From 6 April 2012, the Seed Enterprise Investment Scheme (SEIS) was introduced enabling certain individual investors to benefit from generous tax reliefs for investing into start up companies. At the same time, significant changes were introduced to the Enterprise Investment Scheme (EIS) allowing certain individual investors to invest more money into larger (more established) companies thereby enabling them to access more in the way of tax relief.

Now that a number of months have passed since the introduction of SEIS and the EIS changes were introduced, it seems appropriate to highlight the issues and questions which are commonly arising in respect of SEIS and the effect of the EIS changes.

SEIS
A brief overview of the tax reliefs offered by SEIS is provided below but for more details of the tax reliefs given and the conditions which need to be met please refer to our note on the Seed Enterprise Investment Scheme. In essence, SEIS is heavily based on EIS although there are a number of important differences.

Tax Relief
SEIS gives income tax relief to an investor at the rate of 50 per cent of the amount subscribed for shares in qualifying companies up to an annual investment limit of £100,000 (i.e. the maximum amount of relief is £50,000 per year). The relief is given as a credit against such person’s income tax liability for the relevant tax year. The SEIS shares must be held for at least three years. Gains arising on a disposal of the shares are exempt from capital gains tax (again provided that the shares have been held for at least three years). In the same way as for EIS disposals, any loss arising on a disposal of the shares is allowable against other income or gains. Furthermore, for this current tax year, 2012/13, there is a re-investment exemption for capital gains tax available on any asset disposed of by an investor if the gain realised is invested in SEIS shares.

Practical Issues
In the past few months, we have seen a number of recurring practical issues and questions in relation to SEIS including the following:

- The SEIS shares must be fully paid up in cash when they are issued. Indeed, HMRC note in their guidance on SEIS that this is one of the most common reasons why access to SEIS relief is failed.
- The issuing company is not able to raise more than £150,000 through SEIS investments. The issuing company is able to seek EIS or VCT investment after issuing SEIS qualifying shares but only if at least 70 per cent of the monies raised by the SEIS issue have been spent. If a company is seeking to raise in excess of £150,000 through the tax advantaged venture capital schemes, it must complete the SEIS qualifying issue and spend at least 70 per cent of the monies (and be able to demonstrate this) before seeking EIS or VCT investment.
- Further, companies cannot issue SEIS compliance certificates to investors unless they have spent at least 70 per cent of the monies raised under the scheme. Companies should therefore, if possible, keep SEIS funds in a separate account and prioritise their utilisation ahead of other sources of funding.
- SEIS qualifying shares cannot be issued if a company has already received EIS or VCT investment.
- The issuing company must not at any time in the period beginning with the date of incorporation and ending on the date 3 years after the issue of the SEIS shares be controlled by another company. This has led to a concern that the purchase of an “off the shelf” company from a corporate provider could lead to this condition being failed. This would be a rather strange outcome but for the moment, following correspondence between the Chartered Institute of Taxation and HMRC, this appears to be the case. In view of this anomaly, an entrepreneur hoping that investors will be able to access SEIS relief should set up a new company rather than acquiring an existing “off the shelf” company.
A director of the investee company can be entitled to SEIS relief. However, caution must be exercised to ensure that where this is the intention, the entitlement to relief is not inadvertently failed. This could be because:

- Any individual (including directors) seeking relief must not have a “substantial interest” in the company at any time in the period commencing with the date of incorporation and ending three years after the date of the issue of the SEIS shares. A substantial interest is, broadly, a stake in the company which exceeds 30 per cent of the issued share capital, ordinary share capital or voting rights. An individual will not be treated as having a substantial interest in the company at a time when the company has not issued any shares other than subscriber shares and has not begun to carry on or prepare to carry on a trade or business. Where it is intended that a founder director will hold less than 30 per cent and there is a hiatus period in which other investors are subscribing for shares and that founder director’s holding is not immediately diluted down to 30 per cent or less, then this condition will be breached.

