

## TAX UPDATE

---

# Looking for capital growth without tax? EIS could be the answer.

The Enterprise Investment Scheme has been around for many years, but there is still a lack of awareness of the tax benefits it offers – particularly the opportunity for tax-free capital growth.

EIS was specifically designed to help smaller trading companies raise finance. Because these companies tend to be higher-risk investments, the government offers attractive tax breaks for people who choose to invest in them.

There are three main tax reliefs available:

- Income tax: 30% relief up front
- Capital gains tax: Tax-free capital growth  
Tax deferral  
Loss relief
- Inheritance tax: Up to 100% IHT relief on death

One of the most attractive aspects of EIS is that when shares are ultimately sold, any capital gain is exempt from CGT. However, to obtain the CGT exemption, two specific conditions must be satisfied.

### Condition 1: Three-year holding period

The shares must be sold at least three years after their original issue. If the company was preparing to trade at the time of the EIS share issue, the period will be three years after trading commenced.

### Condition 2: Income tax relief on original share issue

The investor must have obtained income tax relief on the original share subscription. Full relief on the whole share issue is not necessary – all that is needed is at least £1. But it is essential that, once granted, the income tax relief is not withdrawn in subsequent years.

To be eligible for this relief, the investor must not be connected with the company during the three-year window. In broad terms, this means:

- The investor, or associates, should have no financial interest in the company. This essentially means no more than 30% of shares or entitlement to assets on winding up

- The investor, or associate, should not be an employee of the company. An associate could be a business partner, employee of a business partners, or settlor of a trust. It could also be a relative such as parent, grandparent or child – but a sibling is not considered an associate. The connection test applies from two years before the share issue until three years after it.

It is important to remember that income tax relief can be withdrawn, and this would prejudice any claim to future capital gains exemption. This could occur if within three years of the subscription, or three years from the commencement of trade if later, any of the following events occur:

- The shares are gifted or sold to anyone other than the spouse.
- The subscriber receives value from the company or a connected person. 'Value' is extensively defined; however, insignificant value of under £1,000 can be ignored.
- The company (or subsidiary) repays or repurchases share capital from any shareholder who has not had relief.
- The subscriber disposes of any share capital or securities of the company to a person connected with the company.
- The investor, or an associate, becomes connected with the company.
- The shares cease to be qualifying shares.
- Relief is found subsequently not to be due (ie the money raised requirements are not met by the company, or else the company is not a qualifying company)

The deadline for claiming income tax relief is 5 years and 10 months after the end of the tax year of the original share subscription. It is longer if the company was not trading at the time of the original share issue. Relief cannot be claimed until the relevant EIS3 certification has been issued by HMRC.

To summarise, the capital gains tax exemption is one of the most attractive features to potential investors in EIS companies. However, it is easy to be tripped up and lose the valuable tax benefit.

The same principles also apply to the Seed Enterprise Investment Scheme (SEIS), which is available for smaller investments into lower-value trading companies . The upfront income tax relief on SEIS qualifying investments is 50%.

### Further information

Please contact your usual Menzies tax team representative or e-mail [taxconnect@menzies.co.uk](mailto:taxconnect@menzies.co.uk)

[www.menzies.co.uk](http://www.menzies.co.uk)