CHAPTER 26

EIS REINVESTMENT RELIEF

26.1 Introduction

TCGA 1992, Sch 5B

In this chapter we shall consider another type of CGT deferral relief, that being "EIS reinvestment relief".

You will have looked at the Enterprise Investment Scheme from an income tax perspective when you studied the personal tax course.

When an individual subscribes for shares in a qualifying EIS company, he receives income tax relief by way of a tax reducer at 20% of the amount subscribed. This is capped at £500,000 giving a maximum tax reducer of £100,000.

In this chapter we shall look at EIS from a capital gains tax perspective. If an individual sells an asset, and **reinvests** the sale proceeds in acquiring qualifying EIS shares, he may claim **EIS reinvestment relief**.

Like rollover relief and gift relief, EIS reinvestment relief allows the taxpayer to **defer** the capital gain to a later time. There is **no ceiling** to the amount of the gain that can be deferred – **the £500,000 subscription limit only applies for income tax purposes.**

EIS reinvestment relief is more flexible than rollover relief and gift relief, in that it allows the gain on **any asset** to be deferred, as long as the proceeds are reinvested in qualifying EIS shares.

Rollover relief and gift relief only apply if the individual is disposing of a business asset. However, any taxpayer – not just those in business – can take advantage of EIS reinvestment relief.

Illustration 1

An individual sells a painting for £200,000 realising a capital gain of £80,000. He uses part of the money to subscribe for qualifying shares in an EIS company. The new shares cost £120,000.

Because the taxpayer has sold an asset and has subscribed for new EIS shares, he can make an EIS reinvestment relief claim to defer all or part of the gain of £80,000. The amount of the gain that can be deferred is the **lower** of three amounts: TCGA 1992, Sch 5B para 2(1)

(i) the **gain**;
(ii) the **amount reinvested;**

(iii) the **specific amount claimed.**

As the taxpayer has made a gain of £80,000, it makes sense that he can only defer a gain of up to £80,000.

The EIS reinvestment relief claim **cannot exceed the amount reinvested** in the new shares. Here the maximum claim is therefore the lower of £80,000 or £120,000, being £80,000.

If the taxpayer wishes, he **could claim a specific amount,** which is less than £80,000. The EIS reinvestment relief rules state that the investor must claim a specific amount of reinvestment relief, which could be less than the maximum permitted. This will allow the taxpayer, for example, to **take advantage of any unused annual exemption or capital losses.**

Note that the rollover relief or the gift relief rules do not permit the taxpayer to claim a specific amount. Rollover relief and gift relief are "all or nothing" reliefs and do not allow the claimant to restrict a claim to utilise annual exemptions or losses.

Assume here that the taxpayer has already used his annual exemption so he claims the maximum amount of EIS reinvestment relief, being £80,000. This reduces his gain to zero.

	£
Proceeds	200,000
Cost	(120,000)
Gain	80,000
EIS reinvestment relief	(80,000)
Chargeable gain	Nil

26.2 How the deferral operates

The £80,000 of deferred gain is not rolled over against the base cost of the new EIS shares, but is **frozen** instead. Therefore EIS reinvestment relief does not work in the same way as rollover relief, because the base cost of the replacement asset – i.e. the new EIS shares – remains the same. TCGA 1992, Sch 5B para 2

This frozen gain of £80,000 will **crystallise** and become chargeable, in the year of what we call a "chargeable event". We shall look at chargeable events later, but the most common chargeable event is the **sale of the EIS shares**.

You will see therefore that the way EIS reinvestment relief works, is very similar to the way in which we give rollover relief when a taxpayer sells a business asset and replaces it with a depreciating asset. There are only two ways in which HMRC allow taxpayers to defer a capital gain - one is by **rolling** the gain against the base cost of another asset. The other is by **freezing** the gain until the happening of a later event. EIS reinvestment relief is given by freezing the deferred gain.

26.3 Amount of relief

The claimant must stipulate the amount of EIS reinvestment relief he wishes to take. In the previous illustration the taxpayer made a gain of £80,000 on the disposal of an asset and claimed £80,000 relief leaving no chargeable gain.

EIS reinvestment relief is very flexible in that it enables taxpayers to claim a lower amount so as to utilise losses or annual exemptions.

Illustration 2

Assume that the taxpayer in the previous illustration had not made any other disposals in the year so the annual exemption of £10,100 was still available. The objective of the taxpayer is to **restrict his EIS reinvestment relief** claim as far as possible, without having to pay capital gains tax. The calculation will be as follows:

	£
Gain	80,000
Less: EIS reinvestment relief	(69,900)
	10,100
Less: annual exemption	(10,100)
Taxable gain	Nil

This gain will be frozen until the taxpayer sells his EIS shares. By restricting the claim to £69,900, the taxpayer is reducing the amount of future CGT he will have to pay, and is also making sure that his annual exemption for 2010/11 does not go to waste.

