

An Introduction to the Enterprise Investment Scheme (EIS)

Version 2

This print reflects the EIS legislation and HMRC online guidance as at 20 September 2010. If it is some time since you printed it, you may wish to refer back to the 'Print this guidance' page in the online guidance at <http://www.hmrc.gov.uk/eis/print.htm> to check it has not been superseded by a later version.

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Introduction

The EIS is designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies.

This guide provides an overview for companies and potential investors who have heard of the Scheme and want to know more about it and how it works. It does not cover all the detailed rules, so companies and investors should not proceed solely on the basis of the information in it, and should consider seeking professional advice.

The information in this guide relates only to shares issued on or after 6 April 2009.

It does not cover the legislation relating to shares issued before that date. And readers must bear in mind that the reliefs and legislation relating to them may change in the future.

The Budget on 22 June 2010 announced changes to the Capital Gains rules.

Assuming that the legislation is enacted as anticipated, these changes may affect deferral under EIS of any gains accrued after that date as it will no longer be possible both to defer such gains under the EIS rules, and for them to qualify for Entrepreneur's Relief. If you think that you may be affected by this you should seek advice before proceeding with investment under EIS.

HM Revenue & Customs (HMRC) provides more detailed guidance in the Venture Capital Schemes Manual (VCM), to which this guide occasionally refers.

This guide is divided into two parts:

Part 1 focuses on the investor

Part 2 focuses on the company

And there are pointers to additional sources of information at the end.

It is strongly advised that you read both parts, irrespective of whether you are a potential investor or a company considering using the Scheme.

It is important that investors are aware of the rules the company has to observe, not just at the time of the investment but for at least three years afterwards. If it fails to meet those rules tax relief will not be given, or, if it has already been given, will be withdrawn. Similarly, it is important that companies appreciate the conditions to be met by investors, so that shares are not issued on which the investor expects to be able to claim tax relief, only to find that no relief is due.

Both investors and companies should note that no relief will be given (or if it has been given, it will be withdrawn) if any scheme has as its main purpose, or one of its main purposes, the avoidance of tax. (The tax reliefs available under the EIS are of course not considered to be avoidance of tax.)

Part 1 EIS and the investor

1.1 The investment

All shares must be paid up in full, and in cash, when they are issued.

They must be 'full-risk' ordinary shares, with no preferential rights to dividends, or to the company's assets in the event of a winding up. There must also be no

arrangements to protect the investor from the normal risks associated with investing in shares, and no arrangements for the shares to be purchased by anyone else after the end of the relevant period. Investment can be directly into the company, or through an EIS Fund. For more on EIS Funds, see 1.6 below

1.2 The Tax Reliefs available

1.2.1 Income Tax Relief

This is available to **individuals** only, who subscribe for (although this can be through a nominee), shares in an EIS qualifying company. There has to be a minimum investment of £500 worth of shares in any one company in any one tax year. The relief is 20 per cent of the cost of the shares, to be set against the individual's income tax liability for the tax year in which the investment was made. Relief can be claimed up to a maximum of £500,000 invested in such shares, giving a maximum tax reduction in any one year of £100,000 providing you have sufficient income tax liability to cover it. (Please note that this relief cannot be set off against dividend income, as the tax credit attached to the dividend is not recoverable.)

There is a 'carry back' facility which allows all or part of the cost of shares acquired in one tax year to be treated as though the 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.

The shares must be held for a certain period or income tax relief will be withdrawn. Generally, this is three years from the date the shares were issued. But if the qualifying trade started after the shares were issued, the period is three years from the date the trade actually started.

Income tax relief can only be claimed by individuals who are not 'connected' with the company. (See 'Connection with the company' at 1.3 below)

1.2.2 Capital Gains Tax Exemption

If you have received income tax relief (which has not subsequently been withdrawn) on the cost of the shares, and the shares are disposed of after they have been held for the period referred to at 1.2.1 above, any gain is free from Capital Gains Tax.

1.2.3 Loss Relief

If the shares are disposed of at a loss, you can elect that the amount of the loss, **less any income tax relief given**, can be set against income of the year in which they were disposed of, or any income of the previous year, instead of being set off against any capital gains.

1.2.4 Capital Gains Tax deferral relief

This is available to individuals and trustees of certain trusts. The payment of tax on a capital gain can be deferred where the gain is invested in shares of an EIS qualifying company. The gain can arise from the disposal of any kind of asset,

but the investment must be made within the period one year before or three years after the gain arose.

