

Introduction

The Enterprise Investment Scheme (EIS) was introduced as the successor to the Business Expansion Scheme (BES) in 1994. In April 1995, the first venture capital trusts (VCTs) were launched. Both the EIS and VCTs were designed to encourage investment by individuals in unlisted trading companies. The hope was that both schemes would enable small companies to raise cheaper finance compared to, say, bank borrowing, without creating the tax avoidance opportunities which eventually led to the demise of the BES.

While many aspects of the EIS and VCT legislation are identical, the schemes do have significant differences. Both offer income tax relief on investment (for the EIS at 20% and for VCTs at 30%) and capital gains tax (CGT) reliefs for disposal. Relief is also available by way of CGT deferral on EIS investment only. The reliefs are generally subject to a three-year holding period for the EIS and five years for VCTs.

The price for these reliefs is the risk that the investor accepts. Neither the EIS nor VCTs offer the features of investment in let residential property and pre-arranged exits that made the BES so popular in the early 1990s.

- The EIS applies to investments made on or after 1 January 1994, and allows investors tax relief at the rate of 20%.
- The VCT rules apply to investments made on or after 5 April 1995. Relief was similarly at 20% up to 2003/04 and was increased to 40% for 2004/05 and 2005/06, before being cut to 30% from 2006/07.
- EIS investments must be kept for three years and VCT investments for five years, otherwise relief is withdrawn. A time limit of five years applied to EIS and VCT shares issued before 6 April 2000. For VCT shares issued between 6 April 2000 and 5 April 2006, the time limit was three years.
- Broadly speaking, there is a limit of £1 million on the amount that a company can raise under the EIS or from an individual VCT each year. The Finance Act 2007 also imposed a £2m restriction on the total amount a company can raise in a 12-month period and limited to less than 50 the number of full-time employees (or their equivalents) that a company may have when raising capital.
- The annual maximum in 2009/10 on which the investor can obtain income tax relief is £500,000 for the EIS. For VCTs, the corresponding maximum is £200,000. Between 6 April 2006 and 5 April 2008, the EIS limit was £400,000 and between 6 April 2004 and 5 April 2006, the EIS limit was £200,000. Before 6 April 2004, the limits were £150,000 for the EIS and £100,000 for VCTs.

This section outlines the main rules of the EIS, highlights the differences that apply to VCTs and examines alternative small company investments.

The Enterprise Investment Scheme (EIS)

An investment in an unlisted company generally carries a high element of risk, as was evident from the early days of the BES and during the recession of the early 1990s. There is also the problem of realising the EIS investment at the end of the three-year qualifying period.

In theory it is possible to eliminate some of this risk by investing through an approved investment fund that invests in several EIS companies. In practice, this type of fund is extremely rare, as most investors seeking diversification prefer VCTs (see page 8, "Venture capital trusts") or a portfolio of EIS companies.

Relief under the EIS is available to individuals who subscribe for eligible shares in a qualifying company which is either carrying on, or which is proposing to carry on, a qualifying trade.

The income tax relief

Tax relief at the rate of 20% is given on qualifying investments in the EIS. The relief is given as a tax credit against an individual's income tax liability. This means that the individual must have an income tax liability at least equal to the tax credit for the full relief to be obtained.

Minimum and maximum investment

To obtain relief, the minimum amount that an individual must invest in any one company in any one tax year is £500. The maximum total investment that can qualify for income tax relief is £500,000 in 2009/10. This maximum is available to both husband and wife individually.

Claiming the relief

The relief is given for the year of assessment in which the shares are issued, rather than when the investment is made. Shares are not issued until they are registered in the company's books (*National Westminster Bank plc v CIR 1994*). Care should therefore be taken in making sure that relief under the EIS is given for the appropriate tax year.

To obtain relief under the EIS, a claim must be made to HM Revenue and Customs (HMRC). It cannot be submitted until the company making the claim has carried on a qualifying trade for four months.

A claim must be accompanied by an EIS3 certificate issued by the company, stating that the relevant conditions for both itself and its trade have been satisfied. Relief must be claimed within five years from 31 January following the tax year in which the EIS shares were issued.