26.4 Conditions for the relief

There are certain conditions to be satisfied before an individual can claim EIS reinvestment relief. Firstly the investor must be **UK resident** at the time the gain was made and at the time of the reinvestment. TCGA 1992, Sch 5B para 1(1)(d)

The investor must be **"subscribing"** for shares in a qualifying EIS company. A qualifying EIS company is broadly an **unquoted** company, carrying on a **qualifying trade** wholly or mainly in the UK. ITA 2007, s. 180

The company must also satisfy other conditions, such as raising only a certain amount of share capital (maximum £2m in the 12 month period ending with the date of issue of the shares), and using that money within two years.

The shares issued to the investor must be **new ordinary shares** with no special rights to dividends and not redeemable within three years.

There is a specific **time window** in which the investor must subscribe for his EIS shares. The reinvestment must be made within **12 months before or 36 months after** the disposal of the original asset. This four year time window is exactly the same reinvestment period as applies for roll-over relief. TCGA 1992, Sch 5B para 1(3)(a)

The EIS reinvestment relief **claim** itself must be made no later than **4 years** from the end of the tax year in which the shares are issued. Therefore for claims in respect of shares issued in the tax year 2010/11, a claim must be made no later than 5 April 2015. TCGA 1992, Sch 5B para 6

You may recall from the personal tax course, that for an investor to obtain income tax relief on an EIS subscription, he must not be "connected" with the company. Employees and certain directors are "connected" with a company, as are individuals who own more than 30% of the shares. If the investor is connected with a company, no income tax relief will be available.

This rule **does not apply for EIS reinvestment relief** for CGT purposes. Therefore **if an individual sells an asset and subscribes for shares in an EIS company, he will receive reinvestment relief, regardless of his stake in the company.**

A CGT deferral claim can be made, even if the investor is an employee of the company, or he holds 100% of the shares. Therefore a taxpayer can sell an asset, set up his own qualifying EIS company in which he owns all of the shares, and make a claim to defer the capital gain. Whilst HMRC will give CGT deferral relief, in this instance no income tax relief is available, because the taxpayer has more than 30% of the share capital.

26.5 The frozen gain

The frozen gain becomes chargeable when there is a chargeable event. TCGA 1992, Sch 5B para 3

The most common chargeable event is the **sale of the EIS shares** themselves. When the EIS shares are sold, there will sometimes be a gain on the shares themselves, and this disposal will also crystallise the frozen gain. We will look at gains and losses on EIS shares in the next chapter.

A **gift** of the EIS shares is also a chargeable event, **unless** the gift is to one's **spouse**. If a taxpayer gifts shares to his spouse, this does not crystallise the frozen gain. However when the spouse ultimately disposes of the EIS shares, this will be a chargeable event.

If the investor **becomes non-UK resident within 3 years** of the issue of the shares, this is a chargeable event which will crystallise the frozen gain. The exception to this is if the investor goes abroad on a full-time employment contract and returns to the UK within 3 years.

Finally if the EIS **shares themselves cease to be eligible** shares, the frozen gain will become chargeable. For example, if the EIS company changes its trade and engages in non-qualifying activities, the deferred gain is charged.

However, a **flotation** of the EIS company on the Stock Exchange **does not crystallise the frozen gain**. If the previously unlisted company became a quoted company, this will not result in the frozen gain being charged, unless there were "arrangements" in place for the company to float at the time the shares were originally acquired.

The frozen gain will crystallise in the year of the chargeable event, and not when the original disposal took place. TCGA 1992, Sch 5B para 4

26.6 Interaction with entrepreneurs' relief

It is possible for a gain to be eligible for both EIS reinvestment relief and entrepreneurs' relief.

The way the reliefs interact depends on when the gain arose.

Gains arising before 23 June 2010

Where a gain arose **before 23 June 2010** which was eligible for entrepreneurs' relief but could also be deferred by EIS reinvestment relief, **both claims for relief could be made**. **Entrepreneurs' relief applied first.** The gain was reduced by 4/9ths, then the balance of the gain was deferred by EIS reinvestment relief.

Illustration 3

Mrs N, a higher-rate taxpayer, sold her business on 1 May 2010 and realised a gain of £99,000 which qualified for entrepreneurs' relief. She reinvests £100,000 of the proceeds of sale in qualifying EIS shares.

As £100,000 has been reinvested, the full amount of the gain of £99,000 could be deferred. However, a claim for entrepreneurs' relief would reduce the amount of chargeable gain, and the balance could be deferred.

	£
Gain	99,000
Less: entrepreneurs' relief @ 4/9	(44,000)
	55,000
Less: EIS reinvestment relief	(55,000)
Taxable gain	£NIL

If Mrs N wished, she could claim an amount of EIS reinvestment relief of less than £55,000. She might wish to do this if her annual exemption were still available.

When Mrs N sells the EIS shares in the future, **the deferred gain of £55,000 comes back into charge**. This gain will be taxed at 28% as Mrs N is a higher-rate taxpayer.

