

An Adviser's Guide to the Enterprise Investment Scheme

2023/2024 Edition

Find inside:

- EIS landscape
- Risks and rewards
- Rules for investors and qualifying companies
- Claiming the tax reliefs
- EIS structures
- Charges and practicalities
- Suitability
- Research and due diligence
- Case studies

A fully updated resource, with straightforward explanations of the workings, risks, rewards and fundamentals of EIS investments, including when and how they might be suitable.



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Tax treatment depends on an investor's individual circumstances and may be subject to change. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors.

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Introduction



The Enterprise Investment Scheme (EIS) has been a valuable growth investment vehicle, tax-planning tool and driver for UK SME funding since 1994.

But, like every long-running initiative, it is subject to rule changes and is impacted by the developing context.

This guide aims to provide the latest technical insights, practical case studies and important considerations for a potential EIS investment recommendation.

We also produce a free quarterly EIS Industry Update offering a snapshot of market conditions through opinions, analysis and research.

GUY TOLHURST

MANAGING DIRECTOR, INTELLIGENT PARTNERSHIP

Learning Objectives

After reading this guide, advisers will be able to:

- Apply the main rules and practicalities that govern the EIS reliefs available.
- Explain the main risks associated with EIS investments.
- Define the key aspects that need to be taken into account when considering client suitability for an EIS investment.
- Identify the main steps to claim EIS tax reliefs.
- Evaluate the main considerations for an EIS investment and investment provider.
- Ascertain the circumstances in which EIS reliefs can be withdrawn.

Acknowledgements

We would like to thank our sponsor, Octopus Investments. It would not be possible to produce educational material like this without their generous support and contribution towards the production and distribution of the guide.



Opening Statement

This year marks 29 years of the Enterprise Investment Scheme (EIS). EIS is helping innovative small businesses and entrepreneurs across the UK to find early-stage funding, with over £2.3 billion raised in 2021/22.¹

It's important to look at our current economic surroundings, to make sense of what the coming year holds. We're in a moment of balance. That balance is between clear headwinds, with increased uncertainty in markets due to rising rates and a correction to tech stocks, and a potentially more favourable environment for new start-ups. Incumbent businesses are laying off staff, increasing talent availability, and their appetite for experimentation is shrinking, decreasing competition.

This situation, while proving difficult for some, can help other companies shine: Uber, Airbnb and Zoopla were all founded at the height of the last financial crisis, in funding conditions not dissimilar to today. This environment has the potential to be fertile ground for investing in small businesses and targeting significant growth.

EIS reliefs incentivise investment into small UK companies with growth potential. Investing in these businesses is a high-risk activity, and the relief is there to compensate for some of this risk. When considered as part of a full assessment of a client's needs, the current climate could represent an ideal time to invest for those clients who are suitable and comfortable with the risks.

EIS-qualifying investments attract 30% income tax relief on investment, plus any successful investments grow free of capital gains tax (CGT). The impact of those that fail can be mitigated through up to 45% loss relief. You should be aware that tax treatment depends on individual circumstances and tax rules could change in the future. Tax relief depends on portfolio companies maintaining their qualifying status.

For clients with previous experience of other tax-efficient investments, such as Venture Capital Trusts (VCT), a managed EIS investment is a compelling way to invest in similar companies, but with the ability to target high growth from a more concentrated portfolio.

Through an EIS service, investors benefit from owning shares directly in a concentrated number of early-stage companies. This concentration means where a company succeeds, investors can really feel the impact of the growth. Equally, any losses will be felt more sharply. However, as noted earlier, loss relief is available on a per company basis, meaning losses can be mitigated, even where a portfolio as a whole has grown in value.

This is different from a VCT, which is typically invested across a larger number of companies, ranging in maturity from companies at a very early stage to more mature businesses that have been backed by the VCT for a number of years. Successes and failures can net off within the VCT. This means VCT performance is less capable of delivering the same pronounced outcomes that could be created with an EIS portfolio.

Of course, investing in high-growth small companies is high-risk.

Bear in mind that the value of EIS investments can fall as well as rise, investors could end up getting back less than they invest. Shares in EIS-qualifying companies could fall or rise in value more than other shares listed on the main market of the London Stock Exchange. They may also be harder to sell.

All things considered, for clients who can hold an investment for between five and ten years to feel the full potential benefits, EIS could be an intriguing way to target growth and diversify their portfolio.



The EIS landscape

Purpose

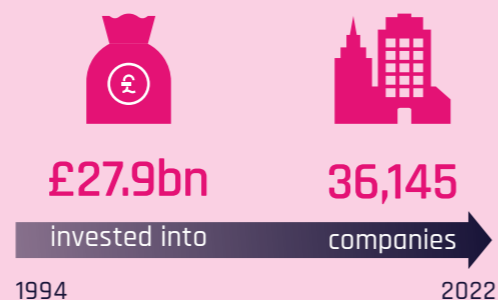
The Enterprise Investment Scheme (EIS) is a government scheme designed to encourage investment into small and medium-sized enterprises (SMEs) that have a permanent establishment in the UK.

Along with the other Venture Capital Tax Reliefs (which include the Seed Enterprise Investment Scheme (SEIS) and Social Investment Tax Relief (SITR)), the scheme offers tax relief to individuals as an incentive to invest in SMEs and social enterprises that are not listed on any recognised stock exchange.

Many SMEs and unlisted companies are likely to struggle to obtain alternative sources of finance. However, these potentially high growth companies, while deemed risky, are recognised to be a vital contributor to economic growth and job creation.

Therefore, the government offers generous incentives to investors in these schemes to reward them for assisting such companies to grow and develop.

History and main developments



EIS was launched in 1994 as a replacement for the Business Expansion Scheme. Since then, over £27.9 billion has been invested into over 36,000 companies via EIS. This is widely seen as a great success and the scheme has enjoyed the support of successive governments.

Over its lifetime, a number of changes introduced to the rules governing EIS have been made with the intention of expanding the scheme - as well as ensuring that EIS continued to meet EU State-aid requirements and remains focused on growing and innovative businesses.



Many successful companies (including household names such as Gousto, Money Dashboard and Bloom & Wild) have used enterprise investment schemes as part of their early-stage funding. As, despite the risks, there is an opportunity for an investor to make a substantial capital gain on a successful investment”.

OFFICE OF TAX SIMPLIFICATION, 2021

SIZE OF EIS-QUALIFYING COMPANIES

- PRIOR TO 6 APRIL 2012
- ON OR AFTER 6 APRIL 2012



up to 50

full-time equivalent employees



up to 250

full-time equivalent employees

The rate of income tax relief was increased from 20% to 30% from April 2011 and the scheme was expanded in 2012 to allow greater levels of investment into larger companies.

This coincided with a boom in investment into renewable energy projects that often also qualified for other government subsidies and new investment managers entered the market to meet the increased demand.

However, in 2014 the Chancellor excluded subsidised electricity generation from the EIS reliefs (with ALL energy generation activities excluded from April 2016), recognising that these investments were not sufficiently risky (especially those subsidised through other means) to justify the EIS tax advantages.

Further changes were made in 2015 in order to ensure that the EIS reliefs continued to comply with EU State-aid requirements. These changes had the effect of tightening up the rules in some areas by adding further restrictions on the types of companies that qualify for EIS.

In addition, and in line with similar rules introduced for VCT and SEIS, from March 2018, the 'risk to capital' condition was introduced to identify and exclude lower risk activities that should not benefit from the tax relief.

Since April 2018, Knowledge Intensive Companies (KICs), those which are carrying out significant levels of research and development (R&D) can qualify for higher amounts of EIS (and VCT) funding than other EIS-qualifying companies. See page 29 for HMRC's definition of R&D.

None of these recent changes should be interpreted as the government changing their support of EIS. The changes were designed and targeted to ensure that EIS continues to be both compliant with EU State-aid rules and meets the purpose for which it was introduced, namely to address the UK equity gap, i.e. equity funding for small businesses.

Risks and rewards

Investments into unquoted small and medium-sized enterprises are deemed high risk. It is important to understand the risks associated with EIS-qualifying investments in a general sense, and we will examine some of those risks here.

However, each individual EIS investment opportunity has its own unique risks and, therefore, each opportunity must be individually assessed.

Investment risks

Statistically speaking, smaller companies fail more often than larger, established companies. The reasons for this include:

- They can be more reliant upon a small number of customers;
- They have less capital available to withstand a downturn in their fortunes;

- They can take a long time to bring new initiatives to fruition and become profitable.

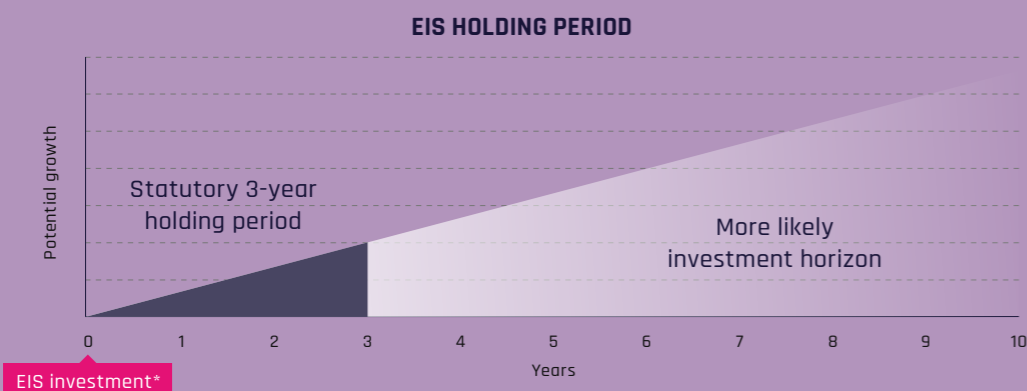
These risks can be offset, to some extent, by skilful stock selection and sufficient diversification.

Liquidity

Although the minimum holding period to qualify for the full income tax relief and tax-free growth is at least three years (note, there is no minimum holding period for Capital Gains Tax (CGT) deferral relief), in reality investors are likely to have to commit their funds for much longer; most EIS investments should be viewed on a five to ten-year investment horizon.

Previously, some EIS funds have been positioned as 'lower-risk' and some may have had an objective of winding up as soon after the three-year period as possible. But this is still subject to being able to successfully dispose of the qualifying investments without there being any arrangements for this in place from the outset (as required by EIS rules).

However, the risk-to-capital condition (explained on page 25) means that anything structured to be 'lower risk' has no longer qualified for new EIS investment since 15 March 2018, when the Finance Act 2018 received Royal Assent.



* EIS shares must be held for a period of at least three years - from the later of the issue of shares, or commencement of trade if the shares were issued when the company hadn't commenced trading.

There is no large-scale active secondary market in unquoted shares and EIS managers do not offer buy-backs.

It may be possible to arrange a private sale of shares to a third party, but, at the point of investment, investors should regard themselves as locked in to the shares until the underlying company either lists on a recognised stock exchange, achieves a trade sale, or the company is wound up. (EIS rules dictate that should a company list on a recognised stock exchange within an investor's relevant three-year holding period, EIS relief for that investor will be withdrawn. However, some stock exchanges such as AIM fall outside the definition of a recognised exchange so it may be possible to list on AIM without a withdrawal of relief. This is considered further in the Rules for qualifying companies section).

Exit risk

As unquoted investments, any gains in EIS-qualifying shares are only 'attributed gains' (unrealised) until the investor can exit and realise those gains. There is no active secondary market in unquoted shares, so an exit is most likely to come in one of THREE ways:

1. **An Initial Public Offering (IPO)** - The company lists on an exchange and shares can be sold on the open market.
2. **A trade sale or management buyout** - A majority of shareholders agree to sell their shares to another company or possibly the incumbent management team.
3. **Voluntary liquidation by shareholders** - The company is wound up and the assets are sold, with the proceeds distributed to shareholders. This doesn't necessarily mean that the company has failed; depending on the remaining assets of the company, the distributions to the shareholders may be worth more than the initial price they paid for their shares.

'Zombie companies'

There is a risk of an investment continuing indefinitely with no large-scale active secondary market in EIS shares; this is to the extent that described exit routes cannot be achieved at either a gain or a loss. A loss could at least be offset against other gains. Since very few small companies pay dividends and dividends paid from an EIS-qualifying company are subject to tax, there is unlikely to be any income. In this scenario the funds remain tied up indefinitely with little prospect of recycling them. EIS investee companies in this situation are often referred to as 'zombie companies'.

Tax risks

A company that issues EIS-qualifying shares must meet a number of different criteria. Some of these criteria apply at the point of investment and some apply for the minimum three-year holding period.

If the company changes its activities or structure in such a way that it no longer meets these qualifying criteria during that three-year period, then investors lose their tax reliefs. See the Rules for qualifying companies section on pages 25-27 for more details.

Relief will be denied on any shares issued under arrangements that offer investors a protection against the risks of making the investment or which would effectively guarantee (or at least make it likely) that the investor will receive their money back at some point in the future through some mechanism introduced by the provider or the company itself. This would be considered to be part of an arrangement, for the purpose of tax avoidance.

However, simply making an investment with the aim of qualifying for relief is unlikely to be viewed as tax avoidance in itself.

TAX RELIEFS IN SUMMARY

EIS tax reliefs are only available to investors with a UK tax liability, and are only available if the investee company maintains its qualifying status throughout an investor's minimum three-year holding period. The amount of relief an investor will get depends on their individual circumstances.

While it is important to understand the details of the tax reliefs available, tax should not be the only driver for investment in shares in an EIS-qualifying company.

The investment must be suitable for the client even without taking tax relief into consideration and there is likely to be a specific planning scenario involved.

There are FIVE potential tax reliefs available for EIS investors, some or all of which may be available/applicable to a particular investor:

- **Up to 30% income tax relief**
- **100% CGT deferral relief**

- **100% IHT relief** (via BR after a minimum holding period, applicable to most EIS-qualifying companies)
- **Tax-free capital growth** (subject to meeting certain conditions throughout the minimum holding period and claiming income tax relief)
- **Loss relief** (losses are available to offset against capital gains or, in certain circumstances, income tax)



TAX RELIEFS SUMMARY

	RATE OF RELIEF	MINIMUM HOLDING PERIOD
INCOME TAX RELIEF	Up to 30% of the value of EIS-qualifying shares subscribed for	3 years from the acquisition date of the shares (however, if the company is not trading when the shares are issued, the period ends on the third anniversary of commencement of the trade)
CGT DEFERRAL RELIEF	100% of a gain can be 'deferred' if it is invested in qualifying shares, thereby deferring the CGT liability	The gain crystallises when the qualifying shares are disposed of (or deemed to be disposed of)
IHT RELIEF	100% of the value of the EIS shares at the time of death (or other chargeable event for IHT purposes)	2 years from the date of acquisition of the shares where the company is trading at the time of the share issue. Replacement business property rules may also apply
TAX-FREE GROWTH	100% CGT exemption on EIS shares	3 years from the acquisition date of the shares (if the company is not trading when the shares are issued, the period ends on the third anniversary of commencement of the trade)
LOSS RELIEF	Losses can be offset against capital gains or income tax and the prevailing rates will depend upon the individual's circumstances and tax position	None

WINDOW OF OPPORTUNITY	MAXIMUM LIMIT	FURTHER CONSIDERATIONS
The tax year of the share issue, with the potential to carry back some or all of the investment to the previous tax year	£300,000, based on the annual EIS limit of £1 million. It is also possible to carry back an investment of up to £1 million to the prior tax year. Where at least £1 million is invested in knowledge-intensive companies, the annual investment limit for individuals is increased to £2 million. This allows up to £600,000 income tax relief in a tax year.	Can only be offset against income tax paid. Income tax relief must be claimed, and not withdrawn, in order to achieve tax-free growth - see below
3 years after or one year prior to the disposal of the original asset giving rise to the gain	Unlimited	If the EIS shares are disposed of, the crystallised gain can be reinvested into further EIS shares and deferred again
Relief must be applied for by the executors of the deceased's estate (IHT must usually be paid within 6 months from the end of the month of death) or by the transferor in the event of a lifetime transfer	Unlimited	IHT is unlikely to be primary driver when considering an EIS investment
No CGT to pay upon disposal if EIS shares are sold at a gain	Unlimited	Income tax relief must have been claimed and not subsequently withdrawn in relation to the purchase of the EIS shares
Losses can be offset against other capital gains in the year of the loss and any excess can be carried forward. Losses can potentially also be offset against income tax in the current or preceding tax year	100% of the capital loss on the EIS shares (less the income tax relief), provided there are sufficient gains / income tax to offset the loss against	

Income tax relief: Examples of use

EIS investors can claim a reduction in their income tax bill of 30% of the cost of the EIS-qualifying shares they have subscribed for.

The reduction can either apply to the tax year in which the shares were issued, or it can be carried back to the previous tax year (subject to how much, if any, of the previous year's allowance is still available).

Example

A client who subscribed for £250,000 of EIS-qualifying shares would be entitled to claim up to £75,000 of income tax relief (£250,000 x 30%).

While we recognise the potential benefits of EIS as an investment opportunity, it is important that investors who acquire EIS-qualifying shares have a clear understanding of the risks, as well as the benefits, associated with investing in them.

POINTS TO NOTE:

1

An investor's **overall income tax liability** cannot be negative (i.e. it is not possible to claim relief on tax that hasn't been paid or isn't due to be paid).

Example

A client who subscribed for £250,000 of EIS-qualifying shares would be entitled to claim up to £75,000 of income tax relief (£250,000 x 30%).

If the client had only paid £50,000 of income tax over the previous two years, £25,000 of that relief would be lost (£75,000 - £50,000).



The government recognises the roles that these schemes have played in removing obstacles which prevent the UK's young, innovative and high-risk companies accessing the finance they need to grow.

JEREMY HUNT, CHANCELLOR OF THE EXCHEQUER, MARCH 2023

2

The **maximum** that can be invested in EIS-qualifying opportunities annually by an individual (and still qualify for the income tax relief) is £1 million.

From 6 April 2018, this was extended to £2 million provided that any amount above £1 million is invested in knowledge-intensive companies. The 30% income tax relief applies to this extra limit also. This means that the maximum income tax relief in a single year is £600,000 (£2 million x 30%).

Example 1

A client could subscribe for £2 million of EIS-qualifying shares and, assuming that they had not used any of the previous year's EIS income tax relief allowance, they could carry £1 million of the share purchase back, thus claiming £600,000 income tax relief in total:

(£1 million x 30% = £300,000 relief in 2023/24 + £1 million x 30% = £300,000 relief carried back to the previous year).

However, if the client had subscribed for £600,000 of EIS-qualifying shares in the previous year (and claimed the tax relief for that year), then they would only be able to carry back £400,000 of 2023/24's purchase (£1 million - £600,000) and claim £120,000 income tax relief for 2022/23.

Example 2

Alternatively, a client could subscribe for £2 million of EIS-qualifying shares, £1 million of which represents holdings in knowledge-intensive companies. They could then claim £600,000 income tax relief in total in the 2023/24 year (£2 million x 30% = £600,000).

