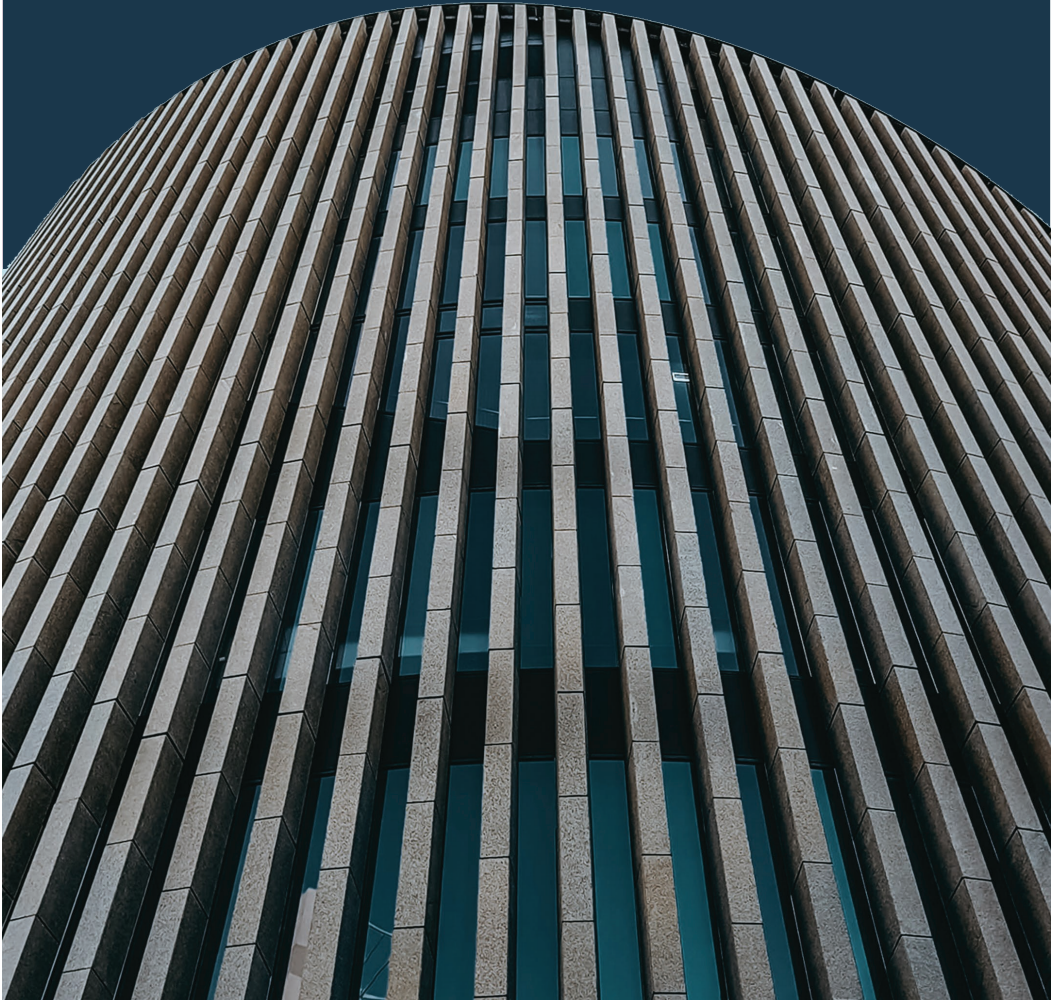


Enterprise Investment Scheme (EIS)