Carry-back of relief

Subject to the overall annual maximum limit of £500,000, it is possible to carry back some or all of the relief to the tax year before the year in which the shares are issued.

Before 2009/10, this carry-back was only possible for tax relief from shares issued between 6 April and 5 October. There was also a carry-back limit of one-half of each investment made during the relevant period, subject to an overall maximum carry-back of tax relief on investments of £50,000.

Example

An individual invested £60,000 under the EIS on 15 May 2009.

Tax relief of £12,000 (£60,000 x 20%) is available against the individual's income tax liability for 2009/10.

Alternatively, the individual could carry back tax relief of up to £12,000 to 2008/09, and in 2009/10 claim any balance of the relief not carried back.

Disposal of shares

The first disposal of shares on which relief has not been withdrawn is exempt from CGT. If the disposal results in a capital loss, then relief for the loss is available against either income tax or CGT.

If a written claim is made, the loss can either be set against capital gains of the same or future tax years, or it can be deducted from taxable income of the year of disposal or the preceding year. Tax relief of up to 40% may therefore be available, depending on the individual's tax position.

Example

An individual subscribes for shares under the EIS that cost £100,000. The shares are sold after three years for

- a. £160,000, or
- b. £60,000.

Relief has not been withdrawn for the shares.

Income tax relief of £20,000 (£100,000 x 20%) will be given in the year that the shares are issued.

- a. If they are sold for £160,000, then the capital gain of £60,000 [$£160,000 - £100,000$] will be exempt.
- b. If the shares are sold for £60,000, then there will be a loss of £20,000 [$£60,000 - (£100,000 - £20,000)$].

The cost of the shares is reduced by any tax relief given under the EIS.

If a written claim is made, the loss can either be set against capital gains of the same or future tax years, or it can be deducted from taxable income of the year of disposal or the preceding year. Offset against income will generally be preferable now that the rate of CGT is 18%.

Tax relief of up to 40% may therefore be available, depending on the individual's tax position.

Capital gains tax deferral relief

An investment into an EIS company allows an individual to defer all or part of any gain chargeable to CGT to the extent that the amount of gain is matched by EIS investment. The gain reinvested can be one that was realised in the three years before EIS investment or the twelve months afterwards.

The gain deferred is the gross gain, after deduction of any annual exemption, but before the application of taper relief for tax years before 2008/09.

Investment limits

There is no lower or upper limit to the amount that can be invested under the deferral relief rules, although ultimately the rules on qualifying company size set an upper limit for investment in any one business. CGT deferral relief can be given without income tax relief.

Claiming the relief

The procedures for claiming deferral relief generally follow those for income tax relief, even if income tax relief is not being sought.

Disposal of shares

The disposal of shares will bring an end to the deferral of the chargeable gains, which then become taxable in the year of disposal. For 2009/10, no taper relief applies to the deferred gains, even if they had originally qualified for this relief. However, the 18% tax rate will often more than compensate for the loss of taper relief.

Any gain arising from the EIS investment is itself CGT-free.

Example

In 2009/10 an individual subscribes for shares under the EIS that cost £50,000. In 2007/08 they had realised capital gains of £40,000 in excess of their annual exemption. The taper relief applying to these gains was 30% and the CGT paid by the investor was £11,200 (£40,000 x 0.7 @ 40%).

If the investor claims CGT deferral relief for their EIS investment, the £11,200 will be repaid.

If the EIS investment is realised in 2014 for £75,000, the deferred gain of £40,000 will be crystallised, but the growth on the investment will be tax-free.

The investor will therefore face CGT on that crystallised gain of £7,200 (£40,000 @ 18%).

Qualifying individuals and trustees

The main qualifying condition for income tax relief is that an individual must have no connection with the company that is issuing the shares. The aim of the EIS is to give income tax relief only to individual outside investors.

