The Enterprise Investment Scheme: a consultation document

March 2008

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a consultation document

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Contents

1 INTRODUCTION

THE ENTERPRISE INVESTMENT SCHEME: A CONSULTATION DOCUMENT

1.1 The Enterprise Investment Scheme (EIS) aims to incentivise investment in smaller, higher-risk companies that have growth potential but sometimes struggle to raise finance. The EIS plays a significant role in the provision of venture capital for small businesses, having helped raise over £6.1 billion, invested in over 14,000 companies.

1.2 Building on the enhancements of recent years, Budget 2008 announces a further increase[1] in the annual investor limit to £500,000 (subject to State aid approval) to ensure that the scheme continues to stimulate investment. To complement this increase, the Government is keen to ensure that the scheme continues to be effective in promoting enterprise and in encouraging investment, and that it is imposing the least burden necessary on users. To achieve these objectives, the Government will continue to engage with stakeholders to ensure that full and best use is being made of the scheme.

1.3 This consultation examines the rules and processes governing the scheme, and aims to explore how it may be made more accessible, both to investors and to companies seeking finance. The main areas the Government would like input on are how users (and potential users) feel that the scheme could be simplified; how administrative or regulatory burdens could be reduced; and how awareness of the scheme could be raised among potential users. Specific areas for consideration are highlighted throughout the document but the Government would also welcome more general comments.

1.4 The Government welcomes responses by Friday 20th June 2008. The Government will report back on the results of this consultation document, with an accompanying Impact Assessment (if relevant), in the autumn.

THE GOVERNMENT'S OBJECTIVES

Productivity

1.5 The Government's central economic objectives are to achieve high, stable and sustainable rates of economic growth and employment. A key determinant of long-run growth is productivity growth that, together with employment growth, leads to greater prosperity.

1.6 Over the last decade the UK has made progress on raising the rate of productivity growth and narrowing the productivity gap with comparator countries. Since 1997 the UK has narrowed the gap with France (from 24 percentage points ahead to 17) and Germany (from 27 percentage points ahead to 17), and is the only G7 country to keep pace with the United States' impressive productivity performance (22 percentage points ahead to 19).[2]

1.7 While a number of factors are likely to have contributed to this, including the UK's policy of openness to trade and investment and maintenance of macroeconomic

1 The limit was raised from £150,000 to £200,000 in 2004, and to £400,000 in 2006

2 *International comparisons of productivity*, Office of National Statistics, 19 February 2008

stability, improved performance has coincided with significant reforms structured around the Government's five drivers of productivity: skills; competition; innovation; investment; and enterprise.

Enterprise

1.8 As one of the drivers of productivity, enterprise is at the heart of the Government's approach, bringing ideas, knowledge and skills, and providing incentives to innovate through raising competition. Enterprise can be considered both in terms of entrepreneurial entry (how many people become entrepreneurs) and how much entrepreneurial activity they undertake.

Access to finance

1.9 One of the Government's priorities in promoting enterprise is to ensure deserving companies have good access to both debt and equity finance. Securing external funding is vital to new start-up companies, as well as to expanding companies, in order to grow, develop and become viable, sustainable, profitable enterprises.

1.10 Although surveys have found an improvement in the overall financing environment for small and medium-sized enterprises (SMEs) over recent years, they mask a more complex underlying picture. For a minority of SMEs, especially young or potentially risky SMEs with high growth aspirations, debt finance alone (such as bank loans) is inappropriate and risk capital in the form of equity finance is more suitable. Evidence indicates that such firms may have difficulty accessing relatively modest amounts of equity or other forms of risk capital[3].

1.11 Risk capital is demanded by high growth potential firms, and is offered by investors ready to take high risk in exchange for potentially high returns. As the European Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (SARC guidelines)[4] acknowledge:

> *"…there is an 'equity gap' in the risk capital market, a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides, which negatively affects European small and medium-sized enterprises".*

ADDRESSING THE EQUITY GAP IN THE UK

1.12 Many venture capitalists are reluctant to invest small amounts in companies for a variety of reasons: principally high fixed transaction costs, shortage of available exit options, and a perceived greater risk in investing in early-stage companies. This reluctance has translated into a funding gap where smaller, higher-risk companies struggle to obtain the finance they need in order to grow. This is known as the "equity gap".

1.13 Although the existence of a UK equity gap has been known about since 1931[5], questions persist over how to identify and target the gap. It remains fundamentally difficult to pin down the size or shape of the gap, even through inexact proxy measures. There are a number of reasons for this.

1.14 The primary obstacle is the inherent difficulty of differentiating between those deals that are deserving of finance (and yet unable to secure it because of market

[3] *Bridging the finance gap: a consultation on improving access to growth capital for small businesses,* HM Treasury and Small Business Service, April 2003

[4] *Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (2006/C 194/02),* Official Journal of the European Union, August 2006

[5] *The report of the committee on finance and industry,* Macmillan, June 1931

inefficiencies) and those that are rightly denied it (for example due to lack of demand or a poor business case), even in an efficiently operating market. Not only is this distinction subjective, it is largely unobservable, because being unable to secure finance affects a wider population than those actually turned down by investors. The effects of the gap may actually deter an investor from even trying to seek finance.