3

The **minimum holding period** to retain income tax relief starts on the date of the share issue. It ends on the third anniversary of the later of the date of the share issue and the date of commencement to trade.

If an investor disposes of their shares prior to the end of the three-year period, HMRC claws back the income tax relief.

Example 1

The clawback can never be more than the amount of the initial income tax relief (subject to any interest that may be due). If the shares are disposed of at a gain within three years, HMRC will claw back the full amount of the tax relief received.

Assume a client subscribes for £500,000 of EIS-qualifying shares and receives £150,000 income tax relief. If the client was to then sell those shares for £1 million within three years, HMRC would claw back the full £150,000. It might only make sense to sell the shares within the three-year period, when the sales proceeds exceed any clawback of income tax relief and any CGT liabilities.

Example 2

If the shares are disposed of at a loss within three years, the clawback will be equivalent to the sales proceeds multiplied by 30%.

Assume a client buys £500,000 of EIS-qualifying shares and receives £150,000 income tax relief. If the client was to then sell those shares for £400,000 within three years, HMRC would claw back £120,000 (£400,000 x 30%) - the client may be able to claim share loss relief on the net loss of £70,000 i.e. £100,000 less the remaining income tax relief of £30,000.

CLAWBACKS

Transferring the shares to a spouse or civil partner within the three-year period does not trigger a clawback of income tax relief, but transferring the shares to any other third party does. (This may be driven by the investment manager for a commercial reason and be out of an investor's hands). There is no clawback if the disposal or transfer is a result of the investor's death.

HMRC claws back income tax relief by raising a special assessment for the tax year in which the relief was obtained.

Normally, interest is charged from 31 January following the end of the tax year for which the assessment is made. Where

the shares were acquired from a spouse or civil partner, the assessment is made on the person they were transferred to as if they purchased them on the date of acquisition by the transferor.

BRAND NEW SHARES

Finally, to qualify for income tax relief the client must subscribe, fully pay for in advance and be issued brand new shares that the investee company is issuing to the market.

Secondary purchases, either purchased on an exchange or arranged privately, do not qualify for EIS tax relief.



HMRC Guidance

HS297 Enterprise Investment Scheme and Capital Gains Tax

Who can claim deferral relief?

You can claim relief if you are an individual resident or ordinarily resident in the United Kingdom (UK). You cannot claim relief if you are treated by double taxation arrangements as resident elsewhere, so that (ignoring any Disposal Relief) you would not be liable to UK Capital Gains Tax on any gain from the EIS shares. The trustees of certain settlements may also claim relief.

CGT deferral relief

If a client reinvests a capital gain from the sale of another asset into qualifying shares in an EIS company, they are entitled to defer the gain on the original asset.

This means that any CGT liability on that gain is deferred. The gain is deferred until the investor sells their shares (or is deemed to have disposed of their shares) in the EIS company, at which point the gain crystallises and CGT is then payable at the prevailing rate applied at that time.

EIS cannot be used to reduce, for example, the rate of CGT applying on the sale of property (currently 28% for a higher rate taxpayer). A revived gain is chargeable to tax at the rate applying to the original asset.

If the proceeds from the sale of the EIS shares are reinvested in another EIS-qualifying company, the gain can be deferred again if reinvested during the relevant time window. This can continue indefinitely and, if the investor were to die holding an EIS investment

that had enabled them to defer gains in this manner, then the CGT liability is extinguished.

In order for the gains to be matched to an EIS investment, they must arise within a four-year time window commencing one year before and ending three years after the share issue date.

Example

A client sells a residential property (that was not their main residence) for £300,000, making a capital gain of £50,000.

By investing that £50,000 into EIS-qualifying shares, the CGT on the gain is deferred until the client disposes of the EIS-qualifying shares. This has the effect of deferring the CGT liability of £14,000 (£50,000 x 28%), assuming the client has no remaining CGT annual exempt amount that year and pays CGT at the higher rate for property disposals.

If the client had sold their property 30 months ago, they still have six months in which to invest their gain into EIS-qualifying shares and defer the CGT on the gain. The same timeframe applies to each subsequent reinvestment in EIS shares.

Only the capital gain (or a proportion of it) needs to be invested in an EIS, NOT the entire proceeds of the sale. This feature can be useful in scenarios where advisers want to ensure that conventional CGT annual exempt amounts are maximised.

Example

a) *Our client could choose to invest just £25,000 from the sale of their house into EIS-qualifying shares. Deferring £25,000 would leave them a CGT liability of £7,000 (£25,000 x 28%), assuming the client has no remaining CGT annual exempt amount that year and pays CGT at the higher rate for property disposals.*

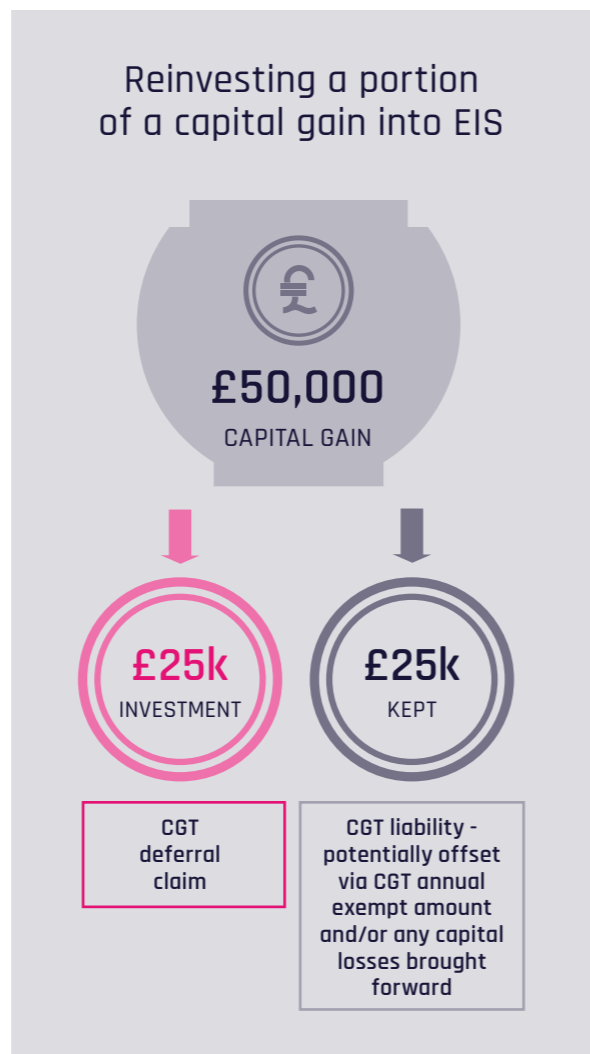
b) Let's assume our client does in fact have their full CGT annual exempt amount available (£6,000 for 2023/24). Rather than claiming CGT deferral relief on the full amount of the gain reinvested, they could claim less, for example, if they wanted to use their CGT annual exempt amount to cover part of their gain. For example, they could invest £44,000 in EIS and claim £44,000 in CGT deferral relief, leaving £6,000 to be covered by their CGT annual exempt amount and no CGT would be immediately payable.

Only UK resident individuals and trustees of a qualifying UK resident settlement can claim deferral relief. The qualifying settlement is where all beneficiaries are either individuals or charities. There is no restriction on connected individuals claiming EIS deferral relief as there is in relation to income tax.

There is no upper limit on how much capital gain can be deferred: the £1 million (£2 million for investments into knowledge-intensive companies) limit only applies to the income tax relief and even if the investor is not intending to claim income tax relief at all, there is no limit.

Similar to income tax relief, gifting the shares to a spouse or civil partner does not crystallise the deferred gain immediately; it only crystallises once the spouse or civil partner disposes of the shares (and the gain is assessable on the transferee). However, gifting the shares to a third party crystallises the deferred gain immediately.

There are other events that crystallise the deferred gain. If the investor becomes non-resident in the UK (however, going abroad for full-time employment and returning within three years is allowed) or if the shares themselves cease to be EIS-qualifying shares for some reason (see the section on Rules for qualifying companies), the gain crystallises. Deferral relief cannot be claimed before a compliance certificate (known as an EIS3) is issued by HMRC and



completed and signed by the company and then given to an investor in order to enable them to claim the relief. This applies when requesting CGT and income tax relief. In practice, this can mean CGT has to be paid in the meantime and reclaimed later on. There is more detail on the process of claiming the relief in the 'Claiming the tax reliefs' section which starts on page 33.

There is no stipulation as to which gains have to be deferred: earlier gains do NOT have to be deferred first. Which gains to defer (if there is more than one to consider) is entirely the investor's choice.



Tax-free growth (disposal relief)

Providing EIS-qualifying shares are held for at least three years (from the later of when the shares were issued, or when the company started trading) and the investor successfully claims income tax relief, if the shares are sold at a gain, the gain on the EIS-qualifying shares is exempt from CGT.

If full income tax relief cannot be claimed (or is not claimed) because the investor's income tax liability is reduced to nil, full Disposal Relief is available. If partial relief has been claimed or part of the relief has been withdrawn, then only partial Disposal Relief is available.

As well as being restricted if, for example, there is 'value received', the CGT exemption is restricted in circumstances where the original investment exceeded the maximum permitted for income tax relief (£1 million or £2 million providing at least £1 million is invested into knowledge-intensive companies). For example, ignoring carry back, if an investor bought shares for £3 million, including £1 million in knowledge-intensive companies, disposal relief would be restricted to two-thirds of any gain arising on a disposal.

Example (Disposal relief)

A client invests £50,000 into EIS-qualifying shares and then sells the shares for £75,000 four years later (in 2022/23). Outside EIS, the investor could expect to incur a £2,540 CGT liability.

$(£75,000 - £50,000 = £25,000 \text{ gain.})$
 $£25,000 - £12,300 \text{ CGT annual exempt amount (2022/23)} = £12,700 \text{ gain.}$
 $£12,700 \times 20\% \text{ CGT} = £2,540.)$

However, in these circumstances, the gain on the EIS shares is tax-free.

Loss relief

Relief is available for EIS 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 the investor's capital gains or their income tax liability.

Example 1. Partial loss (after expiry of minimum 3 year holding period)

If the client mentioned earlier invested £50,000 into EIS-qualifying shares and instead sold their shares for a £25,000 loss, they would be entitled to offset that loss against any other gains that year to minimise their CGT liability.

However, they would not be entitled to offset the entire loss. If we assume that they claimed the full £15,000 income tax relief available on the initial purchase, their loss relief is limited to £10,000.

$(£25,000 \text{ loss} - £15,000 \text{ income tax relief retained} = £10,000 \text{ available to offset against capital gains or income.})$

The amount that can be offset is dependent on the applicable CGT or income tax rate.

Since the loss relief is being applied to capital gains charged at 20%, the client can claim 20% of the loss, a total of £2,000 (£10,000 x 20%) against their CGT liability in the year of the loss or any future capital gains.

Example 2. Loss relief - total loss (after expiry of minimum 3 year holding period)

Another client invests £100,000 in EIS qualifying companies. By doing so, they are entitled to reduce their income tax liability by a maximum of £30,000 (30% of £100,000).

The net cash cost of investment is then £70,000. If all the investments failed, the total loss before loss relief would be £70,000.

In the event of total loss, the amount of loss relief that can be claimed is dependent on the investor's marginal rate of income tax. (The investor wants to offset the loss against other income taxable at 45% as opposed to chargeable gains taxed at 20%)

This client pays 45% income tax and can claim 45% of the loss, a total of £31,500 (£70,000 x 45%) against their income tax liability. This means they have received tax reliefs totaling £61,500 against their £100,000 investment, limiting their exposure to 38.5% of the original investment.

If the entire loss cannot be relieved against income in the relevant two years (perhaps because there is not enough income to relieve the losses fully), any unused balance can be used against capital gains arising in the same year as the loss; or carried forward to offset against any future capital gains.

Other loss reliefs that can be set against income, such as trade loss relief, are restricted to the higher of £50,000 or 25% of the taxpayer's income annually.

However, this restriction does not apply to EIS, where EIS income tax relief is claimed (but it does apply where only CGT Deferral Relief is claimed).

Options for offsetting losses on EIS shares

Against Capital Gains

As with conventional capital losses, any losses from the sale of EIS-qualifying shares can be offset against any capital gains made in the same tax year, thus reducing any CGT liability;

Any remaining losses can be carried forward to a future tax year;

Any income tax relief received in relation to the initial investment is subtracted from the capital loss first.

Against Income

The loss can be offset against any income in either the same tax year or the preceding tax year, or both;

The loss is subtracted from the investor's net income when calculating their income tax liability;

Any income tax relief received in relation to the initial investment is subtracted from the capital loss;

In practice, as income tax rates are usually higher than CGT rates, offsetting against income tax will generally be more attractive where a client is subject to the higher rates of income tax.

IHT relief via Business Relief

The vast majority of EIS-qualifying investments attract 100% IHT relief via BR because the qualifying trades for EIS purposes are very similar to those which qualify for BR. However, to be eligible for the EIS tax reliefs, there are additional qualification criteria including the risk-to-capital condition.

Qualification for BR is subject to the minimum holding period of two years (from the later of the share issue date and trade commencement). However the 'replacement property' provisions mean that a qualifying investment may also be treated as satisfying the two-year minimum ownership period. This is where it replaces (either directly or indirectly) other qualifying assets that have been disposed of. In order to qualify for replacement relief, the new investment needs to qualify as relevant business property and must be bought within three years of the disposal of the original qualifying asset.

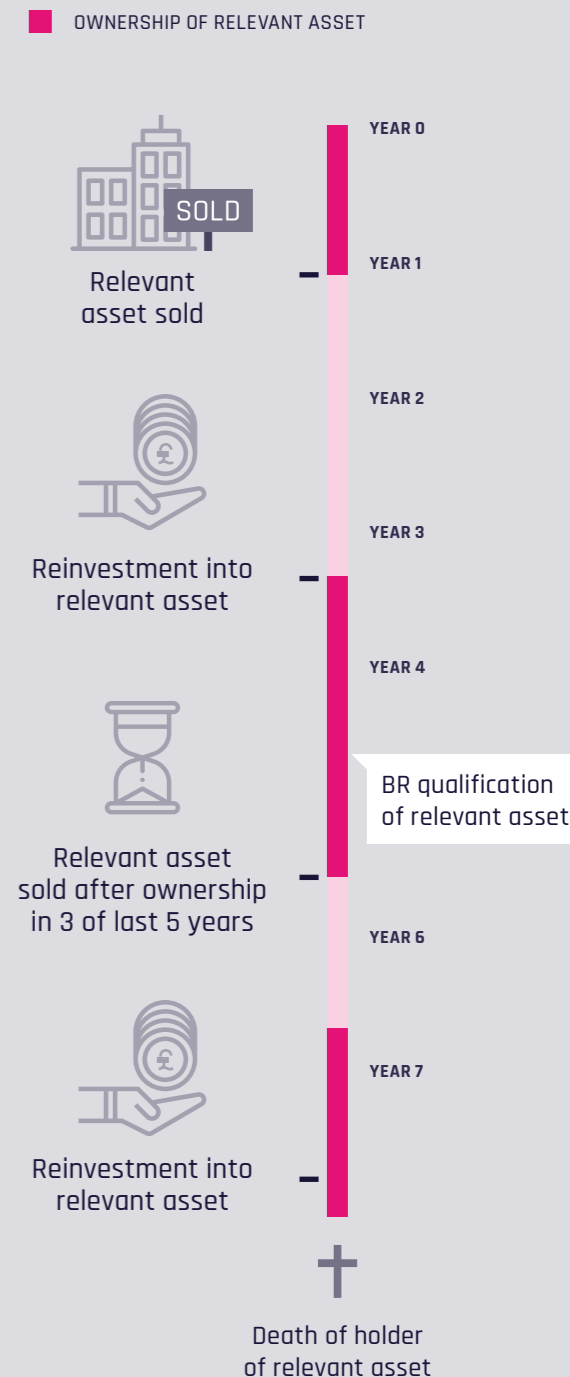
It's also necessary that the replacement investment is still held at death (or the point of any other chargeable lifetime transfer), and that the combined holding period for both is at least two out of the last five years.

To attract 100% Business Relief, 'relevant business property' comprises: a business or interest in a business; unquoted securities that either by themselves or in conjunction with other securities or unquoted shares give their owner control of an unquoted company; or unquoted shares (including those listed on the AIM market).

Example

Consider a client with an estate of over £2 million, who invested £100,000 into EIS-qualifying shares and held these for at least two years prior to their death (or has held qualifying assets for at least two years within a period of five years, where replacement relief has been utilised).

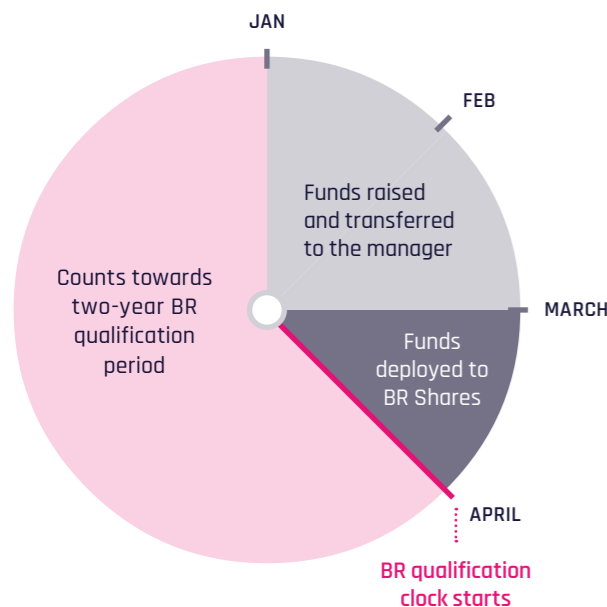
Example of replacement business property



The relevant asset is BR qualifying as it has been held for at least 2 of the last 5 years and it was held by the deceased on death. While this works for BR qualification, EIS qualification requires a minimum, uninterrupted holding period of at least 3 years.

Provided that the shares still qualified for BR at the date of death, they will be passed on to their beneficiaries without IHT being suffered in relation to the value of the EIS shares.

BR qualification clock



Business Relief is a retrospective relief in the sense that it is only assessed when a claim is made: either by the executors of the deceased's estate or when there has been a chargeable lifetime transfer.

When it comes to claiming BR, the two-year qualifying period starts when the money is used to purchase the shares in a trading company, not, for example, when the money is transferred to an EIS investment manager. There will be a lag of weeks or months between a manager receiving money and investing it on a client's behalf, and this lag must be taken into account when determining the dates for qualifying periods.

While EIS qualification brings additional tax benefits, they are usually riskier investments than those targeting BR benefits alone, with lower levels of liquidity and higher levels of fees and charges. So, if the objective is IHT relief while retaining access to the funds and the risk appetite is lower, BR should be preferred over EIS.

While Business Relief can reduce the IHT liability on amounts invested to zero, it does not remove BR-qualifying assets from the investor's estate. As a result, for the purposes of the residence nil rate band (RNRB), used in isolation, it will not be useful in bringing the value of an estate below the £2 million RNRB taper above which £1 of RNRB relief is lost for every £2 of estate value.

