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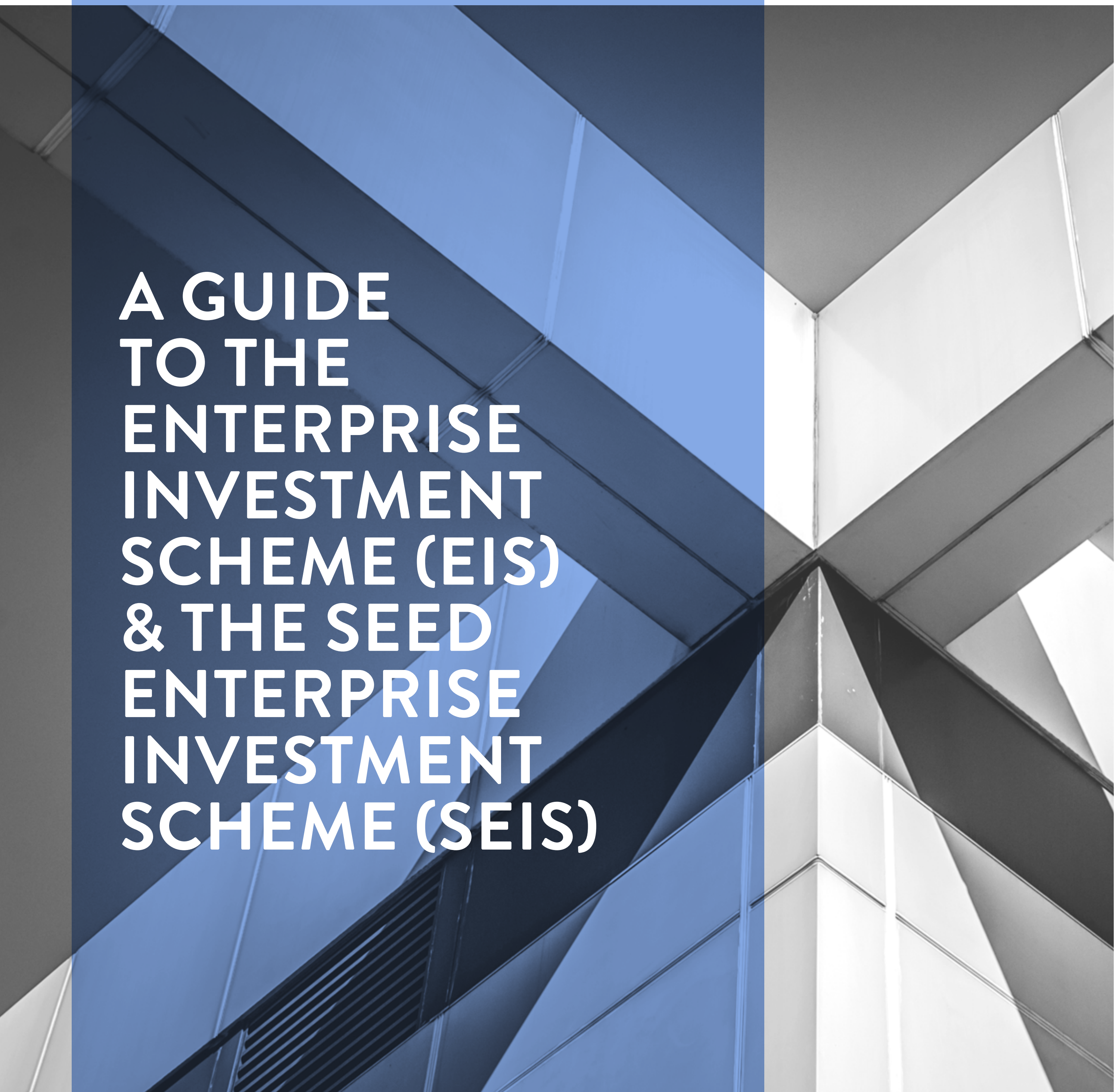

# A GUIDE TO THE ENTERPRISE INVESTMENT SCHEME (EIS) & THE SEED ENTERPRISE INVESTMENT SCHEME (SEIS)

PRODUCED IN ASSOCIATION WITH THE
ENTERPRISE INVESTMENT SCHEME ASSOCIATION (EISA)

FinOptix

2019 / 2020 TAX YEAR

# Contents

# Foreword

Can you tell me a Government backed investment scheme that has lasted over 25 years, has 5 generous tax reliefs, raised over £20bn and helped over 29,000 businesses? That EIS has not only survived notoriously fickle Governments during that time but has gone on to help some of Britain's biggest and brightest companies get started is a testament to EIS's importance in the equity funding landscape for SMEs.

More recently, with the Chancellor reiterating that SMEs "are the champions of small businesses and the entrepreneur", it seems more and more people are slowly coming to realise what we in the EIS industry have known for years - that SMEs and entrepreneurs are the lifeblood of the UK economy.

There is clear evidence that young and innovative enterprises contribute substantially to economic growth and job creation and that EIS fills a niche that allows necessary capital to reach some of the least developed and most unexploited areas. And the good news for investors is that there is a seemingly endless supply of high quality businesses to support. Not only are there more small businesses than ever before but also more small businesses with the appetite and desire to scale up and grow quickly.

The aim of this guide is to empower you with the knowledge you will need to invest in EIS qualifying companies confidently and competently. You will get informed opinion on the relevant issues that we believe you face when investing in this area so we hope you find the guide both useful and informative.

An EIS investment constitutes an investment into innovative, growth pursuing, businesses. What reasonable investor doesn't want to support small UK businesses with bright ideas and the credentials to grow to be a productive, market leading business not just in the UK but globally and to have the opportunity to share in that success?

Mark Brownridge

Mark Brownridge
*Director General*
The Enterprise Investment Scheme Association (EISA)

**Please note that this guide is for general information purposes only. Professional advice should always be taken.**

eisa
enterprise investment scheme association

## About the EIS Association

EISA is a highly effective not for profit organisation which exists to aid the provision of capital to UK small and medium-sized enterprises (SMEs) through the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS).

EISA works closely with HM Treasury, HM Revenue and Customs, Government Ministers, MPs and the FCA to enhance the EIS and promote the benefits of the scheme to investors and companies using EIS/SEIS and their respective advisers.

EISA policy engagement in recent years has been followed by changes to rules and legislation including:

- Increase in EIS income tax relief from 20% to 30%.
- Relaxation of income tax carry-back, permitting investment at any time in a tax year.
- Removal of loss relief cap of £50,000 for investors in EIS.
- Increase in the annual cap for investment into an EIS qualifying company from £2m to £5m.
- Increase in the gross assets limit for companies eligible for EIS investment from £7m to £15m pre new money.
- Increase in the maximum number of employees allowed in an EIS qualifying company from 50 to 250.
- Increase in limits for Knowledge Intensive companies.

