CHAPTER 33
THE ENTERPRISE INVESTMENT SCHEME

In this chapter you will cover the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme including:
- limits on the tax reducer;
- carry back of relief;
- qualifying company;
- qualifying investor;
- clawback of relief;
- relief for losses against income.

33.1 Introduction

The Enterprise Investment Scheme (or EIS) is a scheme which encourages individuals to invest in certain companies by giving income tax relief on the amount invested.

The Seed Enterprise Investment Scheme (or SEIS) aims to support small, early-stage (or “seed”) companies which often have difficulty in accessing equity finance. Again, qualifying investments are eligible for income tax relief.

An individual may claim both EIS and SEIS relief in the same tax year.

Many of the detailed conditions in relation to the SEIS mirror the EIS conditions. In this chapter we will take a detailed look at the EIS scheme. We will then look at the relief available from the SEIS scheme, highlighting any differences in the conditions which need to be met.

33.2 Enterprise Investment Scheme

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 2015/16 tax relief is restricted to the lower of the amount subscribed or £1 million and is given by way of a tax reducer at a flat rate of 30%. The maximum amount of income tax relief that an individual can receive in 2015/16 is therefore:

\[
\text{Maximum tax reducer} = \text{£1 million} \times 30\% = \text{£300,000}
\]

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.

A claim for EIS relief must be made by the 5th anniversary of 31 January following the end of the tax year in which the shares are issued. So for shares issued in 2015/16 a claim for relief must be made by 31 January 2022. ITA 2007, s.202
A claim cannot be made until a certificate – EIS3 – is issued to the investor by the company. This cannot be issued until the trade has been carried on for 4 months.

### 33.3 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 £200,000 of shares on, say, 30 September 2015, the taxpayer could elect for the full amount of the subscription to be carried back and relieved in the 2014/15 tax computation. However, if the taxpayer had already subscribed for £850,000 of EIS shares in 2014/15 only £150,000 of the 2015/16 investment could be carried back to 2014/15.

Where a subscription made in the current year is carried back to the previous year, it is treated as if it was actually made in the earlier year.

### 33.4 Qualifying Company

**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. **ITA 2007, s.180**

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, coal and steel production and trades which consist of the generation or export of electricity. **ITA 2007, s.192**

It is possible for the company to be registered outside the UK. However, to qualify for relief, the company must have a permanent establishment in the UK. Most EIS companies will be resident in the UK. **ITA 2007, s.180A**

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**

In addition, the company must meet the financial health requirement, which basically means that the company is not in difficulty, in order to prevent relief being obtained for investments in companies which are clearly failing. **ITA 2007, s.180B**

The company must not be a 51% subsidiary or otherwise be under the control of another company. **ITA 2007, s.185**

In addition the company must only have qualifying subsidiaries, being ones in which 51% or more of the shares are owned by the parent. Where the subsidiary is a property managing subsidiary, at least 90% of the subsidiary must be owned by the parent. **ITA 2007, s.187; ITA 2007, s.191; ITA 2007, s.188**
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 £15 million before the share issue and must not exceed £16 million after the share issue. ITA 2007, s.186

Companies or groups with 250 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. Money used to buy shares or stock in another company is not regarded as having been used for a qualifying business activity. ITA 2007 s.175

Shares may only be eligible for EIS relief where the issuing company has not raised more than £5 million through EIS, SEIS and Venture Capital Trust (VCT) shares in the previous 12 months. 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

### 33.5 Relevant Shares

The shares subscribed for must themselves meet certain conditions.

The shares must be ordinary shares which do not carry preferential rights to assets on winding up. In addition, the shares must not carry preferential rights to dividends, being where the amount and timing of the dividends depends on a decision by the company or where the rights to dividends are cumulative. ITA 2007, s.173

The shares must be issued and subscribed for, for genuine commercial reasons and not for tax avoidance schemes or arrangements. ITA 2007, s.165; ITA 2007, s.178

### 33.6 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 in the period beginning 2 years prior to the issue of the shares and ending 3 years after the issue (or 3 years after commencement of trade if later). 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, or an associate, is an employee of the company. ITA 2007, s.167

The associates here would include spouses, and ancestors or descendants such as parents and children. ITA 2007, s.253
An employee includes a director. However there are special provisions which allow a director of a company to be eligible for EIS relief and thereby to obtain income tax relief on a subscription for shares. A director can obtain relief if:

1. He is an unpaid director in the period 2 years before the share issue and 3 years after the issue (other than receiving reimbursement of reasonable business expenses or rent which does not exceed a reasonable commercial rent); or ITA 2007, s.168

2. He was not connected to the company before the share issue and he becomes a paid director after the share issue but any remuneration he receives is reasonable taking into account the services rendered. ITA 2007, s.169

This second provision enables investors, who would like to make their business expertise available to the company in return for reasonable payment, to become directors without this prejudicing entitlement to income tax relief. These investors are often referred to as “Business Angels”.

