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News letter
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Enterprise Investment Schemes

What are Enterprise Investment Schemes?

The Enterprise Investment Scheme (EIS) is a government initiative designed to encourage individuals to invest in smaller private companies. To achieve this, the Government offers EIS investors a range of tax reliefs. The tax advantages available from an EIS investment provide investors with a significant head start in comparison to more traditional investment products. Providing the underlying investments made by the EIS are held for at least three years, there are five separate tax advantages:

1. 30% upfront income tax relief
2. 100% inheritance tax relief after two years (provided the investments are held at time of death)
3. 100% capital gains tax deferral for the life of the investment
4. Tax-free growth
5. Loss relief

Further information on all of these is available later in this summary. Please note, tax treatment will depend on individual circumstances and may change in the future.

The tax reliefs are available to investors who directly invest into EIS qualifying companies.
In order for a company to qualify for EIS relief it must be unquoted or quoted on the Alternative Investments Market (AIM) or the PLUS markets. There are also a lot of trades that are excluded - these tend to be those that look like financial services or are property based. So, dealing in shares, securities, futures, commodities or other financial instruments would be excluded. Likewise dealing in land, operation of hotels or nursing homes, farming and forestry enterprises are all excluded.

A summary of the qualification criteria is provided below:

- The investment must be into new shares (therefore an investor canôt simply buy existing shares)
- The company is an unquoted company at the time the shares are issued
- The company is not controlled by another company
- The company has fewer than 250 employees
- The company has gross assets that do not exceed £15million before investment, or £16 million after investment
- The investee company uses the money raised within 24 months
- Any investment of EIS (or VCT) funds does not exceed more than £5 million in any one company in any one year.

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TAX ADVANTAGE 1: INCOME TAX RELIEF

30% income tax relief is granted on qualifying investments made, up to a maximum of £1 million for the 2013/14 tax year and £1 million if carried back to the 2012/13 tax year. In order to retain this relief the investment must be held for at least three years.
The tax relief is generated as and when the money is employed by the qualifying companies.

TAX ADVANTAGE 2: 100% INHERITANCE TAX RELIEF AFTER TWO YEARS

Provided funds remain deployed in the underlying trades, the investments should be eligible for Business Property Relief (BPR). Investments which qualify for BPR are excluded from an investorȩs estate for Inheritance Tax purposes, if held for a minimum of two years (and at time of death). This two year period applies from the date the money is invested into qualifying companies.

TAX ADVANTAGE 3: CAPITAL GAINS TAX DEFERRAL

If youȩve made a capital gain that is taxable, it can be invested into EIS shares and the capital gain will be deferred for the life of the investment.
You should note that :

- Capital gains tax deferral will apply as and when the investments into qualifying companies are made.
- The gain must be invested into qualifying companies within three years from the date that it was realised (i.e. you can even reclaim tax you have already paid)
- If you die while your money is invested, the tax due on your capital gain will die with you.

TAX ADVANTAGE 4: TAX FREE GROWTH

Where gains arise from holdings within the portfolio there is no capital gains tax.

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TAX ADVANTAGE 5: LOSS RELIEF

Loss relief is one of the most compelling features of an EIS because the impact of losses at an individual company level is reduced. This loss relief significantly improves the overall post-tax risk/return profile of the investment.

For most investments the tax man gives with one hand and takes with the other. So when normal shares fall in value investors have an allowable loss, but then they face capital gains tax (CGT) when they go up in value. Some specific investment types (such as ISAs or VCTs) are free from CGT when they go up in value, but understandably there is no tax relief if they go down in value. Both situations seem consistent.

EIS, however, is different. Gains are not taxed, but losses attract relief. Each individual holding is assessed separately for loss relief. This means that any holding that has fallen in value at the time of sale will qualify for loss relief, irrespective of the overall portfolio performance. Even if only one holding within a portfolio of ten investments falls in value, investors are entitled to loss relief on that one holding.

Whatôs more, investors can choose whether that relief is set against other gains (then or in the future) or against income tax in that year (or for the year before). So they get to decide which use of the relief would be most beneficial to them, potentially recovering up to 50% income tax if an investor pays it at that rate.

EIS products can usually be separated into three different types :

1. Single company EIS
2. EIS portfolios
3. Approved EIS funds

Single Company EIS

A single company EIS is often the highest risk as it invests in one individual company. An investorôs fortunes will depend upon the performance of that one underlying company. Usually unlisted, there will often be no exit route until the company is either floated or sold.

