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From little seeds grow... Seed Enterprise Investment Scheme (SEIS)

The Enterprise Investment Scheme (EIS) has been in place for a number of years and provides tax relief for individuals prepared to invest in new and growing companies. Investors can obtain generous income tax and capital gains tax (CGT) breaks for their investment and companies can use the relief to attract additional investment to develop their business. In his Autumn Statement on 29 November 2011, the Chancellor, George Osborne, announced the imminent arrival of a junior version of EIS to be known as Seed Enterprise Investment Scheme (SEIS) which is set to arrive on 6 April 2012.

Initially it is planned that the new relief will be available on qualifying investments made up to 5 April 2017. The detailed rules of SEIS have now been published and this briefing sets out the main points of those rules. It must be emphasised that these rules are only in draft and may be subject to amendment when the complete Finance Bill 2012 is published and as it proceeds through Parliament.

Key features

The key features of the new relief can be summarised as follows:

- a qualifying investor will be able to invest up to £100,000 into qualifying companies in a tax year
- they will receive income tax relief of up to 50% of the sum invested
- unused relief in one tax year can be carried back to the preceding tax year if there is unused relief available for that year
- the maximum amount that a company can attract in investment qualifying for SEIS is £150,000 in total
- the company must not have net assets of more than £200,000 before any SEIS investment
- for 2012/13 only an individual who makes a capital gain on another asset and uses the amount of the gain in making a SEIS investment will not pay tax on that gain subject to certain conditions
- as has become the norm in recent years with tax breaks there is a huge amount of anti-avoidance legislation to prevent exploitation for tax avoidance purposes.

Who can invest?

The official term is a 'qualifying investor'. The primary requirement is that the investor or someone who is associated with them must not be an employee of the company in which the investment is being made. They can however be a director. They must also ensure that they do not have (directly or indirectly) a substantial interest in the company. This is defined by reference to holding more than 30% of any of the following (in either the company itself or a 51% subsidiary of the company):

- ordinary shares
- issued shares
- voting rights
- assets in a winding up.

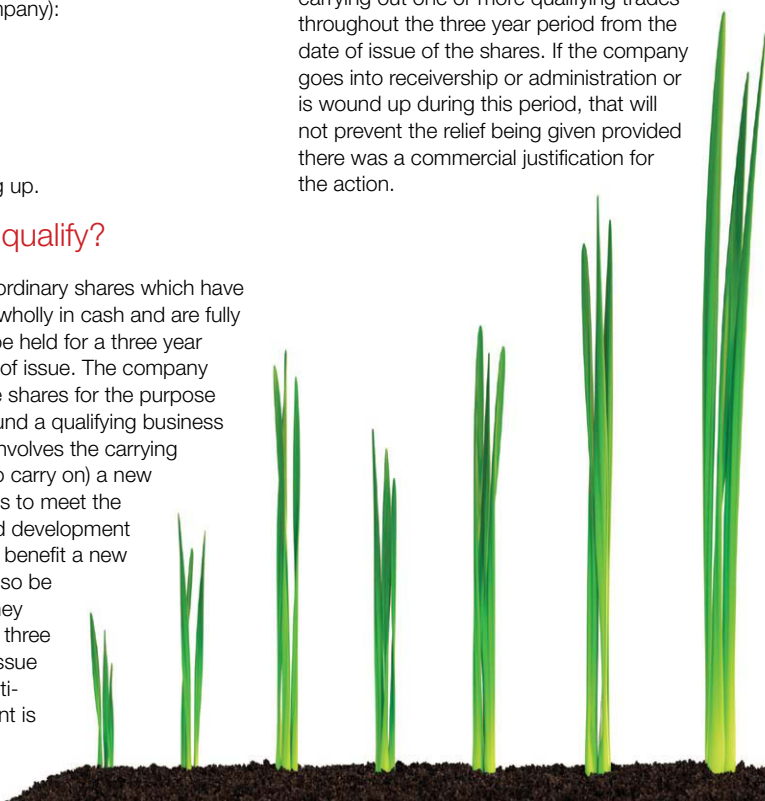
Which shares qualify?

The shares must be ordinary shares which have been subscribed for wholly in cash and are fully paid up. They must be held for a three year period from the date of issue. The company must have issued the shares for the purpose of raising money to fund a qualifying business activity which either involves the carrying on (or preparations to carry on) a new trade. Using the funds to meet the costs of research and development intended to create or benefit a new qualifying trade will also be acceptable. The money must be spent within three years of the date of issue of the shares. The anti-avoidance requirement is

that there must be no pre-arranged exit for the investor involving the purchase of the shares, or the disposal of assets.

Which companies qualify?

The new rules are intended to benefit new companies. The basic requirements are that the company must be unquoted and must not have been incorporated for more than two years before the qualifying shares are issued. The company must exist wholly for the purpose of carrying out one or more qualifying trades throughout the three year period from the date of issue of the shares. If the company goes into receivership or administration or is wound up during this period, that will not prevent the relief being given provided there was a commercial justification for the action.



