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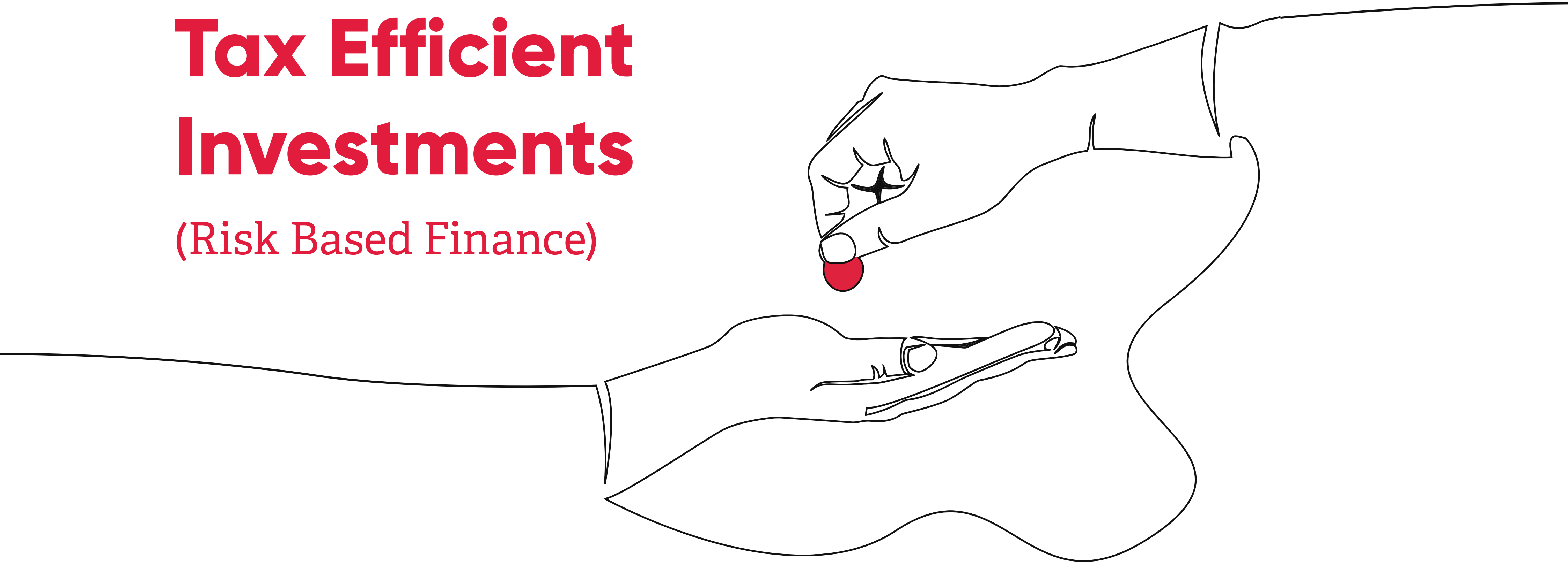
Tax Efficient Investments

(Risk Based Finance)



Financial Services: A22

There are 4 types of relief for investment into qualifying companies.

EIS, SEIS and SITR

Listen to our Audio Quick Guide on the subject here

There is also a Venture Capital Trust (VCT) which is a company that has been approved to make investments into the above.

They are all fairly similar and incredibly attractive, with a range of tax reliefs connected around making investments in risking young businesses, or investing in a social enterprise.

A word of warning however. The schemes are by their definition applicable to start ups. However there are incredibly complicated and strict rules that once you are using the schemes, relief can easily be withdrawn by the actions of the company or the investor.

BENFITS OF EIS

EIS Tax relief is designed to encourage investment in small high risk companies.

- 30% income tax relief for investor, for investments up to £1 million Relief can be carried back to previous tax year;
- Shares can be sold, after a qualifying period, free of Capital Gains Tax and shares will normally qualify for relief from inheritance tax too. This relief from Capital Gains Tax is contingent on claiming the Income Tax Relief and may be restricted if full Income Tax Relief is not obtained on the amount invested. (The qualifying period is normally 3 years from date of investment or, if trade began later, 3 years from commencement of trade);
- Capital losses on disposal of shares can be offset against income;
- Other capital gains can be deferred by investment in EIS shares under EIS Defferal relief .
    - Important to note that EIS Defferal relief allows the roll over of any gain into shares issued in a company, and that this specific relief does not have the same rules of “connection” that the income tax relief has. This means that you can invest in your own company, which you could own 100%, and roll over any gain into this company provided the other rules of the EIS relief are met.. However no income tax relief would be available on the roll over.

Rules for the company:

- Cannot be controlled by any other company;
- Must be in ordinary shares that do not have a preference right over other shares. This is a thorny area – be careful.
- The company must be either a UK resident incorporated company or a foreign company with a UK permanent establishment.
- Cannot be quoted on stock markets, although can be listed on AIM and some international stock markets;
- Gross assets must be less than £15 million before the investment and less than £16 million after the investment;
- Must have fewer than 250 full time employees;
- Must be a trading company, carrying out a qualifying trade, or the parent company of a qualifying trading group;
- Trades considered low risk, or asset backed are ineligible. These are broadly:-
  - leasing activities
- letting ships on charter
- receiving royalties or license fees
- dealing in financial instruments like commodities, futures, shares and securities
- dealing in land
- running a nursing home or residential care home
- managing property used as a nursing home or residential care home
- banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities
- property development
- fishery and aquaculture
- agriculture
- production of gas or other fuel
- generating energy like electricity or heat
- exporting electricity
- road freight transport for hire

You may not qualify if your enterprise provides services to another business and both of the following apply:

- that business's trade consists mostly of excluded activities
- a person has a controlling interest in both your enterprise and the other business
- It must be within 7 years of the company's first commercial sale, except if Knowledge intensive (see below), or when it is follow on funding and previous EIS investments have been made.
- The investment must met the risk to capital condition:
  - The company must use the money for growth and development
  - The investment must be a risk to the investor's capital.
- Maximum capital raised under EIS and similar tax favourable schemes must not exceed £5 million in any 12 month period;
- Lifetime limit of £12 million of capital raised
- Companies can apply to HMRC for assurance that they qualify, once they have a shareholder they can name.

