

The Enterprise Investment Scheme: summary of responses

November 2008



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Contents

		Page
Chapter 1	Introduction	3
Chapter 2	Summary of responses and the Government's proposals	5
Annex A	List of respondents	17
Annex B	Clarifications	19
Annex C	EIS policy basis	21

1

Introduction

1.1 The Enterprise Investment Scheme (EIS) plays a significant role in the provision of venture capital for small businesses, having helped raise over £6.1 billion since inception, invested in over 14,000 companies to date¹.

1.2 The scheme provides tax reliefs for additional private investment (risk capital) into smaller, higher-risk, unquoted trading companies that would otherwise struggle to obtain appropriate levels of finance due to a market failure. This stems from the reluctance of many investors to invest in companies for a variety of reasons, including high fixed transaction costs and a shortage of available exit options. 'Information gaps', particularly where investors know less about the prospects of a business (and so may be unable to quantify the level of risk involved in a particular company), may also lead to a perception of greater risk in investing in early-stage companies.

1.3 The Government is keen to ensure that the scheme remains an effective means of promoting growth and enterprise, especially given the current exceptional economic circumstances. The Government published *'The Enterprise Investment Scheme: a consultation document'* in March 2008². This consultation aimed to identify opportunities to improve further the practical operation of the scheme for investors, investee companies and advisors.

1.4 This document summarises the points that were raised through the consultation, and explains what action the Government intends to take in response.

The consultation

1.5 The consultation period ran between 12 March 2008 and 20 June 2008.

1.6 The consultation document posed 17 questions which covered four broad themes:

- Promotion of the scheme and the awareness of its existence in the business community;
- The regulatory burden placed on investors and companies seeking finance;
- How the EIS rules impact on businesses receiving EIS investment over the longer term; and
- Ways in which the administration of the scheme by HM Revenue & Customs (HMRC) might be simplified.

1.7 As well as responses to the 17 questions, a number of comments were also received which fell outside the remit of any specific question. These proved to be useful in assessing the value of the scheme in a broader context, both in relation to the business community in the UK and also in an international setting. These comments have been considered alongside the other suggestions.

¹ These statistics are based on the claims received by HMRC up to 1 October 2007. Updated statistics will be published in December 2008.

² See http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_fullindex.cfm

Next Steps

1.8 The Government is grateful to the businesses, organisations and individuals who responded, often in detail, to the consultation. Chapter 2 sets out the actions that the Government will take to improve the operation of the scheme, recognising the importance of minimising administrative and regulatory requirements for a sector that operates with limited resources. It considers in particular how certain rules may be simplified, how the scheme could be made more flexible to take account of commercial realities, and how better information might be made available online.

1.9 The Government will continue to consult informally with industry bodies to plan, develop and assess the viability of potential changes. We will seek to bring forward legislation for a number of changes at Finance Act 2009. Some of the more technical changes will require further consultation on their impacts and applicability, and on the details of any resulting legislation. Should these changes prove to be necessary and viable, the Government would seek to bring forward legislation at Finance Act 2010.

2

Summary of responses and the Government's proposals

2.1 Fifty respondents replied to the consultation document. Respondents included individuals and companies that use the scheme, professional advisors and promoters, as well as industry representatives and organisations involved in the small business sector. A full list of respondents is available at Annex A. Most respondents shared the opinion that the EIS is an effective intervention for smaller, higher-risk and growing businesses. The Government is also pleased at the high regard in which companies, investors and advisors alike hold HMRC's Small Company Enterprise Centre.

"Many of the investors with whom we work regard EIS [investments] as an asset class and we believe they would be significantly less likely to commit funds to such high risk ventures if the relief was not available."

Business Angel Syndicate

"The EIS scheme has been of great benefit in stimulating the early stage investment market and is an exemplary model both to the rest of Europe and internationally, as a means to support and promote angel investment."

Trade Association

2.2 Responses to the questions are summarised under seven broad headings:

- Awareness of the scheme (Q1, 7, 11).
- The broader regulatory regime (Q2, 8).
- Rules relating to the investee company (Q3, 4, 5, 6, 13, 14, 15).
- Rules relating to the investor (Q9, 10).
- HMRC processes (Q12).
- EIS Funds (Q16).
- Other points (Q17).

2.3 Having considered the views expressed in response to the consultation, the Government proposes to make a number of changes to the operation of the scheme. These proposals are also detailed below. The Government will consult further with stakeholders about the details of any legislative changes, before any such changes come into effect.

2.4 The Government is still negotiating with the European Commission to secure State aid approval for the scheme. Any changes as a result of this consultation will also have to be approved by the European Commission before they are introduced.