EIS portfolio (or Unapproved EIS Funds)

An EIS portfolio is generally a managed service that invests in a number of underlying single EIS investments - often up to 20 different companies. It will be professionally managed, normally on a discretionary basis, and EIS relief is available as each individual investment is made and not when the money is placed into the portfolio service.

It is Important to note, whilst the tax regulations refer to Enterprise Investment Schemes as ñFundsò they should not be confused with mutual funds or collective investment schemes. An investor in an EIS fund will be the beneficial owner of shares in the underlying companies, rather than owning shares or units in the fund.

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Approved EIS fund

An approved fund will have four or more different underlying companies. Clearance is received from HMRC prior to the fund launch. This has no bearing on the underlying investments, however it means the income tax relief is given in the tax year the fund closes. CGT deferral is not available until the manager has made the underlying investments. An approved fund has a requirement to invest 90% of funds raised within 12 months of when the fund closes to new business.

Generally, EIS investments are classified as high risk investments. However, recently a number of EIS investment managers have launched EIS products that are focused on investing into businesses focused on capital preservation. Typically these may include the following characteristics:

- The use of insurance to reduce risk
- Substantial backing with easily valued assets
- Predictable (bankable) revenue streams
- Creation of intellectual property of known value
- 100% owned by investors with lower risk appetite
- Fund manager remuneration aligned with capital preservation

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Questions

Q: Who would find an EIS investment useful?

This investment may be suitable for investors who are looking to:

- Take advantage of income tax relief
- Defer payment of capital gains tax
- Shelter investments from inheritance tax
- Harness the potential for significant tax free capital growth in today's financial markets
- Diversify their existing investment portfolio
- Find a complementary solution to pensions

Q. What should I consider when choosing a EIS?

Always consult a financial adviser if unsure of where to invest

- Decide how much risk you want to take. All EIS investments have risk attached but some EIS offerings target companies with a focus on capital preservation
- Understand what the manager is going to invest in and the investment process involved
- The experience of the manager in investing in smaller companies is very important
- Consider the charges and compare with other EIS investments

Q. Who is eligible to invest ?

Any UK taxpayer is eligible for the tax breaks. The initial tax relief is limited to the amount of tax the individual pays

Q. What are the risks?

As with any stock market investment there are risks attached:

- Rates of tax, tax benefits and allowances may change from time to time and are not guaranteed
- Tax treatment is dependent on individual circumstances and may be subject to change in the future
- Past performance is not a guide to future performance and may not be repeated
- The value of shares can go down as well as up and you may not get back the full amount invested
- You should consider an EIS as a long-term investment
- An investment in an EIS will be higher risk than investing in securities listed on the London Stock Exchange official list

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Q. When can I sell ?

EIS investments will be in companies which are not readily realisable investments.
You should be prepared to retain an EIS investment for at least three years or you will lose any initial reliefs claimed.
Once the company in which you are invested has been trading for at least three years, the following options may become available to you to realise your investment at a later date:

- Disposal of your shares to a third party or back to the company
- Management buyout
- Trade sale
- Liquidation of the company on a winding up

Q. How do I invest and receive the tax breaks?

The relevant date for income tax relief, from a tax year perspective, is the date on which investments are made into each qualifying company, rather than the date on which you invest into an EIS fund or portfolio service.
The exception is an Approved EIS Fund where the start date is the date the fund closes.

You cannot claim tax relief until the company sends you a form - called an EIS3. If you invest through an Approved EIS Fund you will receive a different form - an EIS5.

Your claim can be made via your self assessment tax return for the tax year in which the shares were issued. If the shares were issued in a previous year, and/or if the claim is for capital gains deferral relief, the claim part of the form EIS3 must also be completed and sent to your tax office.

If you have an EIS3 that would allow you to claim income tax relief in the current tax year, you can request a change to your PAYE tax code, or an adjustment to any self assessment payment on account due. You will still have to make the claim itself on your tax return when you obtain it. Full use of these tax advantages will depend on individual circumstances and if youꞌre unsure of your own potential tax liabilities, you should seek professional advice from a qualified tax adviser. Please remember that tax rules and regulations are subject to change.

At Seven Financial we are here to help.
Please contact the team.