CHAPTER 31

THE ENTERPRISE INVESTMENT SCHEME

31.1 Introduction

An individual will receive tax relief in his Income Tax computation where he subscribes for shares in a qualifying EIS company. By **"subscribing for shares"** we mean that the **company is issuing new shares to the investor.** ITA 2007, s. 158

In 2010/11 tax relief is restricted to the lower of the amount subscribed or £500,000 and is given by way of a tax reducer at a flat rate of 20%. The maximum amount of income tax relief that an individual can receive in 2010/11 is therefore: ITA 2007, s. 158(2)

Maximum tax reducer = £500,000 x 20% = £100,000

The minimum amount an individual can invest in an EIS company in a tax year is £500. ITA 2007, s.157(2)

The tax reducer is limited to the individual's tax liability for the year – i.e. the EIS relief cannot create a "negative" figure for the tax liability. The tax liability can be reduced to nil by EIS relief, leaving tax deducted at source either under PAYE or from bank interest, to be repaid to the taxpayer.

31.2 Carry back of relief

Income tax relief is usually given to the investor in the year in which the subscription is made. However, it is **possible to carry back an EIS subscription to the preceding tax year,** providing the limit for relief was not exceeded in that earlier year. ITA 2007, s.158 (4)

For example, if a taxpayer subscribes for £20,000 of shares on, say, 30 September 2010, the taxpayer could elect for the full amount of the subscription to be carried back and relieved in the 2009/10 tax computation. However, if the taxpayer had already subscribed for £492,000 of EIS shares in 2009/10 only £8,000 of the 2010/11 investment could be carried back to 2009/10.

31.3 Qualifying company

ITA 2007, s. 180

Tax relief will only be given if the individual subscribes for shares in a qualifying EIS company. It is important therefore that we are comfortable with exactly what is a qualifying company under the EIS rules.

The company must be a trading company. Therefore, any company which derives its income wholly or mainly from making investments is not a qualifying company for EIS purposes. ITA 2007, s. 181

There are **certain prohibited or excluded trades** for EIS purposes. Companies whose activities are primarily **financial** – by this we mean companies dealing in shares or securities or commodities etc. - are excluded, as are companies providing **legal and accountancy** services. **Farming and market gardening** are also excluded activities as is operating or **managing hotels**, **property development,** shipbuilding and coal and steel production ITA 2007, s. 192

It is possible for the company to be registered outside the UK. However, to qualify for relief, the company's trade must be wholly or mainly carried on within the UK. Most EIS companies will be resident in the UK. ITA 2007, s. 179

The **company must be an unquoted company**. This means that its shares must not be marketed to the general public by being listed on a recognised Stock Exchange. ITA 2007, s.184

Most companies qualifying for EIS relief are relatively small trading companies and the EIS rules place a limit on the value of the assets within the company. The assets of the company must not exceed **£7 million before** the share issue and must not exceed **£8 million after** the share issue. ITA 2007, s.186

Companies or groups with 50 or more full-time equivalent employees cannot raise money via an EIS scheme. ITA 2007, s.186A

Having raised the share capital from its investors, the company must use the cash raised for a qualifying business activity within a certain period of time. All the money must be used for a qualifying business activity within 2 years of the date of issue (or commencement of trade if this is later). Qualifying business activity essentially means that the company must use it for some sort of trading purpose. ITA 2007 s. 175

Shares may only be eligible for EIS relief where the issuing company has not raised more than £2 million through EIS and Venture Capital Trust (VCT) shares in the previous 12 months. VCTs are covered in the next chapter. ITA 2007, s. 173A

The company must have carried on the trade for which the money was raised for at least 4 months in order for an investor to be eligible for EIS relief. ITA 2007 s. 176

Finally, there must be no pre-arranged exits – i.e. the company must not guarantee the investor any sort of return on his investment. Only if the investor is taking a bona fide commercial risk, will HMRC offer any form of tax relief. ITA 2007, s. 177

31.4 Qualifying investor

There is also one important qualifying condition as far as the investor is concerned. In order to obtain income tax relief, the **investor must not be connected with the company.** Broadly speaking an investor is connected with an EIS company if he breaches one of two main conditions. ITA 2007, ss.162& 163

The investor is connected with the company if he is an employee of the company. ITA 2007, ss. 167 & 168