However, Business Relief can be used to mitigate the costs of reducing the estate value by moving assets into trust. The usual immediate 20% charge to IHT is reduced to 0% when Business Relief qualifying assets, in excess of the available nil rate band, are settled into a Discretionary Trust.



Most EIS qualifying investments also meet the requirements for business property relief and an EIS investment would usually fall out of an individual's estate for inheritance tax purposes once held for a period of two years.

SMITH & WILLIAMSON

Comparison: EIS and VCT

There are some notable differences in how the tax reliefs available with EIS compare to those available through Venture Capital Trusts (VCTs) (the other major tax-advantaged venture capital scheme in the UK).

- VCTs generally operate a much bigger pool of investee companies, giving increased diversification and limiting investment risk.
- Income tax relief is subject to a five-year minimum holding period with VCTs, compared to a minimum of at least three years with EIS (although realistically the holding period is likely to be much longer).
- Unlike EIS, VCT investment cannot be carried back to previous tax years.

- There is no loss relief, CGT deferral relief or IHT relief with VCTs.
- VCTs can pay dividends tax-free, EIS cannot.
- VCTs have greater liquidity

With a VCT, income tax relief is claimed at the point at which the funds are invested in the VCT. This is also treated as the starting point for the minimum holding period. With an "unapproved" EIS fund (which comprise most EIS funds), the reliefs and associated minimum holding periods apply each time the manager invests a proportion of the clients' funds in an underlying investee company.

	VCT	EIS portfolio/fund
INCOME TAX RELIEF	30%	30%
MINIMUM TERM	5 years	3 years
LIKELY INVESTMENT HORIZON	5-10 years	5-10 years
MAXIMUM ANNUAL INVESTMENT ELIGIBLE	£200,000	£1m plus £1m carry back (and from 6 April 2018, max £2m where at least £1m is invested in knowledge-intensive companies)
DIVIDENDS	Tax exempt	Taxed
CAPITAL GAINS	Tax exempt	Tax exempt
CGT DEFERRAL	No	Yes
LOSS RELIEF	No	Yes
LIQUIDITY	Up to 20% of the VCT's assets (up to 30% for accounting periods beginning before 6 April 2019) may be held in cash, or certain other liquid assets. VCT managers often offer share buyback schemes but usually at a discount to NAV and they are not guaranteed. VCTs' shares are not widely traded and usually trade at a discount to their NAV.	There is no large-scale active secondary market in unquoted shares and EIS managers do not offer buy-backs. Investors should regard themselves as locked in to the shares until the underlying company either lists on a recognised stock exchange, achieves a trade sale, or the company is wound up. AIM listed EIS-qualifying shares have the potential for faster disposal.
DIVERSIFICATION	30-60 companies	4-15 companies
IHT RELIEF	No	100% after 2-year holding period
TARGET DEPLOYMENT TIMELINE	1 - 6 months unless there are fixed allotment dates for each tax year	12 - 24 months

Subject to conditions being met.

EIS and other tax wrappers

EIS AND PENSIONS

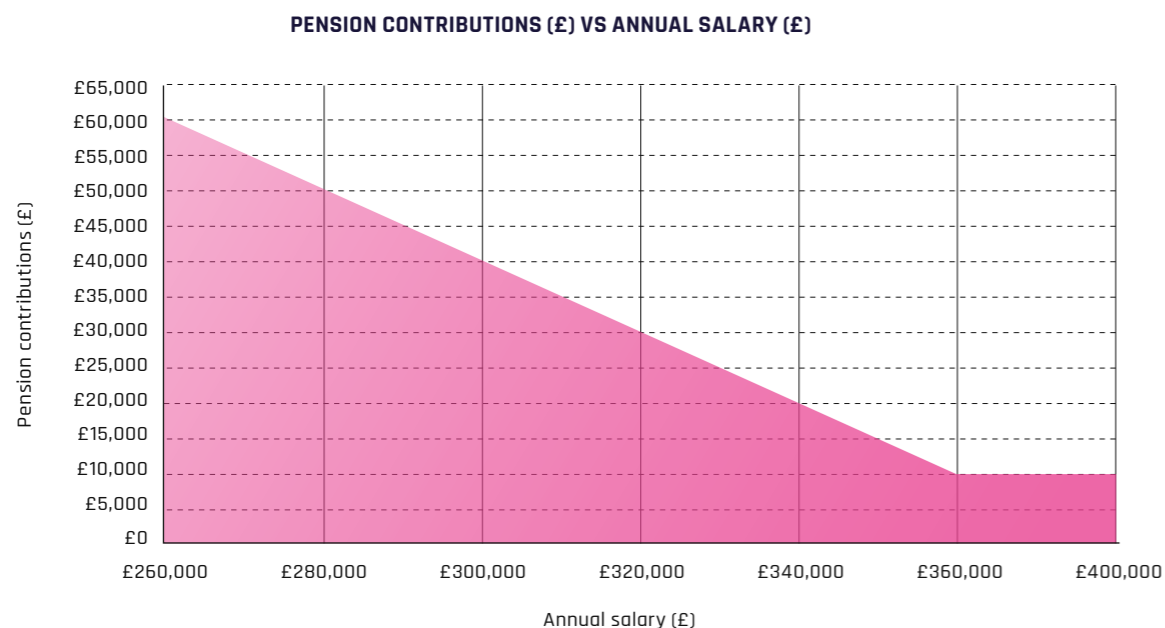
An investor may wish to use an EIS portfolio to complement existing pension and retirement planning strategies. However, it should be remembered that an EIS portfolio (which invests in what most would classify as high-risk companies) should NOT be considered as a replacement for pension investments, which will typically be lower risk.

From 6 April 2023, those whose 'adjusted net income' is more than £260,000 per year have their annual pension allowances reduced by £1 for every £2 of adjusted net income. The minimum reduced annual allowance went back up to £10,000 from £4,000 from 6 April 2023.

The annual tax free pension contribution limit was also raised from £40,000 to £60,000 from 6 April 2023.

If an investor exceeds the annual allowance in a year, they won't receive tax relief on any contributions that exceed the limit and will be faced with an annual allowance charge. High earners may be concerned that they can't get enough money into their pension as a result of this restriction.

In this situation, an investment into an EIS portfolio alongside the pension could provide an appropriate longer-term and tax-efficient investment.



Rules for investors and qualifying companies

Investments into unquoted small and medium-sized enterprises are deemed high risk. It is important to understand the risks associated with EIS-qualifying investments in a general sense, and we will examine some of those risks here.

However, each individual EIS investment opportunity has its own unique risks and, therefore, each opportunity must be individually assessed.

Investors

As well as a number of conditions that must be met by the EIS company itself during the relevant investment period, there are some rules that investors in EIS-qualifying shares must adhere to if they are to receive and maintain the full benefits of the reliefs available. Some of these have been covered in other sections, and they are set out in more detail here.

The overarching criteria is that the investor should have an appropriate tax liability or a potential tax liability that they wish to offset and/or defer:

- Either an income tax liability or potential income tax liability in the tax year of the

prospective EIS share issue, or the prior tax year if carry back is available (in order to claim the EIS income tax relief and potentially qualify for disposal relief).

- A CGT liability or a potential CGT liability in the relevant period (in order to claim CGT deferral relief where relevant).
- A potential IHT liability (in order to qualify for BR, subject to a minimum holding period).

Minimum holding periods

Investors must hold the shares for a minimum of three years in order to qualify for income tax relief and disposal relief (where the shares are disposed of at a profit).

Any disposal of the shares (excluding a transfer between spouses) prior to the end of the minimum three-year period leads to HMRC clawing back some or all of any income tax relief. Any deferred capital gains are also crystallised on disposal (although this is the case whether the shares are disposed of before or after the expiration of the minimum three-year period, to the extent that a further EIS investment isn't made to further defer the crystallised gains).

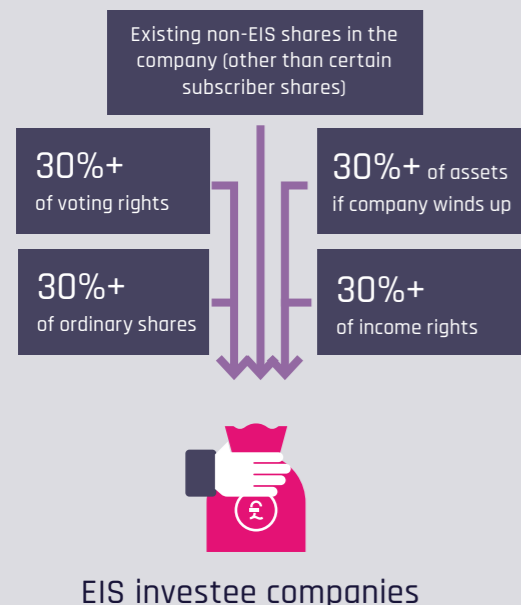
The minimum holding period starts from the acquisition date of the shares (if the company is not trading when the shares are issued, the period ends on the third anniversary of commencement of the trade).

Research and Development (if that is the qualifying business activity of the EIS company) is considered 'trading' for these purposes.

For IHT purposes, investors must hold the shares for a minimum of two years from the later of the issue of the shares or the commencement of the trade, in order to qualify for IHT relief via BR (unless the investment counts as 'replacement business property').

Connected parties

EIS income tax relief is restricted for individuals who are employees of the investee company, or who are 'associated' with such employees or they are a business partner, spouse, civil partner, parent, grandparent or child of an investor where alone or together, they have:



Connected parties

In order to obtain the maximum tax relief, the investor (or any 'associate' of theirs) must NOT have a connection with the company at any time in the period from two years before, to the later of three years after the investment was made and the date the company commences trading.

An individual is connected if he or she, whether alone or together with any 'associate' (associates can be business partners, spouses and civil partners, parents, grandparents, children and grandchildren), directly or indirectly possesses or is entitled to acquire:

- More than 30% of the ordinary share capital of the company;
- A right to more than 30% of the income, or they can otherwise control the company;
- More than 30% of the assets in the event of the company winding up (this assessment includes any loans made to the company);
- More than 30% of the voting rights in the company.

These conditions also apply to any 'follow on' investment: for example, if an investor already has a 20% stake in a company, and then subscribes for an additional 15% stake, they breach the '30% test'. If the second investment is made within the minimum three-year holding period for the first investment, income tax relief would be withdrawn in respect of the first investment.

There is an exception to the 'Connected Parties' test for 'business angels', who are directors with no previous connection to the company prior to investing. If they subsequently become a paid director of the EIS company, and provided that the remuneration is reasonable, the relief is not withdrawn. Any director involved in the EIS company's trade prior to the share issue is likely to be connected and relief will be denied.

There is also the "Independent Investor" requirement. This says that at the time of the share issue, if the investor holds other shares in the company for which SEIS or EIS income tax relief cannot be claimed, then the new share issue does not qualify either.

The only exception is if the existing shares are 'subscriber shares' issued to the individual when the company was founded or the shares were acquired when a pre-formed dormant company was bought 'off the shelf'.

No linked loans

No relief is available (between the period commencing two years before the issue of EIS shares and the later of three years after the investment was made and the issue of EIS shares and the date the company commences trading) if the investor or any associate receives a loan from any person that would not have been made, or would not have been made on the same terms, were it not for the EIS investment.

Genuine Commercial Purpose

There must be no arrangements or structuring of a company's activities where those activities have no commercial purpose other than to generate tax relief.

Pre-arranged exits

No relief is available if there are certain arrangements in connection to the share issue, including:

- Arrangements that might, in any way, lead to the disposal of the shares, or of other shares in the company;
- Arrangements that might lead to the cessation of the company's trade, or of any trade carried on by a person connected with the company;
- Arrangements for the disposal of some or all of the assets of the company or of any person connected with the company.

This rule is intended to ensure that the company is capable of carrying on its trade indefinitely under its existing ownership. But, it does not stop the directors of a company from

indicating in advance to potential investors how they envisage that shares in the company might be disposed of at some later date.

Receiving value

Investors (and their associates) must not 'receive value' from the investee company: if they do so the tax relief is withdrawn in proportion to the value received and any deferred capital gains crystallise.

Receiving value includes any kind of payment, service, goods, benefit or loan that transfers value from the investee company to the investor; this includes any transfer of this kind in exchange for the shares or any rights attached to the shares. It can also include repayment of loans to the investor or their associate. The investor can interact with the company as an ordinary customer, but this must be on the same terms as other conventional customers.

Types of shares

Investors must subscribe for and purchase full risk, new ordinary shares with no arrangements in place to protect the investor from the normal risks associated with investing in shares. They cannot be redeemable, nor have any preferential rights to a company's assets in the event of a winding up.

In certain circumstances, the shares may have limited preferential rights to dividends, but the rights to dividends cannot be cumulative (where unpaid dividends accumulate and are paid to the shareholder at a later date when funds are available) and the preferential rights to dividends cannot be subject to discretion as to the amount or timing of payment.

During an investor's relevant three-year period, none of the company's shares can

be quoted on a recognised stock exchange and there can be no arrangements in place to list on an exchange at the time the shares are issued. However, the Alternative Investment Market (AIM) is not considered to be a recognised stock exchange in the rules governing EIS. Nevertheless, the vast majority of EIS offers are not focused on companies that are listed on an exchange.

The shares must NOT be issued under any reciprocal arrangement (“I’ll invest in your company if you invest in mine and we can both benefit from the tax relief”) and the shares must be subscribed for, for genuine commercial reasons and not for the purpose of participating in a tax avoidance scheme of any description.

Finally, the shares can either be purchased directly by the investor, or via a nominee or EIS fund. See pages 36 to 38 for more detail on EIS funds.

Underpinning value

There can be no arrangements that are intended to protect the value of the investment in any way. This includes, for example, schemes that insure investors against making a loss, and schemes to maintain the value of the shares artificially. There is an exception for ordinary commercial matters, such as insurance by the company against normal trading risks.

Follow on investments

Following a review by the EU in 2015, it was perceived that the ability for existing, non-SEIS and EIS shareholders to subsequently claim EIS relief on a follow-on investment is not in line with the intention of the scheme to attract new full risk capital investment to the company.

As a result, since 18 November 2015, relief has been denied to ‘follow-on’ shareholders unless the only other shares they hold at the time of the proposed EIS investment are:

- Shares that previously attracted relief under EIS, SEIS or social investment tax relief; or
- Subscriber shares that have either been held since issue or acquired from an ‘off-the-shelf’ formation agent before the company issued any non-subscriber shares.

Care should be taken to establish what holdings clients have in a company raising further share capital under EIS. This is particularly relevant for companies issuing new placings on AIM - shares may be held as part of a BR portfolio and may have been acquired in the open market and not from a prior EIS raise. The test is at the time of the prospective EIS share issue and therefore the existing shares can be sold or given away (and will be taxed accordingly) or transferred to a spouse or civil partner.



Qualifying companies

In order to ensure that EIS is meeting its objective of financing small to medium-sized businesses that might otherwise struggle to obtain investment from other sources, there are stringent criteria that govern whether a company and its proposed share issue qualifies for the EIS reliefs. These criteria change from time to time.

This section sets out the rules as they stand today and also details some of the most recent changes.

Risk-to-capital condition

Announced at the Autumn Budget 2017, the risk-to-capital condition applies to all investments made on or after Royal Assent of the Finance Act 2018 on 15 March 2018.

However, HMRC has applied the test for all EIS advance assurance applications submitted from December 2017. From this point, HMRC has declined to provide advance assurances for investments that, taking into account all the facts available to them, appear likely to fail the risk-to-capital condition.

The government is keen to stress that the Venture Capital Schemes are intended to support early-stage, entrepreneurial companies that have the potential to grow in the long term. The company must be set up to carry out trade on an ongoing basis, not to carry out a single project before being wound up.

The risk-to-capital condition is intended to exclude tax-motivated investments, where the tax relief provides most of the return for an investor or with a limited risk to the original investment (that is, preserving an investor’s capital).

The risk-to-capital condition depends on HMRC taking a ‘reasonable’ view as to whether an investment has been structured to provide a low risk return for investors.

The condition has TWO parts:

1. Whether the company has objectives to grow and develop over the long term (which broadly mirrors an existing test with the schemes); and
2. Whether there is a significant risk that there could be a loss of capital to the investor of an amount greater than the net return.

The condition requires all relevant factors about the investment to be considered in the round.

The legislation contains a non-exhaustive list of the factors that may be considered. Even if one or more indicators of potential capital preservation are present, this does not necessarily mean that the risk-to-capital condition will not be met in a particular case.

A judgement about whether capital preservation activity is taking place will depend on the overall context of the investment.

Likewise, even if none of the indicators listed in the legislation are present, the risk-to-capital condition may NOT be met if the wider circumstances of a case suggest that capital preservation is taking place.

Ultimately, a judgement will depend on the level of risk posed to investors’ capital and whether the company has genuine intent to grow and develop in the long term.

The risk-to-capital condition sits above the other existing eligibility requirements for the venture capital schemes. Even if the condition is met, all other requirements must also be met for an investment to be eligible for tax relief under the schemes.



The growth and development of your company should be permanent and not rely on the investor's continued support.

HMRC



Examples of non-qualifying companies

Example 1

In 2013, EIS manager A invested clients in a company that was constructing and operating a solar-photovoltaic farm. This would no longer be a qualifying investment for an EIS portfolio, as energy generation activities no longer qualify.

Example 2

In 2013, EIS manager B invested clients in a company that was undergoing a Management Buyout (MBO) and the EIS funds were being used to acquire the shares of exiting management.

This would no longer be a qualifying investment for EIS as EIS funds can no longer be used to acquire part of an existing business*.

Example 3

In 2015, EIS manager C invested in a company that was established to operate, through subcontractors, a pub. Certain factors indicated a capital preservation strategy.

This would no longer be a qualifying investment for EIS as it is unlikely to qualify under the 'Risk-to-capital' condition introduced for all EIS and VCT investments made on or after 15 March 2018.

Rules governing the size and type of company

There are rules which set out in detail the criteria for firms that wish to issue EIS-qualifying shares. In summary, a qualifying company must:

1 NOT be in financial difficulty.*

2 Be unquoted (however, the AIM market is not a recognised exchange for this purpose).

3 NOT control another company which is not a subsidiary of the company; and it cannot itself be controlled by another company and there can be no plans in place at the time of the share issue that would jeopardise this independent status.

4 Have a permanent establishment in the UK (the company does not need to be a UK company, however).

5 Have fewer than 250 employees (or 500 for a knowledge-intensive company).

6 Have gross assets under £15m immediately before shares are issued and under £16m immediately after shares are issued. However, the company can continue to grow afterwards.

7 Not have been trading for more than seven years (ten years for a knowledge-intensive company) unless specific conditions are met.