There are no minimum or maximum amounts for deferral. And it does not matter whether the investor is connected with the company or not. Unconnected investors may claim both income tax and capital gains deferral relief.

There is no minimum period for which the shares must be held; the deferred capital gain is brought back into charge whenever the shares are disposed of, or are deemed to have been disposed of under the EIS legislation.

1.3 Connection with the company

You are not eligible for income tax relief on the cost of your shares if you are connected with the company. You can be connected in two ways.

1.3.1 Connection by financial interest in the company.

A financial interest in the company, or in any subsidiary of the company, can make you connected with it. If you control the company, or hold more than 30 per cent of the share capital (or share and loan capital taken together) or voting rights, you are connected with the company. If you are entitled to more than 30 per cent of the assets in the event of a winding up you are also connected; note that in looking at entitlement to assets, loans to the company are taken into account.

These conditions apply throughout the period beginning two years before the issue of the shares and ending three years after the issue (or three years after the commencement of the trade if that followed the share issue).

So if you take a 15 per cent stake and are given income tax relief, and a year later you take an additional 20 per cent stake, you have become connected, and the relief will be withdrawn.

Shareholdings/voting rights/rights to assets in a winding up held by your **associates** are also taken into account. Associates are defined as business partners, trustees of any settlement where you are a settlor or beneficiary, and relatives. Relatives are spouses or civil partners, parents and grandparents, and children and grandchildren; brothers and sisters are not counted as associates for the purpose of the EIS.

1.3.2 Connection by employment.

If you are a partner, director (though see 'Business Angels' below) or an employee of the company, you are connected with it. You are also not eligible for relief if an associate (see above) is so connected. As with connection because of an interest in the company, this restriction applies not only at the time the shares were issued but to the two year period before the shares were issued and the three years after the issue (or the three years after the commencement of the trade if that followed the share issue).

1.3.3 Business Angels

However there is an exception for directors who are 'Business Angels'. Where your **only** connection with the company is as a director who **receives no remuneration (and is not entitled to such remuneration)**, and you had not previously been involved in carrying on the trade the company is carrying on, an investment may qualify for income tax relief.

That relief is not withdrawn if you **subsequently** become a paid director, providing the remuneration is reasonable. You can also claim income tax relief on investments made **after** becoming a paid director, providing those shares are issued during the period as covered at 1.2.1 above relating to the shares issued before you became a paid director.

1.3.4 Summary of tax reliefs

Reliefs available depend on whether an investor is connected with the company		
	Unconnected	Connected
Income tax Relief on subscriptions	✓	✗
Capital Gains Exemption on disposal of shares eligible for income tax relief	✓	✗
Loss Relief on disposal of shares disposed of at a loss	✓	✓
Capital Gains Deferral (unlimited)	✓	✓

1.4 How to claim tax relief

You cannot claim relief until the company sends you a form EIS3. (See Part 2 for an explanation of what the company has to do to put itself in that position.) If you invest through an Approved EIS Fund you will receive a form EIS5; see 1.6 below.

Your claim can be made on the Self Assessment tax return for the tax year in which the shares were issued. If the shares were issued in a previous year, and/or if the claim is for capital gains deferral relief, the claim part of the form EIS3 must also be completed and sent to your tax office.

If you have an EIS3 for a year for which you have not yet received a tax return, you can request a change to your PAYE tax code, or an adjustment to any Self Assessment payment on account due. You will still have to make the claim itself on your tax return when you get it.

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

1.5 When is relief reduced or withdrawn?

Tax relief will be **withdrawn** if, during the period set out at 1.2.1 above:

- You or an associate become connected (see above) with the company.
- The company loses its qualifying status. The circumstances in which this can happen are set out in Part 2. It is important to realise that the company may do something over which you have no control which results in its losing its qualifying status, and your relief being lost. But if a company, for genuine commercial reasons, goes into liquidation during the period, any income tax relief is **not** withdrawn.

Tax relief will be **reduced or withdrawn if**, during that period:

- Any of the shares are disposed of (**unless** the disposal is to a spouse or civil partner - in those circumstances the shares are treated as if the spouse or civil partner had subscribed for them).
- You (or an associate) 'receive value' from the company (or a person connected with that company). What constitutes receiving value is set out at VCM26320. It includes receiving a loan or benefit from the company, or the company selling an asset to you at less than market value (or you selling an asset to the company at more than market value). Relief can also be withdrawn if the company repays or

repurchases its own share capital from **any** shareholder. How much income tax relief is withdrawn will depend on the amount of the value received, but the whole of any deferred capital gain will be brought back into charge. However, 'insignificant' amounts of value received can be ignored, and there is also a facility in some circumstances whereby if the value received is replaced as soon as is practicable, relief will not be withdrawn.