2.5 The consultation also highlighted a small number of misunderstandings of the EIS rules. Although not strictly part of the consultation response, these issues are listed at Annex B, together with a brief clarification of the points. In addition to this, HMRC will take account of requests for guidance to be reviewed so as to make the requirements clearer.

Awareness of the scheme

2.6 The Government is keen to continue to raise awareness of the scheme. Pricewaterhouse Coopers LLP published the results of their survey "*Enterprise in the UK: Impact of the UK tax regime for private companies*" in October 2007, which indicated that awareness of the EIS has already increased, with 65 per cent of respondents aware of it, up from 52 per cent in 2006. **The consultation document therefore asked if there is any way that awareness of the scheme, amongst companies, investors, and agents could continue to be improved.**

2.7 Many respondents felt that there is already a good level of awareness among investors and companies alike. Others, however, felt that some action to increase awareness would increase usage of the scheme. In particular, it was suggested that while there is a good level of awareness among professional bodies, broadly speaking, awareness of the scheme could be improved amongst those companies and individuals who do not receive professional advice.

2.8 The majority of respondents felt that including more information on the scheme in existing Government correspondence to individuals, accounting firms, and companies would improve the situation. Other suggestions included launching a Government-backed publicity campaign, working with business angel networks, and working with professional institutes to continue to improve knowledge of the scheme among individual advisors.

The Government's response

2.9 The Government is pleased that respondents reported a good level of existing awareness of the scheme, particularly amongst professional advisors. With the intention of widening this awareness, **HMRC will now look at the range of information already sent to companies by HMRC, and assess where information on the EIS may usefully be included.**

2.10 HMRC will also **reorganise and streamline the information available on the HMRC website** about the EIS, with links to other helpful Governmental materials and websites.

The broader regulatory regime

2.11 The consultation document asked if there is anything in the broader regulatory regime that **hampers either investee companies, or investors seeking potential investee companies, in their use of the scheme.**

2.12 Although not specifically related to the rules of the scheme, some respondents felt that rules imposed by the Financial Services Authority (FSA) are an obstacle to raising finance under the scheme. More specifically, the application of the European Markets in Financial Instruments Directive (MiFID) within FSA rules, were cited as a particular burden.

The Government's response

2.13 This is an issue that affects not just those who use the EIS, but small businesses and investors more generally. **HM Treasury and HMRC are therefore engaging with EIS industry bodies and the Financial Services Authority (FSA), to understand better what these issues mean for the EIS in particular.**

Rules relating to the investee company

2.14 The consultation document invited comments and responses on the following aspects of the scheme, relating to companies receiving funding from investors under the EIS:

Advance assurances

How well do advance assurances serve their purpose, and is there anything that could be done to simplify the process of securing one?

2.15 HMRC offers companies advance assurances, to reassure companies and potential investors which share issues would be likely to qualify for relief under the EIS.

2.16 Most respondents agreed that advance assurances are beneficial. Some felt that the system could go further, making an advance assurance a more formal and binding indicator of whether or not a subsequent share issue would be accepted as meeting the requirements of the scheme. It was also suggested that more information, with clearer guidance, on what information companies need to provide to obtain an assurance, would be helpful.

The Government's response

2.17 In response to the high number of suggestions received on this point, **the existing online information on the EIS on the HMRC website will be expanded to include a template for the information required for advance assurance applications, along with relevant guidance.** This should help companies applying for advance assurances, ensuring they know what information and documentation should be provided.

Qualifying trades

How well do the restrictions on eligible trades and the control test meet their objective of focusing EIS on smaller companies that face the highest barriers in accessing finance?

2.18 Any company receiving funding through the EIS must either carry on a qualifying trade, or be the parent company of a company that carries on a qualifying trade. A list of excluded trades exists to target investment under the scheme effectively on those companies facing the most severe barriers to accessing finance. In many cases the excluded activities are asset-backed trades where the assets could be used, for example, as collateral to secure a loan. These trades do not suffer the same degree of difficulty in raising finance as those companies without assets. A qualifying trade is therefore one that consists mainly of activities not on the list of excluded activities, and which is conducted on a commercial basis with the intention of making a profit.

2.19 Many representations were received about the restrictions on activities eligible for relief under the EIS. Respondents suggested for example that accountancy, care for the elderly, farming, and the hotel trade should be eligible for relief. Certain respondents also questioned the view that particular excluded sectors – such as 'land backed' activities – are 'low risk'.

2.20 Despite this, many respondents accepted the principle that 'asset-backed' activities should be excluded. A number of respondents suggested that the exclusion of certain activities from the scheme was anomalous. The two most prominent such cases cited related to the definition of relevant intangible assets and certain kinds of leasing. There was also concern as to whether enough account had been taken of the growth of e-commerce in considering whether a company is engaged in 'an ordinary trade of wholesale or retail distribution'.

