Introduction and recent statistics

The Enterprise Investment Scheme (EIS) is one of the most widely-known reliefs for private investors seeking to make a tax-efficient investment in a company seeking to raise equity for the purposes of a qualifying trade. The scheme has been around for several years and gives benefits to the investor such as income tax relief of up to 30% of the cost of the investment and exemption from capital gains tax on the eventual disposal of the shares where the company continues to qualify for the required period of time post investment.

It is noted from the most recent statistics, published by HMRC on the take-up of the EIS scheme, that there has been a marked increase in the number of investors and funds raised. In the tax year to 5 April 2014 £1.56 billion of EIS funds were raised from 26,000 investors in 2,800 companies; nearly half of such companies were raising EIS monies for the first time. This was a 51% increase on the funds raised in 2012-13. Whilst HMRC are yet to report on the years 2014 onwards to the present day it is reasonable to assume that this trend of increased investment under the scheme has continued.

For investments in companies which have been carrying on their business for less than two years, the similar but separate Seed Enterprise Investment Scheme (SEIS) is available on the first £150,000 of investment, allowing income tax relief of up to 50% of the funds invested. HMRC statistics again show an increased level of investment under this scheme, where in the year to 5 April 2014 over 2,000 companies raised £168 million of equity investment under the SEIS which is almost double that raised in 2013.

Recent changes in the EIS legislation – for share issues after 18 November 2015

As the EIS reliefs are a form of state aid they are subject to the EU rules on how this state aid must be administered in relation to risk capital. The European Commission adopted new rules on risk finance in January 2014 which impacted on the rules introduced by Finance (No.2) Act 2015, the majority of which took effect from 18 November 2015. A brief overview of these rules and how they affect most companies are outlined below. It should be noted that companies which can be categorised as “knowledge intensive” are subject to relaxed rules - they are covered in the following section and the specific provisions, noted with *, vary:

- The company can only raise monies under the EIS within seven years* of the first commercial sale of the business carried on. This is not only limited to the trade carried on by the company itself but will also be relevant where the company has subsidiaries which have been trading for more than seven years, or even where a trade has been acquired from a third party. If a company has already raised money under the EIS at a time which was less than seven years from the first commercial sale then this requirement is said to have been met.
- There is a relaxation of this rule where a company or group is looking to raise funds from EIS and other risk capital sources in excess of 50% of its average turnover for the past five years, and will use those funds only to expand into a new product or geographical market.
- The company must use the funds raised under EIS not only in a qualifying activity but also for the “growth and development” of that business. HMRC have recently published guidance on what this means [2] which includes the statement that ‘money raised by issuing shares to an EIS investor to replace an existing loan is unlikely to meet this condition’.
- It is now no longer possible to use EIS funds to acquire the trade and assets of another business, or the goodwill and intangible assets of a trade with EIS funds nor raise EIS funds at a time when other funds are being raised to make such an acquisition and the EIS funds are to be used for the working capital of the new trade.
- The company and its subsidiaries cannot raise, in total, more than £12 million* from EIS and other risk capital sources. This will include both monies raised by a company in any previous incarnations (e.g. a shell company on AIM used for a reverse IPO) and also any companies which become subsidiaries after the fundraising but within the EIS qualifying period.
- Where the investors hold other shares in the company it must be the case that all of those shares were shares which either were a risk capital...
investment or the original subscriber shares. This can affect investors who acquired shares in the company previously by way of a share for share exchange or by having a loan made to the company capitalised.

- The above issues do not affect SEIS investment.

**Different requirements under the EIS for ‘knowledge-intensive’ companies**

The new rules introduced by the Finance Act have been relaxed for a new class of companies defined as ‘knowledge-intensive’: broadly companies which have spent in the three years prior to investment, 15% of their operating costs on R&D or innovation or at least 10% of their operating costs on R&D in each of the three years.

Furthermore the company must meet one of two further conditions: Either the ‘innovation condition’ where the company expects to derive the greater part of its business from the exploitation of the intellectual property or by the creation of new products; or the ‘skilled employee condition’ where at least 20% of the company’s full-time equivalent employees have attained a qualification at or above a master’s degree or comparable qualification.

A knowledge-intensive company is able to raise £20 million in its lifetime as opposed to £12 million and can raise funds under the EIS up to ten years from the date of its first commercial sale. In addition, a knowledge-intensive company can employ up to 499 employees at the date of grant.