This 'no connection' rule must be met throughout the period beginning two years before the shares are issued (or the date of the company's incorporation if later) and ending three years after the shares are issued. However, there is no restriction on connection with the company where a claim is made only for CGT deferral relief. Similarly, trustees are able to claim deferral relief, even though they are denied income tax relief.

Connection with a company

Individuals are connected with a company if:

- They are employees of the company.
- They own more than 30% of the company's share capital.

Employees

The connection test is extended to 'associates' of the investor. This includes the investor's husband or wife, parents (or grandparents), children (or grandchildren) and partners. It does not include brothers and sisters.

30% share ownership test

The shareholdings of associates must also be taken into account when considering the 30% share ownership test. This means that relief under the EIS will not normally be available for investment in a family company, although the exclusion of brothers and sisters from the definition of an associate may sometimes make this possible. The 30% test must also be met for voting power, and for the sum of loan capital and issued share capital. This may preclude relief under the EIS where an individual has lent money to the company.

Directors

Special provisions allow a director of a company, who would normally be connected with that company and therefore not qualify for relief under the EIS, to obtain income tax relief in certain circumstances:

- An investor (or an associate) is allowed to be an unpaid director of the company before the share issue, provided no remuneration is received during the three years following the date that the shares are issued. The reimbursement of business expenses and the payment of

dividends, interest and rent are all ignored for this purpose, although the sums involved must be reasonable.

- An investor can also act as an adviser, or in a professional capacity, and receive the appropriate fees from the company without losing entitlement to income tax relief.
- Provided an investor was not connected with the company before, or at the time of, the share issue, they (or an associate) can subsequently become a paid director without this affecting entitlement to income tax relief under the EIS. However, remuneration must be reasonable taking into account the services rendered.

An investor can therefore be an unpaid director before a share issue, and/or become a paid director after the share issue, and still qualify for income tax relief, but may not be a paid director both before and after the share issue. On the other hand, where the investor is claiming only CGT deferral relief, they can own 100% of the company.

Management buy outs and buy ins

The connection rules mean that income tax relief under the EIS is not available for management buy outs. However, relief should be available for management buy ins. For example, where:

- At least four unconnected people set up, and then subscribe for share capital in, a company that acquires a business previously run by an unconnected person or company, or
- An incoming director of a company acquires a 30% or smaller shareholding, as long as the shareholding is acquired before the director becomes a paid director.

When only CGT deferral relief is at issue, such problems do not arise.

Other situations where income tax relief is denied

Relief is denied if an individual is part of a group of people who control both the company issuing the shares and another company, where both companies are carrying on the same type of trade. Relief is also not available to the owners of an unincorporated business when it is incorporated. This is because relief is denied where an investor previously had control over a business now run by the company.

Residence

An individual need not be resident in the UK to qualify for relief under the EIS, but must be liable to UK income tax at the time of the share issue in order to benefit from the tax relief. Individuals and trustees claiming deferral relief must be UK resident or ordinarily resident both at the time the gain to be deferred accrued and when the EIS shares were issued.

Eligible shares

The shares issued must be new ordinary shares, which do not carry any preferential right to:

- Dividends,
- The company's assets upon it being wound up, or
- Redemption.

The purchase of existing shares will not qualify. Any arrangement before or at the time of issue to reduce the investor's risk, eg a pre-arranged exit, will also disqualify the shares. The shares must remain eligible throughout the three-year period starting with their date of issue.

Qualifying companies

There are several conditions that must be met for a company to qualify under the EIS. These conditions must be met throughout the period beginning with the date that the shares are issued,

and ending three years afterwards (or three years after the date that the company starts to trade, if this is later).

If a company is wound up for bona fide commercial reasons, this will not make it a non-qualifying company. The company must be an unlisted company and must either:

- Exist in order to carry on a qualifying trade, or
- Be a holding company of qualifying subsidiaries. A qualifying subsidiary is one that is 90% owned by the main company, 100% owned by a 90% subsidiary or 90% owned by a 100% subsidiary. In each case the qualifying subsidiary must carry on a qualifying trade.