1.15 In addition, the breadth of the gap remains ever-changing, driven by constantly shifting market factors, including:

- the availability of suitable investment opportunities (demand);
- the availability and price of finance (supply);
- the degree of information asymmetry suffered between entrepreneurs and financiers (which differs from deal to deal, sector to sector, year to year); and
- the nature and scale of transaction costs (again, differing from deal to deal, sector to sector, year to year).

1.16 Measures to address the equity gap aim to make the market operate more efficiently, in turn stimulating growth, productivity, innovation and expansion. These are all objectives of common interest and key features of the Lisbon Agenda[6] and the Government's own enterprise agenda.

Competition and State aid

1.17 This agenda rests upon the idea that a market-based economy provides the best guarantee for raising living standards. Efficiently functioning markets are an essential element in providing consumers with the products and services that they want. Furthermore, competition is essential to enhance the international competitiveness of the European economy, as it creates an environment in which efficient and innovative firms are rewarded properly.

1.18 The Government has been a long-term and committed supporter of European competition policy, and continues to believe in the importance of a strong and effective State aid regime that prevents aid that threatens to undermine competition and the efficiency of the Single Market. However, it also believes that there is a clear role for well-targeted interventions to promote structural reform and tackle market failures in support of the goals of the Lisbon agenda.

THE ENTERPRISE INVESTMENT SCHEME

1.19 The EIS was introduced in January 1994 as the natural successor to the Business Expansion Scheme (BES), which operated from 1983 until the end of 1993. It is one of three tax-based venture capital schemes (the others being Venture Capital Trusts, VCTs, and the Corporate Venturing Scheme, CVS), designed to address an acknowledged capital market failure in the UK, by helping small firms (who suffer it most acutely) to obtain the finance they need in order to grow their businesses into sustainable, profitable enterprises. The scheme does this by using fiscal incentives (tax reliefs), to lever additional private investment (risk capital) into smaller, higher-

[6] The Lisbon Agenda is an action and development plan for the European Union. Its aim is to make the EU "the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010". http://ec.europa.eu/growthandjobs/faqs/background/index_en.htm

risk, unquoted trading companies that would otherwise struggle to obtain appropriate levels of finance due to this market failure.[7]

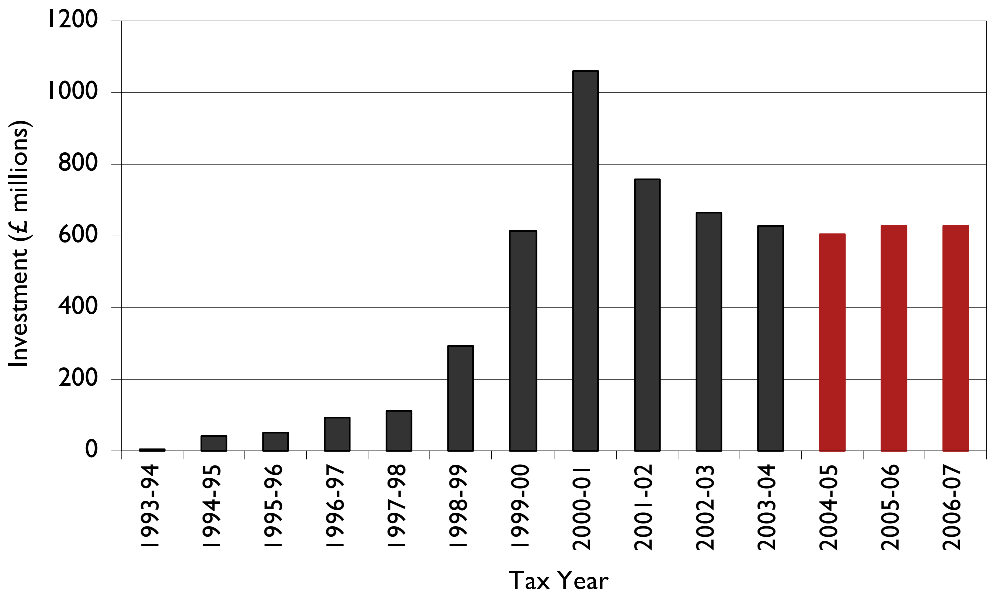
1.20 Chapter 2 contains a detailed description of the scheme, its rules and processes, but broadly, the reliefs available to investors are:

- 20 per cent income tax relief on up to £400,000 investment in any one tax year (giving up to an £80,000 reduction of income tax liabilities). Subject to State aid approval, this limit will be raised to £500,000 (giving up to a £100,000 reduction on income tax liabilities) for the tax year 2008/09 onwards;
- a capital gains tax (CGT) charge can be deferred on a capital gain that is reinvested in an EIS qualifying company; and
- CGT exemption on gains arising on disposal of EIS-qualifying shares.

