover and spends that money on entering a new product or geographic market.

There are some common tax features for all three schemes:

- They all offer a range of income tax and CGT benefits.
- There is a maximum amount that can be invested each tax year.
- Tax relief on the investment is given as an **income tax reducer**. This means the tax relief is deducted from an individual's tax liability.
- There is a clawback of tax relief if the investment is sold within a set period

Enterprise Investment Scheme

To qualify for EIS status when the shares are issued the company must have:

- Gross assets of less than £15m and no more than £16m immediately after the share issue.
- Have fewer than 250 full time equivalent employees
- Be unquoted and have no arrangements in place to become quoted on a recognised stock exchange.

At the time of the share issue AND for three years after the company must:

- Be independent and not under the control of another company.
- Conduct a qualifying trade.
- Have a UK permanent establishment.

EIS status will not be given to companies that are set up to fund management buy outs or acquiring another company.

Taxation

- The tax relief is 30% on subscriptions for new shares to a maximum of £1,000,000 per tax year. This would give a potential reduction of £300,000 in the investor's tax bill.
- The relief is always 30% regardless of the investor's tax status.
- Investments are made gross and tax relief is claimed once they receive the EIS3 certificate from the sponsor who organised the EIS.
- Subscriptions over £1m won't get the 30% relief but the shares will still qualify for CGT deferral relief and Business Relief.
- For a business that qualifies as a **Knowledge Investment Company** this increases to £2,000,000
- The amount invested can be carried back to the previous tax year if the investor has some remaining allowance in the previous year. This can be done at any time in the tax year.

- The relief is clawed back if the shares are sold or gifted within three years of purchase. Gifts to spouse/civil partner are not counted as a disposal, nor is disposal on the death of the investor.

In addition to income tax relief on the initial investment there are other tax benefits.

- Any losses can be offset against income tax liabilities as a trading loss for the year of the tax loss or the previous year rather than a loss for CGT.
- There is no CGT if the shares are sold/disposed after three years. **(Disposal Relief)**
- A CGT liability on the disposal of other assets can be deferred if the proceeds of the sale are invested in an EIS. **(Deferral relief aka Reinvestment relief)**
- The shares qualify for Business Relief so will be exempt from IHT if they have been held for at least two years.
- Any dividends are taxable

All these tax benefits only apply to the purchaser of **new shares**. If they are sold, the new owner will not have these benefits.

Here are some examples of all these in practice:

Initial investment

Dave has an income tax liability of £160,000. He invests £500,000 so the tax relief is £150,000. His income tax liability is reduced to £10,000

If he invested £600,000 the relief is £180,000 and his liability would go down to zero but he would not get a refund.

Disposal after three years

Emil invests £100,000 in an EIS and receives £30,000 tax relief.

Seven years later the business is bought by a private equity fund and he receives £500,000.

His gain is £430,000 (£500,000 less £70,000) and no CGT is payable.

Now let’s look at the situation if a loss is made.

Five years later the business has collapsed and the shares are worthless

Emil’s loss is £70,000, that is the net cost less current value which is zero

If Emil had sold the shares for £65,000 his allowable loss would be £5,000

Disposal within three years

In these examples we will start with a £100,000 original investment where tax relief of £30,000 was given. If these are sold within three years it doesn't follow that £30,000 must be repaid.

Example 1: shares are sold at a profit

Rule: 100% of the tax relief must be repaid

Two years later the shares have doubled in value to £200,000 and all are sold. The gain is £130,000 but the £30,000 tax relief would have to be repaid giving him a net gain of £100,000

Example 2: shares become worthless.

Rule: Provided the company has gone into liquidation for genuine commercial reasons, there is no clawback of tax relief.

Two years later the business the shares are worthless. The loss is £70,000. There is no clawback

Example 3: Shares are sold at a loss

Rule: The amount of tax that is reclaimed is restricted to **sales proceeds x 30%.** The remaining tax relief is still used to reduce the allowable loss

Two years later the shares have fallen to £40,000 and they are all sold. The clawback is £40,000 @ 30% = £12,000. This means that £18,000 of tax relief is available. (£30,000 less £12,000) His allowable loss is £60,000 (£100,000 less £40,000) less £18,000 = £42,000 Without the clawback the loss would have been £30,000 (£70,000 less £40,000)

If the investor **gifts** EIS shares to someone other than a spouse or CP within three years **all the tax relief** is clawed back

Using loss relief

If a loss is made the investor has a choice of either of treating it as a loss for CGT or offsetting the loss against income. It is generally better to offset against income

> Barry invests £200,000 into an EIS at a net cost of £140,000. Four years later he sells the shares for £10,000 so his loss is £130,000.
>
> He is a higher rate tax payer so the loss is relievable at 45%. His tax bill is reduced by £58,500
>
> If the loss is offset against a capital gain the maximum tax saving is £26,000 (£130,000 @ 20%)

Through a combination of initial tax reducer and offsetting a loss, it is possible to calculate the maximum possible loss on an investment.

