Helpsheet

Enterprise Investment Scheme (EIS)

What is EIS?

In a bid to encourage investment into smaller companies and benefit the economy as a whole by enabling them to grow, successive governments have introduced (and tinkered with) a tax incentive for individual investors who may otherwise be wary of these investments, which are by nature higher risk. The EIS regime is aimed at individual investors rather than corporate investors.

The relief applies to qualifying investments in eligible companies who then provide a certificate to the investor to use in completing their own tax return.

EIS relief provides two separate reliefs for investments into eligible businesses – income tax relief and capital gains tax deferral relief. More recently, an even more generous relief has been introduced for the smallest start-up firms, referred to as Seed EIS (or SEIS) relief. This relief operates in a different way to EIS relief and should not be confused with EIS.

How does EIS work?

EIS income tax relief reduces the investor's income tax liability in the year of the investment (or prior year) by a claim on their Self Assessment tax return.

The reduction of tax is at 30% of the invested amount (although it cannot exceed the tax liability for the year).

If the taxpayer chooses, they can claim for some or all of the tax relief to be given in the prior tax year. This can be beneficial if, for example, they would not receive full relief in the year of investment, or if their top tax rate in the prior year is higher than in the year of investment.

The maximum investment limit for income tax relief is £1m per year. The investor must not be an employee of the company (although the rules allow for "angel investors"), and must not hold (together with associated parties) 30% of the company.

Provided that the investment is held for three years and the company remains eligible, any capital gain on the disposal of the EIS shares is also free of capital gains tax.

What are the benefits?

As outlined above, two of the main tax benefits are the initial 30% income tax relief on investing in an eligible company, and a capital gains tax free gain on a disposal (providing that the investment is held for three years).

In addition, once the investment is held for two years, the asset can qualify for Inheritance Tax (IHT) relief at 100%, which can be part of an effective strategy for mitigating a future IHT liability.

Investments in EIS companies can also be used to "freeze" capital gains made by a taxpayer on other chargeable assets in the last three years (or up to a year after the investment). This is separate to the capital gains tax free disposal of qualifying investment, and does not eliminate the original capital gains tax liability – but can defer that gain until the EIS investment is sold or liquidated.

Used in this way, investing the proceeds of a chargeable disposal for capital gains tax into a qualifying EIS investment can be a useful tool in managing an individual's cash flow. The rules for EIS capital gains tax deferral relief are not as stringent as the EIS income tax relief rules and it can be possible to claim deferral relief even where income tax relief is not available. This most typically happens where the investor breaks the 30% connection rule.

If an investment does not perform and the investor realises a loss, this can be used against income of the taxpayer giving them a higher rate of tax relief than for other capital losses.

What companies qualify for EIS?

There are a number of conditions that must be met for a company to be eligible for investment through EIS.

Generally, such companies are smaller trading companies, and they must have a UK permanent establishment. There is a long list of "excluded activities", and companies undertaking any of these activities would not qualify to receive funds under EIS.

The exclusion list includes the property sector, the energy sector, heavy industry (such as shipbuilding, coal and steel production), farming, and financial services (such as banking and insurance). Even lawyers and accountants are excluded!

There are also limits on the amount that a company can receive through EIS, and the gross value of their assets, number of employees etc. Essentially, the relief is restricted to smaller standalone companies who are still in their startup phase (within seven years of first trade).

Some of these limits (such as the number of employees, the maximum investment allowed per year and in total, and timescale of the investments) are more generous for companies which qualify is "knowledge intensive" companies.

In order to prevent abuse, Government introduced a "risk to capital" condition and the investment has to hold genuine risk for the investor rather than a guaranteed return.

Companies apply for clearance under EIS and each time they issue shares to investors, they provide the relevant information to HMRC who then authorise the company to issue the investor with the EIS certificate they require for their tax return.

Caveat emptor

Investors do need to be aware that EIS companies tend to be smaller firms that are still becoming established, and are therefore inherently more risky as an investment.

Taxpayers should consider taking independent investment advice before investing in such companies. That said, if there is a possible investment in a small business (such as the company of a friend or – for deferral relief - a family member), EIS could mean that an investment, which would be made anyway, could provide some unexpected tax relief.

EIS qualifying companies can provide an attractive option for investors as part of a balanced investment portfolio, giving income tax, capital gains tax and inheritance tax relief.

How can we help?

Charter Tax is experienced in advising on the tax implications of investments and transactions. We can advise both individual investors, and companies looking to benefit from EIS investment.

We can apply for clearance from HMRC for a company, and advise on the best way to run the process of receiving investments. We can also complete all the related forms required.

If you would like further assistance, please contact **Janet Pierce** at janet.pierce@charter-tax.com or Tom Barker at Thomas.barker@charter-tax.com

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