Fundraising and investment

1.21 Charts 1.1 and 1.2 show the breakdown of investment and investee companies since 1993-94.

Chart 1.1: EIS investment by tax year

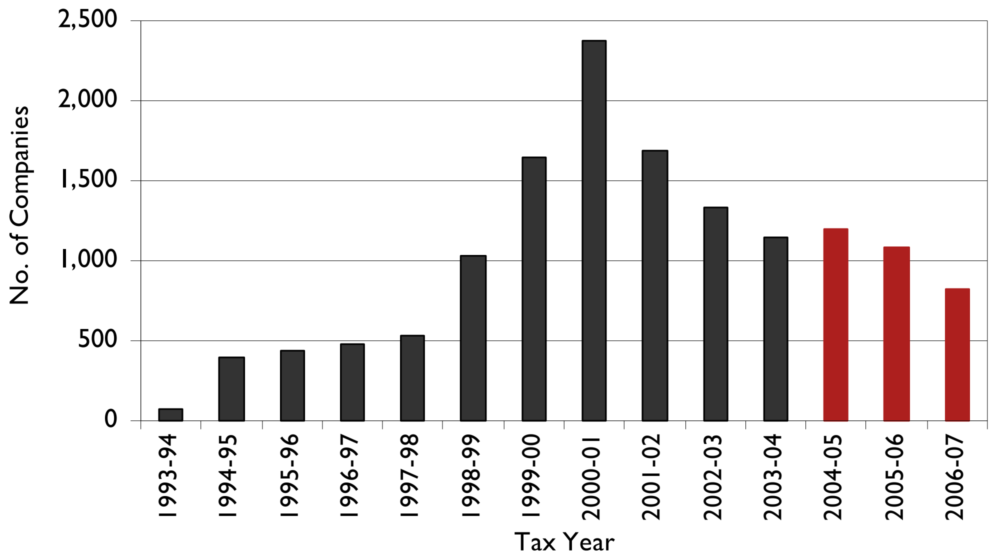


Note: As companies can have up to three years after shares are issued to seek to obtain an EIS compliance certificate, data from 2004/05 onwards is incomplete, and subject to revision.

1.22 As the chart above clearly shows, there was a steady rise in EIS investment levels from the year of inception, to a peak of over £1 billion in 2000/01, at the height of the dot-com boom. Recent investment levels have been over £600 million per year.

[7] A more detailed introduction to EIS can be found at: http://www.hmrc.gov.uk/eis

Chart 1.2: New EIS companies by tax year



Note: As companies can have up to three years after shares are issued to seek to obtain an EIS compliance certificate, data from 2004/05 onwards is incomplete, and subject to revision.

These figures refer to new companies only. They do not reflect the total number of companies raising funds in a given year as companies can issue shares under the EIS in subsequent years.

1.23 Since inception, the number of new companies issuing shares under the EIS also rose year on year to a peak of over 2,000 companies, also in 2000/01. In recent years, over 1,000 new companies have obtained EIS funding each year.

Econometric evaluation

1.24 On 12th March 2008 HM Revenue & Customs (HMRC) published the results of an independent econometric evaluation of the EIS and VCTs, conducted by the Institute of Employment Studies (IES)[8]. Following on from an earlier study in 2003 by independent consultants Public and Corporate Economic Consultants (PACEC)[9], this evaluation used HMRC's administrative data since the inception of the schemes, together with actual company performance and financial information, to produce a robust assessment of the impact of the schemes on recipient company development.

1.25 The results of this latest study suggest that the injections of equity finance through the EIS and/or VCT investment are used to grow businesses. Companies receiving investment through these schemes exhibited higher fixed asset formation, sales turnover and employment than companies not receiving EIS or VCT investment. Companies with EIS and/or VCT investment had lower aggregate level profitability and survival rates over the period covered by the study. The evaluation emphasised that *"It is important that these findings are interpreted within the context of the target community of young, growth-orientated small companies in higher risk trades"*.

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[8] HMRC Research Report 44 (2008) "Study of the impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on company performance"

[9] HMRC Research Report 2 (2003) "Research into the Enterprise Investment Scheme and Venture Capital Trusts" http://www.hmrc.gov.uk/research/summary.pdf

1.26 The report represents a valuable addition to the evidence base and benefits from the use of real company performance data, rather than subjective survey-based perceptions of performance. Independent analysis of relevant HMRC data is unique to this study, enabling examination of the absolute and relative effects of the two equity-based schemes across a large number of companies and over time. The focus on smaller and younger companies also provides important insights into a relatively under-researched aspect of equity finance in the UK economy.

2 THE ENTERPRISE INVESTMENT SCHEME IN OPERATION

OVERVIEW

2.1 As set out in Chapter 1, the Enterprise Investment Scheme (EIS) offers a variety of tax reliefs to individual investors in smaller, higher-risk, unquoted trading companies.

2.2 The investor can either subscribe for full-risk, ordinary shares in the company directly, or can put money into an EIS fund (see paragraphs 2.62-2.67) that subscribes for shares in a range of qualifying companies on behalf of investors.

2.3 Both the company and the investor must meet various conditions in order to obtain, and retain, EIS-qualifying status and the accompanying tax reliefs. HM Revenue & Customs (HMRC) has responsibility for administering the scheme[1], and ensuring that these qualifying conditions are met.

2.4 This chapter sets out details of the reliefs available through the scheme, the conditions that must be met for those reliefs to be obtained, and the point of view of the investee company, the investor and HMRC throughout the investment cycle. The Government would welcome views on the questions set out within the chapter, as well as views on any other administrative issues concerning the EIS.

GENERAL CRITERIA

2.5 Specific details of the scheme, its rules, processes and qualifying conditions can be found in the rest of this chapter. However as an overview, the main, overarching parameters are set out in the section below.