- In determining whether an investor has a “substantial interest”, shareholdings of “associates” are taken into account. Associates include, amongst other things, relatives, such as spouses, civil partners, parents, children and grandchildren (but not brothers or sisters). This can limit the availability of SEIS relief where shares in the investee company are largely held by family members.

- SEIS is not available to employees of a start up company. This approach seems inconsistent with the Government’s objective to encourage employee share ownership.

EIS

The EIS was introduced to encourage individuals to invest in smaller trading companies to help alleviate the problems such companies have in raising finance. This problem of raising finance is as acute as ever in today’s market. The changes introduced by the Finance Act 2012 have significantly increased the effectiveness of EIS in achieving this aim, with investors being able to invest more money within the scheme into larger more established (and potentially less risky) companies ensuring more tax relief on the investment.

Tax Relief

EIS gives income tax relief to an investor at the rate of 30 per cent of the amount subscribed for shares in qualifying companies up to an annual investment limit of £1 million (i.e. the maximum amount of relief is £300,000 per year). The annual investment limit was increased from 6 April 2012 from £500,000. The relief is given as a credit against such person’s income tax liability for the relevant tax year. As with SEIS, the EIS shares must be held for at least three years. Gains arising on disposal of the shares are exempt from capital gains tax (again provided that the shares have been held for at least three years). Losses arising on a disposal of the shares are allowable against other income or gains. Capital gains tax deferral relief is available on the disposal of any asset by re-investing the amount of the gain (or part) in EIS eligible shares.

Individuals can invest in qualifying companies directly or through a nominee or an EIS investment fund (for more information on funds, see below).
Changes to the conditions - Is the Investee a qualifying company?

There are a number of conditions which need to be met by an investee company in order for it to be a qualifying company for EIS purposes. A full list of the conditions is outside the scope of this note but the conditions which have recently changed which have increased the number of companies which could fall within the ambit of EIS include:

- The value of the investee company’s gross assets (or in the case of a group, the value of the group’s gross assets) must not exceed £15 million immediately before the shares are issued and £16 million immediately afterwards. This was increased from £7 million immediately before the share issue and £8 million immediately afterwards.

- The number of employees of the investee company (or group if the investee company is the parent company of a trading group) must not exceed 250 full-time employees or (part-time equivalent). This was increased from 50 full-time employees (or part-time equivalent).

- The investee company cannot raise more than £5 million in total over a 12 month period under the EIS or VCT scheme or other scheme that qualifies as state aid. This was increased from £2 million.

The recent changes to EIS have unsurprisingly increased investor popularity with the scheme and the amount being invested though EIS has significantly increased in the past few months (partly at the expense of investment through Venture Capital Trusts).

It is also worth noting that the Government introduced a new business investment relief with effect from 6 April 2012, aimed at encouraging overseas investment into UK companies. The relief allows UK resident but non-domiciled individuals to invest their foreign income or gains into certain unlisted companies without suffering a UK tax charge on remitting those funds into the UK. Importantly, claiming the new business investment relief does not prevent an individual from claiming other tax reliefs, including SEIS and EIS. As such, UK resident non-domiciled individuals can now potentially invest their foreign income and gains into qualifying UK SEIS and EIS companies without suffering a remittance charge and whilst retaining the tax benefits of those schemes.

EIS and SEIS funds

Given the difficulties investors may have in identifying suitable investment companies, and the inherent risks arising from investing in smaller trading companies, investors may wish to make their investments through a form of “EIS fund” (which can either be approved or unapproved by HMRC). These funds can be structured as having a fund manager with a nominee company holding the shares in the portfolio companies on behalf of the individual investors, thereby enabling investors to claim EIS relief but with the benefit of having access to a managed portfolio of companies.

The widening of the scope of EIS to include larger companies, and the resulting increased pool of qualifying investment companies, will likely continue the growth in popularity of these funds.

Whilst EIS funds have become increasingly popular, specific SEIS funds have yet to gain traction. However, hybrid EIS/SEIS funds are beginning to emerge which can offer investors access to both schemes.

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