Gains arising on or after 23 June 2010

The position is different when the gain arises **on or after 23 June 2010**. The individual can choose to **either;**

1) **claim entrepreneurs' relief** in respect of the gain. in which case the gain will be chargeable in the year incurred at a rate of 10**%, or**

2) **claim EIS reinvestment relief instead of entrepreneurs' relief**. If EIS relief is claimed, **the gain will be frozen** when in is made. When the frozen gain comes back into charge, it will be taxed at 18% or 28% depending on whether the individual is a higher-rate taxpayer. It will not qualify for the special rate of 10%.

The individual **can no longer claim both reliefs** in respect of the same gain.

Illustration 4

Returning to Illustration 3, but this time assuming that Mrs N sold her business on 1 July 2010, realising a gain of £99,000 which qualified for entrepreneurs' relief.

Again, she reinvests £100,000 of the proceeds in qualifying EIS shares.

Mrs N has two choices.

1) She could claim entrepreneurs' relief in respect of the gain. Assuming she has no other gains in the tax year, her CGT will be:

	£
Gain	99,000
Less: AE	(10,100)
Taxable gain	88,900
CGT:	
£88,900 @ 10%	£8,890

2) Mrs N could claim EIS reinvestment relief instead of entrepreneurs' relief. This would defer the full gain of £99,000 such that no tax is payable in 2010/11. However, when the gain comes back into charge, for example when the EIS shares are sold, it will be taxed at 28% (as Mrs N is a higher rate taxpayer).

Mrs N will need to decide whether she wishes to pay tax earlier, but at a lower rate or defer tax but pay at a higher rate in the future.

If a claim for entrepreneurs' relief is made, but the full gain does not qualify for relief because the individual's lifetime limit has been exceeded, then the excess gain can be deferred using EIS reinvestment relief.

Entrepreneurs' relief on gains before 6 April 2008

Entrepreneurs' relief first became available on 6 April 2008. However, if an earlier gain was deferred using EIS reinvestment relief, it may be possible under certain circumstances to claim entrepreneurs' relief when that gain becomes chargeable.

A claim can be made **if the original disposal would have satisfied the qualifying conditions for entrepreneurs' relief**. However, the relevant EIS shares must still be held by the original investor. If the shares have been transferred to a spouse or civil partner, entrepreneurs' relief will not be available, even if the shares are transferred back before the gain becomes chargeable.

If the deferred gain became chargeable before 23 June 2010, the gain was reduced by 4/9ths if a claim for entrepreneurs' relief was made.

If the deferred gain becomes chargeable on or after 23 June 2010, the full gain will be charged to tax at 10%.

Illustration 5

Mr C sold his trading business in May 2005 and realised a gain of £270,000. He subscribed £250,000 for qualifying EIS shares in July 2006 and made the maximum claim for EIS reinvestment relief. In August 2010 he sells the EIS shares and the deferred gain becomes chargeable to CGT.

Mr C is a higher rate taxpayer. He has not made any other claims for entrepreneurs' relief. He has no other gains in 2010/11.

The gain on the disposal in 2005 would have qualified for entrepreneurs' relief had the relief been available then. Mr C can therefore claim entrepreneurs' relief in respect of the deferred gain when it comes back into charge on the disposal of the EIS shares in August 2010.

His CGT position for 2010/11 is:

	£
Deferred gain	250,000
Less: AE	(10,100)
Taxable gain	239,900
CGT:	
£239,900 @ 10%	23,990

Example 1

Graham, a higher rate taxpayer, sold his 40% shareholding in Gunn Ltd in June 2010 making a gain of £50,000. He had owned the shares for many years but had never worked for the company. This was his only disposal in 2010/11.

Graham subscribed for 35,000 £1 shares in Risky Business Ltd, a qualifying EIS company, in March 2011.

What amount of EIS reinvestment relief would you advise Graham to claim?

Example 2

Julie ran a manufacturing business for many years as a going concern. She sold the business in May 2004 resulting in gains of £185,000.

She invested £100,000 in a qualifying EIS company in April 2005. She sold these shares in July 2010.

What amount of CGT in respect of the sale of her business will be payable for 2010/11, assuming that Julie always makes any beneficial claims for relief?

Answer 1

2010/11:	£
Gain on Gunn Ltd shares	50,000
Less: EIS reinvestment relief	(35,000)
Gain	15,000
Less: annual exemption	(10,100)
Taxable	4,900
CGT @ 28%	£1,372

Graham should claim the full **£35,000** of EIS reinvestment relief.

Entrepreneurs' relief will not be available as he did not work for the company.

Answer 2

An EIS claim for £100,000 would have been made in respect of the 2004 gain. This £100,000 would have been frozen until the disposal of the EIS shares.

The frozen gain therefore becomes chargeable in 2010/11.

	£
Deferred gain now chargeable	100,000
Less: AE	(10,100)
Taxable gain	89,900
Tax @ 10%	£8,990

As the original disposal of the business would have satisfied the conditions for entrepreneurs' relief, an ER claim can be made when the frozen gain crystallises in 2010/11. The resulting gain would then be taxed at 10%.