Company size and status

2.6 In order for an issue of shares to qualify for EIS investment, there are two main tests that a company must meet:

- **Gross assets test** – the gross assets of the company (or of the whole group if it is the parent of a group) cannot exceed £7 million immediately before any share issue and £8 million immediately after that issue; and
- **Employees** – the company (or the whole group if it is the parent of a group) must have fewer than 50 full-time employees (or their equivalents) at the time the shares are issued.

2.7 Besides carrying out a qualifying activity (see paragraphs 2.19-2.22) the company must also be an unquoted company when the shares are issued. That means that it cannot be listed on the London Stock Exchange or any other recognised stock exchange. The Alternative Investment Market (AIM) and the PLUS Quoted and PLUS Traded Markets are not considered to be recognised exchanges for this purpose.

EIS reliefs

2.8 The following reliefs are available to investors under the EIS:

- **Income tax relief.** This is based on the amount invested in the company. The relief given is 20 per cent of the amount invested, with a minimum investment of £500 per company per tax year. The maximum total investment in any tax year on which income tax relief is available is

[1] Within HMRC, the EIS is administered by a specialist office, the Small Company Enterprise Centre (SCEC)

currently £400,000. Subject to State aid approval, this limit will be raised to £500,000 for the tax year 2008/09 onwards.

Income tax relief can only be claimed by individuals who are not "connected" with the company. See "Connected Parties" at 2.35-2.39 below.

- **Capital gains tax (CGT) deferral relief.** If a capital gain (from any asset) is invested in shares of a company that qualifies under the EIS rules, then CGT on the gain is deferred until the EIS shares are disposed of. The EIS investment must be made no earlier than one year before, and no later than three years after, the gain arises.
- **CGT exemption.** Provided income tax relief has been granted (and not withdrawn), any gain from the disposal of the shares in an EIS company is exempt from CGT.

Qualifying period

2.9 An investor is entitled to these reliefs provided that the shares are held in a company that remains an EIS-qualifying company for a period of three years after the issue (or three years after the commencement of the trade if that followed the share issue).

THE INVESTMENT CYCLE

2.10 The table below summarises the lifecycle of an EIS investment from the perspectives of the investee company, the investor and HMRC.

Investee company	Investor	HMRC
Stage 1 – Before investment		
Be aware of the EIS	Be aware of the EIS	Encourage awareness of the EIS
Research appropriateness of the EIS to current circumstances	Research appropriateness of the EIS to current circumstances	Publish guidance, assist potential investors and investee companies
Identify potential investors	Identify potential investments	
Apply for advance assurance	Achieve comfort that selected investment will qualify for the EIS	Receive and consider applications for advance assurance
Stage 2 – Making the investment		
Issue the shares	Make the investment	
Complete compliance statements, issue compliance certificates		Receive and consider EIS1 forms and approve issue of EIS3 forms
	Claim relief (including claims to deferral on gains already charged to tax)	Check claims and give relief (including claims to deferral on gains already charged to tax)

Investee company	Investor	HMRC
Stage 3 – The three-year qualifying period		
Meet qualifying conditions for three-year period – including employment of money, location of trade, no inappropriate restructuring etc. Give assurance to investors. Provide HMRC with necessary information	Meet qualifying conditions for three-year period – including holding time of shares and connected parties rules. Seek comfort that qualifying conditions have been, and will continue to be, met by the company	Check that qualifying conditions are met
	If qualifying conditions are not met, notify HMRC that relief needs to be withdrawn	Withdraw reliefs if qualifying conditions not met

2.11 The next section of this chapter sets out each stage of this investment cycle and asks questions about where simplifications could be made.

2.12 For simplicity, EIS funds (see 2.62 to 2.67) are not dealt with separately in the table above. Funds sit naturally between the investee company and the investor, and share elements of both from a fund-raising perspective, an investing perspective and as a prospective investment opportunity. As such, the questions in this chapter can apply equally to EIS funds and the Government would welcome responses that deal with both direct and fund investment.

BEFORE INVESTMENT – THE INVESTEE COMPANY

2.13 Before investing, the company needs to be aware of the existence of the EIS and understand how it applies to its current circumstances. Most importantly the company needs to know whether it would qualify. However, even if it would qualify, the company needs to make a judgement about whether EIS investment is appropriate and how it fits with its particular circumstances.

2.14 For example, if the company's business plan envisaged a sale of the business within the three-year period, then the EIS would not be appropriate as the sale would mean relief being withdrawn.

2.15 If the EIS is appropriate for the company, it will then wish to identify potential investors and seek investment.

Q1 In October 2007 PricewaterhouseCoopers LLP published the survey "Enterprise in the UK: Impact of the UK tax regime for private companies", which showed 65 per cent of respondents were aware of the EIS – up from 52 per cent in 2006. What more can be done to continue this trend of increasing awareness of the scheme?

Q2 Is there anything in the broader regulatory regime that hampers investee companies seeking external investors under the scheme? If so, how could this be addressed?

2.16 The company can seek an advance assurance from HMRC (the Small Company Enterprise Centre – SCEC) that its share issue is likely to qualify, although this is not a mandatory requirement. The aim of such an assurance is to reassure the company as well as potential investors.

Q3 How well do advance assurances serve their purpose? Are there any ways in which the process of gaining an advance assurance could be simplified?

Conditions for relief

2.17 The company must meet several conditions before an EIS investment can be made, and must continue to meet these conditions throughout the qualifying three-year period.