A company is listed if any of its share capital or loan capital is marketed to the general public. However, shares that are listed on the Alternative Investment Market (AIM) or PLUS Market are treated as unlisted for the purposes of EIS legislation. In practice, this may offer a future exit route for existing EIS investors.

Trading wholly or mainly in the UK

The company does not need to be incorporated or resident for tax purposes in the UK, but it must be trading wholly or mainly in the UK. In deciding whether or not a company is trading wholly or mainly in the UK, the activities of the trade as a whole must be considered.

Employee equivalent test

For EIS companies whose shares were issued after 18 July 2007, the number of full-time equivalent employees must be less than 50 at the time of share issue.

Gross assets test

A qualifying EIS company cannot have gross assets of more than £7m before the issue of shares and £8m after the issue. The corresponding limits before 6 April 2006 were £15m and £16m. Gross assets are normally taken at the value shown in the balance sheet. This rule effectively restricts the amount that can be raised by an EIS company.

Investment limit

For EIS companies whose shares were issued after 18 July 2007, the amount that may be raised in any period of 12 months by way of the EIS, VCTs and the Corporate Venturing Scheme cannot exceed £2m.

Qualifying trades

A qualifying trade is one that is conducted on a commercial basis with a view to making profits.

Several trades do not qualify for relief under the EIS. The aim is to exclude trades of a low risk nature.

The main exclusions are:

- Dealing in land, commodities, or shares and securities.
- Banking, insurance, hire purchase, leasing or other financial activities.
- Legal and accountancy services.
- Oil extraction activities.
- Dealing in goods unless it is by way of an ordinary wholesale or retail trade.

- Shipbuilding, coal production and steel production.
- Property development, farming or market gardening, forestry, hotel operation or management, managing or operating nursing homes.

The long list of excluded activities reflects successive attempts by HMRC to ensure that the tax reliefs given are for genuine risk investments.

If the company is not carrying on the trade at the time that the shares are issued, it must begin to do so within two years of the shares being issued. Otherwise, relief under the EIS will not be available.

For investments made on or after 22 April 2009, all monies raised by an EIS issue must be used in the trade within 24 months of the issue, or within 12 months of the company starting to trade, if this is later. For earlier investments the requirement is that at least 80% of monies are used within 12 months, with the balance by the end of 24 months. This prevents monies raised being held, risk-free, on deposit.

Withdrawal of the relief

The income tax relief and CGT reliefs given by the EIS will be withdrawn if:

- The investor disposes of the shares within three years of their acquisition.
 - The grant of an option to sell the shares is generally treated as a disposal, unless the option is granted to the controlling shareholders of the company for a period.
 - Shares that qualified for relief under the EIS are deemed to be sold before shares that did not qualify.
- The company is no longer a qualifying company within three years of the shares being issued, eg the company may become listed, or change its trade to a non-qualifying one.
- The investor is no longer a qualifying investor within three years of the shares being issued. For example, the 30% shareholding limit for income tax relief may be exceeded.
- The investor receives a loan from the company, in circumstances where the loan would not have been made if the investor had not bought the shares. This prevents an investor obtaining an immediate return on the investment by means of a loan back scheme.
- The investor receives value from the company. Value is received when, for example, the company sells an asset to the investor at less than market value, or waives a liability due from the investor.

The relevant period in the last two cases is that beginning two years before the shares are issued (or the date of the company's incorporation if later) and ending three years after the shares are issued.

The full relief is withdrawn except where the investor disposes of the shares in an arm's length transaction. In this case, the relief withdrawn is limited to the disposal proceeds multiplied by the relief tax rate of 20%, should this be less than the full relief.

Reorganisation of a company's capital structure

The reorganisation of a company's capital structure will not normally result in relief being withdrawn, unless the reorganisation leads to the investor receiving a cash amount, or where the value of the EIS shares owned after the reorganisation is less than the value of the shares owned before the reorganisation, and also less than the amounts originally subscribed. For example, this might occur following a rights issue.

Investor dies

Relief is not withdrawn if the investor dies or the company is wound up for bona fide commercial reasons. Nor is it withdrawn when transferring shares between a husband and wife.