8 Be operating in a qualifying trade, preparing to trade and commence trade within two years, or conducting research and development. Most trades qualify, however, there are a number of exclusions:

- Dealing in land, commodities, futures, securities or financial instruments (including investment activities)
- Dealing in goods other than normal retail or wholesale distribution
- Banking, insurance, hire purchase, money lending, and other financial activities
- Leasing
- Receipt of royalties or licence fees
- Legal and accounting services
- Property development
- Farming and market gardening
- Forestry
- Operating or managing hotels or residential care homes
- Coal production, steel production and shipbuilding
- All energy generation activities (from 6 April 2016)

! Excluded activities must not be a 'substantial' part of the company's trade. HMRC takes 'substantial' to mean more than 20% of the company's activities.

*HMRC's interpretation of the financial health requirement requires consideration of whether a company which has been trading for more than seven years and has lost more than half of its subscribed share capital. Since adjusted HMRC guidance in December 2022, this requirement will only be applicable for companies outside their 'initial investing period'. For 'knowledge intensive companies' the 'initial investing' period is ten years, and for other companies the 'initial investing period' is seven years. This ensures that knowledge intensive companies that are between 7 and 10 years old meet the financial health requirement.

Rules governing the raising and spending of funds

Likewise, there are rules governing the amounts that qualifying companies can raise and how quickly that money must be deployed within the business.

The funds raised by the issuance of EIS-qualifying shares must be employed by the issuing company, or by a qualifying subsidiary which is at least 90% owned by the company, within two years of the share issue. The funds must be used either for carrying on a qualifying trade, or for preparing to carry on a qualifying trade which is then begun within two years of the share issue. They cannot be used to acquire the shares, goodwill or intangible assets of another company, even if that company is carrying on a qualifying trade.



In calculating the maximum amounts that can be raised, funds raised from any of the UK's tax-advantaged venture capital schemes must be counted. The FOUR schemes are:

- The Enterprise Investment Scheme
- The Seed Enterprise Investment Scheme
- Social Investment Tax Relief
- Venture Capital Trusts

In addition, any other relevant approved risk finance State-aid must also be counted. This includes Enterprise Capital Funds and certain Regional Development funding.

12-MONTH INVESTMENT
RAISE LIMIT

£5m

12-MONTH INVESTMENT
RAISE LIMIT (KICS)

£10m

The maximum amount that a firm can raise from tax-advantaged venture capital schemes and any other form of risk finance State-aid in any 12-month period is £5 million (although for investments made on or after 6 April 2018, the 12-month maximum amount of funding that knowledge-intensive companies (KICs) can receive increased from £5 million to £10 million).

LIFETIME INVESTMENT
RAISE LIMIT

£12m

LIFETIME INVESTMENT
RAISE LIMIT (KICS)

£20m

The maximum amount that a firm can raise from tax-advantaged venture capital schemes (and risk finance explained above) cumulatively over the firm's entire lifetime is £12 million (or £20 million for a KIC).

Knowledge-intensive companies

Knowledge-intensive companies are defined broadly as follows:

- In at least one of three years prior to investment, the company or group has spent at least 15% of operating costs on research and development or innovation; or
- In each of those three years, the company or group has spent at least 10% of operating costs on research and development or innovation; and

either of the following conditions is also met:

- The **'innovation condition'** - When the relevant shares are issued, the company or group is engaged in the creation of intellectual property from which, within 10 years, it is expected, will derive the greater part of the company's or group's business, either from the exploitation of the

intellectual property or by the creation of new products, processes or services which use the intellectual property.

- The **'skilled employee condition'** - At least 20% of the company's or group's employees are 'skilled' and are engaged directly in research and development or innovation activities carried on by the issuing company or any qualifying subsidiary of that company. The definition of 'skilled' relies on higher educational attainments.

To qualify for EIS investment, a knowledge intensive company must have been trading for no more than ten years. Since 6 April 2018, knowledge-intensive companies have been able to choose whether to use the current test of the date of first commercial sale or the point at which turnover reached £200,000 to determine when the 10-year period has begun.

Knowledge-intensive companies are also now part of the approved fund structure - the Knowledge-Intensive EIS Approved Fund. More details can be found on page 38.

More generous rules for knowledge-intensive companies



10YRS

AGE LIMIT



£20m

LIFETIME CAP ON
TAX-ADVANTAGED VC



499

EMPLOYEE
LIMIT



£10m

12-MONTH RISK CAPITAL
FUNDING LIMIT

WHAT IS RESEARCH AND DEVELOPMENT?

R&D for tax purposes takes place when a project seeks to achieve an advance in science or technology. The activities which directly contribute to achieving this advance in science or technology through the resolution of scientific or technological uncertainty are R&D. Certain qualifying indirect activities related to the project are also R&D.

The UK Subsidy Control Regime

Since the UK's exit from the European Union, the EU State-aid rules that previously applied to EIS with the intention of ensuring a level playing field in trade relations within the EU, no longer apply. Those rules defined what constitutes reasonable levels of state aid, or government subsidies for business. The restrictions to qualifying criteria for investee companies and on the level of reliefs available under EIS, have been at least partially attributed to the EU's intervention in this regard.

In the EU-UK Brexit trade deal the parties take a principles based approach to controlling subsidies, with the UK free to design a system that meets these principles. If the UK or EU creates a subsidy which the other party feels could create a negative effect on trade or investment between the parties, it may then take remedial actions proportionate to remedy the negative effect. However, the new regime is more permissive than the EU State aid regime, with no EU regulator nominated to adjudicate what subsidies may be deemed in compliance.

One of the UK-EU Trade deal subsidy principles is that, "Subsidies are designed to bring about a change of economic behaviour of the beneficiary that is conducive to achieving the objective and that would not be achieved in the absence of subsidies being provided." There has been no suggestion that approval of the current EIS rules under the previous EU State aid requirements means anything other than that they meet this principle.

The new UK subsidy control regime was formally brought into existence with the Subsidy Control Act 2022 which received Royal Assent on 28 April 2022.

This replaced the interim rules and the UK's Subsidy Control regime involves public bodies making assessments of the compliance of subsidies they award against seven main UK wide principles. The intention is to ensure that, "support for businesses reflects the United Kingdom's strategic interests and drives economic growth."

Advance assurance

Companies that are seeking subscriptions under EIS may seek an assurance from the Venture Capital Reliefs Team (VCRT) at HMRC that a prospective investment is likely to be eligible, before issuing the shares. The advance assurance service is discretionary and non-statutory. There is no requirement for a company to obtain an advance assurance before receiving an investment or issuing shares to investors.

As part of the advance assurance process, companies are required to submit, among other things, their business plan and financial forecasts, a copy of their latest accounts and details of all trading and activities to be carried out.

Companies are expected explain how they will employ EIS funds raised to deliver growth rather than preserving the status quo such as simply paying day to day expenditure. This is referred to as the growth and development test.

As mentioned, there is no obligation upon firms to go through this advance assurance process, but it does provide an opportunity to spot any problems before the shares are issued and an assurance from the VCRT is useful for companies to show to potential investors. In addition, HMRC requires a similar level of detail as an advance assurance application when the company submits an EIS1 application (if it has not had advance assurance), so providing this information in advance may well speed up the EIS1/EIS2/EIS3 process.

Advance assurance is NOT a guarantee that a share issue qualifies or that the company will continue to qualify. If something important was not disclosed to the VCRT or, if between receiving advance assurance and the share issue something changes, it may be that the share issue or company is no longer qualifying.

However, if nothing has changed, advance assurance is normally considered binding on HMRC (although EIS tax reliefs are also subject to the circumstances of the individual investor, which HMRC will not opine on in advance).

Nevertheless, in recent guidance HMRC states, "An advance assurance has no legal force; it is only HMRC's opinion as to whether a company is likely to meet the qualifying conditions, if it receives an investment under the circumstances set out in the application."

From early 2018, HMRC has declined to consider speculative applications. Confirmation of who the likely investors are is required before HMRC will give an opinion. If details can't be provided HMRC rejects the application.

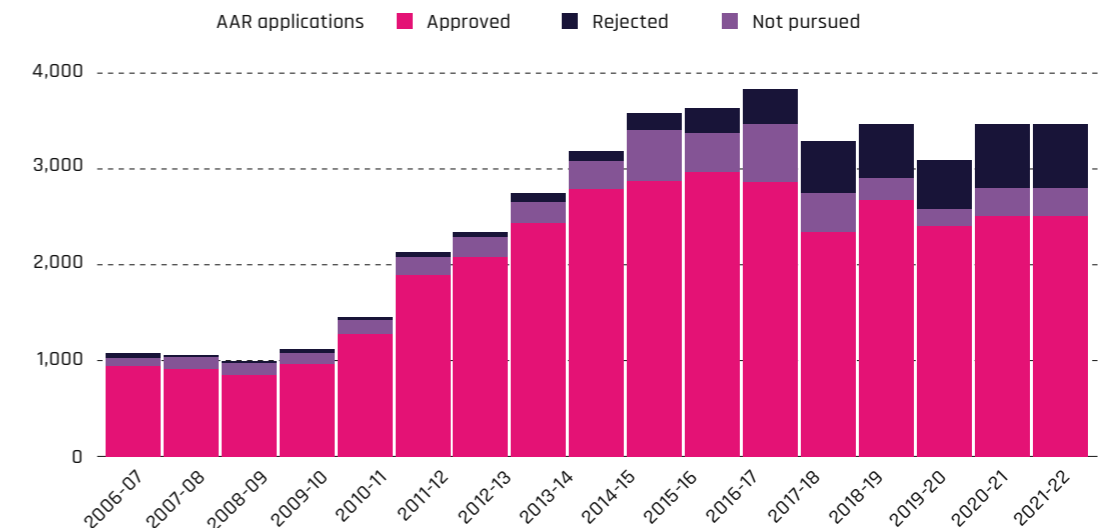


Any advance assurance given to a company using the Enterprise Investment Scheme is only in respect of certain conditions of the venture capital schemes being met based on the information provided by the company. It should not be taken as a more general endorsement or as an indication of potential investment performance.

HMRC, MAY 2022

HMRC does not generally identify which companies qualify as KICs at the time of advance assurance review unless this status is relevant to the proposed investment (for example if a prospective investor is interested in investing over £1 million into the company in a single tax year, or if the company is raising more than £5 million from EIS investors in a tax year).

NUMBER OF EIS ADVANCE ASSURANCE APPLICATIONS RECEIVED, APPROVED AND REJECTED, APRIL 2006 TO 2022



SOURCE: HMRC

Rules for EIS-qualifying companies

The current rules are summarised below for reference:

MAXIMUM AGE	7 years unless total investment represents more than 50% of the company's average turnover over the preceding 5 years and the company is using the funds to enter a new product or geographic market, or it received previous risk finance within its first 7 years	
LIFETIME CAP	£12m	
12-MONTH INVESTMENT LIMIT	£5m	
EMPLOYEE LIMIT (FTE)	Fewer than 250 FTE	
USE OF EIS MONEY FOR ACQUISITIONS OF BUSINESS	New rules to prevent EIS funds being used to acquire existing businesses or part of a business (incl. intangible assets that have already been used in a trade)	
GROWTH AND DEVELOPMENT TEST	Requirement that all investments are made with the intention to grow and develop business	
EXISTING SHAREHOLDERS	For EIS only, a requirement that investors are independent from the company at the time of the first share issue (excl. founder shares)	
CARRY BACK/FORWARD	Income tax relief can be applied to the year of the EIS investment or the year before that. CGT deferral relief can be claimed against an EIS investment made 3 years after or one year prior to the disposal of the original asset giving rise to the gain. Loss relief can be applied to other capital gains in the year of the loss and any excess can be carried forward, or to income tax in the current or preceding tax year. There is no CGT to pay on gains made on EIS shares sold after the 3 year holding period.	
RISK TO CAPITAL CONDITIONS	A company seeking EIS qualification for a share issue must have objectives to grow and develop over the long term and there must be a significant risk that there could be a loss of capital to the investor of an amount greater than the net return..	
KNOWLEDGE-INTENSIVE COMPANIES	MAXIMUM NUMBER OF TRADING YEARS	10 years. From 6 April 2018, a KIC is able to use the date from which its annual turnover exceeded £200,000, instead of the date of its first commercial sale, when determining the date from which the end of the initial investing period is calculated
	12-MONTH INVESTMENT LIMIT	£10m
	LIFETIME CAP	£20m
	EMPLOYEE LIMIT	Fewer than 500 FTE
	INNOVATION	A company seeking Knowledge-intensive company qualification must have spent at least 15% on R&D or innovation in at least one of three years prior to investment or at least 10% in each of those three years, and either meet the innovation or skilled employee condition.

TAX



Claiming the tax reliefs

The investee company must (often assisted by an EIS fund manager) obtain tax certificates to enable investors to claim the associated tax reliefs; EIS3 forms for each investee company in respect of each investor. For approved Knowledge-Intensive EIS funds and their predecessors, approved EIS funds, the manager applies for a single EIS5 form in respect of an investor's investment in the fund.

HMRC's Venture Capital Relief Team (VCRT) is responsible for administering the EIS approvals process.

Process for investee companies

EIS1

- After a minimum of four months' trading (immediately if the shares were issued when the company had already been trading for at least four months), the investee company can complete and submit a form EIS1 to the VCRT in respect of the share issue.
- The EIS1 lists details of the share issue, the investors intending to claim EIS relief and details about the company's trade and funding.
- The investee company has to complete this form every time it issues EIS-qualifying shares.
- The form must be submitted within two years of the end of the tax year in which the shares were issued or (if later) within two years from the date the company commenced trading.
- The VCRT will assess the EIS1 claim and usually responds within 4-8 weeks, depending on whether the company had advance assurance specific to the issue of shares.
- If the company did not have prior EIS advance assurance, more information is likely to be required by the VCRT in order to process the EIS1 (and this can sometimes delay the process).

EIS2

Assuming the VCRT are satisfied with the EIS1 and any accompanying information, they will issue form EIS2 to the investee company in respect of the share issue in question, informing them that they authorise the company to issue EIS3 forms to the investors listed on the EIS1.

EIS3

- The VCRT send the company a blank EIS3 for each EIS investor listed on the EIS1.
- The investee company then completes the blank EIS3 form for each investor (with details of their name, address, details of the shares issued, the date they were issued and the relevant 'termination date' - the end of the 3-year holding period).
- The EIS3 form enables investors to claim the tax reliefs, so it is an important document that must be kept safe. The EIS3 also contains any information about restrictions on the relief because of "value received".

Process for investors

Option 1

EIS3

If the investor is 'carrying back' the investment to the prior tax year (for which they have already completed their Self Assessment Tax Return - or if they are otherwise not required to complete a Self Assessment Tax Return), they can make the claim by completing the relevant boxes on pages 3 and 4 of the EIS3 form and returning it to HMRC.

Option 2

Self assessment

Alternatively, the claim can be made on an investor's Self Assessment Tax Return (SA108) for the tax year in which the investment was made.

- The investor should make the claim on the 'Additional Information' pages of the Tax Return, including details of the investment in the 'additional information' box. Details of how to do this are included on HMRC's Helpsheet 341 (Enterprise Investment Scheme - income tax relief) and also the 'additional information notes'.
- Employed investors can request a change to their PAYE tax code for the year of investment in order to reduce the amount of tax collected by their employer.
- Investors can also request that their self assessment payments on account are reduced (if appropriate), in order to take account of EIS income tax relief.
- However, the appropriate claim still needs to be made on the tax return, once it is received.
- EIS Disposal Relief and CGT Deferral Relief claims are always made by completing a Self Assessment Tax Return.

Investors cannot claim EIS tax relief or defer payment of tax due because they are expecting to receive an EIS3 form.

This applies to both income tax and CGT, so, if an investor was looking to reinvest a capital gain in EIS-qualifying shares in order to defer CGT, they may still have to pay the CGT liability until they receive form EIS3 and their claim is processed.

Finally, what should be clear from the description of the steps involved earlier is that the whole process can sometimes be quite protracted, especially if the investee company takes two years to submit the form EIS1 that starts the process and where an advance assurance application hasn't been made to HMRC in advance of a share issue.

This should be taken into consideration when managing a client's expectations and incorporating any tax reliefs into financial plans.

CLAIMING THE RELIEFS - EIS FUNDS

An EIS fund may have obtained approved Knowledge-Intensive EIS fund status, or approved EIS fund status from HMRC.

Approved EIS funds and their replacement, EIS approved knowledge-intensive funds, have a number of criteria that are explained on page 38.

If a fund is an approved EIS fund or an EIS approved knowledge-intensive fund, instead of an investor being issued individual EIS3 forms for each of the individual companies they are invested in, investors receive a single EIS5 form from the fund manager.

The EIS5 covers all of the investments made on their behalf. The relevant date for income tax relief purposes is the date the fund closed, rather than the individual dates the underlying shares were purchased.

The rest of the process is unchanged, although an EIS5 is only issued by HMRC once 90% of the fund has been invested, which should be borne in mind by investors and advisers.

If the fund is not an 'approved EIS fund' or an 'EIS approved knowledge-intensive fund', it is referred to as an 'unapproved EIS fund'. An investor in an unapproved EIS fund will still receive individual EIS3 forms for each underlying investment made by the manager, and the relief for each investment has to be claimed separately, following the process described.

TIME LIMITS FOR CLAIMS

There are time limits for claiming the various EIS tax reliefs.

- An EIS1 must be submitted by the EIS company within two years of the end of the tax year in which the subscription took place or, if the four-month trading period straddles the end of a tax year, two years from the end of that four-month period.
- The overall time limit for an investor to claim the income tax relief is five years from 31 January, following the tax year in which the EIS shares are issued.

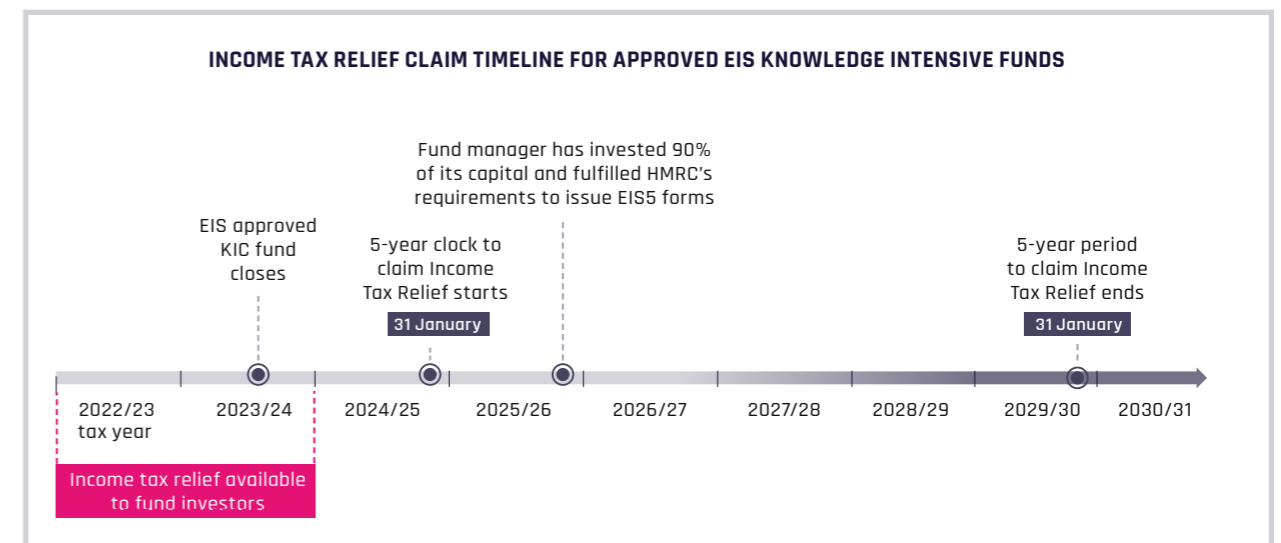
- Deferral Relief claims must be made no later than 31 January falling five years after the end of the year of assessment in which disposal occurred.