2.18 As set out in paragraphs 2.6 and 2.7, the company (or group) must have gross assets of less than £7 million, fewer than 50 employees, and be unquoted when the shares are issued.

Activities

2.19 The company must either carry on a qualifying trade, or be the parent company of a trading group that carries on a qualifying trade. The qualifying trade must be carried on by either the company issuing the shares or by a subsidiary (which must be at least a 90 per cent subsidiary).

2.20 A qualifying trade is one that consists mainly of activities not on a list of excluded activities (see Box 2.1), and which is conducted on a commercial basis with the intention of making a profit.

2.21 The list of excluded activities is designed to target the scheme effectively on those companies facing the most severe barriers to accessing finance. In many cases the excluded activities are asset-backed trades that do not suffer the same degree of market failure as those companies without assets (that can be used, for example, as collateral to secure a loan).

2.22 Budget 2008 announces the addition of shipbuilding and coal and steel production to the list of excluded activities. This change is made in order to comply with the European Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (SARC guidelines)[2]. Any further changes to the list of excluded activities would have to be notified to, and cleared by, the European Commission before they could be implemented.

[2] *Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (2006/C 194/02),* Official Journal of the European Union, August 2006

Box 2.1: Excluded activities

Dealing in land, in commodities or futures in shares, securities or other financial instruments;

Dealing in goods, other than in an ordinary trade of retail or wholesale distribution;

Financial activities such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or any other financial activities;

Leasing or letting assets on hire, except in the case of certain ship-chartering activities;

Receiving royalties or licence fees (though if these arise from the exploitation of an intangible asset that the company itself has created, that is not an excluded activity);

Providing legal or accountancy services;

Property development;

Farming or market gardening;

Holding, managing or occupying woodlands, any other forestry activities or timber production;

Operating or managing hotels or comparable establishments or managing property used as an hotel or comparable establishment;

Operating or managing nursing homes or residential care homes, or managing property used as a nursing home or residential care home; and

Providing services to another person where that person's trade consists, to a substantial extent, of excluded activities, and the person controlling that trade also controls the company providing the services.

Finance Bill 2008 will contain legislation to exclude three further activities – shipbuilding and coal and steel production – in order to comply with State aid rules.

(Section 192 Income Tax Act 2007)

Q4 The list of excluded activities (see Box 2.1) has remained largely unchanged since the inception of the scheme. Do respondents feel it has kept up with commercial and technological developments? Are there any anomalies affecting particular industries or sectors?

Control

2.23 The EIS company must not be controlled by another company (or another company and any person connected with that company). Nor must there be any arrangements in existence when the shares are issued for it to be controlled by another company.

2.24 The reason for this control restriction is that the EIS is intended to help small, independent enterprises that have difficulty raising capital. Where another company controls an enterprise, that enterprise does not suffer the same market failures that the scheme is intended to address. The controlling company could provide finance, collateral (for traditional financing such as a bank loan), or reputation, reducing the risk for potential investors.

Q5 How well does the current control test achieve its objective of focusing relief on financially independent enterprises that have most difficulty raising capital?

Subsidiaries

2.25 The company may have subsidiaries, but if it does they must all be qualifying subsidiaries. That is, the company owns more than 50 per cent of the ordinary share capital of the subsidiary, and the subsidiary is not controlled (by other means) by another company[3].

Qualifying period

2.26 The rules regarding control, qualifying subsidiaries and the company carrying on the trade must be met throughout the qualifying three-year period outlined at paragraph 2.9. Otherwise, the investors will lose all of their reliefs. The three-year period is intended to make sure that the money raised under the scheme is used according to the policy objectives of the scheme for a reasonable time.

Other conditions

2.27 Budget 2007 introduced an annual investment limit of £2 million for companies receiving funding under the EIS and the other tax-based venture capital schemes. If this limit is breached, none of the EIS (or other) reliefs can be claimed on the shares within the issue that caused the breach.

2.28 There are also rules about when, and how, the money raised by the share issue may be used. At least 80 per cent must be employed within 12 months of the shares being issued (or the trade starting if that is later). The remainder must be employed within the next 12 months.

Q6 The Sainsbury Review of Science and Innovation[4] recommended that *"The conditions of the EIS scheme concerning the time constraints for the start of trading and the expenditure of money raised should be reviewed."* While the Government believes that it is necessary to preserve rules requiring the investment to be put to good use promptly, views are welcome about how the requirements might be refined in practice, especially whether there are particular industries that they do not fit well (for example, those whose ability to commence trade is dependent on potentially long regulatory approval procedures).

2.29 The money raised can be used for the purpose of:

- carrying on an existing qualifying trade;
- carrying on research and development intended to lead to such a qualifying trade being carried on; and
- preparing to carry on such a trade[5].

2.30 The trade must be carried on wholly or mainly in the UK. If preparing to trade, the preparation must be for a trade that will be carried on wholly or mainly in the UK.

2.31 If these requirements are not met for the duration of the qualifying period the investors will not be eligible for relief on the cost of their shares, and any relief given will be withdrawn.