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# An Introduction to EIS & SEIS

The Enterprise Investment Scheme (EIS) is a long established government scheme that aims to encourage investment in smaller companies, by providing valuable tax benefits to investors who subscribe to qualifying shares in EIS companies.

The Seed Enterprise Investment Scheme (SEIS), was introduced in 2011, to run alongside the EIS. Both EIS and SEIS serve the same essential purpose, the main difference being that the SEIS is targeted at companies that are generally at an earlier stage in their development than EIS companies.

EIS has delivered over £20bn in funding since its launch in 1994, helping over 29,000 businesses to take root. Additionally, SEIS has helped around 12,000 businesses with over £1bn in funding. By incubating early-stage and pre-profit companies, the model has played a vital role in maintaining the UK's efforts to produce innovative and in some cases world-leading firms.

Both EIS and SEIS encourage early-stage investment into smaller and younger UK companies that show high promise and growth potential, by using investor money, to help finance expansion and development. In exchange for providing capital, investors are granted a variety of generous tax reliefs by the UK government. This helps investors mitigate the investment risks and enhance the returns that can be generated from investing in growing UK companies.

With the government closing many tax "loopholes", it is important to note that both the EIS and SEIS are non-aggressive schemes which the government continues to support. This is because by investing in EIS and SEIS, investors are actually helping both small businesses and the economy - this is highlighted on page 6.

**For simplicity, in this guide, references to EIS can be taken to mean both EIS and SEIS, unless the context indicates otherwise.**

# Why there are 3 Winners with EIS & SEIS

## Winner 1 – The Investor

By investing in EIS and therefore helping small UK businesses, it is only right that the investor should benefit from their investment. Some of the ways investors can benefit include:

- By investing in small promising companies, investors can benefit from significant potential investment returns.
- Unlike investors in many traditional investments, many EIS investors benefit from a closer relationship to the company they invest in.
- Investors benefit from the many valuable tax reliefs available. These can reduce the risk of investing in a smaller company and also enhance overall returns.

## Winner 2 – The Company

Over recent years, it has become increasingly difficult for small businesses to obtain traditional finance. Tougher lending criteria, less support from banks and general restrictions on other forms of finance mean that, however good the company, it can sometimes be exceptionally challenging to raise funds.

EIS provide British businesses with an alternative way to fund their business. The funds raised can be used to help with most aspects of development, such as the creation of new business opportunities, product launches and entry into new markets.

The EIS has been responsible for the success of many businesses - both small and well known.

## Winner 3 – The Country

The benefits EIS provide the UK economy and the country as a whole, is the main reason the government provides the tax benefits. Surprisingly, these benefits are often forgotten by many people. Some of the benefits include:

- Raising Income Tax and National Insurance from EIS company employees.
- Corporation Tax, VAT and other duties from EIS companies, also contribute to the Treasury.
- Helping the economy grow.
- Helping create new British businesses.
- Creating new employment opportunities.

# What is the Difference Between EIS & SEIS?

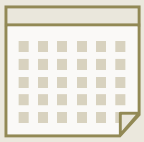
**EIS and SEIS are very similar in many respects, but there are some important differences.**

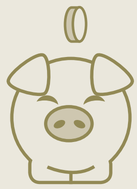
EIS and SEIS serve the same essential purpose – to be a conduit for early stage investment into high growth potential, smaller and younger UK companies, where there is widely regarded to be a 'finance gap', meaning many promising businesses can struggle to obtain growth funding.

The key difference between the two is that SEIS is explicitly targeted at start-ups and very early stage companies, while EIS can be used by larger and more mature companies – though these are still relatively small and young in the context of the business and corporate landscape in the UK.

## SEIS funding criteria for companies

| | | | |
|---|---|---|---|
| **Fewer than 25 employees.** | **Trading for less than 2 years.** | **Gross assets valued at no more than £200,000.** | **No previous investment from a Venture Capital Trust or under EIS. Subject to the SEIS funding limit of £150,000.** |



## The comparable requirements for EIS

| | | | |
|---|---|---|---|
| **Fewer than 250 employees or 500 employees for 'Knowledge Intensive' companies.** | **Trading for less than 7 years or for less than 10 years for 'Knowledge Intensive' companies - typically those with high research and development costs / requirements.** | **Gross assets valued at no more than £15m.** | **Maximum lifetime amount that can be raised under SEIS, EIS and Venture Capital Trusts is £12m or £20m for 'Knowledge Intensive' companies.** |

**A summary of the main tax benefits for EIS and SEIS can be found on the next page.**

# Investor Tax Benefits - EIS & SEIS

## EIS

30%
RELIEF

### 30% Initial Income Tax Relief
Effective net cash outlay of 70p in the £

### CGT Freedom
No Capital Gains Tax to pay on any EIS gains after 3 years

### CGT Deferral Relief
Potential unlimited indefinate deferral of an existing CGT bill

### Loss Relief
Maximum exposure of 38.5p in the £ for a 45% Income Tax payer

### Business Relief
Potential Inheritance tax saving of 40p in the £ after 2 years

## SEIS

50%
RELIEF

### 50% Initial Income Tax Relief
Effective net cash outlay of 50p in the £

### CGT Freedom
No Capital Gains Tax to pay on any SEIS gains after 3 years

### CGT Reinvestment Relief
Potential exemption of an existing CGT bill on 50% of the gain, to the extent reinvested

### Loss Relief
Maximum exposure of 27.5p in the £ for a 45% Income Tax payer (or 13.5% if CGT Reinvestment Relief claimed)

### Business Relief
Potential Inheritance tax saving of 40p in the £ after 2 years

The above is only a simple summary. Further details on EIS and SEIS taxation are covered elsewhere in this guide.

# Tax Summary

Although the tax reliefs provided to investors by EIS are very generous, as the EIS is a government scheme, it is not considered an aggressive tax planning strategy. The tax benefits are provided under current legislation, in order to encourage investment - see page 6.

