Why SEIS/EIS matters more than you think

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David Marcussen offers a practical guide to making the most of these key tax reliefs.

Experience indicates that many tax advisers seem to think that the Seed Enterprise Investment Scheme and Enterprise Investment Scheme (SEIS and EIS) are merely something you claim if your client happens to tell you that they have made a qualifying investment. Well, they need to think again. SEIS and EIS are extremely powerful tools for entrepreneurs and fast growing businesses, as well as for investors. First, they make it far easier for a company to attract investment. Second, they enable those investments to raise more money. And all at the same time, making investors very happy.

Simple, if you think about it. An investor invests £10,000, and gets £5,000 off their income tax bill. Meanwhile the company attracting investment can raise money at higher value. Let's say a company is arguably, in its entirety, worth about £100,000 (the precise value will, of course, be a matter of judgment). For 10% of its shares it can ask for £12,000 rather than £10,000 and the investor won't mind too much paying the "extra" because they'll end up paying a mere £6,000.

Everyone comes out smiling. And it's not something you only do at the startup stage of a business, either. It can run throughout the entrepreneurial lifecycle.

The sting in the tail is that these reliefs are tricky things to get right and there are many pitfalls awaiting the unwary. So here's a practical guide to succeeding with SEIS and EIS (but not an attempt to summarise complex legislation).

The focus in this series of articles will mainly be on external taxes, but don't forget internal taxes such as corporation tax, VAT and PAYE. My advice is always keep this "clean" as you don't want anything "clever" going on within the company that will come back to haunt you at the time of sale.

How it works: top line overview

SEIS:

- 50% Income Tax relief – current year, or carry back 1 year
- CGT exemption after 3 years or more
- CGT Reinvestment relief – 50% relief (up to 14% CGT saving)
- Income Tax loss relief – up to 82.5% underwritten by tax
- Limits – £150k per company, £100k per individual per annum
- IHT Business Property relief

EIS:

- 30% Income Tax relief – current year, or carry back 1 year
- CGT exemption after 3 years or more
- CGT Deferral relief
- Income Tax loss relief – 61.5% underwritten by tax
- Limits – £12m per company, £1m per individual per annum
- IHT Business Property relief

How it works – for the investor

Maximum 30% shareholding

An investor can only hold up to 30% of the company's shares. This isn't necessarily simply about the number of shares, economic rights or voting rights. It is based on the nominal value of the shares, together with voting rights. Care is therefore needed with different classes of shares.

No employees or directors

Anyone who's an employee or director is "connected" with the company for SEIS and EIS purposes, and not able to invest under SEIS or EIS. However, there are "business angel" rules that allow individuals who become directors (but not employees) after the share issues to qualify. So the simple approach is to allow the individuals to subscribe for (and be issued with) their shares before they're appointed as a director.

Subscribe for fully paid up shares in cash

This is a simple rule that catches out the investor, so the order of events matters:

1. The investor gives the company a share subscription letter and arranges payment of the subscription funds – evidence that the funds are not a loan.
2. The company then issues the shares – and must write up the share register in the company statutory books, issue the share certificate and notify Companies House.

There should be no undue delay between (1) and (2), otherwise HMRC may argue that (2) is the conversion of a loan in (1). Delays of up to around three months seem to be OK.

How it works – for the company

Must be unquoted and independent

If there are arrangements to sell the company, care is needed. Is it still independent? Generally, HMRC regard arrangements as arising when heads of terms

are signed to sell a company.

Gross assets must be under £200,000 for SEIS, £15m for EIS

The key point to watch here is where there's an initial funding round of more than the SEIS limit of £150,000. Anything over £150,000 is considered EIS funding, but the SEIS share issue needs to be complete before the EIS funds can be invested, otherwise the £200,000 gross assets test for SEIS can be breached. Our recommendation is to pay the £150,000 SEIS funds into the company and issue the SEIS shares on one day. Then, completely separately, pay in the EIS funds and issue the EIS shares the following day.

Employee limits – 25 for SEIS and 250 for EIS

These rules are measured on the full-time equivalent number of employees (eg two part-time employees may be counted as one full time employee). Seasonal businesses, that breach the limits, may be able to complete their funding rounds during off seasons when their employee numbers are lower.

Shares must be ordinary – no preferential rights

This is an interesting rule. In the context of SEIS and EIS preferential rights mean a right to something "in advance" of someone else. It does not mean a right to "more" of something.

Funds must be raised for "qualifying business activity"

This subject is covered in detail in the HMRC guidance. However, it's useful to understand that activities like property development and financial activities are only excluded if there's balance sheet risk for the company. For example, with property development, owning the underlying freehold property is not permitted, but providing development services to someone else is permitted.

Permanent establishment in UK

The EIS company raising the funds must have a permanent establishment in the UK. If there's a group, it must be the top company in the group.