IHT RELIEF

As noted earlier, the IHT relief is actually obtained by claiming Business Relief (BR), which is administered separately to the income tax and CGT reliefs.

A claim for BR would normally be made during the settlement of the shareholder's estate (unless it relates to a chargeable lifetime transfer of business property).

To obtain IHT relief via BR, the executors of the estate will need to complete a copy of probate return form IHT412 and return this to HMRC as part of the overall probate process. HMRC will then assess the claim.





EIS structures

There are a number of different ways to gain exposure to EIS-qualifying shares and, as with conventional equities, it is often better to engage the services of a professional manager, in order to benefit from their expertise and greater levels of diversification.

These arrangements are referred to as EIS 'funds' and the providers of these arrangements are known as fund managers. It is estimated that, collectively, EIS funds have accounted for the majority of annual EIS investment. In this section we'll look at the concept of EIS funds in more detail.

SINGLE COMPANY EIS



The most straightforward way to get exposure to EIS-qualifying shares is by investing directly in a single company's share issue.

However, this entails spending significant amounts of time and effort on research, and requires the investor or their adviser to have the requisite knowledge to assess the opportunity. It also makes diversification difficult or near impossible.

DISCRETIONARY MANAGED PORTFOLIO



A discretionary managed portfolio is an individual service provided by an EIS manager to an investor.

Technically, this is not a 'fund' at all; it is a bespoke portfolio specifically constructed to meet the needs and objectives of that particular individual. It is likely that every subscriber to a discretionary managed service will have a slightly different portfolio, as the EIS manager will make investments on the basis of their suitability for each individual investor.

ALTERNATIVE INVESTMENT FUNDS



The Alternative Investment Fund Managers Directive (AIFMD) was announced on 22 July 2013, and introduced rules for qualifying fund managers on delegation, transparency, disclosure, remuneration, debt and reporting. Alternative Investment Funds (AIFs) are collective investment undertakings (CIUs) that have a defined investment policy, among other criteria.

The FCA has advised that it is likely that, where the manager is not making investments on the basis of their suitability for any individual investor, an EIS fund should be considered to be a CIU and an AIF.

With an AIF, all investors will be invested into the same basket of underlying companies, as the EIS manager does not have to consider the individual needs and objectives of each investor - it only needs to consider whether the EIS fund is appropriate for the investor.

EIS funds

EIS funds pool investors' money and invest in EIS-qualifying opportunities that are in line with the funds' investment mandate.

Each investor will have beneficial ownership of the underlying investments and will receive shares in each investee company, pro rata to the size of their investment into the fund.

Again, technically this is not a 'fund' in the same sense as a conventional OEIC or other form of collective investment. The investor does NOT own units or shares in the fund and their underlying investments may differ from other investors, depending on when they first invest into the fund.

This is the arrangement that is most commonly referred to as an EIS fund.

Specialist expertise in sourcing and selecting opportunities

Increased diversification

Access to professional service firms (or the in-house capabilities) to advise on the qualifying status of investee companies, both ongoing and at the point of the share issue

Ongoing oversight of investee companies, and a big enough stake in the underlying companies to have influence over board level decisions or a seat on the board itself

Expertise in negotiating and/or structuring of the eventual exit from the underlying investments

Advantages of EIS funds



A survey by the UK Business Angels Association found that 90% of angel investors would materially change their capacity to back high-risk start-ups without EIS and other tax reliefs.

**CHRISTIANA STEWART-LOCKHART,
EISA DIRECTOR GENERAL**

EIS Approved Knowledge-Intensive Fund

From 5 April 2020, EIS approved knowledge-intensive funds replaced the existing EIS approved funds.

An 'approved' EIS fund had 12 months to invest 90% of the funds it raised across a minimum of four companies, with the amount invested in any one company not exceeding 50% of the fund capital.

Like EIS approved funds, EIS approved knowledge-intensive funds are beneficial for investors as the administration is greatly reduced for them, with a single EIS5 form being issued once 90% of the funds have been invested.

EIS approved knowledge-intensive funds are focused on directing capital to knowledge intensive companies and they are required to have:

- invested 50% of their capital within 12 months of the date the fund closed,
- invested 90% of their capital within 24 months of the date the fund closed,
- within that 24 month period at least 80% of the fund's capital has been invested in the shares of companies that were knowledge-intensive at the time the shares were issued, and
- provided HMRC with: the date that the fund closed, the names, addresses and Unique Taxpayer Reference numbers of the investors in the fund, the total amount of capital the fund has received from each of those investors, the shareholdings in which that capital has been invested, the date on which each of those investments was made and whether or not each shareholding

was in a KIC at the time the investment was made. HMRC will not provide an approved fund manager with form EIS5 unless it has received this information

For income tax purposes, the investments made by EIS approved knowledge-intensive funds are treated as if made in the year in which the fund closed, even if they were actually made in a later year. Investors may also elect to treat some or all of their investments as made in the year prior to that in which the fund closed

Investors receive a single EIS5 form and can treat the date the fund closed as the date of investment for the purposes of claiming EIS income tax relief (the reference date for EIS deferral relief remains the date the investment is made into the investee companies).

Mirroring the rules applicable to 'EIS approved funds', an 'EIS approved knowledge-intensive fund' is required to invest in a minimum of four companies, and the amount invested in any one company should not exceed 50% of the fund capital.

'Unapproved' (i.e. funds that aren't 'approved') funds don't have such constraints on how they deploy their money, giving them greater flexibility and, therefore, unapproved funds make up the majority of EIS funds today.

However, it should be noted that no tax relief is available until the funds are deployed and the administration is potentially more complex, with investors receiving multiple EIS3 forms (refer to page 33-35 for more details). It's worth noting that some investors and advisers favour receiving multiple EIS3 forms, as it allows for more flexibility in tax planning.

EIS: AN OPEN WINDOW TO HIGH GROWTH VC OPPORTUNITIES IN ANY ECONOMIC CLIMATE

A Discussion with Jessica Franks, Head of Investment Products, Octopus Investments



While high risk, the Enterprise Investment Scheme (EIS) offers a route to the exceptional growth potential of venture capital (VC) that likely wouldn't be available to retail investors without the valuable tax reliefs that incentivise its use. So, why is EIS such a precious commodity for both individual investors and government?

One reason for investors is the powerful portfolio diversification it can provide, and also the potential for high growth. A report by Hardman and Co showed that adding venture capital to your portfolio can increase returns without, pushing up the level of risk, as long as you change asset allocation¹. That can heavily influence the best client outcomes that sit at the top of the FCA's Consumer Duty agenda.

From the government's perspective, EIS is a route, often through critical tech enablement, to the type of fast growth that can deliver both healthy returns to investors, but also companies that can rapidly scale to become big employers and tax-payers.

Beyond money, facilitating the kinds of disruptive ideas that VC often backs is also proving to be a crucial fast track to urgent sustainability solutions.

The risks, aren't for everyone, though, especially in tough times. Nonetheless, Jessica Franks, head of investment products at Octopus Investments, points out that there are some notable positives for EIS in the current economic environment.

With large tech companies shedding jobs, the talent essential for success is much easier for start-ups and scale-ups to access; with credit

markets drying up, investment managers are likely to have less competition to buy in at lower prices; and with less funding available, there are fewer companies working on similar projects, pushing up the odds of backing the eventual winner in that particular sub-sector.

While global VC saw drops in average deal size and investment across most funding stages during the turbulence of 2022, seed funding increased 4% year-on-year.² This is testament to the value of backing the best founders from the outset when their competition is struggling. The Octopus Ventures EIS Service is one of the few in the EIS universe in a position to span investment stages from pre-seed to series A.

Franks thinks the depth and breadth of VC expertise available to Octopus are what make this possible, as younger investees generally involve lower levels of investment. As a result, last year some of its EIS portfolios exceeded its target number of companies in order to deploy all the relevant cash. Since the research and due diligence required by Octopus doesn't vary based on the size of the investment, the resource to follow this path is likely more than the majority of other EIS managers can call on.

Investee companies for the Octopus Ventures EIS Service are chosen by the same team that manages Octopus Titan VCT, the UK's largest VCT³. They have a track record of backing unicorns, having backed four. Franks says, "All EIS investment managers rightly expect a high proportion of investee company failures, we target companies we think could reach a 10x return with the realistic goal of at least doubling our investors' money overall and uncovering the future unicorns that will drive the UK economy."

The upshot is that, many economic clouds have multiple silver linings for VC investors, although it's still important to select the investment managers with the right capabilities to build the most resilient portfolios to deliver the best eventual realised growth.

¹<https://hardmanandco.com/wp-content/uploads/2021/11/TEs-white-paper-How-much-should-clients-invest-in-venture-capital-November-2021.pdf>, Hardman & Co, TES white paper: how much should clients invest in venture capital?

²<https://www.bain.com/insights/global-venture-capital-outlook-latest-trends-snap-chart/Crunchbase; Bain Startup Investment Cruncher; Bain analysis>

³Association of Investment Companies, January 2022



The Seed Enterprise Investment Scheme

Introduction

The Seed Enterprise Investment Scheme (SEIS) launched in 2012 as a derivative of EIS. Its aim is to encourage seed investment in early stage companies and while the rules governing it are similar, there are some important differences between the two.

Since its launch, just under 1750 companies have received investment and more than £1.7 billion of funds have been raised. It therefore remains a small section of the overall EIS market,

Rules for investors and qualifying companies

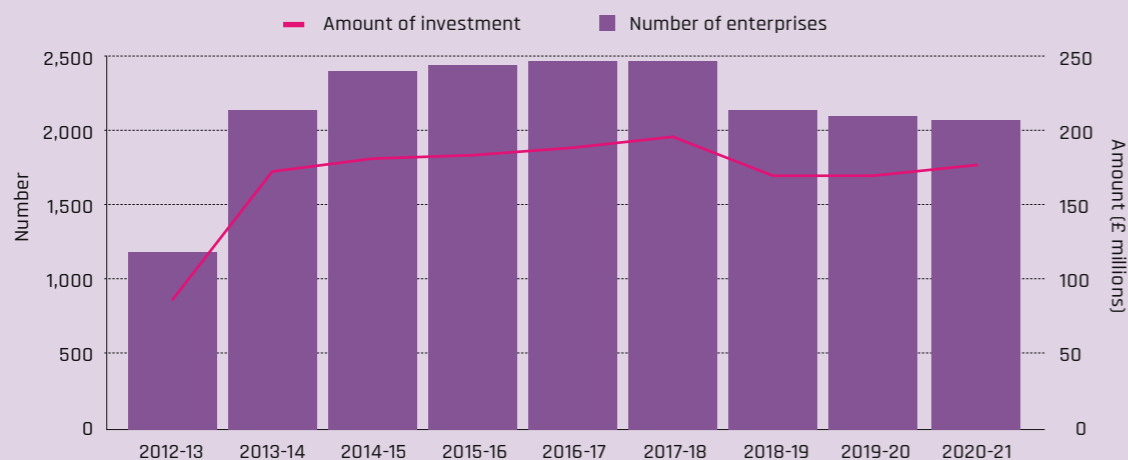
While the majority of rules related to qualifying companies for EIS also apply to the SEIS, the latter has some slightly more stringent requirements.

An investee company must carry out a **new qualifying trade**, which means that the trade must not have been carried out for more than two years by either:

- the investee company
- any other person who then transferred it to the investee company

The investee company, or any qualifying subsidiary, must not have carried out any other trade before starting the new trade. It also cannot be a member of a partnership.

NUMBER OF COMPANIES RAISING FUNDS AND AMOUNT RAISED, APRIL 2012 TO 2021



SOURCE: HMRC

Size of SEIS-qualifying companies when shares issued



No more than
£350,000 gross assets
(previously £200,000)



Less than
25 full-time equivalent employees



No more than
£250,000 lifetime company investment limit
(previously £150,000)



No more than
3 years old company's "new qualifying trade" (previously 2 years)

The government announced the expansion of SEIS in late 2022 and from 6 April 2023, it increased the existing limits that apply to company access and use of the SEIS and the investment amounts on which individuals can claim tax reliefs.

The size of the investee company must also be considerably smaller than the maximum size of an EIS-qualifying company when the shares are issued.

Risks and Rewards

Clients will face the same risks as those for EIS, however due to the smaller size of the companies some of these will be magnified, with the likelihood of a company collapsing substantially increased, for example. In return for these higher risks, the SEIS offers reliefs more generous than EIS in two ways:

- Up to **50% income tax relief**, although this is limited to £200,000 (previously £100,000) of SEIS investments per year and there is no special treatment for knowledge-intensive companies. As with EIS, the minimum holding period is three years and income tax relief can be carried back to the previous tax year.
- **50% reinvestment relief** - this is not deferral relief (as under EIS), but will see 50% of the reinvestment become exempt from tax. This is capped at £200,000 (previously £100,000) investment, so the maximum relief available is £100,000 (previously £50,000).

SEIS also offers reliefs similar to EIS:

- 100% CGT relief on disposal
- 100% IHT relief (via Business Relief after a minimum holding period, applicable to most SEIS-qualifying companies)
- Loss relief (losses are available to offset against capital gains or, in certain circumstances, income tax)

Charges and practicalities

Investment objectives

Since 15 March 2018, all EIS funds have been expected to have a growth strategy, with capital preservation strategies outlawed after the Patient Capital Review.

Some offers now target high growth (particularly in the technology/science sectors) and others aim for more modest growth.

Growth objectives will also be impacted by levels of diversification within a fund,

with most funds investing in a range of underlying small, high-growth businesses and acknowledging that, while some may provide outstanding returns, others may fail. (This is where combining a portfolio strategy with loss relief is very effective).

Popular sectors include high-tech firms and general enterprise and it could be argued that these funds are closer to the 'true spirit' of EIS.

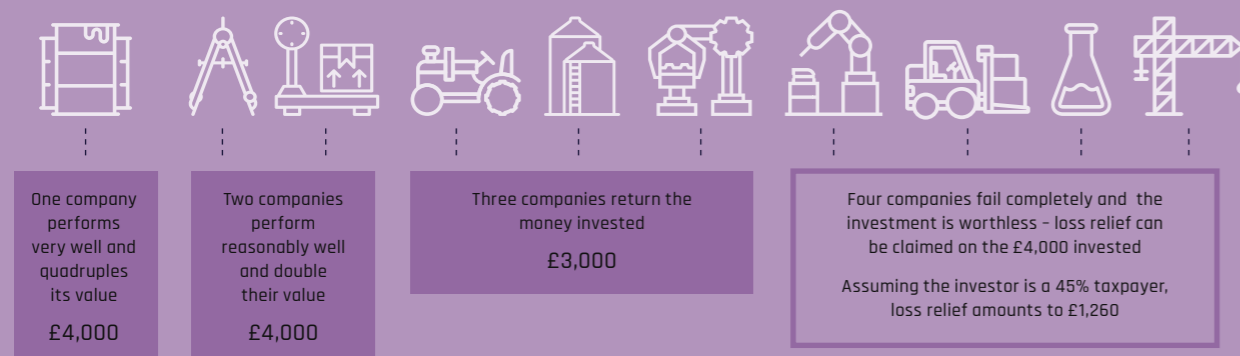
Typical target returns

Some funds quote specific target levels of return. Some providers do not publish a specific target return. However, they will usually give an indication of the growth they are seeking to achieve, whether this is 1.5x, 2x (net of fees) or more. (Well over 2.5x (net of fees) is the current average target return).

EIS PORTFOLIO EXAMPLE

£10,000 investment split equally across 10 companies

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



Assumes all investments held for relevant 3-year period and no income tax relief is withdrawn

Total return to investor is £12,260 excluding income tax relief

Some of the former Capital Preservation strategies did not target a specific return at all and were, therefore, largely relying on the tax relief to generate value for the investor. This is one of the reasons the government and HMRC were keen to refocus EIS and the wider Venture Capital Tax Reliefs, following the Patient Capital Review in 2017.

While the overall risk profile of EIS investments has gone up as a result, the risk profiles of the offerings still vary. Returns must be placed in the context of the risk, liquidity and level of charges when choosing the most suitable fund for a client.

Typical charges

Meaningful comparisons between different EIS fund charging structures can be challenging. Funds typically charge:

- An initial fee;
- An AMC (Annual Management Charge);
- A performance fee charged either annually or upon exit, usually subject to exceeding a certain hurdle.

Fees are usually charged on the investment amount rather than the value of the investment at the time of the fee. For example, the AMC is often charged on the initial investment sum, even if the value of the investment has decreased.

Tax relief is only available on the amount invested in the underlying EIS-qualifying companies. Any fees deducted from the initial subscription amount will reduce the amount actually invested and therefore the value of the tax reliefs.

Example:

After professional advice Brian invests £100,000 in EIS-qualifying shares. The initial charge from the EIS fund manager is 2% of the gross investment amount = £2,000

Brian has also agreed an adviser fee of 2% of the gross investment amount, which the EIS fund manager has agreed to facilitate from the investment = £2,000

The EIS manager also charges an AMC of 2% of the investment amount and for this offering it takes three years AMC upfront = £6,000

This leaves £90,000 for actual investment into EIS-qualifying companies. Consequently, instead of being able to claim £30,000 income tax relief on the investment (30% x £100,000), Brian can only claim £27,000 income tax relief (30% x £90,000).

For some fees, most notably the initial fee and the AMC, the total can be made up of a portion charged directly to the investor and a portion charged directly to the investee company.

Other fees to look out for are dealing fees, administration fees, exit fees and fees charged to the underlying investee companies.

Low fees in one area may offset higher fees in another, so, when comparing charges, it is important to look at them in total and not to just compare individual fees on different products. It is also necessary to consider the impact of fees charged to investee companies (often the case where there is no fee to the investors) on their ultimate performance.

MOST COMMONLY APPLIED FEES AND ENTRY LEVELS

INITIAL FEE	0%-10% of the investment amount
AMC	0%-5%
PERFORMANCE FEE	0%-25% of profits above a certain hurdle
ANNUAL ADMIN CHARGES	0%-1% of the value of the investment
MIN. SUBSCRIPTIONS	£5,000 to £100,000

SOURCE: MICAP (AT MARCH 2023)



Suitability

Suitability is an important topic, and what follows are guidelines to bear in mind when considering whether an EIS investment is a suitable investment for a client. Investments into smaller, unquoted companies are high risk and advisers need to spend time thinking about suitability and documenting the thought process in suitability reports when recommending an EIS.