The other main conditions relating to the company can be summarised as follows:

- the company must have a permanent establishment in the UK
- the company must be effectively solvent at the date of issue of the shares
- the company must neither control another company nor be controlled by another company throughout the three years from the date of incorporation
- the company must not be a member of a partnership
- immediately before the investment the gross assets of the company plus the value of any related entity (one that holds more than 25% of the capital or voting power in the issuing company) must not exceed £200,000
- there are less than 25 full-time employee equivalents in the company and any related entity
- the company must not have had EIS or Venture Capital Trust (VCT) investment before the SEIS shares are issued
- the company can seek EIS or VCT investment after it has received SEIS investment but must show that it has spent at least 75% of the money received under SEIS and
- the total amount of investment made under SEIS in the company must not exceed an aggregate of £150,000.

Which trades qualify?

The primary requirement is that the company must carry on a genuine new trading venture. There may be a problem if the same activities had been carried on as part of another trade. Basically any trading activity will qualify unless it is an excluded activity within the definitions used for EIS. This means that activities such as property development, retail distribution, hotels, nursing homes and farming will not qualify. The trade must be carried out on a commercial basis.

How is relief obtained?

The relief is given as a reduction against the total tax liability for the year but cannot turn a tax liability into a tax repayment. In that situation the individual would be able to carry back the unused relief to the preceding tax year for use if there was any tax unrelieved for that year. It is unlikely that a carryback to 2011/12 will be allowed for shares issued in 2012/13, as 2012/13 is the first tax year for which the scheme will operate but this is not yet clear.

Examples

Samantha invests £60,000 under SEIS in 2012/13. Potentially her tax relief is 50% of her investment which is therefore worth £30,000. As her tax liability for the year is £45,000, the maximum relief is available to reduce her tax liability to £15,000.

Richard is also planning to invest £60,000 under SEIS but not until 2013/14. His forecast tax liability for 2013/14 is only £20,000 so the claim to relief under SEIS will be limited to £20,000 for that tax year. However, Richard can in addition make a claim to carry back the unused relief of £10,000 (£30,000 less £20,000 relieved in 2013/14) to the preceding tax year 2012/13.

The relief must be claimed and requires a certificate from the company issuing the shares. This is a critical point in relation to the validity of any claim as the relief can only be claimed when the company has spent at least 70% of the money raised by the share issue on qualifying business activities.

Can the relief be withdrawn?

The short answer is 'yes' if certain events happen within three years of the date on which the shares are issued. The most obvious event is the disposal of the shares in that period. There are complex rules that will cause the relief to be withdrawn if the investor receives 'value' from the company during this period.

What about the CGT position?

Where shares are sold more than three years after the date on which they are issued then any resulting gain is free of CGT. Shares sold within three years would be chargeable but may qualify for the 10% rate of CGT under Entrepreneurs' Relief if the various conditions are met.

Where a disposal is exempt for gains purposes, this would normally mean that a loss would not be allowable for CGT purposes, but an allowable loss is available under the scheme. Where SEIS income tax relief has been obtained and is not withdrawn then the capital loss is reduced so that tax relief is not duplicated.

Example

Murat intends to invest £25,000 in SEIS in 2012/13 for which he will receive £12,500 relief against his income tax liability of £35,000. If 4 years later the company is unsuccessful and is liquidated with no value returned to the shareholders then his allowable capital loss will be £12,500 being the amount invested of £25,000 less the income tax relief obtained of £12,500.

Clearly investors will hope that they are not in a capital loss position but where this does happen, the allowable loss qualifies for relief against either gains or income. The facility to use a capital loss against income is only available in certain specified circumstances which include a capital loss on SEIS. It can be used in the year of the loss and/or the preceding year to relieve net income and can therefore potentially save tax at the individual's highest rate of tax.

A bonus exemption

It is also proposed that there will be a specific exemption for 2012/13 only where assets are disposed of at a gain in that year and funds equal to the amount of the gain are invested in SEIS shares. Where only part of the gain is invested in such shares then only that part is exempt. The maximum gain to be relieved will be capped at £100,000. Further, this relief will only be allowed where the investment also qualifies for income tax relief and a claim is made. If for any reason the SEIS

relief is withdrawn on the shares then the 2012/13 gain will be reinstated.

Example

Isaac sells quoted shares in 2012/13 for £200,000 making a gain of £80,000. He invests £60,000 of the proceeds in new shares which qualify under SEIS. He will be able to claim a reduction of £60,000 in the chargeable gain on the shares.

Comparison to EIS

The introduction of SEIS from April 2012 supplements the current long established EIS scheme. Some aspects of both schemes are similar but there are also key differences. These are not considered in detail here but for example, consider the position of the individual investor. A proposed improvement to the EIS scheme means that those investing in qualifying companies under that scheme will from 6 April 2012 be able to put up to £1 million into EIS companies, for which they will receive income tax relief at up to 30%. From a tax relief perspective on investments up to £100,000, the SEIS is more favourable but it clearly cannot be used for larger investments.

Final thoughts

SEIS is likely to be a welcome addition to the existing EIS and related Venture Capital Trust investment schemes particularly as it may be an alternative way of attracting funds at a time when it is still difficult to obtain finance from traditional sources such as banks. Even when the scheme is final, great care will still be required to ensure that all opportunities to use it are obtained for investor and qualifying company alike. Meanwhile, some of the detailed rules may be refined as the proposals pass through the legislative process so please do contact us if this is an area of interest so we can keep you informed of any further developments in the proposals.