Where things have changed

EIS must be for growth and development

New rules for shares issued on or after 18 November 2015 require the funds raised to promote the “growth and development” of the company. HMRC’s view is that the EIS funds cannot simply fund existing working capital requirements or repay existing debts. They need to fund development expenses, such as hiring new staff, developing new IP, or marketing. Interestingly, this rule does not technically apply for SEIS share issues, but we have had experience of HMRC looking to apply a similar view for SEIS funding rounds.

The 7 year rule

The rules on the maximum age of the business were introduced from 18 November 2015. What counts is the age of the underlying business, not how old the company is. Young in this context is 7 years (or 10 years for knowledge-intensive businesses). Where more than 7 years old, the investment can still qualify if established businesses are raising funding to launch a new product or enter a new geographic market. HMRC take a strict line here – the new product or geographic market must be a real risk for the investor. What’s more, the amount of funds raised need to be at least 50% of the average turnover for the last five years (although limited sales to test a new market are permitted).

Existing shareholders not allowed

Rules for shares issued on or after 18 November 2015 say that the EIS investor cannot already own shares in the business except ones that are, broadly, SEIS / EIS shares. However, the non-SEIS / EIS shares can simply be gifted to a spouse pre-investment.

Risk to capital

New rules for shares issued on or after 15 March 2018 further restrict SEIS and EIS:

a) The company must have objectives to grow and develop over the long term.

b) The investment must carry a significant risk that the investor will lose more capital than they gain as a return (including any tax relief).

Essentially, these rules remove from the SEIS / EIS world property-backed or low risk structured investments.

Sunset clause

Current EIS legislation only applies to share issues up to 6 April 2025, so if EIS is to continue legislation will need to change before then. Commentary in recent Budgets suggests the current intention is for it to be extended.

Where to be smart

Preference shares

As already mentioned, preferential rights mean a right to something “in advance” of someone else, not to “more” of something. Therefore it is possible, with the blessing of HMRC, to ensure by careful drafting of the share class waterfall in the Articles so that the SEIS / EIS shares do receive “more” than other share classes.

Loans before share issue

Loans cannot be made by an EIS investor and then converted into shares, because of the “value received” rules. However, a private company, 100% owned by the EIS investor, is not an “associate” of the investor and can make the loan – leaving the investor free to invest under EIS. This can be a useful route for early stage funding before the company is ready for an SEIS / EIS share issue.

30% limit

As mentioned above, the limit of 30% of the company’s shares is based on the nominal value of the shares. Opportunities arise around structuring EIS share classes with economic rights representing, potentially, more than 30% of the share capital, whilst also satisfying this rule.

Qualifying trades

As mentioned previously, it’s important to look at whether the company is taking a balance sheet risk with the activities. You can also look at whether the company is providing a “service”, or simply receiving “passive income”. A “service” is generally qualifying.

It’s really worth interrogating exactly what the company does, how it operates and what assets and capital it puts at risk. Sometimes businesses that, at first blush, might not qualify can qualify.

What to remember

HMRC clearance

If there’s one thing you take away from these articles it should be that EIS can always fail for one reason or another because of the widely drafted anti-avoidance rules. Therefore, a highly detailed – and complete – prior clearance should always be submitted to HMRC.

What appear to be very simple cases can have quirks that have catastrophic effects for the qualifying status of the company. HMRC now require details of the proposed investors, which leaves the company in a bit of a chicken and egg situation – they need the clearance to wind in the investors… but they need investors to get the clearance…

Qualified lawyer

It is alarmingly easy to fall foul of rules like the shares being issued fully paid, or preferential rights where there are multiple share classes. Wherever possible, work with a lawyer who is familiar with EIS.

EIS 1 and EIS 3 forms

Great care is needed to ensure the EIS 1 and EIS 3 (and corresponding SEIS forms) are completed correctly. Simple errors like the date of issue of the shares can mean investors don’t get the tax reliefs. Sounds obvious, but it’s amazing how many times these are completed incorrectly when the clients do them themselves. HMRC have limited patience dealing with corrections.

Connected rule

Remember that family members of the investor are subject to the same restrictions as an investor. Here’s an example. A client invested into a technology company, and two years later his son was employed by them as a graduate trainee. His father lost his EIS relief – resulting in a substantial 20% CGT liability when the shares were sold (as well as a clawback of the original upfront income tax relief). Ouch.

S431 restricted securities elections

Slightly off piste, but worth remembering, the S431 elections for investors who may become a director. This move ensures all the gains on the eventual disposal are exempt from tax – and not potentially in part charged to income tax under the employment-related securities rules.

I hope this gives an insight into both the importance of SEIS and EIS and the complexities and traps lying along the way. My second article will cover Entrepreneurs and Investors Reliefs and the third Enterprise Management Incentive share option plans.