Please note that you are required by law to inform your tax office within 60 days of any of the events above occurring.

1.6 Investment through EIS Funds

You can also invest through an EIS Fund, which will invest on your behalf in a number of qualifying companies. You are still the owner of the shares, and the process for claiming relief is as set out above.

Some Funds, set up in a particular way, are approved by HMRC. If you invest through one of these funds, then providing certain conditions are met, there is no minimum investment per company requirement, and you can claim income tax relief as if the shares were subscribed for on the date the Fund closed, rather than the date when they were actually purchased. (Capital gains deferral relief is still claimed by reference to the date the investment in the EIS qualifying company was made.) In these cases, instead of you receiving an EIS3 for each investment, the managers of approved Funds will send you a form EIS5 covering all the investments made on your behalf.

Please note that 'approval' by HMRC is relevant only to the tax treatment of the investments. It in no way bears on the commercial viability of the investments, and you are as liable to have relief reduced or withdrawn on any particular investment in the same way as anyone who invests directly into the company.

Part 2 EIS and the company

In order for its investors to be able to claim, and keep, the EIS tax reliefs relating to their shares, the company which issues the shares has to meet a number of rules regarding the kind of company it is, the amount of money it can raise, how and when that money must be employed for the purposes of the trade, and the trading activities carried on.

The company must satisfy HMRC that it meets these requirements, and is therefore a qualifying company. The process for doing this is set out at 2.5 below.

2.1 The kind of company which can use the Scheme to raise money

- Must be an unquoted company at the time the shares are issued. That means it cannot be listed on the London Stock Exchange or any other recognised stock exchange. It can subsequently become a quoted company without the investors losing relief, but only if there were no arrangements for it to become quoted in existence when the shares were issued. For the EIS rules the Alternative Investment Market (AIM) and the PLUS Quoted and PLUS Traded Markets are not considered to be recognised exchanges, so a company listed on those markets can raise money under the EIS if it satisfies all the other conditions.

- Must not be controlled by another company (or another company and any person connected with that company). Nor must there be any arrangements in existence for it to be controlled by another company at the time the shares are issued. However, where a company needs, for commercial reasons, to put a new holding company above itself and:
 - all the shares in the old company are exchanged for shares of the same kind in the new holding company
 - various other conditions, set out at VCM15200, are met

the tax relief applicable to the old shares is effectively transferred to the new shares.

- May have subsidiaries, but if it does they must all be qualifying subsidiaries – i.e., the company has more than 50 per cent of the ordinary share capital of the subsidiary, and it is not controlled (by other means) by another company. (If the EIS company has a property management subsidiary that must be at least a 90 per cent subsidiary.)

- Must be a 'small company'. The measure of whether a company is 'small' is the Gross Assets Test. The Gross Assets of the company – or of the whole group if it is the parent of a group – cannot exceed £7 million immediately

before any share issue and £8 million immediately after that issue. VCM15100 and Statement of Practice 2/06 explain how assets are valued for the purpose of this test.

- Must have fewer than 50 full-time employees (or their equivalents) at the time the shares are issued.
- Can be either a company carrying on the qualifying trade, or the parent company of a trading group. The trade can be carried on either by the company issuing the shares or a subsidiary, but if it is carried on by a subsidiary, it must be at least a 90 per cent subsidiary.

The rules regarding not being controlled by another company, qualifying subsidiaries and the company carrying on the trade must be met throughout the period outlined in Part 1. If they are not, then the investors will lose their reliefs.

2.2 Limit on money raised

Companies are not allowed to raise more than £2 million in any 12 month period from the three venture capital schemes. The three schemes are the EIS, the Corporate Venturing Scheme (CVS) and Venture Capital Trusts (VCTs), Investments from any or all of these schemes must fall within the £2 million limit. **If any share issue breaks that limit, none of the investors in that issue will be able to claim any of the EIS tax reliefs.**

2.3 How and when money raised by the share issue must be used

The money raised by the share issue can be used either for the purpose of an existing qualifying trade or for the purpose of **preparing to carry on** such a trade, providing the trade, or the preparation for it, is carried on wholly or mainly in the UK. If the company is preparing to trade, the trade must start within two years of the shares being issued.

Alternatively it can be used to carry on research and development intended to lead to such a qualifying trade being carried on.

The money raised by the share issue must also be employed for the purposes of the trade or research and development within two years of the shares being issued (or within two years of the trade commencing, if that is later).