[3] If the EIS company has a property management subsidiary, that must be at least a 90 per cent subsidiary

[4] http://www.hm-treasury.gov.uk/independent_reviews/sainsbury_review/sainsbury_index.cfm

[5] If the company is preparing to trade, the trade must start within two years of the shares being issued

BEFORE INVESTMENT – THE INVESTOR

2.32 As with the investee company, before investing, the potential investor needs to be aware of the existence of the EIS and understand how it applies to their current circumstances. For example, the tax benefits of investing under the EIS may not be available if the investor is likely to need access to their capital within three years, or if they do not have sufficient income tax liabilities to use the tax relief available (although relief for shares subscribed for in the first half of the tax year can be carried back to the previous year, within certain limits[6]).

2.33 The investor needs to know what potential investments are available, and be reasonably confident that they will qualify for the EIS. The investor must also consider the risk of that investment.

Q7 Is there an adequate level of awareness among potential investors of the existence of the EIS? If not, do you have specific proposals regarding how investor awareness could be increased?

Q8 Is there anything in the broader regulatory regime that hampers external investors seeking potential investee companies under the scheme? How could this be addressed?

Q9 Could any added value be gained from adapting the carry back provisions to allow carry back or carry forward for one year either side of investment?

Conditions for relief

2.34 EIS shares must be held for a minimum period of three years from issue (or from when the qualifying trade started, if this is later). The three-year period is intended to make sure that the money raised under the scheme is used according to the policy objectives of the scheme for a reasonable time.

Connected parties

2.35 Neither income tax relief nor capital gains tax exemption is available to individuals who are connected with the company. An individual is considered to be connected with a company in two ways:

- **Employment** – someone is connected with a company if they, or an associate, are a partner, director or employee of the company.
- **Financial interest** – neither the investor nor an associate can have a financial interest, which includes control of the company, holding more than 30 per cent of the share capital (or share and loan capital taken together), voting rights, or being entitled to more than 30 per cent of the assets in the event of a winding up[7].

2.36 A person's associates are defined as their business partners, trustees of a settlement (where they are either a settlor or a beneficiary), and relatives (spouses or civil partners, parents and grandparents, children and grandchildren – but not brothers and sisters).

[6] Half of the shares subscribed for in the period, up to a maximum of £50,000

[7] In looking at entitlement to assets, loans to the company are taken into account

2.37 However, there is an exception for directors who are Business Angels[8]. Where the investor's only connection with the company is as a director who receives no remuneration (and is not entitled to such remuneration), and who had not previously been involved in carrying on the trade the company is carrying on, an investment may qualify for income tax relief.

2.38 Income tax relief is not withdrawn if the investor subsequently becomes a paid director. The investor can also claim income tax relief on shares subscribed for after becoming a paid director, (providing any remuneration is reasonable), and those shares are issued to him no more than three years after the original shares he subscribed for. If the company had not started to trade when the shares were issued to the investor as an unpaid director, relief can be claimed on further issues within three years of the company starting to trade.

2.39 These conditions apply throughout the qualifying period outlined at paragraph 2.9.

Q10 Are there examples where the rules surrounding connected parties work in a way that seems anomalous to, or at odds with, the purpose of the scheme?

BEFORE INVESTMENT – HMRC

2.40 HMRC is responsible for administering and policing the EIS scheme. HMRC also has an interest in spreading awareness of the scheme among those for whom it is appropriate, in order to ensure that it meets its objectives, which would not be the case if take-up were too low.

2.41 Furthermore, HMRC wants to ensure that investors, companies, and their advisers understand the rules so that they are able to comply with them.

2.42 HMRC provides a short introduction to the EIS on its website at: http://www.hmrc.gov.uk/eis. This guide briefly covers the main features of the scheme, and points to the more detailed guidance that is available in the Venture Capital Schemes Manual: http://www.hmrc.gov.uk/manuals.vcmmanual/index.htm.

Q11 Are HMRC or other Government departments missing any opportunities to raise awareness of the scheme among potential investors and/or companies? Is there anything that HMRC or other Government departments are doing that impedes the links between potential investors and companies?

2.43 HMRC's first formal involvement in a potential investment will generally be upon receipt of an application for an advance assurance. Companies hoping to attract subscriptions under the EIS are encouraged to seek such an assurance, by contacting the SCEC and supplying information about the company and the share issue. Details of the information required can be found at: http://hmrc.gov.uk/manuals/vcmmanual/VCM21020.htm.

[8] Business Angels are high net worth individuals who invest on their own, or as part of a syndicate, in high-growth businesses. In addition to money, Business Angels often make their own skills, experience and contacts available to the company

2.44 Once it has received complete information, the SCEC will reply to the company. The reply will say whether or not, on the basis of the information provided, HMRC would approve a share issue by the company if it were to apply formally.

2.45 This is not a statutory process, but HMRC is normally bound by any assurance given, provided that the information supplied was correct and complete at the time it was given and has not been superseded by subsequent events.

2.46 Requests can only be dealt with if they come from the company secretary or directors or from some person authorised by them to negotiate with HMRC on their behalf. The rules of confidentiality apply, and potential investors making enquiries about a company should address those enquiries to the company itself.

2.47 It is not necessary for the request to identify the intended investors, and no assurance as to the availability of relief to a particular subscriber can be given either to the company or to the subscriber in question.

MAKING THE INVESTMENT

2.48 There are a range of forms that need to be completed by the investee company and the investors to claim EIS relief. The process is described in Box 2.2.