November 2024

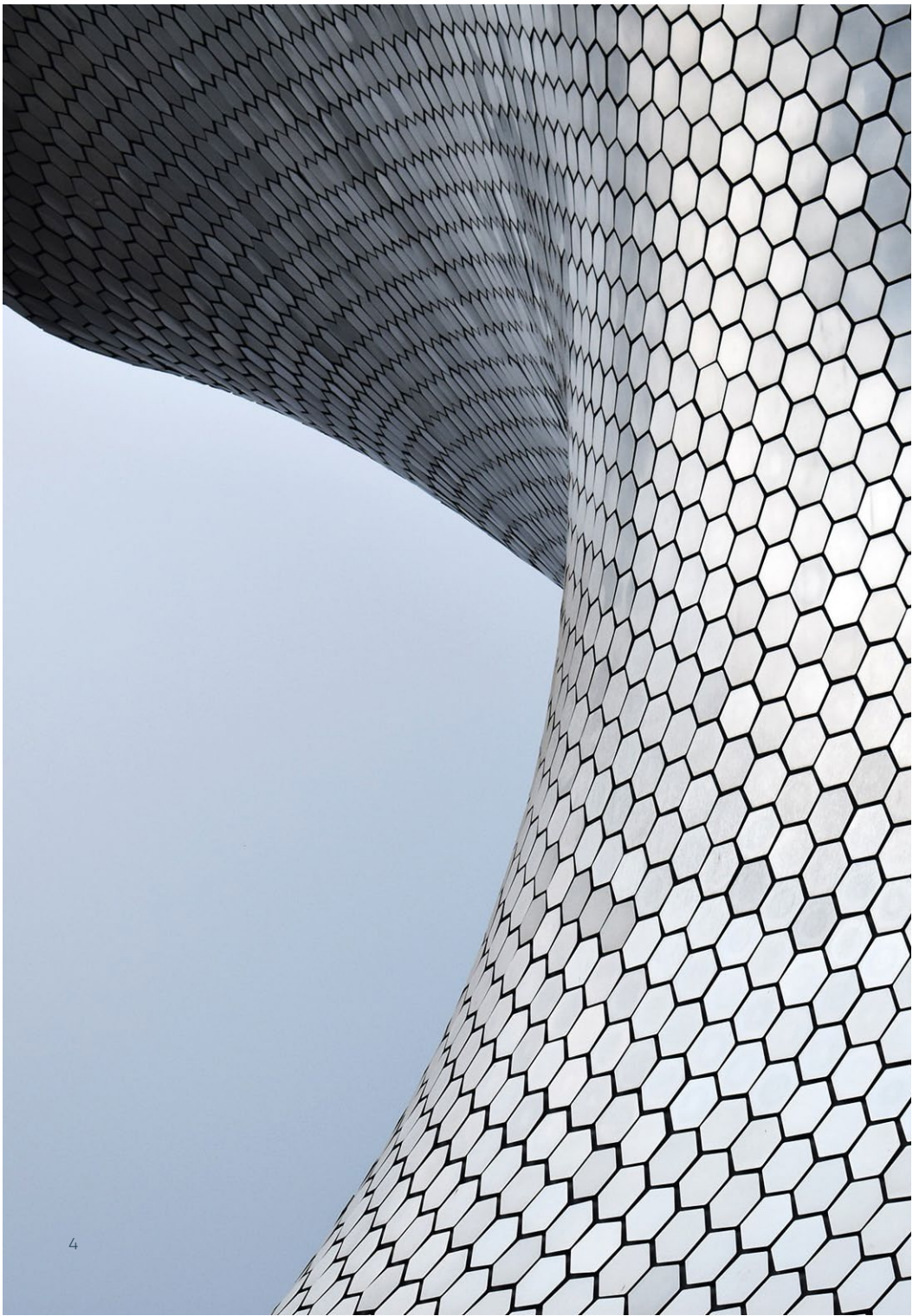


The EIS offers tax incentives to individuals investing in small and medium-sized trading companies. The purpose of the scheme is to help those companies which might otherwise struggle to raise finance.

This note covers the basics of how the scheme works, what tax relief is available and who can qualify for the scheme. It reflects the law and practice as applicable at November 2024.

Contents

- 5** **How does the scheme work?**
- 6** **How long do the shares have to be held for?**
- 7** **Are there restrictions on who can be a qualifying investor?**
- 8** **Which companies qualify for EIS?**
- 10** **What investments qualify for EIS?**
- 12** **EIS funds**
- 14** **Key contacts**



How does the scheme work?

The scheme provides income tax and capital gains tax reliefs for individual investors who subscribe in cash for ordinary shares in qualifying companies.

Income tax

An investor who qualifies for the relief can claim an income tax reduction equal to 30% of the money subscribed. The relief is subject to an annual subscription limit of £1 million (£2 million for investments in 'knowledge intensive companies', discussed later in this note). This gives a maximum income tax reduction per tax year of £300,000 for most investors (£600,000 for investors in 'knowledge intensive companies').

Capital gains tax

Provided the shares have been held for the requisite period of time (which is discussed later in this note), any gain made by the investor on a disposal of EIS qualifying shares is exempt from capital gains tax.

There are also special rules which allow losses incurred on the disposal of EIS qualifying shares to be set against an investor's income tax liability (net of income tax relief at investment).

For example

If an investor subscribes £50,000 for shares and claims EIS relief, they can deduct £15,000 from their income tax liability for the tax year (although EIS relief can only be used to the extent that they have an income tax liability, it cannot create a loss or a repayment of tax).

This income tax relief can be 'carried back' in whole or part to the previous tax year, subject to the same investment limit for that year, to 'accelerate' relief for the taxpayer.

How long do the shares have to be held for?

To benefit from full income tax relief on acquisition and capital gains tax exemption on disposal, EIS shares must be (broadly) held for at least three years after the date of their issue. If an investor disposes of EIS shares within three years of their issue, then the EIS income tax relief is withdrawn by reference to the proceeds that the investor receives.

