EIS – the enterprise investment scheme

A quick guide

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If your company qualifies as an eligible company under the EIS – and most do – then any eligible investor such as a business angel can get income tax relief worth 30% of their investment in your business. In other words, the real cash cost of their investment would be only 70% of the amount they invest, because they get 30% of the amount back when they do their tax return. In addition, if the shares are held for at least three years, there is no capital gains tax payable on profits on their subsequent sale.

From 2017 the tax benefits for certain types of companies were improved for EIS purposes; known as 'knowledge-intensive' companies (KIC) they tend to be in the tech sector and spend a lot on research and development. See later for the definition of a KIC.

EIS investors can invest in companies with up to 250 employees (500 for KICs) and gross assets of up to £15m. Under EIS, companies are able to take up to £5m (£10m for a KIC) of investment a year. To enable an EIS scheme for your company, various steps are recommended, including applying to HMRC for advance assurance that your company qualifies. Then you need to ensure that each individual investor qualifies, and post-investment there are various forms and information required by HMRC.

How we can help:
The EIS/SEIS Full Solution Package - a complete service to set your company up as EIS or SEIS eligible, including obtaining advance assurance from HMRC, advice on how to structure your scheme, helping to complete the official forms after completion of your funding, and issuing shares and share certificates if required: **£1395 + vat.**

Practicalities – how it works

Companies looking to raise equity funding would be well advised to use EIS if possible as it is a major incentive for investors. The 30% tax benefit reduces the financial risk of any loss to 70% of the amount invested, if the company should fail, and even this loss can normally be offset against other taxable income. To use the EIS, it's best to obtain advance assurance of eligibility for EIS from HMRC so that you can prove to investors that they will definitely get the tax relief. After completing the funding, the company needs to request certain forms from HMRC that the investor uses to get their relief in their tax return.

Note that if your business is under two years' old, you may be eligible to use a scheme for young companies called **SEIS** (see our brochure). This provides 50% tax relief on the first £150k of equity funding.

Eligibility for EIS: the company
As noted above, the majority of businesses are eligible for EIS. A company can raise up to £5 million (or £10 million for KICs) under the scheme. However, if the activity listed below is a substantial part of the company's activities, it is likely to be ineligible for EIS:

- Dealing in land
- Dealing in commodities, futures or goods (subject to exceptions for wholesaling and retailing)
- Dealing in shares, securities or other financial instruments
- Banking, insurance, money lending, debt factoring, hire purchase financing or other financial activities
- Leasing, including the letting of assets on hire
- Receiving royalties or licence fees
- Providing legal or accountancy services

- Property development
- Farming and market gardening
- Activities concerned with forestry and timber production
- Shipbuilding
- Coal production and steel production
- Operating or managing hotels and similar establishments
- Operating or managing nursing homes and residential care homes

Additional rules from July 2015 regarding company eligibility:

- The EIS funding must be used for the growth and development of the company (or a subsidiary)
- **Companies must raise their first investment within 7 years of making their first commercial sale or 10 years if the company is a KIC**. However, no age limit will apply to companies raising an investment where the amount of the investment is at least 50% of the company's annual turnover, averaged over the previous 5 years.
- In addition to the existing annual cap on investments of £5 million, a new cap will be introduced on the aggregate amount of investments a company may raise under EIS of £12 million or £20 million for KICs.

Definition of a KIC:

Qualification as a KIC, according to the official guidance, will be satisfied by the following tests:

Operating costs
At least one of the following conditions must be satisfied:
• The company must have spent at least 15% of its relevant operating costs on research and development or on innovation in one of the three relevant years1 preceding the date of the investment.
• The company must have spent at least 10% of its relevant operating costs on research and development or on innovation in each of the three relevant years preceding the date of the investment.

Skilled employees/innovation
At least one of the following conditions must be satisfied:
• A minimum of 20% of the company's full-time-equivalent employees must be classified as skilled employees2 at the time of the investment and for the following three years.
• The company should be engaged in work to create intellectual property (IP) at the time of the investment, and within 10 years most of the company's business activities might be expected to consist of (i) the exploitation of the IP, (ii) business that uses the IP or (iii) both.

Investor eligibility – main rules:
1. The investor and their associates must have no 'connection' with the company e.g. an employee or director, a close relative (except sibling) or spouse, or already owns more than 30% of the company.
2. The investor must have subscribed for the shares for genuine commercial reasons.
3. The investor has not exceeded the maximum annual EIS entitlement of £1 million (£2m for KIC from April 2018).

Tax reliefs – the details:

Income tax relief - provided EIS qualifying shares are held for more than three years either from the date of issue, or commencement of trading, an individual with no more than a 30% equity share in the company can get income tax relief worth 30% of the amount invested. The minimum subscription is zero and the maximum in respect of which a subscriber may obtain income tax relief in any year is £1 million (£2m for KIC). Investors can elect to carry back their investment from the tax year they made the investment to the previous tax year; you can treat some or all of the shares as issued in the previous year and claim relief in that previous year, subject to the maximum relief limit for the year.

CGT Relief – No capital gains tax is payable on disposal of the EIS shares after three years.

CGT Deferral Relief – capital gains tax payable on a different asset can be deferred by offsetting it against the share investment, where disposal of that other asset was less than three years before the EIS investment or less than one year after it.

Loss Relief – If EIS shares are disposed of at any time at a loss then the loss can be set against the investor's capital gains, or his income tax in the year of disposal or the previous year, meaning maximum exposure of 38.5p in the £ for a 45% income tax payer.

Inheritance Tax Relief – Shares in EIS qualifying companies will generally qualify for Business Property Relief for Inheritance Tax purposes at rates of up to 100% after two years.

Common pitfalls in using the EIS scheme
It is essential that the detailed rules are followed or the company or investor could fall foul and lose the tax reliefs. Examples of where the strict EIS rules are not followed include:

- The funds are used in a subsidiary that is not at least 90% owned by the parent
- Shares are not paid for in cash, are not fully paid up or are not newly issued shares.
- Issuing EIS certificates without having proper HMRC approval.
- An individual cannot convert loans to the company into EIS shares.
- The investor is appointed as a director before subscribing for shares and is therefore connected with the company.
- The individual must not have signed trading contracts on behalf of the company before he subscribes for his EIS shares. If he does then he would not qualify for EIS relief as he would have been previously involved in carrying on the company's trade.
- During the company's three year qualification period there are arrangements in place where the company will, or even could, come under the control of another company even if these arrangements will not take effect until after the relevant period has passed.

- Shares with preferential rights are created inadvertently, for example by issuing restricted shares to employees. The existing EIS shares would as a result have a preferential right that could be caught.
- The shareholders' agreement states that the EIS shareholders get their money back before another class of shareholders in the event of winding up.
- The shares are not issued properly because the investor's name has not been entered onto the register of members correctly or at all.
- The share certificate has not been issued properly or at all.
- There is a share reorganisation within the company which means that the "EIS shareholders" no longer qualify for EIS relief because they hold more than 30% of the ordinary share capital, even if this is only for a short period of time.
- The company uses premises which are owned by an EIS shareholder or their associate and the company pays an above-market rent.

To discuss your requirements please call or email Jerry Davison: 01392-432654 or jerry@millconsultancy.co.uk