The tax reliefs available to investors in companies qualifying under the EIS and SEIS are summarised below:

## 1. Income Tax Relief (EIS & SEIS)

- EIS - An individual can reduce their Income Tax liability by up to 30% of the amount invested in qualifying EIS shares.
- SEIS - An individual can reduce their Income Tax liability by up to 50% of the amount invested in qualifying SEIS shares.
- EIS & SEIS - A qualifying investment must be held for no less than 3 years from the date of issue (EIS & SEIS), or for 3 years from commencement of trade if later (EIS), to avoid Income Tax relief being withdrawn.
- EIS - There is no minimum subscription per company and the maximum investment in respect of which an investor may obtain Income Tax relief in any tax year is £1m. The maximum is £2m for Knowledge Intensive Companies - see page 16.
- SEIS - There is no minimum subscription per company and the maximum investment in respect of which an investor may obtain Income Tax relief in any tax year is £100,000.
- EIS & SEIS - "Carry Back" - Individuals may elect for their subscription for shares (up to their maximum annual allowance) to be treated as if made in the previous tax year, thereby effectively carrying Income Tax relief back 1 year. This means that with EIS, up to £2m can be invested of which £1m can be applied to the previous tax year. With SEIS up to £200,000 can be invested, of which £100,000 can be applied to the previous tax year.
- EIS & SEIS - Income Tax relief is limited to the amount which reduces the individual's Income Tax liability for the year to 'nil'.

## 2. CGT Freedom (EIS & SEIS)

- No Capital Gains Tax is payable on the disposal of shares after 3 years, or 3 years after commencement of trade, if later, provided the initial Income Tax relief was given and not withdrawn on those shares. The shares can be held for much longer, thus providing the potential for any CGT free gain to accrue over a longer period.

## 3. CGT Deferral Relief (EIS)

- By investing in an EIS, where an investor disposes of an asset that gives rise to a capital gain, the capital gains realised can be deferred for as long as the EIS qualifying shares are held. The disposal of the asset that generated the gain being deferred, must have happened less than 36 months before the date of the issue of shares in the EIS investment or, less than 12 months after the issue of EIS shares.
- Deferral relief is unlimited, in other words, this relief is not limited to investments of £1m per annum and can also be claimed by investors whose interest in the company exceeds 30%.

## 4. CGT Reinvestment Relief (SEIS)

- By investing in an SEIS, where an investor disposes of an asset that gives rise to a capital gain, Reinvestment Relief of 50% of the gain reinvested is available. Eligibility for this relief follows that of the Income Tax relief. The disposal of the asset that generated the gain being deferred, must be in the same year as the Income Tax claim.
- Reinvestment relief is limited, to £100,000 in a tax year.

## 5. Loss Relief (EIS & SEIS)

- EIS & SEIS - If EIS shares are disposed of at any time at a loss (after taking into account Income Tax relief), such loss can be set against the investor's capital gains, or income in the year of disposal or the previous year.
- EIS - For losses offset against income, the net effect is to limit the investment exposure to 38.5p in the £1 for a 45% tax payer, if the shares were to become totally worthless.
- SEIS - For losses offset against income, the net effect is to limit the investment exposure to 27.5p in the £1 for a 45% tax payer, if the shares were to become totally worthless. This can be reduced by up to a further 14p in the £1 if CGT Reinvestment Relief is claimed, limiting the investment exposure to 13.5p in the £1.
- EIS & SEIS - Alternatively, the losses can be carried forward and offset against future capital gains at the prevailing rate.

## 6. Business Relief – Inheritance Tax 'IHT' (EIS & SEIS)

- Shares in qualifying companies will generally qualify for Business Relief for Inheritance Tax purposes at rates of up to 100% after 2 years of holding the investment. This means any liability for Inheritance Tax is reduced or eliminated in respect of such shares.

**There are a number of criteria that EIS and SEIS companies need to meet, in order to be a qualifying investment. These criteria are beyond the scope of this guide. Professional advice should always be taken.**

# Income Tax Relief Example

If an EIS qualifying investment is held for at least 3 years from the date of issue of the shares, or 3 years from commencement of trade (if later) an individual who holds no more than a 30% interest in the company (passes 30% Interest Test) can reduce their Income Tax liability by up to 30% of the amount invested. In the same circumstances, with an SEIS, they can reduce their Income Tax liability by up to 50%.

There is no minimum subscription and the maximum investment in EIS qualifying shares which qualify for EIS Income Tax relief is £1m in the current tax year. The maximum is increased to £2m for Knowledge Intensive companies (see page 16). The maximum investment in SEIS qualifying shares which qualify for SEIS Income Tax relief is £100,000 in the current tax year.

Tax relief is offset in the appropriate year of claim, up to a maximum of the investor's Income Tax liability. In other words, initial Income Tax relief can reduce an investor's tax bill to nil.

Investors may elect for subscriptions to be treated as if they were made in the previous tax year, provided their total claim, including any amount already subscribed for in the previous tax year, does not exceeded the annual limits for the tax year in question. So for example, an investor who had made no EIS investment in a tax year can make EIS subscriptions of up to £2m in the following tax year and elect to carry back £1m to the previous tax year to claim Income Tax relief.

Income Tax relief is available to individuals (counting spouses and civil partners separately) for the entire amount subscribed for eligible qualifying company shares.

This relief is usually passed to the Investor in the form of a tax rebate or via an adjustment in their PAYE code. The relief can only be claimed once the investor has received Form EIS 3 or SEIS 3 from the company.

### Example - A higher rate tax payer invests £100,000 in an EIS and an SEIS

| | EIS | SEIS |
|---|---|---|
| Gross Total Initial Investment | £100,000 | £100,000 |
| Less Income Tax Relief @ 30% or 50% | (£30,000) | (£50,000) |
| **Net Cost of Investment** | **£70,000** | **£50,000** |

# CGT (Capital Gains Tax) Freedom Example

There is no CGT payable on gains in respect of Investments made in an EIS or SEIS Company (on which EIS / SEIS Income Tax Relief has been obtained and not withdrawn) where the Investments have been held until the later of 3 years from the date of subscription (EIS & SEIS), or from the date of commencement of the Company's trade (EIS). EIS or SEIS Income Tax relief must be granted on shares in order to qualify for CGT Relief on disposal. If full Income Tax Relief is not retained, then partial CGT Relief on disposal may be available.

### Example - A higher rate tax payer invests £100,000 in an EIS and an SEIS - each investment is sold for £160,000 after 3 years

| | EIS | SEIS |
|---|---|---|
| Gross Total Initial Investment | £100,000 | £100,000 |
| Less Income Tax Relief @ 30% or 50% | (£30,000) | (£50,000) |
| **Net Cost of Investment** | **£70,000** | **£50,000** |
| Hypothethical Value of Investment after 3 years* | £160,000 | £160,000 |
| Tax Free Gain | £60,000 | £60,000 |
| **Total Tax Free Return to Investor (Tax free gain of £60,000 plus Income Tax relief)** | **£90,000** | **£110,000** |

*The hypothetical values are for illustration purposes only.