Existing directors of the company who are paid remuneration for their services will not therefore receive income tax relief on a subscription for EIS shares.

The above provisions also need to be considered where an associate of the investor is a director.

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 taken into account. ITA 2007, s.170

33.7 Clawback of Relief

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. ITA 2007, s.209

No clawback of relief occurs if the disposal takes place as a result of the individual’s death.

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 the initial rate of relief obtained.

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 clawed back.

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; ITA 2007 s.239
Illustration 1

In December 2012 an investor subscribed for £50,000 of shares in an EIS company. The investor claimed a tax reducer of £15,000 in the tax year 2012/13.

The investor disposes of the shares in June 2015 – i.e. within three years of their issue.

**Explain the consequences on the Income Tax reducer if the disposal was by way of a gift, sale at a profit, or if a loss was made and assume sales proceeds of £40,000 in this circumstance.**

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 2012/13 to clawback the relief of £15,000.

If the shares were sold for £60,000, the Income Tax relief to be withdrawn would again be £15,000. 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 30%**. In this instance, £12,000 will be clawed back.

33.8 **Seed Enterprise Investment Scheme**

Income tax relief will be available where an individual subscribes for shares in a qualifying SEIS company.

Relief is calculated in respect of the lower of the amount subscribed or £100,000, and is given by way of a tax reducer at a flat rate of 50%. Although the amount of investment which qualifies for relief is significantly lower than under the EIS, the rate of relief is higher to help make investments commercially viable for investors. **ITA 2007 s.257AB**

The maximum amount of income tax relief that an individual can obtain under SEIS is therefore £100,000 @ 50% being £50,000. As with EIS, the amount of relief cannot exceed the individual’s tax liability for the year. A claim can also be made to treat the subscriptions as made in the previous tax year provided the limit for relief in the earlier year is not exceeded.

A claim for SEIS relief must be made by the 5th anniversary of 31 January following the end of the tax year in which these shares are issued. The company cannot issue the necessary certificate to enable the investor to claim relief until the trade has been carried on for four months or at least 70% of the money raised has been spent. **ITA 2007 s.257EA**

A disposal of the shares within 3 years will result in a clawback of the relief, exactly as for the EIS. **ITA 2007 s.257ED; ITA 2007 s.257FA**

33.9 **SEIS Conditions**

The SEIS incorporates the same conditions in respect of qualifying shares and qualifying companies as the EIS subject to the following exceptions.
As SEIS focuses on smaller early-stage companies, a qualifying SEIS company cannot have assets of more than £200,000 immediately before the share issue. \( \text{ITA 2007 s.257DI} \)

In addition, the number of full-time equivalent employees must be less than 25 when the relevant shares are issued. \( \text{ITA 2007 s.257DJ} \)

The money raised by the company must be spent on a qualifying business activity within 3 years of the issue of the shares. The qualifying activity must be a new trade which must not be more than 2 years old, regardless of whether the trade was previously carried on by another person. \( \text{ITA 2007 s.257CC; ITA 2007 s.257HF & 257HG} \)

The amount raised by the company by virtue of SEIS investment cannot exceed £150,000. However, this is not an annual limit. The £150,000 cap applies to the total amount raised via SEIS in the three years ending with the date the shares are issued. \( \text{ITA 2007 s.257DL} \)

Finally, the company cannot previously have raised funds through the EIS or Venture Capital Trust schemes. If the company wishes to issue EIS shares in the future, at least 70% of the money raised by SEIS must have been spent before EIS shares are issued. The maximum amount that can be raised under EIS must take into account the amounts raised under SEIS. \( \text{ITA 2007 s.257DK; ITA 2007 s.173B} \)

Having looked at the differences between an EIS company and an SEIS company, there is one important difference to note regarding the actual investor. As with an EIS investment, the individual cannot be connected with the SEIS company.

An individual is connected with the SEIS company if they, or an associate, are an employee during the period beginning with the issue of the shares and ending 3 years later. In addition, the individual or associate cannot own more than 30% of the share capital or voting rights of the company, in the period beginning with incorporation and ending 3 years after the issue of the shares. \( \text{ITA 2007 s.257BA; ITA 2007 s.257BB} \)

However, a director of the SEIS company is not treated as an employee. Therefore an individual is not treated as connected with an SEIS company simply by virtue of being a director.

