

## TAX EFFICIENT INVESTING UNDER THE SEED ENTERPRISE INVESTMENT SCHEME AND THE ENTERPRISE INVESTMENT SCHEME

This note provides a summary of the tax reliefs which can be obtained by individual investors under SEIS (targeted at small investments in start-up companies) and EIS (allowing for larger sums to be invested, typically in start-up or early-stage companies).

We also include a checklist of some of the key conditions to be satisfied in order to secure such reliefs. This is designed to help the initial process of identifying whether SEIS or EIS reliefs may be available to investors.

Detailed tax advice should be sought before any decisions are taken based on the expected availability of SEIS or EIS reliefs. The note is based on the law in force on 6<sup>th</sup> April 2018.

### TAX RELIEFS AVAILABLE UNDER EIS AND SEIS

Income tax relief for amount subscribed for new shares	
SEIS	EIS
50% relief (£100,000 annual limit on investment for investor).	30% income tax relief. £1m annual limit on investment for investor. For shares issued on or after a date to be appointed (expected to be 6.4.2018) the limit rises to £2m, provided at least £1m is invested in knowledge intensive companies (requiring a substantial R&D element).
Relief for the tax year in which the shares are issued; or investor can claim to carry back to previous year (subject to annual limit rules).	Tax year in which relief is available: same as for SEIS.

Capital gains tax relief (on sale of shares)
<b>SEIS &amp; EIS</b>
CGT exemption on sale of shares if investment qualified for income tax relief and if shares have been owned for 3 years after the issue of shares or commencement of trading, if later.

Capital gains tax "reinvestment relief"	
SEIS	EIS
Tax exemption for gains realised on disposal of other assets in the tax year in which the SEIS shares are issued, limited to 50% of the amount eligible for SEIS relief on an investment in that tax year (so up to £50,000 of gains can be exempt).	CGT deferral for gains realised on the disposal of other assets if the gains are reinvested in EIS shares within the permitted period: <ul style="list-style-type: none"> <li>• The permitted period is the period starting one year before and ending three years after the disposal in question</li> <li>• Deferral only: the tax deferred crystallises on a sale of the EIS shares.</li> </ul>

## INVESTOR'S NET EXPOSURE AFTER TAX RELIEF

If the investor loses the whole of his or her investment (e.g. due to the investee company going into insolvent liquidation) the resultant net loss, after taking into account the benefit of SEIS/EIS reliefs and income tax loss relief available on the occasion of the liquidation, could be:

- SEIS: a 27.50p in the £ net loss, or, if the investment also secured a saving of CGT at the rate of 20% on a disposal made in that same year, the net loss could be at 17.5p in the £ (13.5p if a 28% CGT rate is applied).
- EIS: a 38.50p in the £ net loss.

The above figures will depend on the circumstances of the particular case and include assumptions that the investor pays income tax at the top rate in the year of the loss and that top rate is 45%.

## SOME KEY CONDITIONS

There follows an outline of some of the key conditions to be satisfied to secure SEIS or EIS tax reliefs. The list is far from comprehensive. There are also rules which can result in tax reliefs which were properly obtained being lost due to events which take place after the investment was made. This note does not include information about such rules.

It is common practice to seek a ruling from HMRC that the circumstances of the investee company are such that it is eligible to issue shares which can attract SEIS or EIS relief. Full information must be provided about the company and the investment proposals in order to secure a robust ruling.

Age of company/business	
SEIS	EIS
Shares must be issued within 2 years of commencement of trade. The company must not have carried on any other trade before it starts the relevant qualifying trade.	First risk finance funds must usually be raised within 7 years after first commercial sale. For "knowledge intensive companies" the period is 10 years after turnover exceeds £200,000 (expected to apply for shares issued on or after 6.4.2018).

Size of company	
SEIS	EIS
The company/group must have fewer than 25 employees	The company/group must have fewer than 250 employees
The company's/group's balance sheet gross assets must not exceed £200,000	The company's/group's balance sheet gross assets must not exceed £15m before the investment and £16m after the investment.

Risk to capital condition
SEIS & EIS
The company must have objectives to grow and develop the trade in the long-term; and There must be a significant risk that there will be a loss of capital for the investors of an amount greater than the net return (allowing for the benefit of tax relief).

Limit on size of total investment	
SEIS	EIS
<p>£150,000 limit.</p> <p>Company must have had no previous venture capital investments (and must not have an EIS issue on the same day as the SEIS issue).</p>	<p>£5m (£10m for knowledge intensive companies - expected to apply to shares issued on or after 6.4.2018) annual limit on total investments that a company can secure benefiting from venture capital tax reliefs and £12m overall (not annual) limit (£20m for knowledge intensive companies).</p>

Method of investing
SEIS & EIS
Unquoted ordinary share capital (widely defined) without preferential rights as to dividends or capital on a winding up and no rights to be redeemed.

Types of shares to be used*
SEIS & EIS
Subscribing for new shares with cash payable in full on issue - no deferred/installment payments of purchase price.

The investor* (not relevant in the case of CGT reinvestment relief)	
SEIS	EIS
The investor must not own more than 30% of the share capital/ have rights to more than 30% of assets in winding up at any time after incorporation (interests of "associates" to be included for this purpose).	The investor must not own more than 30% of the share capital/ have rights to more than 30% of assets in winding. In addition the investor must not have owned any shares before the EIS investment but exceptions apply for cases where those shares qualified for SEIS or EIS (and for subscriber shares).
Must not, at or after the time of investment, be employed by the investee company unless also a director.	Must not be employed by the investee company or be a paid (pre-investment) director (including in the period of two years before the investment). There are exceptions where the investor has previously made a SEIS or EIS investment in the company.