# CGT Deferral Relief & Reinvestment Relief Examples

With EIS, CGT on gains realised on different assets can be deferred if an investor invests their gain into EIS qualifying shares. To receive this relief the investor must subscribe for EIS shares during the period 1 year before or 3 years after selling or disposing of their assets that generated the gain being deferred - i.e. gains made 3 years before or 1 year after the date of the EIS investment can be deferred. It is not necessary to claim EIS Income Tax relief to obtain deferral relief. Deferral relief is unlimited and can also be claimed by investors (individuals or trustees) whose interest in the company does not fail the 30% tests.

If the shares against which the gains are deferred are held until death, the deferred gain is never chargeable, so the deferral is indefinite.

There are various circumstances in which a chargeable event may occur relating to deferred gain resulting in the gains, becoming chargeable. Individuals and trustees should seek advice about the events which could trigger the withdrawal of relief.

With SEIS, investors can benefit from Reinvestment Relief on 50% of the gain realised from assets. The investor must claim relief against a gain in the same year as Income Tax. Unlike EIS, where the gains are deferred, with Reinvestment Relief, the 50% tax on gains does not become repayable in the future.

## Worked Example

A higher rate tax payer has a £300,000 capital gain on the disposal of a second home. The investor has already used their full annual CGT allowance. They invest £100,000 in an EIS and £100,000 in an SEIS. The amount of the gain that can be deferred has no maximum and is limited only by the amount subscribed for eligible shares in an EIS qualifying company. Gains may be deferred until the EIS qualifying shares are disposed of or, if earlier, when other events trigger withdrawal of the deferral relief. Once the shares in the EIS Company have been sold, the deferred gain will fall back into charge to CGT in the year of disposal. With the SEIS, Reinvestment Relief is available on 50% of the gains and this is not repayable, providing Income Tax relief is not withdrawn.

The example assumes the investor is liable to "CGT" at the rate of 28%, which is the higher rate of CGT on the sale of residential property that is not the main residence.

### Example - £100,000 capital gain invested into an EIS and an SEIS, and Income Tax relief is also claimed

| | EIS | SEIS |
|---|---|---|
| Initial Investment | £100,000 | £100,000 |
| Less Income Tax Relief @ 30% or 50% | (£30,000) | (£50,000) |
| Capital Gains Deferral Relief (assuming CGT at 28%) | (£28,000) | – |
| Reinvestment Relief (assuming CGT at 28%) | – | (£14,000) |
| Net Cost to Investor | £42,000 | £36,000 |
| Shares Sold - Hypothetical Value* | | |
| Hypothetical Sale Value | £160,000 | £160,000 |
| Capital Gain | £60,000 | £60,000 |
| Chargeable Capital Gain (tax free if held for more than 3 years) | £0 | £0 |
| Deferred Gain Becomes Chargeable | £100,000 | - |
| Tax payable on deferred gain at 28% | (£28,000) | Nothing is payable with Reinvestment Relief |
| Value of EIS deferral relief | Capital gains tax of £28,000 has been deferred. This can potentially be deferred again in new EIS or by for example using future CGT allowances etc. | – |
| Net Profit on the Net Cost to Investor | £90,000 | £124,000 |

*The hypothetical values are for illustration purposes only.

# Loss Relief Example

Loss Relief is available for EIS and SEIS shares that are disposed of at any time at a loss (after taking into account Income Tax relief which is retained). The loss can be set against an investor's capital gains, or their income in the year of disposal or the previous tax year. For losses offset against income, the net effect is to limit the investment exposure to as much as 38.5p in the £1 for EIS, depending on the investor's marginal rate of income tax and if the shares become totally worthless . With SEIS in the same circumstances, the net effect is to limit the investment exposure to as much as 27.5p in the £1 or where Reinvestment Relief is claimed, 13.5p in the £1. Alternatively the losses can be relieved against capital gains at the prevailing rate of 20% for higher rate taxpayers (28% for UK residential property).

## Worked Example

An investor has a loss in an EIS and an SEIS investment - the investments are worth nothing. The loss can be offset against Income Tax for the same year or the preceding tax year. Alternatively, it can be offset against capital gains for the same year or carried forward to be offset against future gains, subject to the normal treatment of CGT losses. Loss relief can reduce the investor's exposure to 38.5% or 27.5% of the original investment if the investor elects to set off the loss against Income Tax due for the current year, and assuming the investor pays Income Tax at a marginal rate of 45% and has sufficient income to offset the loss. It is assumed that Reinvestment Relief is not claimed.

## Example - Loss Relief against Income Tax - EIS & SEIS

| | EIS | SEIS |
|---|---|---|
| Gross Total Initial Investment | £100,000 | £100,000 |
| Less Income Tax Relief @ 30% or 50% | (£30,000) | £50,000 |
| Net Cash Outlay for Investment | £70,000 | £50,000 |
| Net Loss if Investment fell to £0 | (£70,000) | (£50,000) |
| Loss Relief against income at 45% | £ 31,500 | £22,500 |
| Net loss | (£38,500) | (£27,500) |
| Percentage of original outlay | 38.5% | 27.5% |

## Example - Loss Relief against Capital Gains Tax - EIS & SEIS

If the loss is offset against capital gains tax and assuming the investor has sufficient gains against which to offset the loss, this can be claimed against capital gains for the same year, or carried forward and relieved against future capital gains. The current rate of capital gains tax is 20% for higher rate taxpayers (28% for UK residential property).

| | EIS | SEIS |
|---|---|---|
| Gross Total Initial Investment | £100,000 | £100,000 |
| Less Income Tax Relief @ 30% | (£30,000) | (£50,000) |
| Net Cash Outlay for Investment | £70,000 | £50,000 |
| If investment fell to £0 net loss relief at 28% | (£19,600) | (£14,000) |
| Net Loss | (£50,400) | (£36,000) |
| Percentage of original outlay | 50.4% | 36% |

Thus an individual who has income which is charged to income tax at higher rates is likely to wish to offset the loss against income rather than capital gains if possible.

# Business Relief (Inheritance Tax) Example

Shares in EIS and SEIS qualifying companies will generally qualify for Business Relief for Inheritance Tax purposes. Relief can be at rates of up to 100% after 2 years of holding such investment, meaning that any liability to Inheritance Tax is reduced or eliminated in respect of such shares.

## Worked Example - An investor who has already used their full Inheritance Tax nil rate band invests £100,000 in cash, and in EIS and SEIS investments.