The Government's response

2.21 The Government intends to review the restrictions concerning the following specific restrictions in order to ensure that the rules best reflect current commercial practices.

Relevant Intangible Assets

2.22 A number of respondents felt that the current rules on relevant intangible assets (RIAs) are too restrictive. An example of an intangible asset, which these rules may apply to, is intellectual property. Respondents accepted that, in order to qualify, companies exploiting an RIA should have created the whole or greater part of it in terms of value. They were concerned, however, that as currently phrased, the legislation could make it difficult for a company to qualify if it acquires an intangible asset which was already producing an income stream, but which the company buys in order to develop it, and in so doing, create the whole or greater part of its value.

2.23 The Government intends to **review the existing definition of a "relevant intangible asset"**, to assess if more flexibility is needed for companies involved in the development of innovative products.

Leasing

2.24 A number of respondents, while supporting the exclusion of leasing in principle, argued either that exceptions should be made in some cases, or that amendments should be made to the rule so that certain companies, particularly those involved in the exploitation of intellectual property, were no longer deemed to carry out leasing activities.

2.25 In response to these concerns, the Government will **examine the case for relaxing the exclusion of leasing where a company develops and leases a product, where the asset actually represents or embodies intangible property.**

E-commerce

2.26 In light of the growth of e-commerce businesses, the Government will also **review the current exclusion of dealing in goods, other than in "an ordinary trade of wholesale and retail distribution"**. This will determine whether there is a need to amend the legislation or revise the guidance, or, should certain e-commerce businesses not meet the existing legislative requirements, whether there is a case for amending those requirements, to allow them to seek investment under the scheme.

2.27 The Government will continue to consult on an informal basis with industry on the necessity and implications of any such changes, with the intention of taking forward any resulting legislative changes at Finance Act 2010. The wider policy rationale on which trades are eligible for relief under the EIS will also be kept under review, to ensure that investment under the scheme is targeted effectively.

The control test

How well does the control test meet its objective of focusing EIS on smaller companies that face the highest barriers in accessing finance?

2.28 An EIS company must not be controlled by another company, nor must there be any arrangements in existence when shares are issued for it to be controlled by another company.

2.29 A number of respondents were content with the way this test applies. A larger number of respondents, however, objected to the rationale for the existing test, citing a number of issues.

2.30 Some respondents felt that it was unfair that EIS investors could lose their relief if the company merged or was taken over by another company, when such a move was a commercial decision made by the company.

2.31 A number of respondents suggested addressing these perceived problems by allowing EIS companies to be taken over or merged without any loss of relief for investors, or by considering whether existing control rules could be changed. Other respondents suggested making businesses owned by venture capital companies or universities specifically exempt from the control requirement.

The Government's response

2.32 The EIS is intended to help small, independent enterprises that have difficulty raising capital. The Government believes that where another company controls an enterprise, it could look to that controlling company for additional finance, in the same way the controlling company could provide collateral and reputation. The Government therefore does not intend to change the general control rules.

2.33 The Government does, however, intend to **further explore the case for amending the rules to facilitate mergers and takeovers, where all the companies involved are EIS-qualifying companies**. The aim is to safeguard investors' entitlement to any relief, while also permitting companies to take account of commercial realities. Similarly, the Government intends to review the rules on 'qualifying subsidiaries', with a view to exploring whether any changes should be made to facilitate joint ventures. Such a change would provide increased flexibility for expanding companies and enhance their growth potential. If further informal consultation on proposed changes supports changes in this respect, and if the Government considers it viable to introduce such changes, the Government would seek to bring forward any resulting legislation at Finance Act 2010.

The employment of money and commencement of trade requirements

How could the existing requirements, regarding the expenditure of money and the commencement of trade, be refined in practice?

2.34 There is currently a requirement that at least 80 per cent of the money raised by the share issue must be employed within 12 months of the issue (or of commencing trade, whichever is later), with the remaining 20 per cent employed within the next 12 months. If the company is preparing to trade, the trade must start within two years of the shares being issued.

2.35 In line with the Sainsbury Review of Science and Innovation's recommendation that "The conditions of the EIS concerning the time constraints for the start of trading and the expenditure of money raised should be reviewed", the Government sought to assess whether the EIS could do more to encourage investment in sectors with long development cycles. The consultation document therefore sought views on how respondents view current requirements.

2.36 Many respondents viewed the requirement regarding the expenditure of money as particularly onerous for small businesses, suggesting that this requirement may mean that the objective of safeguarding investors' relief overrides commercial decisions. The commencement of trade condition, which requires the company to commence trading within two years of shares being issued, was less of a concern for the majority of respondents. It was, however, pointed out that the trading rule does potentially cause problems for industries in certain sectors such as power, and for wind farms in particular.