Box 2.2: Process for claiming EIS relief

If a company has investors who want to claim EIS relief, the company must obtain an EIS1 form from HMRC, either online or by requesting a paper copy from the Small Company Enterprise Centre (SCEC). The company then fills in the form with details of the share issue (a separate form is need for each issue) and returns it to the SCEC.

The SCEC then checks that the company, its trade and the shares meet the requirements of the EIS, and, if so, sends an EIS2 to the company, authorising it to send EIS3 forms to its investors.

The company must complete the first part of the EIS3 with details of the shares, and the three-year period (see paragraph 2.9) and send it to the investors.

The investors then complete the second part of the form and send it to their own tax office to claim relief. Most investors claim as soon as they receive the form, but a claim can be made up to five years after the 31 January following the tax year in which the investment is made.

If investments are made through an approved EIS fund (see paragraphs 2.63-2.65) the companies send the EIS3s to the fund manager, and the manager then enters the details from all of them on to an EIS5 form that is sent to the individual investors.

2.49 Once a company issues its shares (whether or not an advance assurance has been given), it submits details of the issue on an EIS1 form to the SCEC. A separate EIS1 form must be submitted for each share issue.

2.50 The SCEC can only accept the EIS1 if the company has been trading for four months or longer. And it cannot be accepted if submitted later than two years after the end of the year of assessment in which the shares were issued.

2.51 If the SCEC accepts that the company, its trade, and the shares all meet the requirements of the scheme, it will issue an EIS2 form to the company, and supply EIS3 forms for the company to forward to investors so that they can claim tax relief.

2.52 This process is repeated each time a company issues shares that it wishes to attract EIS reliefs for investors.

The investor

2.53 Having selected a suitable investment, the investor subscribes for shares in an EIS company or places money in an EIS fund.

2.54 If the company and the investment qualify, the company sends the investor an EIS3 form (or the manager of an approved EIS fund sends an EIS5). Having received this form, the investor then claims relief. This can either be claimed on the self-assessment return if the EIS3/EIS5 is received in time, or made as a separate claim if the EIS3/EIS5 is received after the return has been submitted.

HMRC

2.55 When the investment is made, HMRC will receive and consider EIS1 forms and approve the issue of EIS3 forms. HMRC will also check claims and give relief (including claims to deferral on gains already charged to tax), and provide the company with EIS3 forms to give to its investors.

> **Q12** Are there any ways in which the process of obtaining EIS relief (or the forms themselves) could be simplified?

THE THREE-YEAR QUALIFYING PERIOD

The investee company

2.56 As set out at paragraph 2.9 the company must continue to meet a number of conditions for a period of three years, or EIS relief is lost. The company must therefore monitor its compliance with these conditions after the share issue, and notify HMRC if it fails to meet any of those conditions.

2.57 Breaches of conditions by EIS companies fall into one of two categories:

- those resulting from lack of awareness of the rules (accidental breaches); and
- deliberate breaches, where the company takes advantage of an opportunity that is too commercially attractive to overlook. For example, a promising technology start-up may be sold or taken over within the three-year period and the EIS investor, if a minority shareholder, would not be able to prevent this. However the end result would still be that they would have sold their shares and therefore would lose relief.

> **Q13** Is three years a sensible time period for the company to have to continue meeting the qualifying conditions to ensure that the funds raised under the EIS are being used according to the policy objectives of the scheme?
>
> **Q14** What more could be done to ensure that companies meet their obligations and avoid accidental breaches?
>
> **Q15** Are there alternative ways of treating breaches of the requirements that still support the scheme's objectives and deter misuse, but apply more proportionately?

The investor

2.58 Income tax relief will be withdrawn if, during the three-year qualifying period, the investor becomes connected with the company, or if the company ceases to qualify. This could happen if, for example, the investor is taken on as an employee of the company and so becomes connected with it, or if the company begins to carry on an excluded activity such as property development.

2.59 Relief will be reduced or withdrawn if, during the same period:

- any of the shares are disposed of (except to a spouse or civil partner); or
- if the investor (or an associate) receives any benefit or loan (or anything else that constitutes "value") from the company; or
- the company repurchases share capital from another investor.

2.60 The investor therefore needs continuing assurance that both he or she and the company (or fund) continue to meet all the qualifying conditions. While it is of course up to the investor to make sure that he or she personally continues to meet his or her own obligations, he or she cannot guarantee that the company will continue to do so.

HMRC

2.61 Following investment, the investors claim the various reliefs either in their tax returns, or as freestanding claims if their tax return has already been submitted. Investors' own HMRC offices will deal with any queries that arise in relation to their particular claim. HMRC (the SCEC) then monitors the companies to check that the requirements continue to be met throughout the three-year period. If they are not, then investors will lose their relief.

EIS FUNDS

2.62 Some investors prefer to invest in an EIS fund that then identifies opportunities, invests in the underlying target companies, and manages those investments. This allows the investor to spread the risk across a more diverse portfolio. EIS funds can be approved by HMRC (although this is not obligatory). Approved and unapproved funds carry slightly different conditions.

Approved funds

2.63 The main benefit of applying for approved status is that, when determining the tax year for which income tax relief can be obtained, all EIS shares acquired through the fund are treated as though they had been issued on the date when the fund closes (provided that 90 per cent of the fund is invested within 12 months of that date).