However, on death the current value of the shares is included in the value of the investor's estate for inheritance tax (IHT) purposes. Business property relief at the rate of 100% will normally be available for EIS shareholdings, provided these have been held for a minimum of two years. Where CGT deferral relief has been claimed, the gain falls out of account on death.

Venture capital trusts

VCTs were introduced in the year following the EIS and to date have been more widely marketed but raised much less capital. A VCT is an HMRC approved investment trust, listed on the London Stock Exchange.

In theory, this gives the investor additional liquidity compared with an EIS, but in practice the market in VCT shares is very thin: most VCT shares come to market as a result of their owner's death. However, this may start to change now, because the VCT shares bought in the 2004/05 and 2005/06 boom years, when shares attracted 40% income tax relief, are now nearing or have passed the old three-year period for claw back of tax relief.

Tax reliefs

VCTs share similar but different tax reliefs with the EIS:

- Income tax relief is available at 30% for investment in newly issued shares. The maximum VCT investment limit is £200,000 per tax year and there is no carry-back facility. The 30% tax relief is a reduction from the 40% relief, which applied for 2004/05 and 2005/06 only. Previously relief had been at 20%.
- Disposals of VCT shares that qualified for income tax relief are free of CGT, but losses are not allowable. VCTs now have a five-year holding period for income tax relief. The CGT exemption has no such restriction. For shares issued between 6 April 2000 and 5 April 2006, the holding period was three years. This CGT relief also applies to shares acquired on the stock market, provided the total outlay did not exceed £200,000 in a tax year.
- Since 6 April 2004 it has not been possible to defer gains by reinvestment into VCTs.
- Dividends from VCTs (up to the £200,000 issue/acquisition limit) are free of personal higher rate income tax.
- Capital gains made by a VCT can be distributed as dividends and are CGT-free within the trust under normal investment trust rules. However, the 10% dividend tax credit can be repaid to the investor.

VCT investment holdings

A VCT's holdings are subject to a range of investment restrictions:

- At least 70% of investments by value must be in qualifying newly issued securities in unlisted trading companies (including AIM and PLUS Market listed companies). The provisions for qualifying trades and the gross assets test of company size are the same as for EIS companies. The employee and investment limits also apply to VCTs where the funds were raised after 5 April 2007.
- No more than 15% of a VCT by value may be invested in any single company or group of companies.

- At least 30% of the VCT's investments must be in new ordinary shares of qualifying companies, with no preferential rights.
- At least 10% of a VCT's investment in any company must be in ordinary, non-preferential shares.

Trusts have three years from the date of share issue in which to satisfy the 30% and 70% provisions.

VCT and EIS compared

VCTs have a number of advantages over EIS companies for most investors:

- A VCT offers 30% income tax relief against 20% for an EIS company.
- The VCT provides diversification and a further layer of investment management compared with an EIS company.
- VCTs are listed and therefore theoretically more readily realisable than EIS shares. In practice the difference may not be so great, but at least investors have the comfort of seeing a market price quoted, even though the spread between bid and offer prices may be very wide – 10% is not uncommon.
- Many currently open VCT issues are 'C' share top-ups to existing trusts. This means that there is a track record to examine and a potential cost saving on management of the VCT. EIS companies generally make one-off share issues.
- Up to 30% – and initially up to 100% – of a VCT may be invested in less risky investments, eg blue chip shares or gilts.
- VCTs are actively promoted by a handful of specialist investment groups. Some EIS companies are also promoted by specialist groups, but many EIS deals are private arrangements, eg buy ins and one person company CGT reinvestment relief vehicles.
- Gains within VCTs are tax-free and can be distributed during the five-year qualifying period.
- Dividends from VCTs are higher rate tax-free, but those from EIS companies are not.
- Only 30% of a VCT's investment has to be in the equity capital of qualifying trading companies. The balance of exposure to qualifying trading companies can be in less risky securities, eg debentures.