2.37 Many respondents suggested that the current rules for the employment of money could be simplified, by requiring that 100 per cent of the money raised by the share issue be spent within two years. Other respondents suggested that aside from simply lengthening the time limits, EIS relief could be given as the investment is actually deployed by the company or fund, subject to an advance assurance.

The Government's response

2.38 In response to these comments **the Government will simplify the rules concerning the expenditure of money.** The Government proposes to change this rule to remove the requirement relating to the first year. **The requirement would then simply be that that 100 per cent must be employed within two years.** This would simplify the rules and **give more weight to commercial considerations, rather than the wish to safeguard investors' tax reliefs** when a company decides how and when to employ money raised. This would also reduce the scope for investors failing to meet requirements, by reducing the number of 'cliff-edges' in the rules. Should further informal consultation support this proposed amendment, the Government will bring forward the required legislation at Finance Act 2009.

2.39 The Government does not propose any changes to the requirement to commence trade within two years of a qualifying share issue. While it accepts that this may pose potential problems for a small number of sectors, the rules have to apply to a wide range of trades. It would be inappropriate to introduce exceptions to these rules, or different rules for different trades, as this would introduce additional complexity into the scheme. Taking into account the wide range of businesses that use the EIS, the Government believes the two-year requirement remains a fair period.

The three year qualifying period

How well does the three-year qualifying period meet its objectives?

2.40 Companies are currently required to continue meeting the EIS qualifying conditions for three years from the date of share issue (or longer if the shares are issued before the company has started to trade). Some respondents acknowledged that this rule supports the policy intention of encouraging share holding. Others suggested that the three-year period leaves too much scope for accidental breaches of the rules, and places EIS investors' relief at risk from changes in the economic and commercial landscape. Certain respondents also suggested that the rule creates an inherent conflict of interest between different EIS investors over the timing of potential exits.

2.41 Those who felt that the period is too long generally suggested that a two-year rule would be appropriate, or that there should be no minimum period at all. Alternatively, some respondents suggested that where a company failed to continue to meet the requirements of the scheme, the amount of relief withdrawn from the investor should be proportional to the length of time the shares did qualify for relief.

2.42 The majority of responses to this question, however, related to the effect this period has on the likelihood of the company committing an accidental breach of the rules (considered below).

The Government's response

2.43 **The three-year rule incentivises more stable, longer-term investments through use of the EIS.** The Government believes that three years is a reasonable period to require investors to hold their shares, and does not intend to change this requirement.

Accidental breaches

What more could be done to ensure that companies meet their obligations and avoid accidental breaches? Is there any other way of dealing with accidental breaches?

2.44 Relief is withdrawn if, during the qualifying period:

- The investor becomes connected with the company; or
- The company begins to carry on an excluded activity.

2.45 Relief is reduced or withdrawn if, during the same period:

- Any of the shares are disposed of (except to a spouse or civil partner, or in the course of certain kinds of company reconstruction);
- The investor (or an associate) receives any benefit or loan (or anything else that constitutes value) from the company; or
- The company redeems shares from another non-EIS investor.

2.46 A number of respondents questioned how breaches of the rules are dealt with, suggesting some flexibility where these are accidental. Others suggested that breaches actually occur quite infrequently. Overall the main point raised was that the prospect of losing investment and the uncertainty this creates deters investors and companies from using the scheme.

2.47 Certain respondents felt that some kind of period of grace (over and above the existing replacement of value provisions), during which any such breaches could be set right, would increase the attractiveness of the scheme. Some highlighted the provision introduced recently for Venture Capital Trusts (VCTs), which allows fund managers to notify and correct accidental breaches, and suggested a similar provision could be introduced for EIS companies.

2.48 Others suggested that HMRC should take a more proactive role in reminding companies of their obligations, by sending out regular reminders with information on the consequences for investors of failing to meet these obligations. A number of other respondents also suggested that a system of proportional withdrawal of relief, according to the gravity of the breach, or the length of time the shares had been held for, could be introduced.

2.49 Specific circumstances where various respondents suggested that relief should not be withdrawn, or that time should be allowed to rectify the situation, included:

- Where a loan has been made with the intention of converting it into shares at the next EIS share issue, within twelve months of the loan being made; and
- Where funds have been used in a subsidiary company that is at least 90 per cent held, but is more than three tiers away from the parent in the group structure.