The effect of this is that, if an investor sells their EIS qualifying shares within three years of their issue for an amount equal to or greater than the money subscribed for them, the investor's EIS relief would be fully withdrawn.

In addition, if an investor sells their EIS qualifying shares within three years of issue, then any gain ceases to be exempt from capital gains tax.



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Are there restrictions on who can be a qualifying investor?

As the purpose of the scheme is to incentivise external investment in high risk trading companies, the scheme is not generally available to directors and employees of those companies.

However, in recognition of the fact that companies qualifying for EIS can often benefit from the business experience of their investors, there are some exceptions for existing directors who do not receive salary from the company and new directors (e.g. angel directors) who have not prior to their investment been involved in the company's trade. Complex rules apply to these exceptions.

Investors must be 'independent' from the company at the time of their first EIS, Seed Enterprise Investment Scheme (SEIS) or share issue (excluding founder shares). This effectively means that any external investor seeking EIS relief must either have no existing shareholding or have obtained SEIS or EIS relief in relation to any existing holding.

There are also limits on the size of shareholding that an investor can take. EIS relief is not available to investors that hold (directly or indirectly) more than 30% of the company's ordinary share capital or voting rights.

Which companies qualify for EIS?

The scheme is only available to companies which meet certain qualifying conditions. The purpose of these conditions is to restrict the scope of the scheme to those companies which may otherwise struggle to secure financing.

Some of the conditions are more generous if the company is a 'knowledge intensive company'. Broadly, 'knowledge intensive companies' are companies for which R&D spend constitutes a specified proportion (or greater) of their total operating costs and for which either (i) the majority of their business will involve exploiting IP generated within the business or (ii) 20% or more of their workforce has a higher education qualification and is directly involved in R&D activities.

The conditions include:

- The company must have a UK permanent establishment (i.e. it need not be a UK company issuing the shares).
- The company must carry on a qualifying trade on a commercial basis. Companies carrying on certain excluded activities, including (amongst others) dealing in land, property development and banking, are not eligible for the scheme.
- The company must not be listed on a recognised stock exchange (although a company quoted on the Alternative Investment Market can continue to qualify for the scheme).
- The company must not be controlled by another company.
- The company must have gross assets of no more than £15 million before the investment and £16 million immediately after the investment.

- The company must have fewer than 250 full time employees (or fewer than 500 employees for knowledge intensive companies).
- The company must be less than 7 years old (10 years old for 'knowledge intensive companies', unless they make an election for the deadline to run from their annual turnover reaching £200,000) when receiving their first EIS investment (unless the investment will lead to a substantial change in the company's activity).

In addition, companies can only raise a maximum of £5 million (or £10 million for knowledge intensive companies) in aggregate under the EIS, the Seed Enterprise Investment Scheme ("SEIS"), the Venture Capital Trust Scheme (a separate scheme which provides tax benefits for indirect investment in small trading companies through a form of fund known as a Venture Capital Trust) and certain other State aid

investments on a rolling 12 month basis. When testing the relevant threshold it may also be necessary to take into account investments within these categories into certain other companies, including companies acquired by the company now issuing EIS shares and companies that have sold business assets to the company now issuing EIS shares.

In addition to this annual cap, there is a £12 million lifetime cap on total investment received under the tax-advantaged venture capital schemes (increased to £20 million for 'knowledge intensive companies').

Although EIS is generally available only in relation to issues of ordinary shares, shares carrying certain limited preferential rights (not including preferential rights to assets on a winding up, cumulative dividends or dividends where the amount or timing of the dividend depends on a decision of the company or another person) may qualify for EIS.

What investments qualify for EIS?

Investments made under the scheme must be made with the intention to grow and develop a business and cannot be used to fund business acquisitions.

