ENTERPRISE INVESTMENT SCHEME (EIS)

EIS is a great scheme but very complicated; the below is a summary only and detailed advice should always be sought.

EIS offers tax incentives for equity investments to assist smaller, unlisted companies in raising capital. The tax reliefs for investors are generous; subject to a personal annual investment limit (see below) an individual can claim:-

- income tax relief at 30% on the amount invested;
- an exemption from tax on any gain on exit;
- an allowable loss on exit if things go wrong; this loss, equal to the original cost less income tax relief can be set against income or gains.

Additionally, with many less restrictions an investor can defer tax on capital gains by matching gains with EIS share subscriptions made in the period 12 months before and 3 years after the sale. The deferred gain becomes chargeable only when the EIS shares are disposed of. There is a risk on changes in rates, but under current legislation entitlement to Entrepreneurs' Relief (10% tax rate) is preserved.

However, with such generous reliefs there are detailed obligations that have to be met by the investor, the company and on the shares and use of funds. Failure of any one of these tests could lead to a loss of relief.

Personal Annual Investment Limited

An individual can invest £1 million per annum in any EIS shares. Additionally, a further £1 million per annum can be invested but only in shares in knowledge intensive companies.

Qualifying investors

In order to qualify for the relief an individual:-

- must not hold any shares in the company other than existing EIS (or SEIS) investments or founder shares;
- cannot be an employee of the company for a 5 year period beginning within the previous 2 years;
- can be a director of the company but must be unpaid until after the (initial) EIS investment;
- for income tax relief and gains exemption only, must not hold (or have held) more than 30% of the ordinary shares; the limit includes holdings of associates, eg, parents and children (but not siblings) and anyone with whom the individual is in a partnership;

- has to have a UK tax liability against which (at least in part) the EIS income tax relief must be claimed.

The repayment to an EIS investor of any loans made before an EIS share subscription will trigger a withdrawal of relief.

Qualifying companies

The company must be unquoted with no arrangements in place for a future listing (AIM listings are permitted). It must carry on a qualifying trade in the UK; it can be a UK company or an overseas company with a UK branch or subsidiary.

Only non-qualifying trades are defined; these include the below but please note this is not a complete list:

- dealing in land, commodities, shares or other financial instruments;
- financial activities;
- leasing or letting assets on hire;
- providing legal or accountancy services;
- property development;
- farming or market gardening;
- operating or managing hotels, guest houses, hostels, nursing homes or residential care homes;
- energy generation.

There are now two separate categories of EIS companies; knowledge-intensive companies and all of the others. A knowledge-intensive company (KIC) is one where:

- research and development (R&D) costs as a proportion of operating costs are:
    - at least 15% in one of the 3 accounting periods (APs) preceding the share issue; or
    - at least 10% for all 3 preceding APs; or
    - for a new company at least 10% in the 3 years post investment; and
- either the company is engaged in intellectual property (IP) creation at the date of the share issue and it is reasonable to assume that within 10 years the business arising from that IP will form the greater part of its business (in this instance IP is, broadly, legally protected know-how); or
- the company's skilled employees comprise at least 20% of total employees (using full-time equivalent numbers); skilled employees are, broadly, those with a masters or higher qualification working on R&D.

Thereafter the restrictions on the company and the shares may differ depending on its status. In order to qualify for EIS the company, or group must not:

- have more than 250 employees unless it is a KIC when the limit is 500;
- be in financial difficulty (under EU definitions);

- be, or come under the control of another company in the period of 3 years from the date the shares are issued, except in very limited circumstances;
- have gross assets in excess of either £15 million immediately before or £16 million immediately after the issue of the relevant shares.

When the shares are issued it must be reasonable to conclude that the issuing company intends to grow and develop its trade in the long-term and that there is a significant risk of a capital loss exceeding the net investment return.

Qualifying shares and use of funds EIS shares must:

- be ordinary shares with no preferential rights to dividends or assets on a winding up; for example, anti-dilution rights will debar relief;
- be issued fully paid, and the investment should be made in cash, loan conversion does not qualify;
- not be part of an issue with SEIS shares nor part of an issue where funds raised on non-EIS shares are used for non-qualifying activities.

The maximum amount of capital raised by the issue of EIS shares and other risk finance investments in a 12 month period is capped. For a KIC the cap is £10 million, otherwise it is £5 million. This includes any funds raised by a company before it joins a group. Additionally, there is an absolute cap on funds raised under EIS and SEIS. For a KIC the cap is £20 million, otherwise it is £12 million.

Shares have to be issued within a designated period following the company's first commercial sale (or from when turnover reached £200,000 for a KIC). For a KIC the time limit is 10 years, otherwise it is 7.

The only exceptions to the time limit are where:

- EIS/SEIS share were issued within 7/10-year period and the business in which the funds were spent is still being carried on; or
- the EIS investment is at least 50% of the average turnover for the 5 APs preceding the issue date or, if later, 12-months prior to the issue date;
- the company is developing a new aspect of its business and the funds raised are spent on that new business.

The share issue must be to raise money for the purpose of a qualifying business activity, to promote growth and development and there must be commercial risk. Use of the share monies to acquire shares, a business, goodwill or other intangible assets does not qualify under EIS. HMRC's guidance also states that use of funds to pay off prior debts does not qualify. The funds raised under EIS must be spent, or at least committed, within a designated period.

Clearance from HMRC

It may be possible to obtain assurance of qualification from HMRC in advance of a share issue. However, before clearance is requested at least some specific potential EIS investors must have been identified by name or by class.

You can view our EIS Eligibility Flowchart at www.mercerhole.co.uk/business-services/eis-flowchart

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