> An additional rate tax payer invests £100,000 into an EIS. After tax relief this costs £70,000
> Five years later the company collapses and the shares are worthless.
>
> If this loss is set against income there would be a saving of £31,500 (£70,000 @ 45%)
> The maximum loss that can make is £70,000 less £31,500 = £38,500

This illustrates the key tax breaks of using an EIS:

- Assuming it is held for at least three years.
- 30% of the investment risk is taken by the government but the investor takes 100% of the reward.
- The loss to the investor is restricted to 70% of the gross investment which can be reduced further by using loss relief
- For an additional tax-payer the maximum loss is 38.5% of the gross investment.
- For a higher rate tax-payer the maximum loss is 42% of the gross investment.
- For a basic rate tax-payer the maximum loss is 56%

CGT Deferral Relief.

If an investor makes a gain that is subject to CGT, any tax liability can be deferred if the chargeable gain is used to invest in an EIS.

To qualify the EIS shares must be issued to the purchaser in the period beginning 12 months before and ending 36 months after the date of the original disposal.

A non EIS disposal is made on 6 June 2020 which results in a chargeable gain. To qualify for deferral relief the EIS shares must be issued to the seller at any time between 6 June 2019 and 6 June 2023. The claim must be made by 5 years after the 31st January following the end of the tax year in which the EIS shares were issued. If the EIS shares were issued in August 2020 the claim must be made by 31 January 2026

Here's an example.

Ken, a higher rate tax payer, made a gain of £100,000 in 20/21. He has already used his annual exemption He invests £100,000 into an EIS at a net cost of £70,000 and defers the gain so makes a saving of £20,000 (or £28,000 if the gain was from residential property.) Five years later the EIS is sold for £150,000, making a gain of £50,000 No CGT is payable on the EIS but the deferred gain becomes payable in that tax year at that year's rate

If the EIS sale had resulted in a loss this can be offset against the deferred gain and could wipe it out meaning that no tax is payable.

In the previous case selling the EIS meant that the deferred gain became chargeable. The investor could then reinvest the deferred gain of £100,000 into an EIS to avoid paying CGT at that point. In that way CGT could be deferred almost indefinitely.

Seed Enterprise Investment Scheme (SEIS)

This is designed to attract start-up capital to new companies smaller than the typical EIS venture.

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

Taxation

There are similarities between the tax breaks of a SEIS and EIS

- Gains will be free of CGT if shares held for three years.
- There is a clawback of tax relief if shares are disposed of within three years unless transferred to a spouse/civil partner or on the death of the investor.
- Loss relief is also available
- It qualifies for Business Relief

The differences are:

- Subscriptions are limited to £200,000 in a tax year.
- Tax relief of 50% will be given as a tax reducer. This means that the calculation of the withdrawal of tax relief the formula is sales proceeds x 50%
- Subscriptions can be backdated to the previous tax year. However the limit for 22/23 was £100,000
- If the investor has a CGT liability on disposal of another asset 50% of this can become exempt if invested into a SEIS.

Jill, an additional rate tax payer, makes a capital gain of £100,000 after using her 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.

With the addition of the £50,000 income tax relief it would cost Jill £40,000 to make a £100,000 investment.

If the company failed and the shares were worthless she could offset £50,000 (loss after tax relief) against income so saving £22,500. Put another way for an additional rate tax payer who can use the CGT reinvestment a £100,000 investment carries a maximum loss of £17,500. (£50,000 less £22,500 less £10,000)

Venture Capital Trusts (VCT)

This product is a collective investment set up as an investment trust that invests in unlisted trading companies

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.

Taxation

This is similar in structure to an EIS but with some significant differences.

- The maximum contribution to new shares per tax year is £200,000 and 30% relief is given as a tax reducer giving a maximum reduction of £60,000. There is no backdating of contributions.
- This is withdrawn if shares are disposed of within 5 years. (transfers to spouse/civil partner or on death are exempt.)
- They are immediately exempt from CGT but there is no CGT deferral.
- Dividends are tax free.
- They do not get Business Relief
- There is no loss relief

That concludes this part so you should now understand:

- The basic structure of the three schemes
- How the initial tax relief works and how it can be clawed back.
- The CGT and IHT benefits of these schemes
- How loss relief operates.

Further reading

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

https://www.syndicateroom.com/eis

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

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