If the shares have been held for at least 2 years before death, the investment should, in most cases qualify for Business Relief for Inheritance Tax purposes at rates of up to 100% and with the other benefits of the EIS and SEIS, the effective cost of the investment may be greatly reduced.

The example compares an EIS investment of £100,000, an SEIS investment of £100,000 and a holding of cash of £100,000.
It assumes that the investor is a higher rate tax payer, that the investor's Inheritance Tax nil rate band is already fully used and that all other allowances have been used.

| Initial Investment | Holding of cash | EIS investment | SEIS investment |
|---|---|---|---|
| Total Gross Initial Investment | £100,000 | £100,000 | £100,000 |
| Less income tax relief @ 30% or 50% | – | (£30,000) | (£50,000) |
| Net Cash Outlay for Investment | £100,000 | £70,000 | £50,000 |
| Hypothetical value of cash and cash from the EIS / SEIS tax relief * | £100,000 | £30,000 | £50,000 |
| Hypothetical value of EIS / SEIS investment* | – | £100,000 | £100,000 |
| Less IHT on cash balance | (£40,000) | (£12,000) | (£20,000) |
| **Total Value left to Estate** | **£60,000** | **£118,000** | **£130,000** |

*The hypothetical values are for illustration purposes only.

As this example is looking at tax benefits, for simplicity, zero growth has been assumed on the EIS, the SEIS and the cash.

There is no claw back of the income tax relief or deferral relief on death.  Thus in this example, the full value passes to beneficiaries free of inheritance tax and the estate is also augmented by income tax and capital gains tax saved (there is of course no CGT on death anyway) by the deceased in this example.

# How to Invest in EIS

There are a number of different ways to invest in EIS. The approach taken will depend on how much the investor knows about EIS, their risk profile and the level of advice they want. The main options are shown below.

### Some of the most common ways to invest in EIS & SEIS are:

#### 1. Through a Financial Adviser, Wealth Manager or another Professional Adviser

This is a good option where an individual would like professional advice on their finances as a whole. It is also appropriate where specific recommendations and advice are required for EIS funds, EIS portfolios, or EIS companies.

#### 2. Directly with an EIS Investment Manager

This is more common if an investor already has a relationship with the manager and / or considers themselves to be sufficiently sophisticated and experienced to not require professional advice. This option will normally provide investors with the benefits of investing in a diversified portfolio.


#### 3. Direct Purchase of an EIS Qualifying Company's Shares

This may be an approach followed by 'business angels', who tend to be experienced entrepreneurs and serial investors who often provide expertise and contacts as well as investment capital. This route may also be taken by people within the network of the owners of the company who are raising finance through EIS. Finally, some individuals who like to know exactly where they are investing and perhaps have their own portfolio of EIS companies, may take this approach.

#### 4. Through a Crowdfunding or Investment Platform

Increasingly, EIS qualifying companies are seeking to raise money directly from investment platforms in addition to or instead of other distribution channels. This is becoming an easier and more common option for individuals to invest in single company EIS.

Depending on the route investors take, there will be varying levels of support available, although all options will follow the same fundamental underlying process laid down by HMRC. Further details can be found on page 19.

## EIS 'funds', 'portfolios' and single company investments

If some diversification is required,investing in a Fund or Portfolio may be sensible.

Despite the term being in common usage, there is no such thing, in a legal or regulatory sense, as an EIS 'fund'. The term 'Fund' is used as an easily understood shorthand denoting an investment portfolio of single investments in individual companies, professionally managed on an investor's behalf in an arrangement not too dissimilar to a discretionary managed portfolio. It is a requirement that investors are owners of an EIS-qualifying company's shares for tax relief purposes.

This contrasts with a mutual fund or unit trust, where the individual investor owns shares in the fund and the fund, as a legal entity itself – into which all investors' capital is pooled – owns the shares in the underlying companies in which it invests. For all practical purposes, an investor is unlikely to notice any difference between an EIS fund and a traditional pooled subscription fund.

Some EIS investment managers also offer 'portfolio services', through which investors can choose EIS qualifying companies that have been assessed and approved by the investment manager as credible investment opportunities.

It is also quite common to invest in single EIS company investments. These are typically accessed directly by investors through investment platforms and crowdfunding websites, though some investment managers, wealth managers and financial intermediaries may also offer them.

# Investing in EIS - The Importance of Diversification

Predicting which companies will succeed and which will fail when making investment decisions is extremely difficult. This can be even more relevant with EIS companies compared to larger companies listed on a stock exchange, as there is often less information available on the EIS company. Diversification is one of the best ways to reduce specific risk - see page 17. Some of the different ways to diversify follow.

## Investing in a portfolio versus a single company

An investment in an individual EIS company offers 2 outcomes – the company will either succeed or fail. An investor could make a good return if the company achieves a successful exit or lose everything apart from loss relief and the initial Income Tax relief if it fails. Investing across a portfolio of EIS funds or individual companies allows investors to spread their risk and improves their chances of good overall returns.

## Optimum levels of diversification

Diversification can help reduce risk and is particularly important when investing in higher-risk investment opportunities like EIS. However, over-diversification can reduce the chance of a high overall return, as the more companies an investor invests in, the more likely their return is to be close to the median as any super-performers will be averaged out by poor performers. It is important to remember that there are other ways to diversify beyond just numbers, as shown in the  points below.

### *Generalisation versus specialisation*

EIS investments can be specialised in particular areas or provide diversity across multiple sectors and investment types. It is possible to select a variety of individual companies or to invest in sector-specific or generalist funds. Specialist funds draw on their managers' in-depth knowledge and contacts, whereas generalist funds can offer greater diversification. Investors should consider whether the manager specialises by sector or geographic region. There is no right or wrong answer as to which is best. An investor has to make that decision themselves or with the help of their professional adviser, just like any other investment decisions.

### *Diversification across managers*

Further diversification is possible by investment across different managers. This may reduce systemic risk where fund managers have a particular approach, leading them to seek out particular characteristics in the companies in which they invest. It also allows diversification across a greater number of companies than a single manager can actively manage. A platform can provide a simple point of access to EIS investments from different managers while reducing the administrative burden.

### *Diversification by maturity*

A portfolio of investments might feature companies at different stages of their development such as start-ups and more mature, established businesses. This approach balances early-stage investments that have high potential but are higher risk with later-stage investments with a higher valuation but lower risk.

# Recent Changes - Knowledge Intensive Companies

**How does a company meet the government's definition of "Knowledge Intensive"?**

This guide has already touched on how the rules governing EIS differ slightly when applied to investments in companies defined as "Knowledge Intensive". Such businesses are permitted to benefit from EIS if they have fewer than 500 employees (compared to fewer than 250 for other firms) and if they have been trading for less than 10 years (compared to less than 7 years for other firms); they are also allowed to receive up to £20m in lifetime funding through SEIS, EIS and VCTs (compared to up to £12m for other firms).

