EIS traps and opportunities

The Enterprise Investment Scheme (EIS) is one of those schemes the Government just can't leave alone. It was born in 1994 out of the ashes of BES and has been messed with on an almost annual basis since. These frequent changes have left many tax practitioners confused about the benefits that EIS can bring. It helps to remember that EIS is actually a graft of a CGT deferral relief on to the root stock of an investment based Income Tax relief with a CGT off-shoot, but both root and branch retain their own rules.

This article concentrates on EIS investments made after 6 March 2001. As the space constrains discussion of all the relevant conditions for these points the authors recommend that a detailed study of the Revenue Inspector's and Capital Gains manuals should be made before embarking on any EIS scheme.

The bare necessities

Individuals subscribe in cash for ordinary shares under the scheme and do not withdraw their investment for at least three years. The company must be unquoted and trading wholly or mainly in the UK, but the trade must not involve to any substantial extent any activities on the list in ICTA 1988, s. 297(2). The company's gross assets before the investment must be no more than £15 million.

Opportunities:

The company

The benefit for the company that issues EIS shares is clearly the cash injection coupled with a reasonably dedicated group of investors who are tied in for at least three years. The EIS company can even become listed on a recognised stock exchange within three years of the EIS share issue without losing the tax relief. This can provide a useful exit route for EIS investors where there would normally be no market for the shares.

The investor

The income tax relief at 20% can be given on up to £150,000 EIS shares subscribed for in any one tax year. However an investor can subscribe for an unlimited amount of EIS shares and defer tax on an unlimited amount of capital gains made in a period up to 12 months before the investment and three years afterwards. The EIS shares that attract income tax relief are also free of capital gains tax if held for three years. If the business fails and the shares become worthless, the investor relief the loss against his other income under ICTA 1988, s. 574,

Although the income tax relief is an attraction for some investors, the main draw for people who are prepared to sink serious money into what may be quite a risky business is generally the capital gains tax deferral. The investor seeking CGT deferral can be connected with the EIS company, but income tax relief is denied to all connected parties and their associates.

Inheritance tax relief is also available, as any holding of unquoted EIS shares will qualify for Business Property Relief (BPR) under IHTA 1984, s 106. An entrepreneur

who has sold his own unquoted company to an unconnected party can avoid the loss of BPR by investing the entire proceeds in new EIS shares. The two year qualifying holding period for BPR will deem to continue unbroken, as the EIS shares will be treated as a replacing the original shares under IHTA 1984, s. 107(1).

Traps:

Employees and Directors
The Enterprise Investment Scheme works best for brand new businesses. Individuals who are connected with the company cannot receive income tax relief on any EIS shares they subscribe for. Employees are regarded as connected, as are Directors if they receive any Director's remuneration before the EIS shares are issued, (ICTA 1988, ss. 291, 291A). Investors may however act as Directors and receive a commercial level of remuneration for periods worked after the EIS shares have been issued.

Associates
When a group of people come together to start a new business it is usually because they already know each other and may well be related. EIS income tax relief cannot be given to an investor who together with his associates controls or has an entitlement to more than 30% of the company's ordinary share capital, voting power or assets on a winding up. An individual's associates are his direct blood relatives vertically in line in succeeding and previous generations plus his spouse, business partners and trustees of any settlement he is a settlor of. Thus four brothers can each subscribe for 25% of the shares of an EIS company and receive income tax relief, but if the shares were held equally by two of the brothers and their spouses EIS income tax relief would be denied.

Trade
Before issuing any EIS shares the company should seek an informal clearance from the Inland Revenue Small Companies Enterprise Centre that the share issue will qualify under the scheme. The description of the company's intended trade is vital for this clearance as it must be crystal clear to the Inspector that 80% or more of the trade is not comprised of activities listed in ICTA 1988, s. 297(2). For example any licence or royalty fees charged must be for copyright or patents created by the EIS company and not for products bought in and included in its own products.

Loans from Investors
An investor may make a loan to the EIS company to cover expenses incurred before the EIS shares are issued. If that loan is repaid before the third anniversary of the EIS share issue or the commencement of the trade if later, the repayment will constitute a 'return of value' and the investor's income tax relief will be reduced by the amount repaid. In addition any capital gains tax deferred will become immediately chargeable.

Ceasing to trade
If the EIS company ceases trading before the third anniversary of the EIS share issue the conditions for the tax relief are broken. The income tax relief is lost for the year the investment was made, but any capital gains tax deferred becomes chargeable in the year the relief conditions are broken. Thus some CGT deferral is still achieved.

These are only a few of the traps ready to snare EIS investors and their advisers, so proceed with care.