The Government's response

2.50 In response to the concerns raised, **HMRC will include a prominent reminder of the terms of approval when it is granted.**

2.51 The information held by HMRC indicates that accidental breaches by EIS companies actually occur quite infrequently. Of those that do occur, it is difficult to consider the most common cause – the sale of the company – to be truly accidental. In these cases, the sale takes place for sound commercial reasons, often in the knowledge that investors will lose relief.

2.52 Introducing a sliding scale of relief, proportional to the length of time shares had been held for, would effectively represent an opt-out clause for certain investors, going against the existing policy to incentivise longer-term investments. In addition to this, the Government believes that given the relatively small number of accidental breaches, such an option would introduce more complexity in the administration of the scheme than is necessary or beneficial to those who use it.

2.53 Any comparison with the existing provision for VCTs to correct minor breaches is, moreover, misleading. VCTs operate as intermediaries, investing money on behalf of their clients and, as minority shareholders, VCTs often have no control over any subsequent breaches.

2.54 Further, in the case of EIS, HMRC experience is that companies would not realise they had accidentally breached the rules, as this is often only discovered when HMRC receives the company tax return. By this time, the three-year period may well have passed, the company may have become non-qualifying, and investors may have disposed of their shares. **A 'period of grace' to rectify the problem, as suggested by some respondents, would not be able to achieve the required results, as at this stage it could be impossible to reverse or rectify the breach.** The Government therefore does not propose to introduce any flexibility into the current system in this respect.

Rules relating to the investor

2.55 The consultation document invited comments and responses on the following aspects of the scheme, relating to investments made under the EIS:

Carry back provisions

Is there any added value in extending the period over which the carry back provision is available, to allow for carry back or carry forward for one year either side of investment?

2.56 Under current rules, income tax relief for shares subscribed for in the first half of the tax year can be carried back to the previous year. This is subject to certain limits: relief on half the shares subscribed for in that period can be carried back, up to a maximum of £50,000, giving relief of £10,000.

2.57 Most respondents were in favour of the Government's suggestion to extend the carry back provision for up to twelve months, replacing the current six-month limit. Few, however, saw any added value in allowing tax relief to be carried forward to the following year.

The Government's response

2.58 The Government intends to amend existing rules so that **it will be possible to carry back relief to the tax year immediately preceding the year in which the investment is made. The only limit on the amount of relief that can be carried back will be the normal annual investment limit.** This offers increased flexibility for those choosing to offset their investments over a longer period of time, and removes restrictions on the amount that can be offset. The Government intends to bring forward legislation to introduce this change at Finance Act 2009.

2.59 The Government does not propose to change the rules to extend the carry forward provision, as it believes it would introduce unnecessary complication into the scheme.

Connected parties

Does the connected parties rule give rise to cases that seem anomalous to, or at odds with, the purpose of the scheme?

2.60 Under the current rules, income tax relief is not available to individuals who are ‘connected’ with the company.

2.61 An individual is connected with a company if they, or an associate, are a partner, director, or employee of the company or any of its subsidiaries. A person’s associates are defined as their business partners, trustees of a settlement (where they are either a settlor or a beneficiary), and relatives (spouses or civil partners, parents and grandparents, children and grandchildren).

2.62 There is an exception to this rule for directors who are ‘angel directors’, where the only connection with the company is as a director who receives no remuneration (and is not entitled to such remuneration), and who had not previously been involved in carrying on the activity the company carries out. Under these circumstances, an investment may qualify for income tax relief. That relief would not be withdrawn if the individual subsequently became a paid director. In certain circumstances, it is also possible to claim income tax relief on investments made after becoming a paid director. A number of respondents felt that even with this exemption, the rules applying to “angel directors” are too tight, deterring business angels from joining boards, or discouraging second round investment.

2.63 It was suggested that the restrictions on business founders, associates and family members, interfere with the scheme’s success, as these groups are often likely sources of early investment. Many respondents therefore suggested relaxing the rules to let family members, founders, and associates claim income tax relief on investment.

2.64 An individual is also connected to the company if they, or an associate, hold more than 30 per cent of the share capital, voting rights, or are entitled to more than 30 per cent of the assets in the event of a winding up. A number of respondents suggested that this ‘financial interest’ rule may cause accidental breaches, and recommended that the rule should be abolished or disregarded where a holding of over 30 per cent is reduced to 30 per cent within a year of investment. Others recommended that the limit should be increased from 30 per cent to 50 per cent.

The Government’s response

2.65 The EIS is targeted at attracting external investment, including from business angels, rather than encouraging investment from those already connected with the company.