**How can a company seeking (S)EIS investment confirm that it qualifies under the schemes?**

Because of the uncertainties the investor faces when making an investment under (S)EIS HMRC allow the company to seek Advance Assurance that, based on the intended trade and use of funds, the company will qualify under the schemes. As HMRC are currently taking up to two months to process an application for Advance Assurance it is recommended that assurance is sought as soon as the company has made plans to receive an investment, even before approaching investors.

Assurance can be obtained for both EIS and SEIS investment and it is recommended that, where applicable, a company seeks both assurances at the same time. Following the removal of S173B ITA 2007 which previously required 70% of funds raised under the SEIS to have been spent before EIS funds could be raised, it is now possible to raise funds under the SEIS and EIS almost simultaneously (e.g. a day apart). This can allow investors a blended rate of relief under both schemes but careful structuring should be implemented as to when cash is received and when shares are issued.

There is a risk that the SEIS limit in respect of the company’s gross assets could be breached if money intended to be for shares raised under the EIS is received in advance of all shares being issued and therefore causes the gross assets of the company at the time of the SEIS raise to exceed £200,000.

Advance Assurance does not guarantee that the investments to be made in the company will definitely qualify for (S)EIS relief, only that on the basis of the facts provided to HMRC at the time of the application the company is likely to meet the requirements. Accordingly it is in the company’s best interests to provide as much information as possible as to what it intends to do and how the money will be spent, especially where it is uncertain that the company’s trade or use of funds qualifies in relation to the areas above.

Whilst an assurance form is provided on the HMRC website [3], in many cases it is unlikely that this can give the full circumstances of the Company (or its wider group) and the intended uses of funds in order to provide HMRC with the full facts and a covering letter should be prepared by the company or its accountants as to how the company intends to operate.

Financial models can be useful to accompany an advance assurance application and recently these have been requested by Inspectors dealing with assurance applications for certain large capital raises in order to satisfy HMRC that the requirement for funds to be raised for the business’s growth and development is met.

**Once a company has received assurance – is that it?**

Assurance is not a concrete ruling on the company’s qualifying investment status as further factors must be considered at the time of the share issue and in relation to what the company does post investment.

It is imperative that, on subscription, the cash has been received by the company before the shares are issued. HMRC have advised that this is the most common reason that investments fail to qualify. This normally happens where shares are issued on the promise of the cash coming in or shares are subscribed for at the time of the company’s incorporation, before it has its own bank account and the directors are holding the money.

Assurance is only given in relation to the company’s intentions in advance of the issue of shares. The company must continue to meet the requirements of the scheme for three years following the issue of the shares or, if later, three years from the date the trade commenced. Certain circumstances may follow post investment which mean the company ceases to qualify and, should this happen, the directors must tell HMRC as such and there will be a claw-back of income tax relief from the investors.

For example, the simplest situation would be where the investors exit before the three year period is up, i.e. the company is acquired by another
company or there are arrangements for this to occur. Further examples could be if the company’s trade pivots such as a company operating in the Fintech sector changing its product from being a straightforward service company to instead bearing the financial risk of the transactions, therefore carrying on a non-qualifying trade and ceasing to qualify. A company could also no longer qualify by changing its market, such as where the whole team of a company moves to Los Angeles after the EIS funds are raised and the company can no longer satisfy the UK permanent establishment requirement.

The directors of the company (please note that this point is never covered by advice on the EIS and it should be, it is always included in the risks of investment in an AIM admission document) cannot be compelled to take all steps necessary to maintain investors’ EIS relief as they are required to act in the company’s best interests at all times. Accordingly it may be possible that a decision in the company’s best interests, such as selling before the three year time limit is up, is detrimental to the EIS status of investments made by one group of its investors.

Summary

If equity investment under the SEIS and EIS fits in with the directors’ intentions for how the company is going to trade over the next few years then the company should seek assurance as soon as possible and give as much information as possible to cover all intended paths in which the trade may go. However, if it is likely that the restrictions of the EIS legislation will impinge on the way that the directors see the business operating then they may wish to seek alternative forms of finance from day one so as to manage the expectations of their investor base.

Whilst the new rules will have an impact on the types of companies which can seek EIS investment, and deny EIS relief on new investments in companies which have previously been able to raise funds under the scheme, the change in rules may potentially be of benefit to other companies which continue to meet the requirements of the scheme by ensuring that the reliefs are targeted towards their investment needs, rather than investment and its associated tax relief being instead being taken by lower-risk, more established companies or those undertaking management buy-outs, who may otherwise be able to obtain funding from other sources.

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