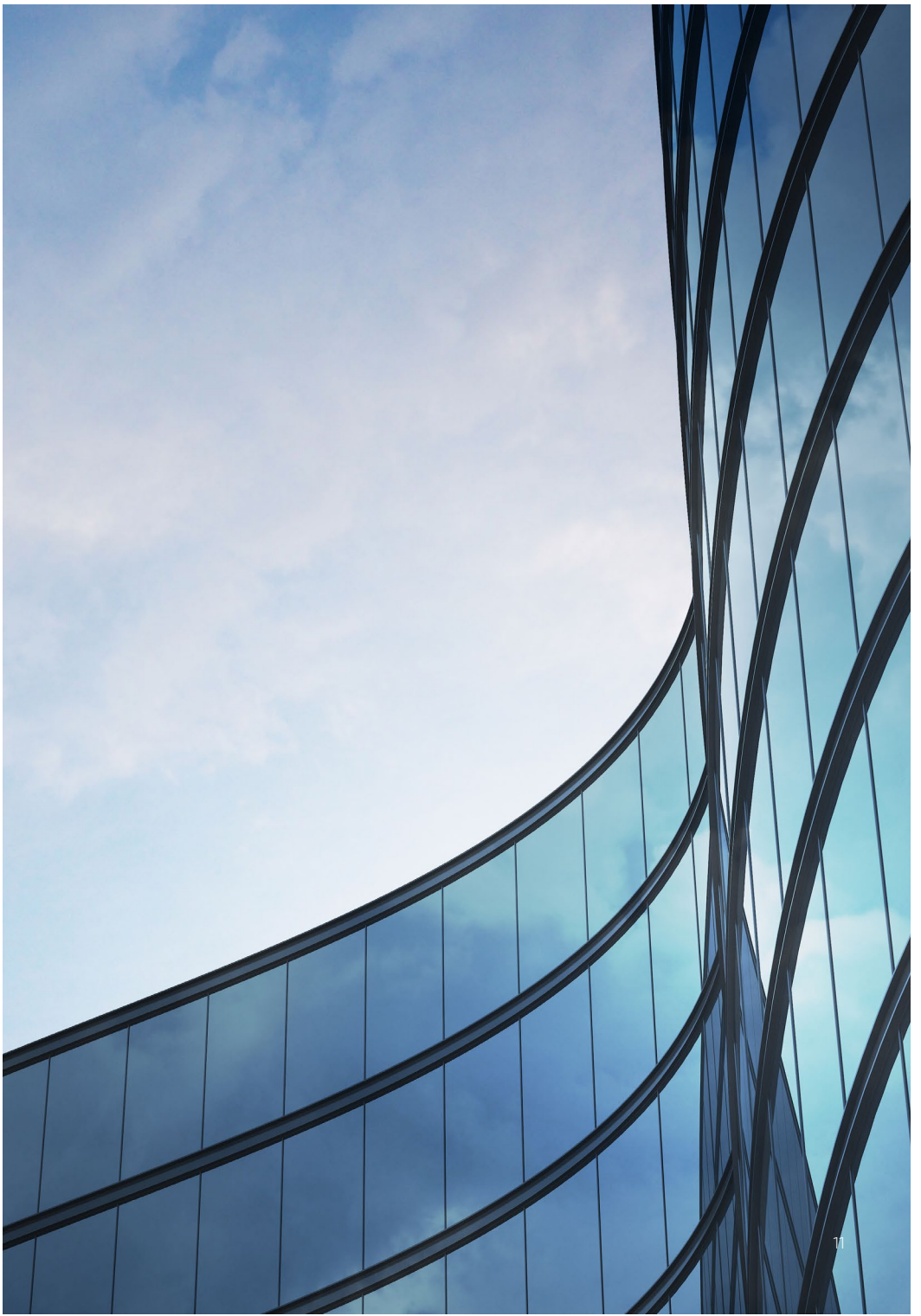
In addition, to qualify for the relief, there must be a “risk to capital” in making the investment.

This requires that (broadly):

- the company in which the investment is made has objectives to grow and develop over the long term; and
- the investment should carry a real risk that the investor will lose more capital than they are likely to gain from a combination of income from dividends, interest and fees, capital growth and upfront tax relief. HMRC will decide whether an investor’s capital is at risk by looking at the company’s financial position, but if any arrangements have been put in place to reduce an investor’s risk (such as that investor receiving priority over other investors in payment waterfalls) these are likely to exclude that investor from the EIS scheme.

A ‘no disqualifying arrangements’ anti-avoidance rule applies to issues of EIS shares. The rule excludes any arrangement from qualifying for relief if it is entered into with the purpose of ensuring that the relevant tax relief is available AND either, (a) all or most of the monies raised are to be paid for the benefit of a party to that arrangement, or, (b) it would be reasonable to expect that, absent the arrangement, the business would be carried on as part of another business. In the latter case, this means that a structure to separate part of an existing business (that would not qualify) so that investment into that part, taken alone, can qualify for relief is no longer effective.

Joint SEIS/EIS funding rounds are possible (although care must be taken to ensure separation of the SEIS and EIS share issues and receipt of monies by the company).



EIS funds

As well as making investments directly in EIS-qualifying companies, it is also possible for investors to qualify for EIS relief by subscribing in an approved EIS fund structure for approved knowledge intensive funds. Under this structure:

- A fund must be established for the purpose of investing wholly (or substantially wholly) in shares in knowledge intensive companies and meet certain other requirements set out in HMRC guidelines.
- A fund must invest in at least four companies, with no more than 50% of the fund capital invested in any one company.
- A minimum of 80% of an individual's investment in the fund must be invested in knowledge intensive companies.
- Funds must invest at least 50% of capital in the first 12 months and at least 90% of capital in the first 24 months.
- Investors are allowed to set their relief against income tax liabilities in the tax year before the one in which the fund closes (if shares are issued in the same tax year as that in which the fund closes).



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