2.66 The scheme aims to incentivise investments in smaller, higher-risk companies, which may not otherwise be made, often as a result of an ‘information asymmetry’, whereby investors may know less about the prospects of a business, and so may be unable to quantify the level of risk involved in a particular small company. Family members and business associates are not affected by this information asymmetry in the same way that external investors are. The Government believes that it would therefore be inappropriate to widen the scheme to allow for the full range of reliefs to be available to these groups. The Government also believes that 30 per cent is a reasonable restriction on the financial interest of an investor.

HMRC processes

2.67 The consultation document asked if there are ways that the operation of the EIS could be simplified.

2.68 HMRC is responsible for giving advance assurances on proposed share issues, for approving share issues giving tax relief to investors and (if any of the conditions subsequently fail to be met for the required period of time) for withdrawing that relief. HMRC's Small Company Enterprise Centre carries out a number of these processes. Companies must have traded for at least four months prior to submitting an application for relief under the EIS.

2.69 Commenting on these processes, some respondents suggested that investors should be allowed to claim relief as soon as they make their investment, and that companies should be able to submit their application for EIS relief even if they have not traded for four months. Others suggested that it should be possible to submit forms online, and that the process should be streamlined to either reduce the number of forms or to allow them to be submitted at the same time.

The Government's response

2.70 In light of respondents' support for making more EIS forms available online, **HMRC will evaluate the business case for online applications for both advance assurances and approval of share issues**, to replace the current paper-based processes.

2.71 The Government believes it is important that companies can demonstrate they are a viable business and that investors' money will be used appropriately, and so requires companies to have traded for at least four months prior to their application for relief under the EIS. This reduces the likelihood of HMRC having to withdraw relief at a later stage through non-compliance issues. This rule represents a safeguard for both investors and companies seeking to use the scheme, and the Government does not propose changing it.

EIS Funds

2.72 The consultation document asked if there are any procedural or administrative aspects of the processes concerning EIS funds that respondents feel could be simplified.

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

2.74 The main benefit of applying for approved status is that, when determining the tax year for which income tax relief can be obtained, all EIS shares acquired through the fund are treated as though they had been issued on the date when the fund closes (provided that 90 per cent of the fund is invested within 12 months of that date). The fund must invest in at least four companies, allocated between investors in proportion to the amount they have contributed. There is no minimum investment level in each company.

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

2.76 As when an individual invests directly in a company, the shares held through any EIS fund (either approved or non-approved) must be held for the qualifying three-year period.

2.77 Most respondents felt that EIS funds have a key role to play in increasing the attractiveness of the EIS as a whole, but that greater flexibility in the rules would enhance this role.

2.78 Some respondents suggested that both income tax relief and capital gains deferral relief should be available to investors as if the investments had been made on the day the Fund closed. Others stated that the distinction between approved and non-approved Funds should be removed, or that Fund managers should be allowed to operate multiple approved Funds simultaneously. Alternatively, it was suggested that non-approved Funds should be able to 'self-certify', providing the companies are approved for investment under the EIS, prior to investments being made by the Fund.

2.79 Some respondents also suggested that the £500 minimum investment be abolished for investments made through non-approved Funds. Other respondents also suggested extending from one year to three years the period of investment in which approved Funds have to invest 90 per cent of the money, which allows investors to get income tax relief as if the investment had been made on the date the Fund closed.

2.80 A number of respondents also cited the broader regulatory environment in which Funds operate as problematic, highlighting Value Added Tax (VAT) liabilities and MiFID rules as particular obstacles.

The Government's response

2.81 As stated at 2.13, HM Treasury and HMRC are working with industry bodies and the FSA to investigate the issues raised over MiFID regulations.

2.82 Furthermore, **HMRC will set up a working party to consider a number of EIS Fund-specific issues raised in consultation responses, mentioned above, and a number of other issues.**

Other points

2.83 The most frequent suggestions for amendments to the scheme's rules, not already addressed in previous sections, are considered below.

Share for share exchange

2.84 The Government will consider how to address an anomaly caused by the interaction of the EIS and CGT rules which can occur when a share-for-share exchange takes place, resulting in a shareholder being liable to CGT in respect of both a deferred gain brought back into charge and the gain on the "disposal" of the shares in the share exchange. The Government intends to introduce legislation to address this anomaly at Finance Act 2009.

Loan conversion

2.85 Where an investor decides at a later date to convert their initial loan into an equity stake, no additional money has been raised. As the amount invested has not actually increased, this is not in keeping with the aims of the scheme, and the investor is not entitled to EIS under current rules. The Government does not intend to reassess the basis of these rules, as it is an important feature of the EIS that it levers additional private investment into smaller, higher-risk companies. Annex B clarifies the existing position that genuine advance payments for shares are not considered to be loans converted into shares.