Knowledge Intensive Companies:

- A number of the requirements and restrictions are relaxed if the company qualifies as 'knowledge intensive'.
- Benefits of being a Knowledge Intensive Company:
  - Investor annual limit increases to £2 million.
  - Time limit is within 10 years of first commercial sale or annual turnover over £200,000
  - Annual Investment Limit is increased to £10 million and Lifetime Limit is increased to £20 million
- To qualify as knowledge intensive the following must be fulfilled:
  - Less than 500 employees at time of share issue
  - One of the following conditions must be fulfilled:
    - The Innovation Condition - Be carrying out work to create intellectual property and expect the majority of your business to come from this

within 10 years, or

    - The Skilled Employees Condition - Have 20% of employees carrying out research for at least 3 years from the date of investment. These employees must be in a role that requires a relevant Master's degree or higher.

  - One of the following Operating Cost conditions must be fulfilled:
    - 10% of overall operating costs spent on research, development or innovation each year for 3 years, or
    - 15% of overall operating costs spent on research, development or innovation in one of 3 years
  - If the company is at least 3 years old, the spend should have been in the 3 years before the investment, otherwise this must occur in the 3 years following the investment. (You will need to submit a schedule, supported by accounts to show that you have)

- Companies can apply to HMRC for assurance that they qualify.
- Rules for the individual (these do not apply for EIS Deferral relief only):
- Cannot be connected to the company, by virtue of holding 30% of the company's share capital in the period beginning 2 years before the investment and ending 3 years after. Shares held by associates (close family or business partners) are included;
- Cannot be a director or employee of the company (an exception is available in certain situations for an unpaid director, and after investment you can be appointed and paid as a Director);
- Cannot be an existing shareholder unless shares obtained from EIS or other Risk Finance Investment, or shares obtained on formation of the company or purchase of an 'off the shelf' pre-formed dormant company.
- It is possible to make an EIS investment through a Fund in order to reduce risk, or through a nominee.

SEIS (Seed Enterprise Investment Scheme):

- Available to very small start-up companies
  - less than 25 employees,
  - assets up to £200,000;
  - investment spent on a qualifying business activity within 3 years
  - the activity must be a new trade that is less than 2 years old
- The investor gets 50% of the amount invested as income tax relief;
- Maximum investment £100,000 per investor;
- Maximum company can raise is £150,000; and
- Investors and their associates can be company directors but can't own more than 30% of the company.
- Gains rolled over into SEIS investment under SEIS Defferal relief can shelter 50% of the gain invested.

SITR is a state aid designed to help you raise money to support the trading activity of your:

- community interest company
- community benefit society, with an asset lock
- charity, which can be a company or a trust
- It follows the sames rules as EIS for the company in terms of size, age and ineligible trades.
- It allows the investor to invest in shares or debt
- Shares must be ordinary new shares, paid in full, without any preference rights – as per EIS
- Debt needs to be a new loan, made in cash, not secured against any assets, and not paid back until at least 3 years later, and not have an unreasonable commercial rate of interest

VCTS (Venture Capital Trust Scheme):

- Available to investors who subscribe for shares in qualifying Venture Capital Trusts
- 30% income tax relief for investor, for investments up to £200,000, relief is given in the year of investment with no carry back permitted.
- You must hold your shares for 5 years (rather than the usual 3 years) in the VCT
- The dividends on the first £200,000 invested in a VCT in a tax year are exempt from tax, regardless of eligibility for Income Tax relief.
- To be eligible, a VCT must fulfil the following:
    - Be traded on a regulated market such as the UK Stock Exchange or an appropriate European exchange.
    - Derive its income wholly or mainly from shares or securities
    - Have at least 80% of its investments in qualifying company with at least 70% of such holdings in the form of eligible shares
    - Cannot invest more than 15% of its funds in any one company and must distribute at least 85% of its profits to its shareholders
- For the purposes of VCTS a qualifying company is one which meets the conditions to be an EIS company. Companies can apply to HMRC for assurance that they are qualifying and this may be a condition of obtaining investment.
- Unlike EIS - VCT have an ability to hold equity and use some debt instruments when they invest into a company.

Scheme	Investment type	Maximum annual investment for individual	Maximum Annual investment for company	Maximum Liftetime investment for company	% of investment you can claim as a tax refund	Number of years investment must be held	Tax relief on Dividends?	Capital Gains Tax relief on reinvest-ment of any gain
EIS	Ordinary Equity Shares without preferential rights	£1,000,000.00	£5,000,000	£12,000,000	30%	3 years	No	Yes on 100% of investment
SEIS	Ordinary Equity Shares without preferential rights	£100,000	£150,000	£150,000	50%	3 years	No	Yes on 50% of investment, capped at £50,000
SITR	Ordinary Equity Shares without preferential rights or Debt	£1,000,000.00	£5,000,000	£1,500,000	30%	3 years	No	Yes on 100% of investment
VCT	Ordinary Equity Shares without preferential rights	£200,000	£5,000,000 or 15% of the fund	£12,000,000	30%	5 years	Yes	N/A

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