These distinctions reflect a belief that Knowledge Intensive companies can play a notably valuable role in boosting the UK economy and are therefore particularly worthy of support. The same thinking lies behind the doubling of the individual investment limit and the annual total investment limit.

It is now especially important to appreciate how a company qualifies as Knowledge Intensive in the eyes of HMT and HMRC. In addition to the stipulations revisited above, the official guidance, as outlined in HMRC's Venture Capital Schemes Manual at the end of 2017, is as follows:

## Operating costs

At least one of the following conditions must be satisfied:

- The company must have spent at least 15% of its relevant operating costs on research and development or on innovation in 1 of the 3 relevant years preceding the date of the investment.
- The company must have spent at least 10% of its relevant operating costs on research and development or on innovation in each of the 3 relevant years preceding the date of the investment.

## Skilled employees/innovation

At least one of the following conditions must be satisfied:

- A minimum of 20% of the company's full-time-equivalent employees must be classified as skilled employees at the time of the investment and for the following 3 years.
- The company should be engaged in work to create intellectual property (IP) at the time of the investment, and within 10 years most of the company's business activities might be expected to consist of (i) the exploitation of the IP, (ii) business that use the IP or (iii) both.

These rules are not especially complex or prohibitive. Some are actually deliberately generous. The threshold for skilled employees, for example, has been set low to avoid complicated regulations for firms that might employ individuals who fall short of a certain level of qualification, but are nonetheless experienced and expert researchers. This, again, underscores the government's commitment to EIS.

Encouragingly, even greater flexibility has been promised in the near future. HMT has indicated its intention to consult on a "new Knowledge Intensive approved fund structure" with a view to providing "further incentives to attract investment".

## The Patient Capital Review

Announced by the Prime Minister in 2016, the Patient Capital Review set out to consider how best to support the UK's fledgling innovative companies in accessing the finance required to achieve scale. It used the term "patient capital" to describe investments made with no expectation of a quick profit, arguing that such investments should underpin the long-term development of the country's most promising businesses.

# The Fundamentals of Risk in EIS

When considering an investment in an EIS, it is important to be aware, that EIS are higher-risk investments. This was recently reinforced by a new principles based test for EIS that was introduced by the Finance Bill 2017-2018. This test involves the "risk-to-capital condition" which now needs to be met to ensure, as stated by HM Treasury, "that tax-motivated investments, where the tax relief provides a substantial part of the return for an investor with limited risk to the investor's capital, will not be eligible for relief". An investment should meet the following requirements to be eligible for the scheme:

- The company in which the investment is made must have objectives to grow and develop over the long term.
- The investment must carry a significant risk that investors will lose more capital than they gain as a return (including any tax relief).

**There are 4 broad types of risk that investors need to consider before investing in EIS.**

## Systemic risk

Systemic risk is the risk of the collapse of a whole market or sector (as in the financial crisis of 2008/9). Companies within EIS portfolios tend to have reduced systemic risk. The long-term nature of the investment and the fact that most are unlisted mean they are often less prone to the emotional highs and lows of markets.

## Specific risk

Specific risk is the risk facing an individual company (like its technology being overtaken or failing to find a market). In general, EIS qualifying investments have heightened specific risk.

## Liquidity

To enjoy the tax benefits associated with EIS investors need to be invested for 3 years. In practice, it may take much longer than that for some EIS investments to reach a successful exit. As most EIS companies are not listed, it will usually be impossible to liquidate an investments in the event of an investor needing cash rapidly. So before investing, an investor should consider carefully the likelihood of needing the cash being invested, before the investments mature.

## Eligibility

In most cases, before considering a company for investment, an investment manager or adviser will want evidence that the company is likely to be EIS qualifying. An investee company may apply to HMRC for 'Advance Assurance', which is an indication that it appears to meet EIS qualifying criteria, based on the information provided to HMRC. Further details on Advance Assurance can be found in the box below.

### ADVANCE ASSURANCE

In order to reduce Eligibility Risk, investors should consider EIS where Advance Assurance has been obtained.

HMRC offer a free service to companies who intend to raise money under EIS or SEIS whereby they will provide an opinion as to whether, following an application by the company, the company's proposed share issue will qualify for the EIS/SEIS tax reliefs.

Advance Assurance therefore gives investors confidence that their investment will qualify for EIS tax reliefs.

# Risk & Diversification as part of a Portfolio

One of the fundamental messages to emerge from recent legislation, including the Patient Capital Review is that EIS investors should be prepared to accept a significant level of risk. This is why EIS investors are incentivised with substantial tax breaks and why the government has taken steps to stamp out practices that are contrary to the spirit of investing in high-risk ventures.

The issue of EIS and risk is an issue that has often attracted surprisingly little attention – not least when capital preservation has been allowed to obscure the basic notion of EIS as an inherently risky, but potentially rewarding undertaking.

Outlined below is a brief examination of the role that EIS can play in a broader investment portfolio and the nature and management of specific risks.

## EIS as a means of portfolio diversification

Faced with concerns such as short-term stock-market volatility, meagre bond yields and historically low interest rates, investors have widened their hunt for outperformance since the global financial crisis. Ideally, what they are looking for are returns that are both higher than and relatively uncorrelated with those available from mainstream asset classes such as stocks and bonds. As a result, alternative investments of various kinds have attracted increasing interest. The fact that they can have a lower level of systemic risk (see page 17), can make alternative asset classes a very usefully part of a diversified portfolio. Indeed they can actually reduce systemic risk in the overall portfolio, through diversification.

An ever-broadening investor demographic is recognising the ability of EIS to tick the required boxes. Whether investing via financial advisers, wealth managers, EIS investment managers, the direct purchasing of shares or crowdfunding platforms, more and more investors, (some institutional, some retail, all of them UK taxpayers) are gaining exposure to an asset class classically defined not just by tax efficiency but by long-term horizons, comparative illiquidity and potentially impressive returns.

The appeal of these attributes earned renewed acknowledgment in the wake of the Patient Capital Review. In November 2017 HMT confirmed that, as part of government efforts to "support long-term investment", the Pensions Regulator is to clarify guidance on how trustees can incorporate investments through EIS and similar schemes "in a diverse portfolio".

## Managing risk in EIS investments

Any investment carries a risk that its value might go down as well as up. It is essential to note that whilst tax reliefs can significantly reduce the risk of investing in EIS, due to their focus on younger and smaller companies, the risk associated with EIS can still be high.

