MOORE Kingston Smith

ENTERPRISE INVESTMENT SCHEME (EIS)

The Enterprise Investment Scheme is designed to help smaller higher-risk trading companies to raise finance by offering investors, who subscribe for new shares in those companies, a range of tax reliefs.

How does a company qualify as an EIS company?

To qualify for EIS investment, a company must meet various requirements, with the following being the main ones:

- The company must be unquoted and have a UK permanent establishment;
- The company must exist to carry on a qualifying trade (see below) or be the parent of a qualifying trading group;
- Generally, the company cannot have been trading for more than 7 years (10 years for knowledge-intensive companies) at the time it receives its first qualifying investment;
- The gross assets of the company must not exceed £15 million before the investment and £16 million after the investment;
- The number of full-time employees of the company must be fewer than 250 (or 500 for knowledge-intensive companies);
- The company must be aiming to grow and develop its trade in the long term;
- There must be a significant risk to the investor that there will be a loss of capital in excess of the amount of net investment return;
- If the company has any subsidiaries, these must be qualifying subsidiaries (broadly 51% subsidiaries which it controls);
- The company must not be under the control of another company; and
- The company must not be in financial difficulty.

The maximum amount that can be raised by a company in a 12 month period through EIS and similar schemes is £5 million (£10 million for knowledge-intensive companies). The maximum total amount that a company can raise is £12 million (£20 million for knowledge-intensive companies).

What is a knowledge-intensive company?

In order to qualify as knowledge-intensive, a company must firstly meet one or both of the following operating cost conditions:

- R&D and innovation expenditure must account for at least 15% of the company's relevant operating costs in any of the previous three years;
- R&D and innovation expenditure must account for at least 10% of the company's relevant operating costs in each of the previous three years.

In addition, the company must meet either the 'innovation condition' or the 'skilled employee condition':

The innovation condition is essentially that the company is carrying out work to create intellectual property; and it anticipates that the exploitation of that intellectual property will comprise the majority of its business within the next ten years.

The skilled employee condition is essentially that at least 20% of the company's employees carry out R&D or innovation activities and hold a Master's degree or above.

How does the investment need to be made?

An EIS investment must be in new ordinary shares which are non-redeemable and which do not carry any preferential rights to assets on a winding up. A preferential right to dividends may be possible in certain circumstances.

Shares need to be subscribed for wholly in cash and fully paid up at the time they are issued.

Can the company carry on any trade?

Certain trades are excluded from being qualifying trades, with some of the key ones being:

- Dealing in land, commodities, futures, shares, securities, and other financial instruments;
- Dealing in goods, other than in an ordinary trade of retail or wholesale distribution;
- Financial activities, such as banking, insurance, money-lending, debt-factoring, or hire-purchase financing;
- Leasing;
- Receiving royalties or licence fees (except, broadly, where the greater part of the value of the associated intellectual property was created by the company;
- Providing legal or accountancy services;
- Property development;
- Operating or managing hotels or similar establishments;

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- Operating or managing nursing homes or residential care homes; and
- Providing services to certain associated persons whose trade consists substantially of excluded activities.

Is there a requirement as to how the money is used in the EIS company?

The shares must be issued to raise money to finance business growth and development. The money raised must be used in a qualifying trade, in preparation for a qualifying trade, or in R&D intended to develop a qualifying trade, within two years of the share issue or start of the qualifying trade.

Can anyone invest in an EIS company?

EIS relief is only available to individual investors and, except for the purposes of Capital Gains Tax Deferral Relief (see below), the investor must not be 'connected' with the company.

An investor will be connected with the company if they, either on their own or with associates, possess or are entitled to acquire more than 30% of the issued share capital, voting power, or assets available on a winding up. An investor will also be connected if they, or any associates, are an employee or director of the company (with certain limited exceptions for directors).

In addition, if the investor already holds shares in the company or a qualifying subsidiary, any new investment will only qualify for EIS if the existing shareholding qualified for EIS (or a similar scheme) or were original subscriber shares.

How does the Income Tax relief work?

- A qualifying EIS investment will give rise to a reduction in the investor's income tax liability for the year of 30% of the amount invested, up to the annual investment limit.
- Where none of the shares issued are in knowledge-intensive companies, the annual investment limit is currently £1 million, meaning that the maximum income tax saving per year is £300,000. The annual investment limit is £2 million for knowledge-intensive companies.
- EIS relief can only reduce the investor's income tax liability to nil, and cannot be used to generate a tax credit. An individual can elect, however, for some or all of an EIS investment made in one tax year to be treated as if it had been made in the previous tax year.
- Income Tax relief can be clawed back if the company or investor fails to meet certain qualifying conditions throughout the three years from the investment date or the trade commencement date, whichever is later. It may also be clawed back if the investor receives value from the company (including receiving a loan), or if the shares are sold in that three year period.

How does the Capital Gains Tax Deferral Relief work?

A capital gain arising on the disposal of any assets can be deferred if the amount of the gain is invested in qualifying EIS shares in the period from one year before the disposal to three years after the disposal.

A deferred gain will usually come back into charge when the EIS shares are disposed of. If the gain would have qualified for Business Asset Disposal Relief at the time of the original disposal, it can also qualify when it comes back into charge.

Will there be a capital gain when the EIS shares are sold?

Where an investor received EIS Income Tax Relief on the subscription for shares, the subsequent disposal of those shares will be exempt from capital gains tax if two conditions are met:

- The shares have been retained for the three year qualifying period; and
- The EIS Income Tax Relief has not been clawed back.

What if the company fails?

EIS investments are likely to be in more risky ventures and it is inevitable that some will fail. A loss made on EIS shares, after the deduction of any EIS Income Tax relief given and not clawed back, will be allowable either against capital gains or alternatively against taxable income.

As an example, an investment of £10,000 made in the 2022/23 tax year that fails in the 2023/24 tax year, with no amounts being recovered, could give rise to the following tax consequences:

	Amount GBP	
Proceeds (no recovery)	£0	
Costs (original investment)	(£10,000)	
Capital loss on investment	(£10,000)	£10,000
Mitigated by: Income tax relief not clawed back (30% of £10,000)		(£3,000)
Capital loss relievable against income (possible income tax saving at 45% of £7,000)		(£3,150)
Net loss on investment		(£3,850)

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How can Moore Kingston Smith help?

We at Moore Kingston Smith can assess whether an investment is, or can be, structured to attract EIS relief.

Where applicable, we can apply to HMRC for advance assurance that the company is a qualifying company conducting a qualifying trade. Once a qualifying investment has been made, we can deal with the requirements that must be met to ensure the investors get the tax relief to which they are entitled.

As EIS relief is subject to withdrawal if either the company or the investor ceases to meet the eligibility requirements, we can help companies and investors regularly review their position in light the relevant eligibility requirements and provide advice where appropriate.

The above provides a brief summary of EIS relief and should not be relied upon without taking further advice. Tax law and practice changes frequently and the above information is based on law and practice at the time of writing. Please get in touch with our team if you would like to discuss aspects of EIS relief in greater depth or other related topics.

CONTACT US

Call:
+44 (0)20 4582 1000

Or email:
pd@mks.co.uk

MOORE Kingston Smith

www.mooreks.co.uk