**33.10 S131 ITA 2007 Election – Use of Capital Losses Against Income**

Under normal rules, a loss on the sale of shares is relieved against capital gains.

However, Section 131 ITA 2007 allows an individual to use qualifying losses in a slightly different way. If a claim is made the capital loss as calculated for capital gains tax purposes, can be deducted in computing the individual's net income, of the current year and/or of the preceding year. \( \text{ITA 2007, s.131} \)

This is very unusual and is the only time when a taxpayer can set a capital loss against income. Section 131 allows a taxpayer to use a loss on shares in much the same way as a trading loss can be used – i.e. in computing net income.

This relief is available on qualifying shares. These are shares on which EIS income tax relief has been claimed or are shares in a qualifying trading company which have been subscribed for by the individual.
In practice, relief will most commonly arise when an individual makes losses on shares which have EIS income tax relief attributable to them. However, if an individual subscribes for shares in an unquoted trading company which meets the conditions for s.131 relief, which broadly means they meet the conditions of qualifying EIS shares, then any loss arising on disposal can be set against net income, even where EIS income tax relief has not been claimed.

As such, any allowable loss on SEIS shares will also qualify for relief under s.131.

33.11 The “Relief Cap”

S.24A ITA 2007 imposes a limit on the amount an individual can claim in a tax year in respect of certain reliefs. This limit is the higher of:

a. 25% of total income for the year; or

b. £50,000.

ITA 2007, s.24A

The relief cap applies to share loss relief claimed under S.131 ITA 2007 but only in situations where the shares do not qualify for either EIS or SEIS relief. Therefore losses on EIS or SEIS shares can be set against income without restriction. ITA 2007, s.24A

The relief cap therefore applies for S.131 purposes but only to shares which do not qualify for EIS or SEIS relief.
EXAMPLES

✈ Example 1

Gary, an employee, had salary and benefits totalling £600,000 in 2015/16. He had no other income.

In March 2016 he subscribed £1,200,000 for shares in a qualifying EIS company.

Calculate his tax reducer for 2015/16.

✈ Example 2

Which of the following trades is not an excluded trade for EIS purposes?

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

✈ Example 3

Alpha-tech Ltd is an unlisted trading company. It has applied for, and received, appropriate designation under the EIS scheme. In January 2016, the following individuals subscribed for shares in Alpha-tech Ltd:

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>% holding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adam</td>
<td>Paid director since 2014</td>
<td>5</td>
</tr>
<tr>
<td>Bill</td>
<td>Employee</td>
<td>5</td>
</tr>
<tr>
<td>Charles</td>
<td>External investor</td>
<td>20</td>
</tr>
<tr>
<td>Danny</td>
<td>External investor (Charles’ brother)</td>
<td>15</td>
</tr>
<tr>
<td>Eddie</td>
<td>Paid director from February 2016</td>
<td>10</td>
</tr>
</tbody>
</table>

The remaining shares are owned by Fred, the Managing Director and founding member.

After subscribing for the shares, Eddie was made a director and receives a reasonable fee for any consultation work.

Which of the above investors will be entitled to income tax relief on their subscription?

- a. None of them
- b. Eddie only
- c. Eddie, Charles & Danny
- d. Adam, Eddie, Charles & Danny
**ANSWERS**

**Answer 1**

| Description                                | Amount  
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Employment income</td>
<td>£600,000</td>
</tr>
<tr>
<td>Less: Personal allowance</td>
<td>-</td>
</tr>
<tr>
<td>Tax</td>
<td>£256,143</td>
</tr>
<tr>
<td>Less: Tax reducer (cannot exceed liability)</td>
<td>-</td>
</tr>
<tr>
<td>Tax liability</td>
<td>Nil</td>
</tr>
</tbody>
</table>

Gary subscribed £1.2 million for shares in a qualifying EIS company.

The maximum tax reducer cannot exceed £1 million × 30% = £300,000. However, the tax reducer cannot exceed the tax liability for the year. This means that the tax reducer for 2015/16 will be £256,143.

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 2014/15, the excess subscription could be carried back to 2014/15 and relieved in this year, provided the limit for 2014/15 is not exceeded.

**Answer 2**

The answer is **A**.

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

**Answer 3**

Adam cannot claim income tax relief as he is an existing director who is paid remuneration.

Bill cannot claim income tax relief as he is an employee.

Charles & Danny are not “associated” under EIS rules. As each holds less than 30% of the ordinary shares, each can claim income tax relief.

Eddie can claim income tax relief because he became a paid director after the share issue and his remuneration is reasonable.

The correct answer is **C** (Eddie, Charles & Danny).