The main points in favour of the EIS over VCTs are:

- The EIS offers CGT deferral, which is no longer available for VCTs.
- The EIS maximum tax-relievable investment is £500,000, against £200,000 for VCTs.
- The EIS holding period is three years rather than five for VCTs.
- EIS shares will normally qualify for 100% IHT relief once they have been held for two years. VCT shares, as listed securities, do not qualify for business assets relief.
- EIS investment can be targeted on just one company, which appeals to 'business angels'.
- It is still possible to find some asset-backed EIS companies, eg concentrating on running pubs or children's nurseries.
- VCT management charges and incentive payments can seriously erode returns.
- The greater promotional activity for VCTs can be a two-edged sword. The huge jump in demand in 2004/05 and 2005/06 was met with a rash of VCT offers, but the cut in tax

relief and longer qualifying period saw take-up fall by about 70% in 2006/07. This left some investors at risk of investing in VCTs that raised just enough to survive, but with relatively high running costs because of their small capital base. VCT providers have increasingly countered such risks by making top-up issues to existing trusts.

The revised tax rules introduced in the Finance Act 2006 for VCTs have changed the market noticeably. EIS companies have become relatively more popular as a consequence. The Finance Act 2007 changes (to employee numbers and total capital raising) have so far had little impact on demand.

Alternative ways of investing in unquoted companies

Investing outside the EIS

A shareholding outside the EIS is not eligible for tax relief, but it does mean that there are no restrictions on investing in companies and no risk of reliefs being lost. If funds are borrowed to finance the investment, tax relief may be available on the borrowing costs.

Although a disposal of shares is subject to CGT, a loss on disposal may qualify for relief against CGT. Investment in unlisted shares (including those listed on AIM) will qualify for 100% business assets IHT relief once the end of the two-year holding period has been reached.

Unit trusts, open-ended investment companies and investment trusts

There are many unit trusts, OEICs and investment trusts which invest in smaller companies, either on a UK basis or internationally. Some investment trusts, including the largest (3i), specialise in providing venture and development capital.

In more normal investment times, the price discount to net asset value of some of these trusts more than equates to the initial 20% tax relief on EIS companies, but rarely reaches the 30% corresponding to tax relief for VCTs. However, very substantial discounts are the order of the day at present because of the high degree of risk associated with private equity in an economic downturn. As at 9 April 2009, the average discount for the private equity investment trust sector quoted by the Trustnet (www.trustnet.com) was just over 50%. Such a wide discount needs to be treated with caution: the valuation of the investments held by private equity trusts is particularly uncertain in such febrile markets.

Although no tax relief is available on a non-VCT trust, the investment will generally carry less risk than a share issue under the EIS, and will normally provide an easy exit route. The FSA has regularly reminded financial advisers not to over-emphasise the importance of VCT tax relief. Towards the end of the 2005/06 season, the regulator took action against some websites promoting execution-only VCT investment.

Investment by way of an ISA will result in tax-free income and gains on investments of up to £7,200 in 2009/10 (£10,200 for those born before 6 April 1960).

For more information on these collective investments, see page 1, "Unit Trusts, OEICs and Investment Trusts".

Conclusion

The EIS and VCTs offer investors some generous tax reliefs, provided that they are prepared to accept the risks associated with investment in very small, unlisted companies. Both schemes have built on HMRC's experience with BES and its predecessor, so there is now virtually no scope to enjoy the tax relief without the investment risk. Even so, it would appear that the Treasury has

some concerns about the relatively low risk approach adopted by some VCTs, particularly where syndicated investment occurs.

The changes to tax relief for VCTs saw the market shrink from £780m in 2005/06 to £270m in 2006/07, and £230m in 2007/08. The 2008/09 figure is likely to be smaller still. Investors considering either the EIS or VCTs should not regard the three- or five-year qualifying periods as the timescale for their investment. In practice, liquidity issues and the time it can take small companies to realise their potential mean that a much longer timescale is more appropriate.

The change to an 18% flat rate for CGT can mean that for some investors, particularly those considering AIM-listed shares, the additional tax benefits of VCTs and the EIS are not worth the constraints imposed.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.