While the scope for mitigating such risk in relation to an individual company is limited, there are means by which risk can be spread. For example, a portfolio of EIS investments might feature several companies of different maturities. It is conceivable that one successful exit of an investment, whether through a sale or a public offering, could more than cover the total investment across a portfolio. Of course, the new risk-to-capital condition should be borne in mind when constructing a portfolio of EIS investments.

Since EIS investments are usually longer-term in nature, illiquidity presents a further risk. It is important to note that there is no liquid, tradeable market for EIS companies and no independent or objective means of valuing them, so planning a route to exit usually requires lots of time, resource and, above all, expertise.

EIS companies are often nearing a point at which, provided they receive the right support, they can take a major step forward in their development. This can lead to a multiple increase in valuation and, by extension, marked shareholder gains upon exit. In the meantime, however, investors are highly unlikely to have access to their capital. EIS providers and companies should therefore generally be exit-focused and aim for optimum, return-driven outcomes rather than taking a "churn" approach that is principally geared towards the claiming of tax reliefs.

Finally, whilst tax reliefs can significantly reduce the risk of investing in EIS, there is the question of political risk. For much of 2017, with EIS investments under intense scrutiny from HMT and HMRC, it appeared that this type of risk might be the most difficult of all to mitigate. Thankfully, fears have proven largely unfounded in this regard. EIS has emerged from the Patient Capital Review and the 2017 Autumn Budget with enhanced government backing, a revised and forward-thinking framework and an even clearer mandate to assist in the growth and development of the country's most innovative young businesses. Ultimately, a new landscape has brought new opportunities and the EIS success story can continue.

# Investment Process & Claiming Tax Relief

Outlined below is a typical timeline for an investor in a single company EIS or SEIS.

The timeline shows the different stages involved and the order in which they occur.

The process for a Fund or portfolio would be similar, the main difference being that the investor would usually subscribe to the fund and the manager would invest in the EIS companies. The manager would then provide the investor with EIS 3 certificates for each EIS company the fund invests in.

## Typical EIS / SEIS Timeline


## How to claim EIS / SEIS Relief

In order to claim tax relief, an investor should complete Form EIS 3 / SEIS 3 and send this to HMRC.

Investors can benefit from the tax relief in a number of ways including:

- An adjustment to their PAYE code
- A tax repayment
- Agreeing to offset the relief against any outstanding tax liabilities

There are additional rules for Capital Gains tax.

Investors should take professional advice on the best way to claim tax relief in their individual circumstances.

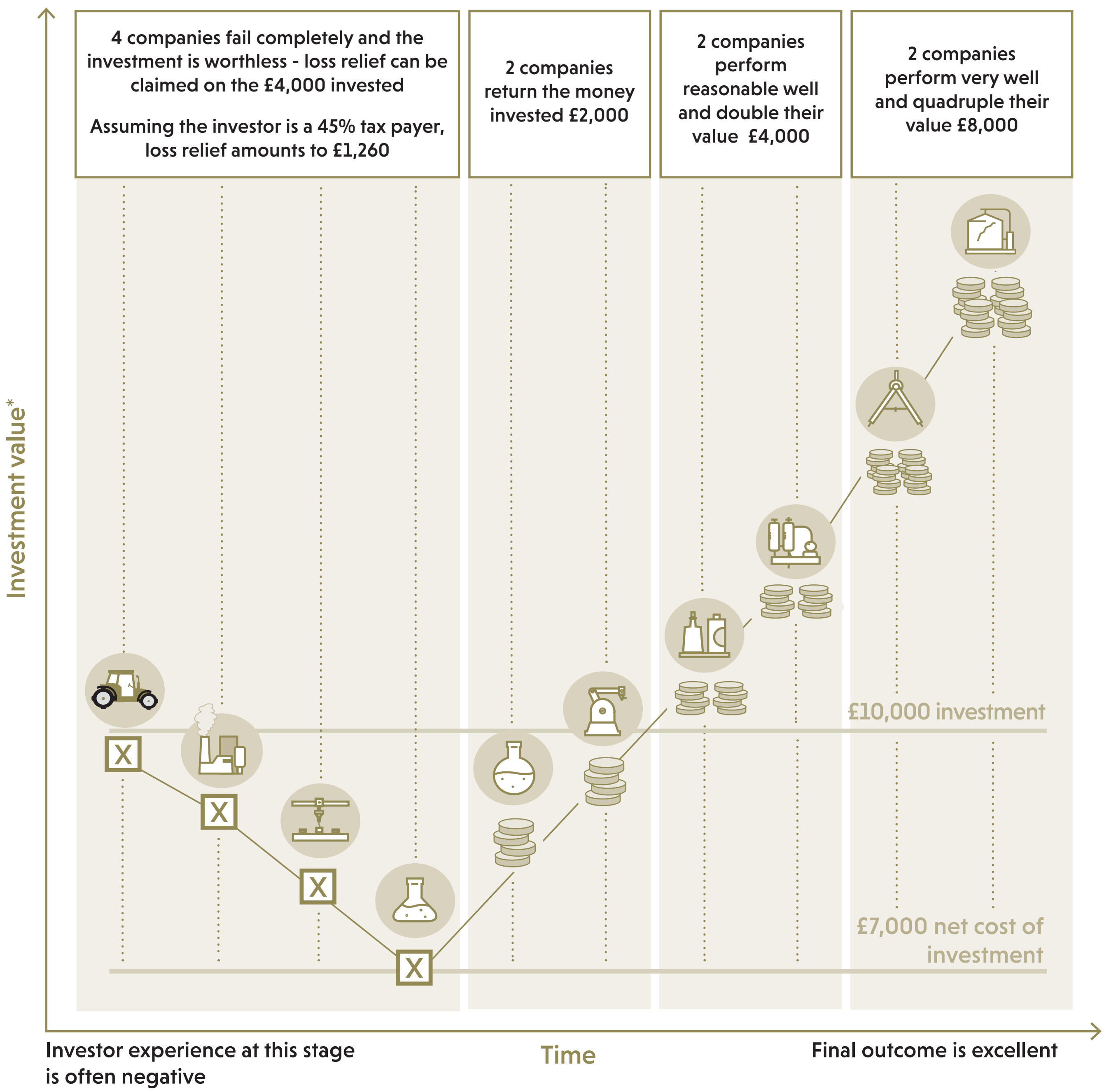
# An Example EIS Investment Journey

The example below illustrates how an EIS portfolio of 10 company investments might perform over time. Overall, this fictional portfolio makes a good return, however, the position relative to the original investment at different points in time varies greatly. As may be typical, 4 companies fail before any returns are realised. For some time, the investor may therefore feel very negative about the portfolio. However, over time, the successful companies make their exits and whilst it can take some years for companies to reach their maximum potential sale value, thereby generating larger returns, the overall portfolio does well.

