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Enterprise Investment Scheme (EIS)

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The EIS is often viewed as a high risk investment, as you are ultimately investing in unquoted companies. In order to make this type of investment more attractive, there are several tax reliefs available. There is also now a mature market in EIS with several promoters offering lower-risk investments.

The purpose of this note is to provide a brief summary of the tax reliefs available to individuals who invest in qualifying companies under the EIS rules. We have separate guidance available for companies that wish to establish themselves as qualifying entities for EIS.

Brief summary of rules

- An EIS company must be an unquoted trading company (which includes companies on the AIM) at the time the shares are issued to investors and have no intention to cease being unquoted.

- For a period of at least 3 years from the date the shares are issued, the EIS company must remain unquoted and carry on a qualifying trade, wholly or mainly in the UK, and not be under the control of any other company.

- The definition of a qualifying trade is quite extensive, but certain activities (such as most dealing operations, banking, leasing, legal & accounting services) are specifically excluded, as are those which are considered asset backed (such as farming and forestry, property development, hotels and nursing homes).

- The total gross assets of the company must not exceed £7 million immediately before the issue of the shares, nor exceed £8 million immediately after the issue. The limits will be increased from April 2012.

- An investor must not be connected with the EIS company, so you cannot be an employee, director, or have control of more than 30% of the company's capital. However, there are some structures which allow participation.

- Non-UK residents can invest in EIS companies, but the tax reliefs available can only be set against UK tax liabilities.

- Dividends received from EIS companies are taxed in the usual way. Basic rate taxpayers will not have any additional tax to pay on receipt of a dividend, while a higher rate tax taxpayer will have further tax to pay on the net dividend received.

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Tax reliefs

The EIS offers four types of tax relief to investors and these are summarised below:

1. Income tax relief

- Income tax relief is available to individuals in the tax year of investment, subject to certain limits. The minimum investment on which income tax relief is given is £500 and the maximum is £500,000 each tax year (£1m from April 2012). The amount of income tax relief given is limited to the lower of:

  a) 30% of the amount subscribed; or
  b) the investor's tax liability for the year.

- It is possible to acquire EIS shares but not receive any income tax relief, for example, if you subscribe for more than £500,000 EIS shares in a tax year or if you purchase EIS shares rather than subscribe for the shares.
- The main reason for purchasing more than the maximum subscription is due to the EIS deferral relief (see point 3 below).
- The income tax relief can be given either through an adjustment to your PAYE code, or by claiming relief on your Tax Return.
- Although income tax relief is usually given in the tax year of subscription it is possible to carry-back relief to the previous tax year.
- In order to receive the full income tax relief, the EIS shares must be held for at least three years. If the shares are held for less than three years, the income tax relief originally given is usually withdrawn.
- Any income tax relief given will be withdrawn if any value is received by the investor within the three year qualifying holding period, for example, by way of sale of the shares or repayment of loans. Relief is not withdrawn where an investor dies within this three year period.

2. Capital gains tax – Disposal of the EIS shares

- Where the EIS shares are sold at a profit after the qualifying three year ownership period, any gain arising on disposal is exempt from CGT, provided income tax relief has been given (and not withdrawn) on all of the shares *sold.*
- If a loss arises on disposal, this is eligible for offset against other capital gains arising in the year.
- Alternatively, the loss can be set against income in the tax year of disposal, or the preceding tax year, or both if there are sufficient losses.
- Where EIS shares are sold, and no income tax relief has been given on these shares, any gain arising on disposal will be taxable to the extent that the gains, together with any other gains in the year of disposal exceed the CGT annual exemption.

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- These types of loss relief are available irrespective of whether the loss arises within or outside the three year ownership period.

- The value of any loss is calculated by deducting from the sale proceeds, the "net" cost of the EIS investment, being the original cost of the shares less the income tax relief given.

3. Capital gains tax – EIS deferral relief

- By investing in EIS companies, this allows the opportunity for all (or part) of a gain arising on disposal of any asset to be deferred, provided that the disposal is matched with a subscription for EIS shares within one year before and three years after disposal.

- It is not a requirement for income tax relief to have been given in order for EIS deferral relief to apply. As such, it is possible to acquire more than £500,000 EIS shares and still obtain deferral relief.

- The deferral relief is given by deducting the cost of the EIS investment from gains arising on disposal of any asset.

4. Inheritance tax (IHT)

- Where you own shares in an unquoted trading company provided the shares have been unquoted and held for at least two years prior to death, Business Property Relief (BPR) is available to reduce the value of the shares entering your Estate.

- As an EIS company is initially an unquoted trading company, it qualifies for BPR at 100%. The effect of this is that the shares are enter your Estate at market value, but are then reduced to nil for IHT purposes.

- It is possible to make EIS investments in a specifically structured portfolio of companies. This is done to reduce risk, especially in the context of a two year investment that seeks to mitigate IHT.

Process and practicalities

- Investors need to be aware that companies have to satisfy a great many tests to become accepted as EIS qualifying companies and to retain that status.

- It can take some time for the investor to receive a certificate (EIS 3) that then permits the tax reliefs to be claimed.

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