ENTERPRISE INVESTMENT SCHEME

What is it?

The Government introduced Enterprise Investment Schemes (EIS) in 1994 to encourage people to invest in smaller companies. They are designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies.

There are several different types of EIS. The tax and investment rules for each type of EIS can vary. Please note that this factsheet provides a summary of the key requirements:

Single company EIS

If you are going to invest in a small business, you may be able to do so through a single company EIS. As the investment is concentrated in just one company, the lack of diversification brings additional risk to this approach. There is often no opportunity to sell your shares unless the company is sold or it has enough cash reserves to buy back its shares.

EIS portfolio (or unapproved EIS funds)

An EIS portfolio is generally a professionally managed service that invests on your behalf in a number of underlying EIS investments – often at least ten different companies. Tax relief is available from the date the EIS invests in each company, not when you place your money with the fund manager.

Knowledge Intensive Funds (KFIs)

On 5 April 2020, HMRC replaced ‘approved funds’ with ‘Knowledge Intensive Funds’ (‘KIFs’).   A KIF is a fund that invests in Knowledge Intensive Companies. A Knowledge Intensive Company is a company that is carrying out research, development or innovation at the time that they are issuing shares although there are also other conditions that must be met.

There are certain conditions a KIF must meet in order to benefit from HMRC approval:

- Of the fund’s capital at least 80% must be invested in companies that were knowledge intensive at the time of the share issue
- The fund must have invested 50% of its capital within 12 months of the date the fund closed and 90% within 24 months.

Please note:

- Whilst the tax regulations refer to Enterprise Investment Schemes as ‘Funds’, they should not be confused with mutual funds or collective investment schemes. An investor in an EIS fund will be the owner of shares in the underlying companies, rather than owning shares or units in any fund.
- HMRC KIFs are only approved in relation to their tax reliefs and not in relation to the performance of the fund.

Unlike Venture Capital Trusts (VCTs), EISs are not quoted on the stock exchange.

Eligibility

The main conditions for gaining EIS relief are as follows:

- Tax relief is given to qualifying individuals who subscribe for eligible shares in a qualifying company.
- A qualifying individual is someone who is not connected with the company when subscribing, although in some circumstances they can subsequently become a paid director of the company.
- A non-UK resident is eligible but can only claim tax relief against his or her liability to UK income tax.
- Eligible shares are new ordinary shares. No income tax relief is given if more than 30% of the capital is acquired.
- A qualifying company must be unlisted when shares are issued and must have no arrangements at that time to become a listed company. It must have a permanent establishment in the UK. This can include companies whose shares are listed on the AIM, but with a requirement that gross assets cannot exceed £15 million before the share issue and £16 million after the share issue. The company must have fewer than 250 full-time employees (or their equivalents) at the time the shares are issued.
- Most trades qualify but the company may not, if more than 20% of the trade includes activities such as; land and property development, hotels, nursing homes, farming, forestry and companies which are mostly involved in financial services or related undertakings.
- To gain freedom from income tax relief claw back, the investor must hold the shares for at least three years from the later of the date of issue, or the date the qualifying trade begins.

Contribution limits

The minimum monthly contribution is normally £25-£50 and the minimum lump sum £500-£1,000. There is no maximum limit although the maximum investment that can qualify for income tax relief is £2,000,000 per tax year (as long as anything over £1,000,000 is invested in knowledge intensive companies).

Taxation

The tax position on EIS investment is broadly as follows:

- The initial investment qualifies for up to 30% tax relief on investments up to £2 million in a tax year as long as anything over £1 million is invested in knowledge-intensive companies, subject to maximum relief equal to the amount of your income tax liability for the tax year. There is a ‘carry back’ facility which allows all or part of the cost of shares acquired in one tax year, to be treated as though they had been acquired in the previous tax year. Relief is then given against the Income Tax liability of the previous year rather than against the tax year in which those shares were acquired. This is subject to the overriding limit for relief for each year. For Knowledge Intensive Funds, EIS income tax relief claims will be at the date the fund closed rather than the date the fund invests in the knowledge intensive companies.
- In relation to EIS investments where income tax relief has been given, gains made are free of capital gains tax.
- Losses are allowable on EIS investments where income tax relief has been claimed, although a deduction is made for the 30% income tax relief. Such losses may be offset against income instead of capital gains in the year of disposal or the previous year.
- The payment of tax on a capital gain can be deferred where the gain is invested in shares of an EIS qualifying company. The investment must be made within the period one year before or three years after the gain arose. There are no minimum or maximum amounts for deferral and there is no minimum period for which the shares must be held.
- Inheritance Tax – EIS shares will usually qualify for 100% Business Relief after 2 years’ ownership (although there is no guarantee that this will remain the case).
- In order to claim income tax relief with an unapproved fund, an EIS3 certificate is issued for each of the underlying companies in which an investment is made. With a Knowledge Intensive Fund, one EIS5 certificate is issued which can make the administration process for investors easier.
- All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs’ practice. Levels and bases of tax relief are subject to change.

Withdrawals

Generally there is little or no liquidity in EIS companies or funds. EISs are investments in individual unquoted companies and EIS funds can consist of as few as four unquoted companies. Shareholders are normally locked in to the investment with no means to dispose of the shares, until the company directors or fund managers achieve an exit (for example quoted market flotation, trade sale or share buy-back). Not all companies/funds offer the ‘share buy-back’ facility which may be a factor worth considering for the prospective investor. It would be prudent to view these investments as medium to long term.

Guaranteed exits are not permitted under the EIS rules.

Risk considerations

Don’t invest unless you’re prepared to lose all the money you invest. This is a high-risk investment and you may not be protected if something goes wrong.

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- There is little or no liquidity and investments may be difficult or impossible to realise at an appropriate time. Generally it is not possible to encash these investments.
- A single company EIS provides no diversification of risk. All the risk is concentrated in one company.
- The aim of the EIS is to help higher risk businesses raise finance by offering investors generous tax reliefs. The failure rate of EIS companies is typically much higher than that of larger companies. Governments can and do change the rules on tax in respect of investments such as EISs.
- Income generated from investments held in EISs is variable and is not guaranteed. The level of income generated by dividends is likely to be low and will be used in the first instance to offset charges.
- Past performance should not be used as a guide to future performance.
- The price of shares and the income from them can fall as well as rise.
- The investment can grow but depending on market conditions you may not realise the initial sum invested. There is no guarantee that you will get more out of an EIS investment than you have paid in.
- If income tax relief is not given on your investment or is subsequently withdrawn, if upon realisation your total gains (from all sources) less any allowable losses are greater than your annual Capital Gains Tax allowance, there will be tax to pay at either 10% (basic rate band), 20% (higher/additional rate band) or a mixture of both rates depending which tax band(s) the gain falls into after adding to total taxable income for the tax year.
- Tax incentives may be lost if the investment is not held for three years. This may occur even if it is the fund manager (and not the investor) who disposes of the asset.
- Flotation will trigger loss of IHT Business Relief and, if within three years, loss of other tax reliefs.
- The failure rate of EIS companies is typically much higher than that of larger companies.
- Tax relief may not be granted if information provided to HMRC is incorrect or inaccurate.
- Investors are responsible for making their own claims to tax relief. Where an unapproved EIS scheme invests in multiple companies. An EIS3 certificate is provided for each company in which the EIS invests. This can pose an administrative and cash flow challenge given that income tax relief can only be claimed once the EIS3 certificate has been issued.
- FSCS eligibility – some, but not all, EIS managers take the view that because of the way their funds are structured there will be no access for investors to the Financial Services Compensation Scheme (FSCS).
- The percentage of the business that you own will decrease if the business issues more shares. This could mean that the value of your investment reduces, depending on how much the business grows. Most start-up businesses issue multiple rounds of shares. These new shares could have additional rights that your shares don’t have, such as the right to receive a fixed dividend, which could further reduce your chances of getting a return on your investment.

Information on high risk investments is available from the Financial Conduct Authority at *fca.org.uk/investsmart/5-questions-ask-you-invest* and *fca.org.uk/investsmart*.