Other points

2.86 Suggestions were also received on raising the rate of income tax relief on investment to at least 30 per cent; relaxing or removing the requirement for trades to be carried out 'wholly or mainly in the UK'; allowing EIS investments to be made using other classes of shares; and reviewing the impact of the European Commission's State Aid Risk Capital Guidelines.

2.87 Some of these points, along with others raised in response to the questions on specific aspects of the scheme's operation, relate to the policy basis for intervention to improve access to finance for small businesses rather than to the operation of the scheme itself. While the Government believes the policy basis of the EIS is sound and does not intend to make changes to the scheme in this respect, it feels it would be useful to take this opportunity to clarify certain aspects of the scheme, in response to these concerns. These are listed at Annex C.

Conclusions and next steps

2.88 This document has set out changes that the Government intends to take forward. It has also outlined areas in which it feels more examination of the points raised needs to be carried out, and areas where the Government does not believe a change is appropriate.

2.89 The Government will therefore continue to consult informally with the relevant bodies and organisations that responded to the consultation, to explore the possible changes highlighted in this document in greater detail. This work will inform future legislative changes, with industry given the opportunity to comment on draft legislation where appropriate. **Regulatory and legislative changes will then be implemented in subsequent Finance Acts.**

A List of respondents

The following organisations, companies and individuals submitted responses to the consultation on the EIS:

- 1 The Advantage Early Growth and Viking Fund
- 2 Angel News
- 3 Archangel Informal Investment Ltd
- 4 Archangels
- 5 BDO Stoy Hayward LLP
- 6 BERR Access to Finance Expert Group
- 7 The BioIndustry Association
- 8 Braveheart Investment Group plc
- 9 British Business Angels Association
- 10 British Private Equity & Venture Capital Association
- 11 Business Link East
- 12 Calculus Capital Ltd
- 13 Confederation of British Industry
- 14 The Chartered Institute of Taxation
- 15 David Baker Farms
- 16 Deloitte & Touche LLP
- 17 Engineering Employers' Federation
- 18 Enterprise Investment Scheme Association
- 19 Federation of Small Businesses
- 20 Franchise Investment Strategies Limited
- 21 HDI Capital Partners LLP
- 22 Howarth Franchising
- 23 Institute of Chartered Accountants in England and Wales
- 24 Institute of Chartered Accountants of Scotland
- 25 Institute of Directors
- 26 Intellect

- 27 IQ Capital
- 28 Keeble Hawson
- 29 Lacomplc
- 30 LINC Scotland
- 31 London Technology Fund
- 32 Martineau Johnson
- 33 MBM Commercial LLP
- 34 MMC Ventures Ltd
- 35 Music Publishers Association
- 36 Nilo Energy Ltd
- 37 Ortus
- 38 Oxford Capital Partners
- 39 Henry Pound
- 40 Quoted Companies Alliance
- 41 Social Enterprise Coalition
- 42 Smith & Williamson Ltd
- 43 Towry Law
- 44 TPP Law
- 45 Wessex Reinvestment Trust
- 46 West Midlands Regional Finance Forum
- 47 WhizzGo
- 48 Yorkshire Association of Business Angels
- 49 Yellowfin Ltd
- 50 YFM Group

B

Clarifications

The consultation process highlighted a number of misunderstandings relating to current rules, and a number of respondents raised queries over the application of certain rules. A brief explanation of these issues, and clarification on the HMRC interpretation of the relevant legislation where appropriate, is detailed below.

B.1 The requirement that the trade be carried on “wholly or mainly” within in the UK does not exclude exporters, nor does it require only minimal foreign activity. HMRC interpret the requirement as meaning that more than 50 per cent of the activity should be in the UK.

B.2 The headcount test applies at time of the first qualifying share issue only. After EIS investment, companies can exceed the current limit, and employ more than the equivalent of 50 full-time employees.

B.3 The rules of the scheme do not exclude “master franchisors” as such. As with other activities based on acquiring and exploiting intellectual property, the issue is what value the company itself adds to the asset.

B.4 If a company has already been trading for four months when it issues shares, it need not wait another four months before submitting an EIS1 form.

B.5 If a company is wound up for genuine commercial reasons, its investors do not lose their relief, whether or not it appoints a liquidator.

B.6 It is acceptable for a payment made in advance of a share issue to be “converted” into shares where it is established that this was always the intention – where the payment was never intended as a loan but was simply an advance payment for the shares.

B.7 Social enterprises are not excluded providing their trade is conducted on a normal commercial basis and with the aim of making a profit. That remains the case even if any post-tax profit, instead of being distributed by way of dividends or otherwise, is re-employed in that, or another, social enterprise or charitable endeavour.