A director is not connected for these purposes if he only receives a payment from the company which is a permitted payment. Permitted payments include payment or reimbursement of expenses incurred wholly, exclusively and necessarily in the performance of the duties and payment of rent which does not exceed a reasonable commercial rent. In addition any reasonable and necessary remuneration paid for services carried out in the course of a trade or profession, other than secretarial or managerial services, can be ignored, provided they are taken into account in calculating the profits of that trade or profession. ITA 2007, s. 168

In addition, if the only way in which the individual is connected with the company is as a director who receives reasonable remuneration, he will not be treated as connected provided that at the time when the shares were issued the director had not been connected with the company or been involved with the carrying on of the trade. This allows investors who would like to make their business expertise available to the company they invest in to become paid directors but still qualify for income tax relief. Such investors are often referred to as "Business Angels". ITA 2007, s. 169

However, an existing director of a company who receives remuneration subject to tax as employment income who subscribes for shares will not be eligible for EIS income tax relief.

The investor is also connected to the company if he holds **more than 30% of the ordinary shares**, or he can exercise more than 30% of the voting rights. In considering whether the 30% limit has been breached, the shareholdings of associates must also be considered. The associates here would include spouses, and ancestors or relatives such as parents and children. ITA 2007, s. 170 & s.253

31.5 Clawback of relief

ITA 2007, s. 209

There are anti-avoidance provisions to prevent an investor from obtaining income tax relief on his EIS subscription, then selling the shares shortly afterwards. If the **investor disposes of his shares within three years of issue, there will be a clawback of the income tax relief originally given.**

If the investor gives away his shares within three years, all of the income tax relief originally obtained will be withdrawn. This will not apply when the gift is to the investor's spouse.

The clawback of income tax relief is slightly different where the shares are sold to an unconnected third party. If the shares are sold within three years, the income tax relief to be withdrawn is the sale proceeds multiplied by 20%.

The clawback of income tax relief cannot exceed the original tax reducer. This means that if **shares are sold at a profit within three years of issue, an amount equal to the original tax reducer is added back to the investor's tax liability in the year of sale.**

HMRC will clawback the relief by raising an assessment for the tax year in which the relief was originally obtained. Interest will be charged from 31 January following the end of the tax year for which the assessment was made. ITA 2007 s. 235 & s.239

Illustration 1

In December 2008 an investor subscribed for £50,000 of shares in an EIS company. In this instance the investor would qualify for a tax reducer of £10,000 in the tax year 2008/09.

The investor disposes of the shares in June 2010 – i.e. within three years of their issue.

If the disposal is by way of a gift, all of the tax relief originally obtained will be withdrawn. This means that an assessment will be raised in respect of 2008/09 to clawback the relief of £10,000.

If the shares were sold for £60,000, the Income Tax relief to be withdrawn would again be £10,000. Remember that when the EIS shares are sold at a profit within three years, all of the original income tax relief given will be clawed back in the year of sale.

On the other hand, if the **shares were sold at a loss within three years** – here assume sale proceeds are £40,000 – the **income tax relief to be withdrawn is the sale proceeds, multiplied by 20%.** In this instance, £8,000 will be clawed back.

Example 1

Gary, an employee, had salary and benefits totalling £191,960 in 2010/11. He had no other income.

In March 2011 he subscribed £600,000 for shares in a qualifying EIS company.

Calculate his tax reducer for 2010/11.

Example 2

Which of the following trades is <u>not</u> an excluded trade for EIS purposes?

a) Research and development
b) Property development
c) Share dealing
d) Market gardening

Answer 1

	£
Employment income	191,960
Less: personal allowance	-
Taxable income	191,960
Tax	£
37,400 @ 20%	7,480
112,600 @ 40%	45,040
41,960 @ 50%	20,980
	73,500
Less: tax reducer (cannot exceed liability)	(73,500)
Tax liability	**Nil**

Gary subscribed £600,000 for shares in a qualifying EIS company.

The maximum tax reducer cannot exceed £500,000 x 20% = £100,000. However, the tax reducer cannot exceed the tax liability for the year. This means that the tax reducer for 2010/11 will be £73,500.

Remember that a tax reducer can reduce a liability down to nil but cannot itself create a tax repayment.

If Gary had not invested the maximum in EIS shares in 2009/10, the excess subscription could be carried back to 2009/10 and relieved in this year, provided the limit for 2009/10 is not exceeded.

Answer 2

The answer is A

Research and development is permitted. The others are prohibited (s.192 ITA 2007).