Vulnerability

The FCA has been placing a growing focus on vulnerable clients and ensuring that they receive the best outcomes. By October 2020, the regulator reported that 53% of the UK adult population had characteristics of vulnerability such as poor health, low financial resilience or recent negative life events.

More recent statistics demonstrate the detrimental impact of the cost of living crisis with a 2022 Royal College of Physicians survey reporting that over half of respondents state that their health has been negatively affected by the rising cost of living. The FCA is monitoring the situation closely. In addition, under the new Consumer Duty, firms must take additional care to ensure vulnerable consumers achieve outcomes that are as good as those of other consumers.

It is within the context of identifying these clients, and assessing whether they have additional or different needs to those without characteristics of vulnerability that advisers must now operate when offering and providing any services to clients. The FCA's FG21/1 Guidance for firms on the fair treatment of vulnerable customers and PS22/9: A new Consumer Duty, provide detailed overviews of what the regulator expects.

Attitude to risk

In general, a client for whom an EIS is likely to be a suitable investment has a high tolerance for risk. Where succession planning is relevant, you should also make the client's intended heirs aware of the risks involved.

EIS investments should be considered as carrying the potential of a capital loss for investors. While this should never be a 100% capital loss when the income tax relief and loss relief are taken into account (assuming income tax relief isn't withdrawn for some reason), clients should be comfortable taking on this risk with the funds they have allocated to EIS investing.

FCA classification

A single company EIS investment is typically classified by the FCA as a non-readily realisable security (NRRS), unless the investee company is listed on the Alternative Investment Market or similar.

NRRS are now in the financial promotion marketing restrictions product category of 'Restricted Mass Market Investments' (RMMI).

An adviser who wants to advise their client to invest into an NRRS requires retail permissions to advise on shares.

The FCA rules on suitability reports require that advisers:

- ✓ Specify the client's demands and needs,
- ✓ Explain why the firm has concluded that the recommended transaction is suitable for the client, having regard to the information provided by the client,
- ✓ Explain any possible disadvantages of the transaction for the client.

An EIS fund will either be structured as a discretionary portfolio service or as an alternative investment fund. From the investor's perspective, these structures may have few material differences - the EIS manager will allocate the investor into a portfolio of EIS-qualifying companies. However, for a discretionary portfolio service, the MiFID investment manager will have to consider the specific needs of the investor, while for an alternative investment fund the alternative investment fund manager will not.

With either structure, the adviser will have to determine whether an investment into unlisted securities is suitable for their client. Further information on Legal and Regulatory Status is also set out on page 54-55.

Tax capacity

Although tax benefits alone should not be the primary driver for the investment, a prospective investor would likely be someone

who is in a position to take advantage of the tax reliefs available from investing in EIS.

Therefore, if they are planning to purchase newly-issued shares in an EIS-qualifying company, the client should have (or expect to incur in the near future) an income tax liability, a CGT bill, or an estate with a potential IHT liability (to the extent that BR was a consideration for the investment).

The client should also be aware that the tax reliefs can be withdrawn and that the shares might, at some point in the future, be worth less than they initially cost, although, where the reliefs are retained, income tax relief and loss relief can limit losses. The client should also be aware that if they are looking to acquire EIS shares in a company which hasn't yet started to trade, the three-year holding period does not start until the company starts its trade (which could be a number of months after investment). This could therefore delay the receipt of income tax relief and mean that shares have to be held for a longer period.

TAX WRAPPER OPTIONS SUMMARY	ISA	Pension	VCT	EIS	SEIS
ANNUAL MAX	£20,000	£10,000 - £60,000	£200,000	£1m (£2m for KICs)	£200,000
LIFETIME MAX	X	X	X	X	X
INCOME TAX RELIEF	X	✓	30%	30%	50%
POTENTIAL FOR LOSS RELIEF	X	X	X	✓	✓
POTENTIAL FOR IHT RELIEF	X only available for AIM	it depends	X	✓	✓
CGT FREE GROWTH	✓	✓	✓	✓	✓
CGT DEFERRAL	X	X	X	✓	X*
TAX TREATMENT OF INCOME	No further tax to pay for higher rate taxpayers; Interest: tax-free.	No further tax to pay for higher rate taxpayers; Interest: tax-free - but only in roll-up phase; Payouts from annuity or drawdown will be taxable.	Dividends within £200k annual maximum subscription: tax-free.	Dividends: taxable.	Dividends: taxable.
TAX-FREE LUMP SUM	✓	Up to £268,275**	✓	✓	✓

* However, where an investor disposes of an asset that would give rise to a capital gain, and reinvests all or part of the gain in shares which qualify for SEIS income tax relief, 50% of the gain reinvested will be exempt from CGT.

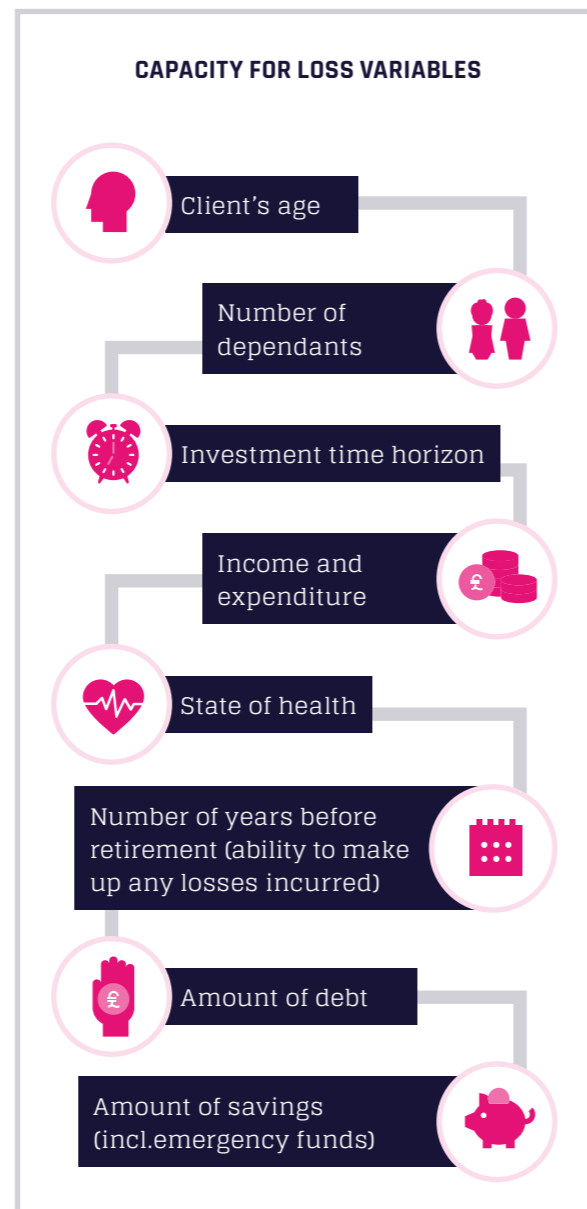
** Under limited circumstances where there is entitlement to a higher lifetime allowance or pension commencement lump sum protection, this may be higher.

Capacity for loss

If a loss of the capital earmarked for EIS investment would have a materially detrimental effect on the client's standard of living, then they should be advised against investing in EIS shares.

Substantial cuts in the tax-free allowance for capital gains taking place in 2023/24 and 2024/25 may impact the tax capacity of some clients and their suitability for EIS investment. The same could apply to the reduction of the income tax additional rate threshold from £150,000 to £125,140 from 6 April 2023.

Attitude to risk and capacity for loss should be assessed independently of each other. They measure the risk an individual is willing to take (attitude to risk) and the risk an individual can afford to take (capacity for loss). Attitude to risk is subjective and based on a client's personal opinions. This differs to capacity for loss which is objective in nature and based on fact.



As a Committee, we've received a significant volume of evidence on the importance of these reliefs to allow businesses to grow, and for firms to plan for the future.

HARRIET BALDWIN, MP, CHAIR OF THE TREASURY COMMITTEE



Liquidity and investment horizon

Although the minimum holding period to qualify for the full income tax relief and tax-free growth is three years from the issue of shares or (if later) the start of the trade, in reality investors are likely to have to commit their funds for much longer and most EIS investments should be viewed on a five to ten year investment horizon. There is no large-scale active secondary market in unquoted shares and EIS managers do not offer buy-backs.

Since EIS investments have no definite exit date, if clients anticipate an urgent need for their investment capital within at least three years, and very likely for several years longer, they should be advised against investing in EIS shares.

Knowledge and experience

Investors (or their representatives) must have the capacity to understand the nature of EIS and the associated risks. In general, EIS investors have experience of investing in a portfolio of more conventional retail investment products, and/or experience in business or a profession and, therefore, should be in a position to make informed decisions about investing in EIS.

Portfolio balance and diversification

It is not appropriate for a client to concentrate their wealth in EIS and, in most cases, EIS investors already have a substantial portfolio of conventional investments that meets the majority of their investment objectives.

Investors should not be overexposed to high risk investments, illiquid assets or unquoted securities. The risks and disadvantages of EIS

shares should be more than offset by the rest of their portfolio. Typically, EIS fund managers will deploy an investor's subscription across multiple companies. The target number varies by manager, but typically is between four and 15.

It is also important to diversify a client's EIS portfolio across different EIS fund managers and EIS offerings. There are varying methodologies for selecting potentially successful EIS investments across managers and the structures, objectives and strategies of investment offerings also vary.

Environmental, Social and Governance (ESG) goals

Recent FCA statistics report that 70% of the UK public now want their money to go towards making a positive difference to people or planet. It is now possible to combine tax-efficiency and high growth goals with an ESG focus by way of some EIS funds. However, it is important to understand the specific ESG concerns the client wishes to address and the ESG targets and strategy applied by individual EIS funds in order to understand whether they are compatible.

Income

Income distributions are not tax-free, and most EIS-qualifying companies do not pay dividends to their investors (they are investing to grow the business and are unlikely to have distributable reserves). For this reason, clients looking for income are not suitable for an EIS.

The consumer duty

Due for implementation on 31 July 2023, the FCA's intention is that this "will set higher expectations for the standard of care firms give consumers." It will require all of those in the investment value chain to be significantly more proactive in taking steps to ensure the best outcomes for clients, from the data they use to design products to meet the needs of the target market they are focused on, to adjudicating fair pricing, ongoing oversight and any relevant actions required to provide additional consumer support and better communication. Regulated firms, including financial advisers and investment managers will be required to evidence that they have met the new criteria.

There are four Consumer Duty outcomes; consumers should receive communications they can understand, products and services that meet their needs, offer fair value, and offer the support they need.

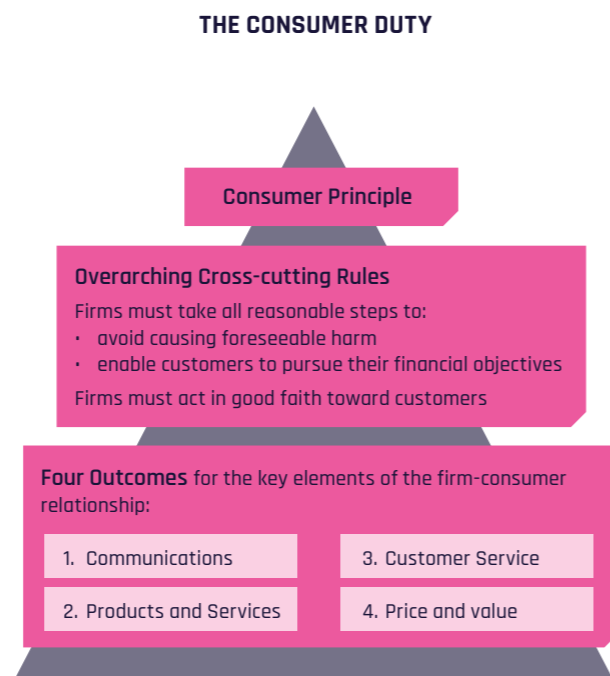
It's been said that the Consumer Duty is about suitability, and the concept of generating and ensuring ongoing suitability not just for the destination, but for the journey as well. This starts with the client understanding what is going on, from reasons for the investment recommendation to how the investment works to enable and empower consumers to make decisions in line with their needs and objectives. This encompasses, for example, an adviser's documentation and that provided by the investment provider.

Advisers also need to consider what represents fair value for all of their clients which takes in not only what the product/service does, what sort of cost that represents, but also what it is priced at. If, for example, a significant element of the pricing within the product/service with an ESG slant relates to social elements that the client has no interest in because their sole focus beyond financial gain is on the environmental gains sought by the investment

manager alongside social goals, does this really represent fair value for that particular client?

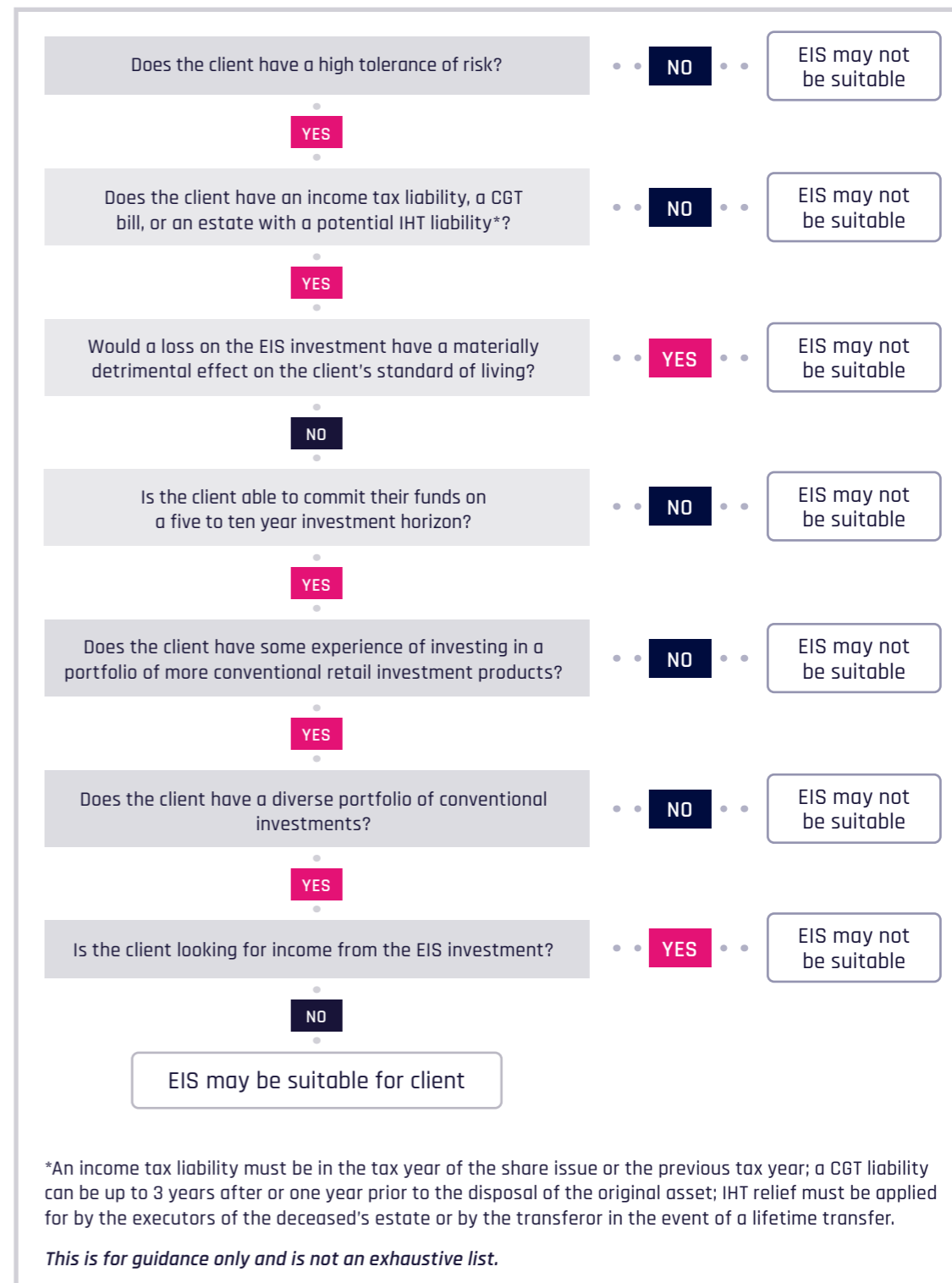
Firms must ensure they can evidence outcomes, reviewing and monitoring outcomes on an ongoing basis and identifying, remedying or mitigating any issues as they come up. Of course, a large element of keeping tabs on the continuing success or otherwise of the investment will depend on the information made available by the product provider.

These items are demonstrative of some of the suitability and due diligence items that the Consumer Duty is likely to bring into sharper focus for advisers.



SOURCE: THE FINANCIAL CONDUCT AUTHORITY

Indicators of when an EIS recommendation may be right



*An income tax liability must be in the tax year of the share issue or the previous tax year; a CGT liability can be up to 3 years after or one year prior to the disposal of the original asset; IHT relief must be applied for by the executors of the deceased's estate or by the transferor in the event of a lifetime transfer.

This is for guidance only and is not an exhaustive list.



Research and due diligence

Performance information

Small, unquoted businesses are illiquid, hard to value and managers can be reluctant to disclose valuations of the businesses that they might be looking to sell in the near future. Consequently, performance information is limited.

Assessing and comparing the performance of EIS funds, or the track record of the fund managers, can be challenging. The best indication of (good) past performance is a track record of successful exits, but not all of the managers are in a position to evidence this yet.

Investors and advisers should not expect to find the kind of in-depth quantitative information that is used when researching stock market-based funds. The lack of past performance information is an additional risk of investing in EIS funds.

The changes in EIS rules announced in the Autumn 2017 Budget also introduced the possibility of some managers that previously focused entirely on EIS investments targeting low risk, capital preservation strategies, having to pivot their activities. This means it is important to review the relevance of their track record to their current investments.

Other risks of funds

The risks of funds are broadly the same as those described on pages 6 and 7. The skill, experience and operational expertise of the fund manager should reduce some of the risks, as should the additional diversification that can be achieved.

Additional risks for funds include insufficient deal flow for the manager to deploy the funds raised in accordance with their stated investment mandate.

If there is not sufficient deal flow, there is a temptation for the manager to invest in opportunities that do not fit the mandate, that are more risky than deals they would normally invest in or at higher valuations (making it harder to earn returns).

Researching funds

Advisers cannot rely solely upon a provider's marketing literature for their research and due diligence. The FCA has said: "Advisers can rely on factual information provided by other EEA-regulated firms as part of their research and due diligence. However, they should not rely on the provider's opinion, for example, on the investment's risk level."

The expectations of both the regulator and the courts of what advisers are required to do by way of due diligence are set very high and it is clear that advisers owe a non-delegable duty of care to their clients. As well as assessing whether an EIS investment is suitable for a client, advisers must also assess the range of offers available in the market, and select the most appropriate investments with the very best outcomes in mind for their clients.