EIS policy basis

The objective of the scheme is to incentivise equity fundraising where the market would not normally provide it. It offers a variety of tax reliefs to individual investors in smaller, higher-risk, unquoted trading companies. The investor can either subscribe for full-risk ordinary shares in the company directly, or can put money into an EIS fund that subscribes for shares in a range of qualifying companies as nominee on behalf of investors.

C.1 The EIS and Venture Capital Trust schemes are targeted at different investor asset classes, and are designed to complement each other. They therefore carry different rights, restrictions and reliefs, in order to ensure the full range of target companies receive investments through the most appropriate measure. Definitions are kept aligned as far as possible (for example, the requirements regarding the companies using either scheme are the same), but each scheme is carefully balanced in its own terms and simply taking across one aspect of, say, the VCT scheme, that looks more favourable than its equivalent in the EIS would upset this balance.

The investor

C.2 The reliefs available for qualifying investors are:

- **Income tax relief:** This is based on the amount invested in the company. The relief given is 20 per cent of the amount invested, with a minimum investment of £500 per company per tax year. The maximum total investment in any tax year on which income tax relief is available is £400,000 (giving up to an £80,000 reduction of income tax liability). Subject to State aid approval, this limit will be raised to £500,000 (giving up to a £100,000 reduction on income tax liabilities) for the tax year 2008-09 onwards. Income tax relief can only be claimed by individuals who are not “connected” with the company;
- **Capital Gains Tax (CGT) deferral relief:** If a capital gain (from any asset) is invested in shares of a company that qualifies under the EIS rules, then the CGT on the gain is deferred until the EIS shares are disposed of. The EIS investment must be made no earlier than one year before, and no later than three years after, the gain arises;
- **CGT exemption:** Provided income tax relief has been granted (and not withdrawn), any gain from the disposal of the shares in an EIS company is exempt from CGT; and
- An investor is entitled to these reliefs provided that the shares are held in a company that remains an EIS-qualifying company for a period of three years after the issue (or three years after the commencement of the trade if that followed the share issue).

C.3 As the EIS is targeted at encouraging external investment in smaller, higher-risk companies, it would not be appropriate to offer the full range of available reliefs to family, business partners and employees. These groups are, however, eligible for CGT deferral relief under the scheme.

The investee company

C.4 For an issue of shares to qualify for EIS investment, the company must meet the following requirements at the time of qualifying share issue:

- **Gross assets test:** the gross assets of the company (or the whole group if it is the parent of a group) cannot exceed £7 million immediately before any share issue and £8 million immediately after that issue;
- **Employees:** the company (or the whole group if it is the parent of a group) must have fewer than 50 full-time employees (or their equivalents) at the time the shares are issued; and
- Besides carrying out a qualifying activity, **the company must also be unquoted when the shares are issued.** That means that it cannot be listed on the London Stock Exchange or any other recognised stock exchange. The Alternative Investment Market (AIM) and the PLUS Quoted and PLUS Traded Markets are not considered to be recognised exchanges for this purpose.

C.5 The gross assets test and the control test have been introduced to ensure that EIS relief is targeted at small companies facing the most severe barriers to accessing finance. A gross assets test is used as the Government believes it gives the most accurate assessment of the overall value of the company. Using a Net Assets Test could result in the scheme being opened up to very large companies with highly debt-based profiles, which would clearly run counter to the scheme's objectives to target smaller companies.

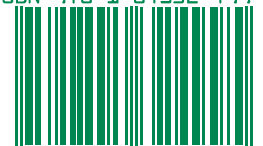
State Aid Risk Capital guidelines

C.6 Following publication of the EC State Aid Risk Capital guidelines in 2006, the UK entered into discussion with the European Commission to ensure the compatibility of the Enterprise Investment Scheme, the Venture Capital Trusts scheme and the Corporate Venturing Scheme with the requirements. To be satisfied of this compatibility, the European Commission requires that the schemes be focused on the smallest businesses (employing the equivalent of 50 full-time employees or fewer) that need equity investments. The Government has ensured that the annual limit for companies receiving investments under the schemes is £2 million, above the normal EC 'safe-harbour' threshold of €1.5 million.

C.7 Under the EC State Aid Risk Capital guidelines, EIS relief could either be restricted to provide financing up to the expansion stage for small enterprises, or for medium-sized enterprises located in assisted areas. The Government believes that a requirement for companies to be based in specific regions would open up the scheme to abuse, and introduce unnecessary complication into the scheme, which is intended to target an equity gap that affects the whole of the UK. The UK therefore chose to focus the scheme solely on small companies.

C.8 The Government is still in negotiations with the Commission to secure approval for the scheme under these guidelines. The Government continues to work with the Commission, to ensure that proper account is taken of the economic arguments for Government intervention when applying the State Aid Risk Capital guidelines.

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