**£10,000 investment split equally across 10 companies**

**Net cost of investment after initial EIS income tax relief = £7,000**

**Hypothetical total return to investor is say, £15,260**




* The investment value represents total investment plus losses and exits, and does not take account of the interim company valuations. These figures are purely for illustration purposes and should in no way be viewed as representative of how a real EIS fund investment is likely to perform. Some portfolios may perform better and some may perform worse than in this example.

# Exit Options

When deciding whether to invest in a company, most EIS investment managers will be thinking about the most viable – and profitable – ways of selling out of it. Similarly, the directors in any single company EIS, should consider the exit options available to them from an early stage in their business plan.

There is no liquid, tradable market for EIS companies or independent or objective means of valuing them – as stock market investments could arguably be described for listed companies. So finding a buyer and agreeing a price for the shares is not as simple as calling a broker or executing a trade at the push of a button.

Instead, EIS managers and the directors of EIS companies, must carefully plan for an exit, looking at a range of possible scenarios and outcomes. They should consider what a company would need to do in order to achieve an exit and make sure the appropriate steps are taken. They should assess all the sectors from which potential buyers might come, and consider the various exits options including the following.

- **A trade sale -** This could be to a company that operates in a similar or complementary sector. Alternatively, it could be to a private equity firm or another professional or institutional investor. Consideration should be given to the specific companies that could be potential buyers, even if the actual sale is not likely to come to fruition for several years.

- **Share buyback -** This is a simple option where the EIS company buys back the shares from the shareholders at an agreed share price.

- **Flotation -** Floating the company on a public stock market, such as the Alternative Investment Market (AIM), can be a good option for all parties. This can allow shareholders to realise their investment by selling their shares after the company floats.

- **Voluntary liquidation -** It can sometimes be beneficial for a company to liquidate its assets. Shareholders would then be entitled to benefit from the return on assets, after any liabilities have been paid.

- **Follow on funding -** Investors and funds that provide follow on funding to EIS Companies can provide investors with an easy exit route.

## Preparing for exit

EIS managers and the directors of EIS companies, will often seek to exit an investment as soon as it is commercially viable to do so after the 3 year minimum holding period for the EIS tax reliefs has passed. However, target time horizons will vary and may depend on a range of factors, including the level of return being sought, the overall economic climate and in the case of a fund, the nature of the companies in which a fund manager invests. A tech start-up with intensive research and development needed before its product or service could become commercially viable will probably take longer to exit profitably than a more mature business with a better-established product or service – though the tech start-up, if successful, may generate better returns for investors.

Preparing an EIS company for exit, will typically be one of the busiest, most time-consuming and resource-intensive periods for both EIS managers and the directors of the EIS company. The process can in some ways be considered akin to preparing a house for sale. When a house is being sold, the vendor will take all steps necessary to maximise the chances of selling their home at the desired price. These might include redecorating it, making repairs, cleaning and tidying, preparing all the essential documentation and any other actions that will make the property as attractive as possible to potential buyers. EIS companies will be subject to a similar deep clean and tidying operation. Key parts of this process will include preparing the selling documents, completing legal paperwork and anticipating and making the company ready for the prospective acquirer's due diligence process. These steps are essential to help to minimise the likelihood of any issues that could result in a reduced offer price or derail the purchase completely.

# Staying on Top of EIS Investments

**Once an investor has invested in an EIS fund or an individual EIS company, they can expect regular communications from the investment manager about how their portfolio is performing as appropriate and to a lesser extent from EIS companies directly.**

With a fund, Investors are likely to receive an update each time a new investment is made, providing information about the company and explaining the rationale for the decision. They are also likely to receive periodic information from the investment manager about the overall progress of investing the total sum of money they committed.

Most investment managers will provide 6 monthly or annual progress reports on the underlying investments, covering notable developments and news about the portfolio companies. Typically, these will be accompanied by portfolio statements and valuation reports, which may come directly from the fund manager or via the fund administrator.

If there is a major development with a portfolio company, investors should usually expect a one-off communication providing details and describing its significance to the investment.

Some fund managers may hold events at which investors are able to meet representatives from portfolio companies, as well as their investment managers.

In most cases, investment managers will also be able to respond to queries and questions post investment.

If a financial adviser, wealth manager or any other professional adviser is used,investors can expect them to be their first point of contact. In these circumstances, the adviser will often report on the EIS as part of an investor's whole portfolio review, as they will usually provide a more holistic service.

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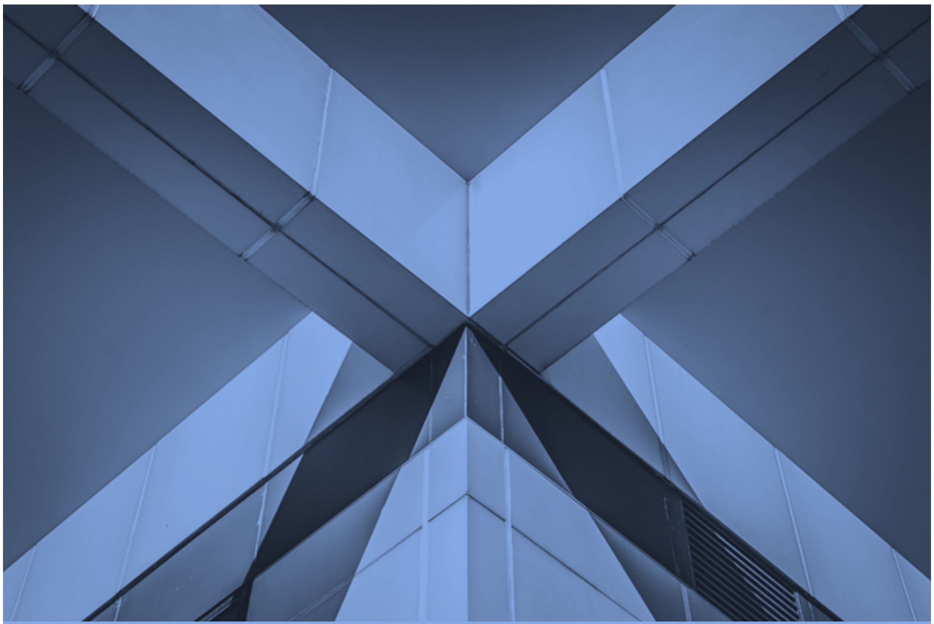

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