In assessing EIS offers, there are a number of areas advisers need to cover and they should document their assessment of each of them to create a thorough research and due diligence process on record.

Advisers must assess the investment provider. The research should cover:

Their **commitment to the market** and level of adviser support

Their investment **philosophy** - a provider's particular approach to maximising returns

Their relevant **sector expertise** and **ability to adapt** to changes in rules and regulations

Their **deal-flow access** and **investment selection process** - do they see enough of the market to get the best deals and how much consideration is given to the merits and potential of the companies?

Transparency on any ESG credentials. Do the Sustainability Disclosure Requirements (SDRs) apply, if so, how are they fulfilling them. If not what relevant information is provided? Additionally, has the provider taken steps within its organisation to address ESG issues, e.g. inclusive hiring policy, renewable only electricity supplier?

The investment provider's financial strength and **stability**

Their **track record** of investment performance, exits and ensuring their investments retain EIS-qualifying status

The **experience** of both the executive and investment teams

Any **support** beyond finance provided to investee companies

Communications, service levels and engagement as items that will impact the ongoing relationship of the adviser, client and EIS manager over the lifetime of the investment and how the requirements are likely to be met. These could be useful indicators of how the manager may fulfill their ongoing responsibilities under the Consumer Duty.

Evaluating the provider

Always consider what could possibly go wrong with an investment offering, or events that could lead to a worse return than expected. When considering the investment provider's experience and track record, verify that it is pertinent to the proposed underlying investments and investment strategy.

Investment objective

Portfolio strategy

Anticipated **returns** (where stated) and gearing

Expected **minimum duration** (where stated)

Exit strategy

Nature of **underlying investments**

Sector and **subsector** (there is a range of general and specific EIS funds).

Any **ESG, sustainability, ethical** or **impact strategy**

Expected Deployment timescales, informed by the track record of deployment of funds

Evaluating the investment

Evaluating the investment

INVESTMENT OBJECTIVE

The proposed underlying investments, the perceived risks of the investment and the anticipated returns that can be generated should all be commensurate with the investment objective.

ANTICIPATED RETURNS

Advisers should assess how returns (without tax reliefs) are generated and take a view on the likelihood of those returns being achieved in different economic conditions.

Some trades have a fairly well-known range of gross returns and advisers should consider if the advertised expected return of the EIS is in line with their expectations. The provider's track record of delivering returns on previous investments should also be assessed.

Some funds use gearing (borrowing money to invest), which can enhance returns but also increase downside risk and advisers need to ensure they are aware of the level of gearing the fund intends to use.

EXPECTED MINIMUM DURATION AND EXIT STRATEGY

There is generally no liquid, tradeable market for shares in EIS companies or independent or objective means of valuing them. Instead, while an EIS company must have no 'pre-arranged exits', EIS managers are likely to carefully plan for a possible exit, looking at a range of possible scenarios and outcomes, and then consider what a company would need to do in order to achieve them.

Exits will often occur via a trade sale (where an acquirer buys all the company's shares from investors, management and any other shareholders) but may be in the form of a liquidation, a buy-out or, more rarely, a stock market listing. In the vast majority of cases,

this will be after the minimum three-year EIS holding period has passed.

Investors may well be keen to see an exit as soon as it is commercially viable to do so after the three-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 the nature of the companies in which a fund manager invests.

A tech start-up might require time-consuming and intensive research and development before its product or service can become commercially viable. A more mature business with a better-established product or service might reach exit sooner – though the tech start-up, if successful, may generate better returns for investors.

Advisers should examine what the intended exit strategy is, when it can be reasonably achieved, and what risks exist which might delay or prevent it. Some favoured trades have a track record of exits that can be examined, along with the provider's track record in the sector.

ESG

Many mainstream and non-mainstream funds are now offering an element of Environmental Social Governance, sustainability or impact investing with additional goals and motives beyond pure profit. These are not all created equal with varying ESG strategies and the potential for overstatement of likely ESG outcomes otherwise known as greenwashing.

EIS managers are subject to the climate related disclosure rules for asset managers, depending on their AUM. In-scope firms must, on an annual basis, produce an entity-level and a product-level disclosure. The entity level disclosure must explain how they take ESG and Impact considerations into account while managing investments. The product level-disclosure must offer consistent and comparable disclosures about the product in question and report back on key metrics.

For more on which EIS managers are subject to the SDRs, see the Legal and regulatory status section of this guide on pages 54-55.

Additionally, new FCA investment product sustainable investment labels (designed to distinguish between different types of investment products based on their sustainability-related objectives and features) and qualifying criteria that firms must meet to use a label, intended to curtail greenwashing are not expected to come into effect until at least 30 June 2024. In the meantime, managers are subject to pre-existing disclosure regulations such as The Listing Rules, Market Abuse Regulation, Disclosure Guidance and Transparency Rules and Prospectus Regulation. All require potential disclosures regarding climate-related and other ESG matters, but advisers should be proactive in their research.

NATURE OF UNDERLYING INVESTMENTS

It is important to understand:

- The nature of proposed underlying trades
- The investment stage
- The industry sectors they are in
- The risks they are exposed to
- The level of returns they can generate and how they are generated
- How quickly they return to cash or how liquid they are
- The manager's experience investing in the proposed trades.

Advisers should also evaluate the anticipated deal flow and deal pipeline for the fund and assure themselves that the manager is able to deploy the funds they raise in line with the proposed investment strategy.

FUNDING STAGE

The EIS rules generally restrict companies that can receive EIS funding to smaller

companies that have been trading for seven years or less (ten years or less for KICs – although a KIC also has more flexibility regarding when this ten-year point starts – see page 29 for more information on KICs). In commercial terms, this means that the companies in an EIS portfolio are all 'early stage'. But, within this classification, there are various stages of fundraising depending on the development stage of the investee.

The funding stage definitions are not fixed, but are typically:

Seed: Seed rounds are among the first rounds of funding a company will receive, generally while the company is young and working to gain traction and build a product from an idea. It is likely to be pre-revenue. Some Seed rounds may also include SEIS investment (see pages 40 and 41 for more on SEIS).

Series A: The company may have some established revenues and is typically pre-profit. At this stage, it is seeking to identify the commercial viability of its product or service (product-market fit).

Series B: The company may be making small profits but is looking to scale and has growth aspirations outside current revenue streams.

Therefore, the funding round is an indicator of risk, with earlier stage funding likely to be higher risk, but lower cost. This brings the opportunity for higher returns, but also greater potential for losses.

It is not unusual for EIS managers to diversify across funding stages. Some also reinvest in the same company at a later stage as it develops and proves its value.

It is also worth noting that follow on investment, by any party, can dilute the shareholding of earlier stage investors if they are not prepared to invest in the new round of funding. EIS shares can't have anti-dilution rights. Consequently, each time equity investment is

taken by the company, new shares are issued.

As a result the total number of shares in issue increases, meaning that an existing shareholder who does not invest in the new round (which would increase the number of shares they hold) will hold a smaller percentage of the new total number of shares.

Nevertheless, if the company is doing well, even without participation in follow on rounds, the smaller percentage of the company held by the shareholder should have a larger value than before the investment round. This is because the price of shares in new funding rounds is likely to rise as the company becomes more successful and this valuation is applied to the business as a whole.

The level of diversification across underlying investments varies, but advisers should assure themselves that it is in line with both the investment objective and is commensurate with the nature of the underlying investments.

As a general rule, the riskier the underlying investments are, the greater the level of diversification should be.

However, some research suggests that beyond a certain point diversification can go too far and that the additional costs incurred do not bring any additional diversification benefits. Advisers need to be confident that the fund is not overly-diversified.

Legal and regulatory status

For single company EIS investments, the shares are typically held in the investor's name. However, in an EIS fund investors' shares are typically registered in the name of a nominee company, although the investor will remain the beneficial owner of the shares.

EIS funds may be structured as MiFID discretionary portfolios or as alternative investment funds. Further information on EIS

structures can be found on pages 36 to 38.

For the purposes of the Retail Distribution Review (RDR), EIS funds are considered to be retail investment products and, therefore, advisers cannot receive adviser commissions. However, EIS managers may facilitate adviser charging, as agreed between the investor and their advisers.

As EIS funds (or single company investments) are not regulated funds, the generally held belief is that they are NOT covered by the Financial Services Compensation Scheme (FSCS) or the Financial Ombudsman Service (FOS).

Nevertheless, the Enterprise Investment Scheme Association (EISA) regulatory committee has clarified with the FSCS and FCA, that it is possible for investors in EIS funds to make compensation claims through the FSCS in the event of the failure of the FCA authorised firm managing that fund should the fund manager go into default. This is where the following key assumptions are met:

- The EIS fund is an Alternative Investment Funds (AIF), and not collective investment scheme, body corporate or a discrete portfolio management service.
- Managers of EIS funds (AIFMs) are authorised by the FCA, which makes them a relevant person.
- The Managers of AIF EIS funds undertake the activity of managing an AIF from a location in the UK.
- The location for AIF EIS funds is the UK, as they would be considered to be "otherwise domiciled" in the UK.

The committee finds that, "Investment related claims on FSCS need to pertain to protected investment business and they are set out in COMP 5.5.1R. The regulated activity of managing an AIF, when performed by an FCA authorised firm, is protected investment business because it is designated investment business."

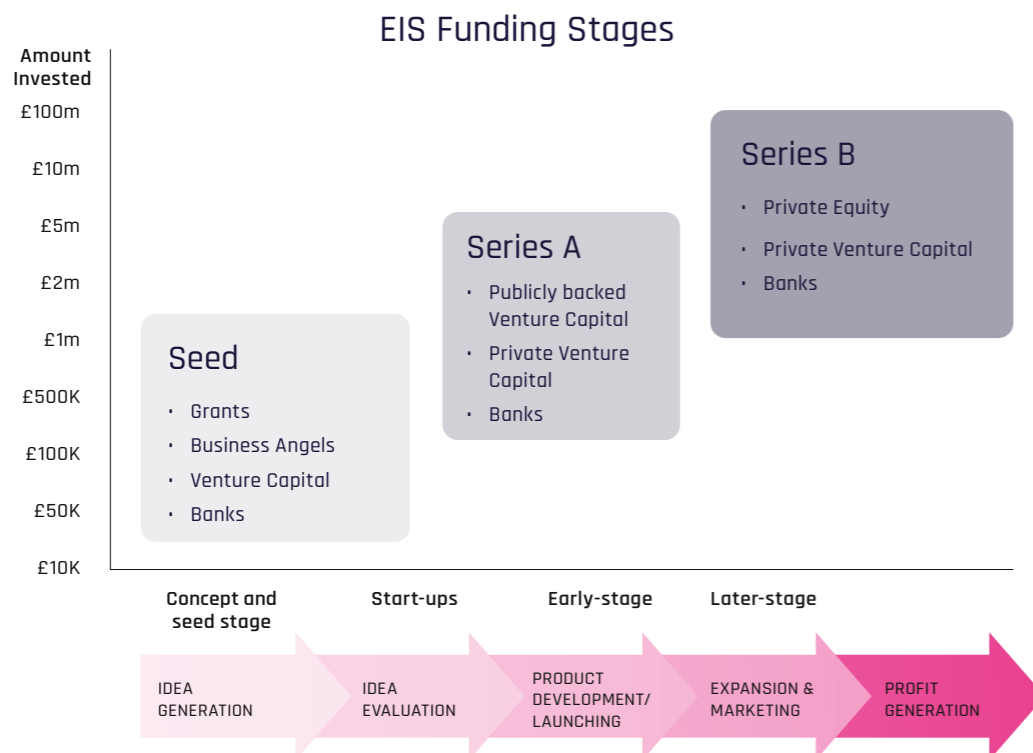
Key Information Documents

Although not specifically mentioned in the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, EIS funds fall under the definition of venture capital investments, which would classify EIS funds as PRIIPs. This means that the EIS manager must issue a Key Information Document (KID), designed to help investors to better understand and compare the key features, risk, rewards and costs of different PRIIPs.

Advisers should be aware, however, that there has been significant discussion regarding KIDs because of concerns that the regulation is not drafted in such a way to create consistent results that do not mislead the consumer.

Since Brexit, in March 2022, new rules were published by which performance scenarios were removed from KIDs and replaced with a narrative description of disclosure. Where the previous rules may have produced inappropriate risk scores, the FCA also introduced a requirement for PRIIPs manufacturers to upgrade their product's Summary Risk Indicator (SRI) score if they consider that the risk rating produced by the methodology is too low.

Moving forward, this issue is likely to be resolved relatively quickly: In its PRIIPs and UK Retail Disclosure consultation of December 2022, HM Treasury discussed the repeal of the EU-inherited PRIIPs Regulation, "as a matter of priority." The consultation, which ended in March 2023, stated, "While this will be a decision for the FCA, it is the government's expectation that the PRIIPs KID – or any new comparable prescriptive disclosure document – will no longer be a feature of the UK's new retail disclosure regime."



Case studies

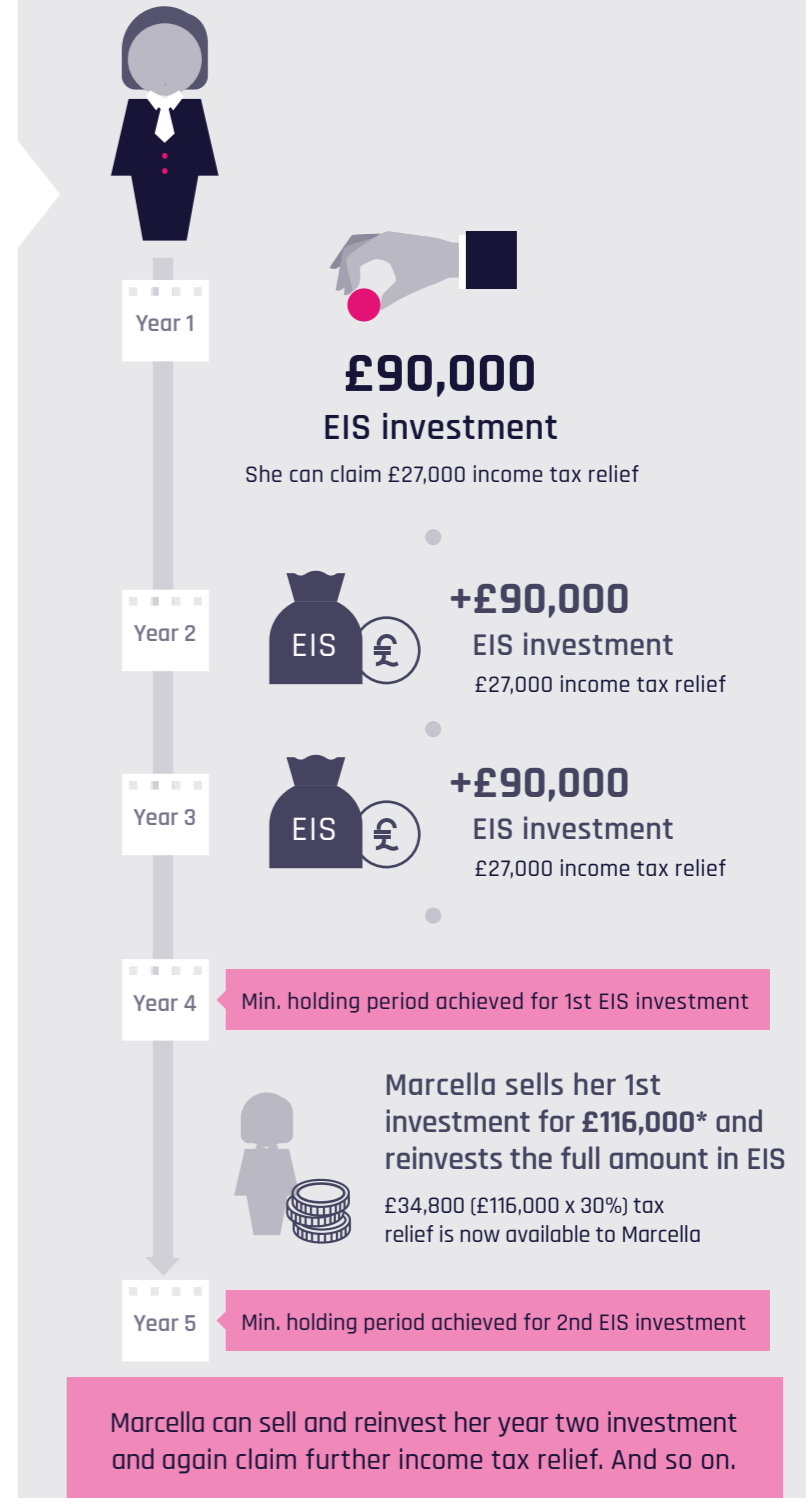
1

Building a portfolio of EIS investments

Marcella earns a salary of £275,000 a year. She has maximised her pension contributions and has an existing portfolio of VCT investments. She is selling her buy to let portfolio and will have gains to carry over which she is looking to invest in something different this year. Marcella seeks advice on building an EIS portfolio.

*If she is making the investments through an EIS fund, timescales for investment or reinvestment cannot be guaranteed and the manager may dictate the timing of any exits, depending on the terms and conditions of the investment.

Additionally, the client or manager may not be able to dispose of the EIS-qualifying shares immediately after three years. This might not be possible unless there is a ready market for these shares. Any disposal of the shares may not necessarily realise a profit.



	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
EIS Investment	£90K	£90K	£90K	£116K	£116K	£116K
Cumulative investment	£90K	£180K	£270K			
30% income tax relief	£27K	£27K	£27K	£34.8K	£34.8K	£34.8K
Cumulative income tax relief	£27K	£54K	£81K	£115.8K	£150.6K	£185.4K

Disclaimer

The following case studies are designed to demonstrate a number of different scenarios that might apply to certain prospective investors. Nothing here should be viewed as advice. Advisers should consider, among other things the impact of charges (including any initial fees as well as annual charges) and the quantum of tax relief that might be available to a particular prospective investor. Any suitability decisions should be based on a comprehensive review of a client's objectives, needs, capacity for loss, investment experience, and attitude towards risk.

2

Deferring your capital gains

Brian, 55, made a capital gain of £84,000 on the sale of a property in the 2021/22 tax year. He had already used his CGT annual exempt amount for this tax year and the property was not his main residence. He has therefore already paid a CGT bill of £23,520 in January 2023.



Brian sold his property in 2021/22 tax year and made £84,000 capital gain



£23,520
CGT bill

PAID



£84,000
EIS investment
(2022/23 tax year)

£23,520
CGT bill*

RECLAIM

*Brian can also benefit from £25,200 income tax relief assuming he has sufficient income tax capacity.