Trading requirements
SEIS & EIS
Company/group must be trading or preparing to trade.
Activities must not consist to a substantial extent (20% +) of non-trading activities or excluded trades - see appendix to this note for list of excluded trades.

Company - other requirements*
<b>SEIS &amp; EIS</b>
The company must not be a subsidiary/under the control of another company
The company must not "control" any other company other than a "qualifying subsidiary" (as defined - requiring ownership of more than 50% of the shares).
The company must have a UK permanent establishment.
The company issuing the shares must not be in financial difficulties in accordance with European Community Guidelines for State Aid.

Application of money invested	
SEIS	EIS
The money must be raised for <b>qualifying business activities</b> and must be spent on those activities within three years.	Investment must be made with the intention to grow and develop the business (not generally to cover pre-existing day-to-day expenses). Cannot use the funds to buy shares or a business. The shares must be issued to raise money for the purpose of a <b>qualifying business activity</b> . The money invested must be employed wholly for the <b>qualifying business activity</b> within two years of the issues of the shares or, if later, within two years of commencement of the <b>qualifying business activity</b> .
<b>Qualifying business activities</b> are defined as carrying on or preparing to carry on a new qualifying trade, or carrying on R&D (narrowly defined) from which a new qualifying trade will be developed (or which could benefit a new qualifying trade).	<b>Qualifying business activities</b> - same definition as for SEIS.

Claiming the relief	
SEIS	EIS
Relief must be claimed until 70% of the money raised has been spent on qualifying activities.	Relief cannot be claimed until the company has traded for 4 months (no relief if the company never gets beyond the stage of preparing to trade).
The company then has to provide appropriate certification to investors (and the company must first file a compliance statement with HMRC and receive authority to issue certificates to investors).	Similar certification procedure as with SEIS.

\*These requirements must continue to be satisfied for the 3 year period after the issue of the shares or, in the case only of EIS, for 3 years from starting to trade (if not trading at the date of issue).

## SOME TRAPS FOR THE UNWARY

The legislation has numerous detailed conditions, including anti-avoidance provisions designed in part to seek to ensure that the investor is not sheltered from normal investment risks. For example, put and call option arrangements relating to an investor's shares are prohibited as are a host of other arrangements which fall within rules designed to prevent "pre-arranged exits" (including arrangements for the disposal of the investee company's assets).

There are many ways in which failure to pay attention to the details of the legislation can result in failure to secure relief. Some examples of situations in which problems can be encountered are as follows:

- Where an investor provides temporary loan funding before the subscription for shares and where that funding is repaid as part of the share subscription arrangements. The arrangements for the provision of funds for the share subscription must also be carefully handled and documented to avoid this problem.
- Where the shares are not paid for in cash in full at the time of issue – no deferred or installment payments are permitted.
- The shares must be "issued" in order for relief to be claimed. To be issued the proper corporate formalities must be undertaken up to and including registration of the investors as shareholders in the register of members.
- Investors may require that management shares are subject to bad-leaver provisions. Care must be taken as to how the bad leaver arrangements are structured to avoid the SEIS or EIS shares being treated as having preferential rights (e.g. where the management shares convert to deferred shares in a bad leaver situation).
- If a start-up company is securing SEIS and EIS funding at the same time the SEIS funding must be completed on a day before the EIS funding.
- Where the investee group includes companies or businesses which have previously been acquired from third parties specific points need to be checked. In certain circumstances risk finance funding secured by such companies or businesses before they joined the investee group may count towards the limits on how much can be raised under EIS; and the period of trading of the business before being acquired by the investee group may count towards the EIS 7 year rule referred to above.
- It is sometimes possible for founder shareholders to claim SEIS or EIS relief in relation to a subsequent provision of share capital funding by the founders. However, great care must be taken to ensure that the founder does not fail to satisfy the requirements relating to investors summarised in the table above. This needs to be carefully planned before the company issues any shares (other than the initial subscriber shares issued on formation) and before it undertakes any activity (including activities preparatory to starting business).
- Relief can be lost to the extent that conditions fail to be satisfied after the investment has been made (typically in the three year period after the issue of the shares or after commencement of trade, if later).
- Relief can be lost where investors receive "value" (broadly defined) from the company in the three year period mentioned above or in the 12 month period before the share issue. Problems can be encountered under this rule where a founder (who will be investing and looking to claim SEIS or EIS relief) has incurred expense on behalf of the company pre-incorporation and wishes to be reimbursed.

## APPENDIX - LIST OF EXCLUDED TRADES

- Dealing in land, commodities or futures, or in shares, securities or other financial instruments;
- dealing in goods otherwise than in an ordinary trade of wholesale or retail distribution;
- banking, insurance or any other financial activities;
- leasing or letting or receiving royalties or licence fees, other than from self-created intangible assets;
- providing legal or accountancy services;
- property development;
- farming or market gardening;
- holding, managing or occupying woodlands, any other forestry activities or timber production;
- shipbuilding;
- producing coal;
- producing steel;
- operating or managing hotels or comparable establishments or managing properties used as a hotel or comparable establishment;
- operating or managing nursing homes or residential care homes or managing properties used as such;
- any trade which consists of generating or exporting electricity for which feed-in-tariffs are obtained;
- any company which benefits from Department of Energy and Climate Change renewables obligation certificates and/or the renewable heat incentive scheme;
- for shares issued on or after 6 April 2016, energy generation activities (including the production of gas or other fuel); or
- providing services or facilities for any trade which consists to a substantial extent of the activities listed above and carried on by another person (other than a parent company) where one person has a controlling interest in both trades.

## FURTHER ADVICE

We can assist in providing advice on the application of the details rules to the facts of any particular case and in preparing pre-investment applications for rulings as to the qualifying status of the investee company.



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