2.64 The fund must invest in at least four companies, allocated between investors in proportion to the amounts they have contributed. There is no minimum investment level in each company.

2.65 As when an individual invests directly in a company, the shares held through the EIS fund must be held for the qualifying three-year period (as outlined at paragraph 2.9).

Unapproved funds

2.66 Unapproved funds are more flexible than approved funds, and do not carry restrictions on the number or timing of investments. There is, however, a minimum investment for each investor of £500 in each EIS qualifying company (which does not apply to investments made through an approved fund), and income tax relief is given according to when the investment is actually made, rather than when the fund closes.

2.67 As when an individual invests directly in a company, the shares held through the EIS fund must be held for the qualifying three-year period (as outlined at paragraph 2.9).

Q16 Are there any procedural or administrative aspects of the processes concerning EIS funds that you feel could be simplified? If so, how?

OTHER

Q17 Do you have any other suggestions on how the administration of the EIS could be simplified and/or improved?

3 SUMMARY OF QUESTIONS

BEFORE INVESTMENT – THE INVESTEE COMPANY

Q1 In October 2007 PricewaterhouseCoopers LLP published the survey "Enterprise in the UK: Impact of the UK tax regime for private companies", which showed 65 per cent of respondents were aware of the EIS – up from 52 per cent in 2006. What more can be done to continue this trend of increasing awareness of the scheme?

Q2 Is there anything in the broader regulatory regime that hampers investee companies seeking external investors under the scheme? If so, how could this be addressed?

Q3 How well do advance assurances serve their purpose? Are there any ways in which the process of gaining an advance assurance could be simplified?

Q4 The list of excluded activities (see Box 2.1) has remained largely unchanged since the inception of the scheme. Do respondents feel it has kept up with commercial and technological developments? Are there any anomalies affecting particular industries or sectors?

Q5 How well does the current control test achieve its objective of focusing relief on financially independent enterprises that have most difficulty raising capital?

Q6 The Sainsbury Review of Science and Innovation[1] recommended that *"The conditions of the EIS scheme concerning the time constraints for the start of trading and the expenditure of money raised should be reviewed."* While the Government believes that it is necessary to preserve rules requiring the investment to be put to good use promptly, views are welcome about how the requirements might be refined in practice, especially whether there are particular industries that they do not fit well (for example, those whose ability to commence trade is dependent on potentially long regulatory approval procedures).

BEFORE INVESTMENT – THE INVESTOR

Q7 Is there an adequate level of awareness among potential investors of the existence of the EIS? If not, do you have specific proposals regarding how investor awareness could be increased?

Q8 Is there anything in the broader regulatory regime that hampers external investors seeking potential investee companies under the scheme? How could this be addressed?

Q9 Could any added value be gained from adapting the carry back provisions to allow carry back or carry forward for one year either side of investment?

Q10 Are there examples where the rules surrounding connected parties work in a way that seems anomalous to, or at odds with, the purpose of the scheme?

[1] http://www.hm-treasury.gov.uk/independent_reviews/sainsbury_review/sainsbury_index.cfm

BEFORE INVESTMENT – HMRC

Q11 Are HMRC or other Government departments missing any opportunities to raise awareness of the scheme among potential investors and/or companies? Is there anything that HMRC or other Government departments are doing that impedes the links between potential investors and companies?

MAKING THE INVESTMENT

Q12 Are there any ways in which the process of obtaining EIS relief (or the forms themselves) could be simplified?

THE THREE-YEAR QUALIFYING PERIOD

Q13 Is three years a sensible time period for the company to have to continue meeting the qualifying conditions to ensure that the funds raised under the EIS are being used according to the policy objectives of the scheme?

Q14 What more could be done to ensure that companies meet their obligations and avoid accidental breaches?

Q15 Are there alternative ways of treating breaches of the requirements that still support the scheme's objectives and deter misuse, but apply more proportionately?

EIS FUNDS

Q16 Are there any procedural or administrative aspects of the processes concerning EIS funds that you feel could be simplified? If so, how?

OTHER

Q17 Do you have any other suggestions on how the administration of the EIS could be simplified and/or improved?

A THE CONSULTATION PROCESS

HOW TO RESPOND

A.1 The Government welcomes comments on the questions posed in this consultation paper. Any comments should be sent to:

EIS Consultation
SME Taxation
Room 2/N2
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 6005
Email: eisconsultation@hm-treasury.gov.uk

A.2 **Comments should be received by Friday 20th June 2008.**

CONFIDENTIALITY DISCLOSURE

A.3 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

A.4 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarding as binding on HM Treasury or HM Revenue & Customs (HMRC).

A.5 HM Treasury and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

ABOUT THE CONSULTATION PROCESS

A.6 This consultation is being conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice (see Box A.1). If you wish to access the full version of the Code you can obtain it at:

www.berr.gov.uk/files/file44364.pdf

Box A.1: The consultation criteria

Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.

Be clear about who may be affected, what questions are being asked, and the timescale for responses.

Ensure that your consultation is clear, concise and widely accessible.

Give feedback regarding the responses received and how the consultation process influenced the policy.

Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.

Ensure your consultation follows better regulation best practice, including carrying out an impact assessment if appropriate.

COMPLAINTS

A.7 If you feel that the consultation process does not satisfy these criteria, or if you have any complaints about the process, please contact:

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