If these requirements are not met then the investors will not be eligible for relief on the cost of their shares, and any relief given will be withdrawn. **It is therefore important that companies do not raise money under the EIS unless they are reasonably confident of meeting these requirements.**

2.4 Trading Activities

The trade must be conducted on a commercial basis with a view to the realisation of profits.

Most trades qualify, but some do not. Those that do not are termed 'excluded activities' and are:

- dealing in land, in commodities or futures in shares, securities or other financial instruments
- dealing in goods, other than in an ordinary trade of retail or wholesale distribution
- financial activities such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or any other financial activities
- leasing or letting assets on hire, except in the case of certain ship-chartering activities
- receiving royalties or licence fees (though if these arise from the exploitation of an intangible asset which the company itself has created, that is not an excluded activity)
- providing legal or accountancy services
- property development
- farming or market gardening
- holding, managing or occupying woodlands, any other forestry activities or timber production
- shipbuilding
- coal production
- steel production
- operating or managing hotels or comparable establishments or managing property used as an hotel or comparable establishment
- operating or managing nursing homes or residential care homes, or managing property used as a nursing home or residential care home
- providing services to another person where that person's trade consists, to a substantial extent, of excluded activities, and the person controlling that trade also controls the company providing the services

A company can carry on some excluded activities, but these must not be 'substantial' part of the company's trade. HMRC take 'substantial' to mean more than 20 per cent of the company's activities.

Although there is no requirement that the qualifying company is resident in the UK, the trade for which the money has been raised must be carried on wholly or mainly in the UK.

If the company fails to meet these requirements throughout the period referred to at 1.2.1, relief will be withdrawn from investors.

Please note that companies that have raised money under the Scheme are required by law to inform their Small Company Enterprise Centre (SCEC)

office (see 2.5 below) if they fail to meet any of the above requirements, or an investor 'receives value' (see Part 1) from the company or an associate, within 60 days of the event which led to that failure.

2.5 How a company qualifies

The EIS is administered in HMRC by the SCEC – see contact details at the end of this guide.

The SCEC decides if a company and a share issue qualifies. If they do, the SCEC then takes responsibility for checking the accounts etc of the company to ensure that it continues to meet the requirements of the Scheme.

The SCEC also operates an advance assurance scheme, whereby companies can submit their plans to raise money, details of their structure and trade etc. before the shares are issued, and the SCEC will advise on whether or not the proposed issue is likely to qualify. Guidance on what kind of information the SCEC need to consider an application for an advance assurance can be found at VCM21020.

Companies are not required to obtain such an assurance, but companies, particularly those using the EIS for the first time, may consider it prudent to do so. It gives an opportunity to spot any problems before shares are issued, and an assurance from the SCEC is also useful for companies to show to potential investors.

Once the shares are issued – irrespective of whether or not an advance assurance has been given – the company has to complete form EIS1 and send it to the SCEC. This form can be got from the SCEC, or downloaded from the HMRC website. A separate form EIS1 must be submitted for each share issue. Please note that a form EIS1 cannot be accepted by the SCEC unless the company has been trading for at least four months. And it also cannot be accepted if it submitted later than two years after the end of the year of assessment in which the shares were issued (or two years after the end of the four month period if that is after the end of that year of assessment).

If the SCEC accepts that the company, its trade, and the shares all meet the requirements of the Scheme, it will issue a form EIS2 to that effect, and supply sufficient forms EIS3 for the company to send to the investors so they can claim tax relief (see Part 1).

This process is repeated each time a company issues shares which it wishes to attract EIS reliefs for investors.

Additional sources of information

The specialist staff at the SCEC are available to give advice on the workings of the Scheme. Their contact details are:

Small Company Enterprise Centre (Admin team)

1st Floor

Ferrers House

Castle Meadow Road

Nottingham

NG2 1BB

Telephone number: 0115 974 1250

Fax : 0115 974 2954

Email: enterprise.centre@hmrc.gsi.gov.uk

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read by people other than those it was intended for. Any information you send to us by email is at your own risk. If you would like us to reply by email, please confirm in your message that you understand and accept the risks involved. However, if our response to you contains any personal or confidential information we will only reply to you by letter or telephone.

The Enterprise Investment Scheme Association (EISA), whose members are accountants and lawyers advising EIS companies and investors, may also be able to advise generally. EISA is the official trade body for the EIS. However, it does not deal with individual cases, which should be referred to HMRC, nor can it match companies and investors.

Their contact details are:

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93/99 Upper Richmond Road

London

SW15 2TG

Telephone number: 020 8785 5560

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