**CGT is deferred until it comes back into charge at a later date if he disposes of the EIS-qualifying shares.

Brian's EIS investment allows him to reclaim the CGT from HMRC and defer it**

3

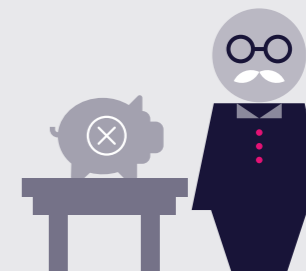
Building a portfolio to accompany pensions

Adil is 52 years old (9 years from his intended retirement) and works as a civil engineer at a large firm. He earns £360,000 a year, so in 2023/24 is a 45% taxpayer. After consideration of the tax relief available on the pension contribution and the impact of the cap on his annual pension contributions at £10,000, Adil is advised to consider alternatives from his pension.

He has already invested the maximum annual investment of £200,000 eligible for VCT tax reliefs in the current Tax Year.

Adil is also entitled to income tax relief. The amount of relief available increases as the investment amounts are compounded.

*If he is making the investments through an EIS fund, the manager may dictate the timing of any exits, depending on the terms and conditions of the investment. Additionally, the client or manager may not be able to dispose of the EIS-qualifying shares immediately after three years. This might not be possible unless there is a ready market for these shares. Any disposal of the shares may not necessarily realise a profit.



Adil makes annual pensions ontributions of £10,000. In addition, he makes annual contributions of £40,000 into EIS



£40,000

This gives Adil £12,000 per year income tax relief

3 years

After each EIS investment reaches 3 years, he would like to exit subject to being able to dispose of the EIS-qualifying shares and reinvest the proceeds in EIS. The amount of relief available increases as the investment amounts are compounded. He does this until he is 60*.

£861,750

Adil ends up with a large amount for his retirement

Tax year	Age	EIS investment	Gain & capital recycled from previous EIS investment reinvested	Total EIS investment in year	EIS income tax relief in year	Total CGT payable on gains	Total value
2023/24	52	£40,000	£0	£40,000	£12,000	£0	£52,000
2024/25	53	£40,000	£0	£40,000	£12,000	£0	£104,000
2025/26	54	£40,000	£0	£40,000	£12,000	£0	£156,000
2026/27	55	£40,000	£50,000	£90,000	£27,000	£0	£233,000
2027/28	56	£40,000	£50,000	£90,000	£27,000	£0	£310,000
2028/29	57	£40,000	£50,000	£90,000	£27,000	£0	£387,000
2029/30	58	£40,000	£112,500	£152,500	£45,750	£0	£545,250
2030/31	59	£40,000	£112,500	£152,500	£45,750	£0	£703,500
2031/32	60	£40,000	£112,500	£152,500	£45,750	£0	£861,750**

The table assumes exits immediately after expiration of three year holding period and 25% gain at each exit.

** In this year, Adil could potentially exit his 2028/29 investments without losing tax reliefs as his 3 year minimum investment period will be up. He would need to wait an additional year for his 2029/30 and an additional 2 years for his 2030/31 investments. But for all the time his funds remain invested, any gains eventually realised would be CGT-free.

4

Income tax and IHT liabilities

Having made investments in other alternative BR solutions, Nadia is looking for a solution to resolve two issues - one from the past and the other for the future.



Nadia, 65, has a significant income tax liability for 2022/23 and is concerned about her increasing IHT liability



£42,000

EIS investment made in 2023/24

£12,600 income tax relief that can be carried back to 2022/23

2 years

BR qualification ✓



When Nadia dies she still holds the investment

100% IHT exemption on the value of the investment

5

Loss relief

Pavel is a higher rate taxpayer and has a diversified portfolio of investments, including £65,000 in EIS-qualifying shares. Due to unforeseen circumstances, in 2023/24 he decided to sell his investment portfolio. Pavel's EIS portfolio sold at a £35,000 loss, however his other (non-property) investments have resulted in a £70,000 gain, incurring CGT of £14,000, and he has already used his £6,000 CGT allowance in 2023/24.



Pavel invested £65,000 into EIS-qualifying shares in 2018/19



5 YR



£30,000

a loss of £35,000 on his original investment



+£70,000

However, Pavel has made a gain on his other investments, incurring CGT of £14,000 (£70,000 x 20%)

£6,000

Peter has already used his CGT allowance in 2023/24

Peter is therefore **able to offset £3,100 of his £15,500 loss** against his outstanding £14,000 CGT liability.* Alternatively, he could offset £6,200 against any outstanding income tax liability he has for 2023/24 and 2022/23. (£35,000 loss - £19,500 income tax relief = £15,500 x 40% (his marginal rate of income tax) = £6,200 available to offset)*

* As a higher rate taxpayer, this £15,500 is multiplied by 20% = £3,100 available to offset against his CGT liability in 2023/24.

6

Seeking income tax relief for a guaranteed tax year

Angel is an experienced investor, with high, but irregular annual income, meaning that in some years, she has large income tax liabilities.

She is aware of the tax benefits of EIS and has a large income tax liability of £56,000 in the 2022/23 tax year. However, in the 2023/24 tax year, she is concerned that she has waited too long to make an EIS qualifying investment that will enable her to claim the relief she needs to cover the entire liability, bearing in mind the average EIS deployment timelines of 12 to 24 months.

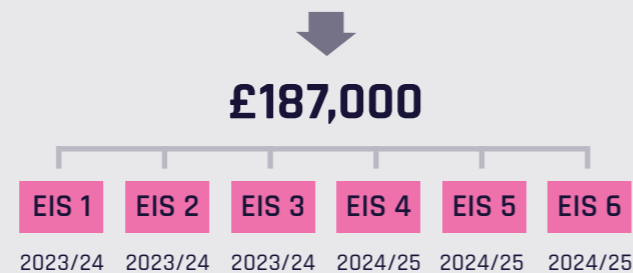
*The investments made by EIS approved knowledge-intensive funds are treated as if made in the year in which the fund closed, even if they were actually made in a later year. Investors may also elect to treat some or all of their investments as made in the year prior to that in which the fund closed.

This case study is for demonstration purposes only. Each client's circumstances need to be analysed on a case by case basis for appropriate client specific recommendations to be made.



Angel wants to use EIS to claim income tax relief against this bill

But EIS discretionary portfolio investments deployment timeline means she cannot cover the entire £56,000 by claiming EIS income tax relief.



Only the first 3 EIS investments made by the EIS manager could be carried back to claim income tax relief in 2022/23



Instead, her financial adviser suggests investing in an EIS Approved Knowledge intensive Fund that will be closing later in 2023/24



Angel can claim £56,000 income tax relief that can be applied to 2023/24 or carried back to 2022/23*

Example Deployment Timeline

Commonly, EIS managers quote a timeline of 12 to 24 months to fully invest each subscription into EIS-qualifying companies. This is dependent on the supply of deals the manager has access to and the number of investee companies it targets for each investor for diversification purposes.

The longer the time taken for full deployment, the bigger the potential impact of cash drag on an investor's uninvested funds. Since the three-year qualification period does not start until funds are invested, it also extends that timeline. And from a tax-planning perspective, it is important to take deployment lead times into account, understanding that deployment may take place over several tax years:

Scenario A – Ms Sanders invests £100,000 with an EIS discretionary fund manager in September 2023:

- Ms Sanders wants to offset a £30,000 income tax bill he has incurred in August 2023 while also starting the clock to become eligible for IHT Business Relief.
- £60,000 of her EIS subscription is deployed into EIS-qualifying investee companies in December 2023 and March 2024.
- The remaining £40,000 of the subscription is deployed into EIS-qualifying investee companies in May 2024 and October 2024.

In this example, Ms Sanders has to use the carry-back facility, allowing funds invested in one tax year to be applied to relieve income tax incurred in the previous tax year in order to offset her full income tax bill.

Time taken for full deployment: 14 months

SCENARIO A

£100,000 INVESTED WITH EIS MANAGER	September 2023	
FUNDS DEPLOYED BY ACQUIRING EIS-QUALIFYING SHARES	£60,000:2023/24	£40,000: 2024/25
YEARS IN WHICH EIS INCOME TAX RELIEF CAN BE USED	£30,000 (30% of £100,000) relief available for 2023/24 tax year	

Scenario B – Ms Sanders invests £100,000 with an EIS discretionary fund manager in September 2023:

- Ms Sanders wants to offset a £30,000 income tax bill she has incurred in August 2023 while also starting the clock to become eligible for IHT Business Relief.
- £30,000 of the subscription is deployed into EIS-qualifying investee companies in February 2024.
- £50,000 of the subscription is deployed into EIS-qualifying investee companies in July 2024, November 2024 and January 2025.
- The remaining £20,000 of the subscription is deployed into EIS-qualifying investee companies in late June 2025.

- Ms Sanders can only offset £21,000 of the £30,000 income tax liability. This is because only 80% of her £100,000 subscription to EIS was deployed in the tax year the liability was incurred, or in the following year (from which it can be carried back).

Of course, the £20,000 deployed in 2025/26 could be used to offset up to £6,000 (30% of £20,000) of other income tax liabilities incurred in 2024/25 or 2025/26, but that wasn't the original plan.

Time taken for full deployment: 23 months



SCENARIO B

£100,000 INVESTED WITH EIS MANAGER	September 2023		
FUNDS DEPLOYED BY ACQUIRING EIS-QUALIFYING SHARES	£30,000: 2023/24	£50,000: 2024/25	£20,000: 2025/26
YEARS IN WHICH EIS INCOME TAX RELIEF CAN BE USED	£24,000 (30% of £80,000) relief available for 2023/24 tax year		£6,000 (30% of £20,000) relief available for 2024/25 or 2025/26

Final summary

1. High growth investment

- £27.9 bn invested in over 36,000 companies through EIS
- 'Risk-to-capital' requirement means focus in on investments with higher growth and risk potential

2. Potential tax benefits

- Up to 30% income tax relief
- 100% CGT deferral relief
- 100% IHT relief (via Business Relief)
- Tax-free capital growth
- Loss relief

3. Potential risks

- Investment risk of smaller companies
- Liquidity
- Exit risk
- Tax risks

4. Rules for EIS investors

- Minimum three year holding period
- Shares must be full risk, new ordinary shares
- No connected parties (for income tax relief)
- No linked loans from the investee company
- No receiving value from the investee company

5. Rules for EIS investee companies

- £5m per company per year investment limit
- £12m lifetime investment raise limit
- £2m per year per investor limit (provided any amount above £1m is invested into knowledge-intensive companies)
- 249 employee limit for investee company
- 7 year age limit
- Unquoted (other than AIM or similar)
- Qualifying trade

6. Knowledge intensive companies

- Benefit from more generous rules
- £20m lifetime investment raise limit
- £10m per company per year investment limit
- 499 employee limit for investee company
- 10 year age limit

For professional advisers and paraplanners only.
Not to be relied upon by retail investors.

Octopus Ventures

About the Octopus Ventures team

We are one of the largest venture capital teams in Europe¹ and aim to invest in the people, ideas and the industries that will help change the world for the better.

£2 billion
AUM²



90
team size³



Supporting
pre-seed to
sale or IPO



Worldwide
presence



Investment focus

Our team is split into specialist areas of focus. This focus helps attract the best entrepreneurs, who tend to have a preference for investors who specialise in their sector.

Health



Deep tech



Fintech



Consumer



B2B
software



Our track record

Some examples of multiples from initial investment achieved include:

Calastone



18x

semafone



8.5x

Zoopla

33x

secret Escapes

80x

The exit multiples above include partial and full exits and are from Octopus Titan VCT and Octopus Eureka EIS only. They do not take into account the impact of fees and costs. Companies featured are for illustrative purposes only, not an investment recommendation.

Of course, not every company we invest in will be successful. 20% of the companies we have invested in have exited at a loss (as at June 2022).⁴ The typical industry failure rate for early-stage companies is around 55%.⁵

Five-year performance of Octopus Titan VCT

Year to 31 Dec	2018	2019	2020	2021	2022
Annual total return (%)	1.8	7.6	7.1	20.3	-22.5

Past performance is not a reliable indicator of future results and may not be repeated

This table shows the annual total return of Octopus Titan VCT for the last five years to 31 December, the VCT's interim accounting period. This is calculated from the movement in NAV over the year to 31 December, with any dividends paid over that year then added back. The revised figure is divided by the NAV at the start of that year to get the annual total return. The NAV is the combined value of all the assets owned by the VCT after deducting the value of its liabilities. The performance shown is net of all ongoing fees and costs.

About the Octopus Ventures EIS Service

Our Octopus Ventures EIS Service is managed by the same investment team as Octopus Titan VCT. It aims to offer investors the opportunity to access 10-15 pioneering businesses with high growth potential.

25

Number of investments
the Service has made in the 12
months to April 2023.¹

54

Number of companies we have
backed since November 2020.¹

9

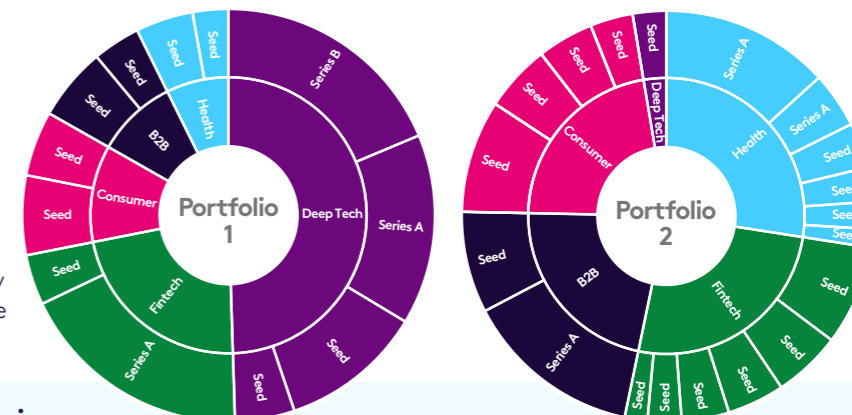
Months

Average deployment for the
last five fully deployed
fundraising groups.

The average deployment is calculated from fundraising group close to all the money invested. This is the average over the last five groups.

Creating a balanced portfolio

We aim to create a portfolio of handpicked early-stage businesses from different industries and sectors, providing investors with a range of companies with high growth potential. Here we show two fully invested portfolios as an example of what investors could expect.²



Example portfolio companies

iSIZE

Deep tech

What it does: A platform that optimises video quality while reducing the size and bandwidth required to transmit data.

Why: Makes streaming quicker, cheaper and less environmentally damaging by reducing carbon footprint.

What we think: "Video streaming is exploding at home but this process is also central to robotics, drones and autonomous vehicle industries."

XYZ

Consumer

What it does: An augmented reality software platform and hardware.

Why: Helps companies build complex things such as data centres and pharmaceutical manufacturing plants.

What we think: "We are incredibly excited to be backing XYZ on their mission to reinvent the construction industry."

Key risks

- The value of an investment in early-stage companies or VCTs and any income returned from it, can fall as well as rise and investors may not get back the full amount invested.
- VCT shares or shares of smaller companies could fall or rise in value more than other shares listed on the main market of the London Stock Exchange. They may also be harder to sell.
- Tax treatment depends on individual circumstances and is assumed as per current legislation and interpretation, which may change in the future.
- Tax reliefs also depend on companies or VCTs maintaining their qualifying status.

¹Octopus Investments, 30 April 2023. ²The investment stage is at the time of investment and the size shows the amount invested at that point. These are examples of two fully deployed fundraising groups from June 2021 and October 2021.

In regards to VCTs, this document is an advertisement and not a prospectus. Any decision to invest should only be made on the basis of the information contained in the prospectus and the Key Information Document (KID) available at octopusinvestments.com. Issued by Octopus Investments Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: 33 Holborn, London, EC1N 2HT. Registered in England and Wales No. 03942880. We record telephone calls. Issued: May 2023. CAM013005-2305

¹Association of Investment Companies, January 2022. ²As at 30 June 2022. Assets under management include assets under advisory mandates and assets monitored. ³Octopus Ventures, April 2023. ⁴Octopus Ventures, includes post period disposal of Glofox.

⁵ONS Survivals and growth by size, June 2020. This data shows the failure rate of UK companies created in 2013 over a five year period to 2018.

Learning objectives

How did you do?

- **Apply the main rules and practicalities that govern the EIS reliefs available:** Rules are covered from pages 21-29, with practicalities on pages 42-43.
- **Explain the main risks associated with EIS:** Investment risks; liquidity; exit risk; and tax risks. More detail is on pages 6-7.
- **Define the key aspects to be taken into account when considering client suitability:** Covered on pages 44-49, including a flowchart indicating when an investment may be appropriate.
- **Identify the main steps to claim EIS tax reliefs:** The processes required are explained on pages 33-35.
- **Evaluate the main considerations for an EIS investment and investment provider:** The research required is covered on pages 50-55.
- **Ascertain the circumstances in which EIS reliefs can be withdrawn:** Covered within the Rules section on pages 21-29, these include instances such as changes to the investee company's activities.

Helpful resources

www.eisa.org.uk



The official trade body for the Enterprise Investment Scheme, EISA is a not-for-profit organisation whose core aim is to help SMEs obtain the funding they need to grow

Steps after reading

Claim your CPD

This guide is accredited for structured CPD by the CII and PFS and readers of the guide can claim one hour of CPD for each hour spent reading the guide, up to a total of four hours. In order to claim CPD, readers will need to complete a short online test For more details on claiming CPD go to:

- intelligent-partnership.com/cpd

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- Intelligent-partnership.com/feedback
- Guides@intelligent-partnership.com

Participation and feedback
are gratefully received

www.micap.com



MICAP is a provider of quality independent due diligence and research on tax-advantaged investments

About Intelligent Partnership

Intelligent Partnership is the UK's leading provider of insights and education in the tax advantaged and alternative investments space.

We organise focused events and provide a suite of materials to keep advisers and industry professionals up to date with the latest developments and on course to meet their training and CPD targets.

Our range of engaging, accessible and CPD accredited resources includes:



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ACCREDITATION

Our CPD tax planning online accreditation programme is aimed at regulated advisers, wealth managers, paraplanners, accountants and solicitors that require a recognised level of knowledge and understanding in EIS, SEIS, VCT and Business Relief.

accreditation.intelligent-partnership.com



WEEKLY INVESTMENT BRIEFINGS

A weekly snapshot of the latest articles, commentary and market data for financial services professionals on tax efficient investment and estate planning. Alongside our regular CPD emails providing the opportunity to earn CPD time based on relevant articles and content provided by ourselves and external providers.



PROVIDER SPOTLIGHT EMAILS

A deeper dive into individual providers giving their input on particular market issues and more detail on the strategies and offerings they have developed to address them.



AWARDS, CONFERENCES, WEBINARS AND WORKSHOPS

Our dedicated programme includes a variety of in-person and virtually hosted events, across the country. Supporting financial advisers and the tax planning community, we facilitate knowledge building of tax wrappers in a workshop environment. We host webinars and conferences that focus on specific areas of tax and estate planning and celebrate the role of the UK SME investment and finance communities through our annual Growth Investor Awards.



In a high inflation context, growth investments like EIS can offer not only the boost portfolios need, but also powerful tax-planning opportunities. But EIS investments are not suitable for every client as risks are high, so a good understanding of how and when they can generate the best outcomes is crucial.

GUY TOLHURST, INTELLIGENT PARTNERSHIP