SUMMARY OF EIS LEGISLATION SUMMER FINANCE BILL 2015

This Note summarises the legislation as published on 15 July 2015. It is expected to be enacted during October 2015. However at time of writing, it is still subject to the UK receiving State aid approval for the tax-advantaged venture capital schemes, and there may yet be changes made as it progresses through the various parliamentary stages.

The legislation makes some significant changes to the EIS income tax rules. **Note**: the legislation makes no changes to EIS Capital Gains Tax deferral relief rules. That means that companies may have to be aware of the different sets of conditions for each relief, depending on whether their investors intend claiming income tax relief or capital gains tax deferral relief. Generally speaking, if a company meets the more restrictive conditions for income tax relief introduced by the new legislation, then investors are likely to be eligible to claim either income tax relief or capital gains deferral relief.

The new legislation inserts a sunset clause, limiting income tax relief on new EIS shares to shares issued before 6 April 2025. There is a provision which allows that date to be amended by Treasury order.

"**Relevant risk finance investments**", referred to throughout this Note, includes any State aid investments which are made available under the European Commission's Guidelines on State aid to promote risk finance investment. That includes EIS, VCT, Social Investment Tax Relief (SITR) and Enterprise Capital Fund (ECF) monies as well as some regional investment aids, and can include overseas aids as well as UK aids.

"**Knowledge-intensive companies**", referred to throughout this Note, are defined in the new legislation broadly as follows:

In at least one of the 3 "relevant years" prior to investment the company or group has spent at least 15% of operating costs on R&D or innovation; or in each of those 3 years has spent at least 10% of operating costs on R&D 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 IP 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 IP or by the creation of new products, processes or services which use the IP.
- the "skilled employee condition" – at least 20% of the company's or group's FTE numbers are "skilled" as defined and are engaged directly in R&D 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.

The 3 "relevant years" prior to investment are the 3 consecutive years ending immediately before the company's last accounts filing period, or if later, 12 months before the date of investment.

There are two changes which are intended to smooth the interaction between EIS and SEIS.

- First of all, the removal of the requirement that any company which has had previous SEIS investment, must have spent at least 70% of the SEIS money before issuing EIS shares. Note that SEIS shares and EIS shares still can't be issued on the same day. This change takes effect from 6 April 2015.
- Secondly, there is a change to the existing legislation which results in EIS relief being recovered from EIS investors, if the company buys back or redeems shares held by other investors who will not have EIS relief recovered as a result of the buy-back or redemption. This will now ensure that no EIS tax relief will be clawed back if the company buys back or redeems shares held by SEIS investors who stand to lose their SEIS relief as a result of the buy back or redemption of their shares. This takes effect in relation to any buy back or redemption on or after 6 April 2014.

Another minor change to the definitions section in the Income Tax Act 2007 makes it clear that "farming" for all purposes includes farming outside the UK, which in turn results in non-UK farming becoming ineligible for EIS investment. This takes effect in relation to shares issued on or after Royal Assent.

The more major changes to EIS all take effect in relation to shares issued on or after Royal Assent to the Finance Act (expected to be in October 2015). These are as follows:

Existing shareholdings requirement

This is a new condition. Where an investor subscribing for shares already has a holding of shares in the company, EIS relief will only be available on the new shares if the other shares held are either:

- part of an issue of shares in respect of which the company has submitted an EIS, SEIS or SITR compliance statement (EIS1, SEIS1 or SITR1), or
- subscriber shares [i.e. those issued to establish the company] which the investor has held continuously since issue or which were acquired by the investor (usually from a company formation agent or other party setting up the company) at a time when the company had not issued any shares other than subscriber shares and had not begun to carry on or make preparations for carrying on any trade or business.

Maximum annual risk capital amount

This existing condition already prevents an issue of shares from qualifying for EIS relief if the total relevant risk finance investments in the issuing company and its subsidiaries in the 12 months up to the date of the current share issue, exceeds £5m. As well as the current share issue and any other relevant risk finance in the company itself, the calculation is now to include:

- Relevant risk finance investments in any company that has been a 51% subsidiary of the issuing company in that 12 month period, including investments before the subsidiary became a subsidiary, but not including investments after it stopped being a subsidiary.
- Relevant risk finance investments in any other company if the money raised by those investments has been employed for the purposes of a trade, and in the 12 month period up to the date of the current issue of EIS shares, all or part of that trade was transferred to the issuing company, to a 51% subsidiary of the issuing company or to a partnership of which the issuing company or a 51% subsidiary is a member. If only a part of the money raised by an earlier share issue is used for a transferred trade, then only that part is taken into account for the purposes of this requirement.

Maximum total risk capital amount when relevant holding is issued

This is a new condition to be met at the time of a share issue. If a share issue takes the total relevant risk finance investment in the issuing company over £12m (£20m in the case of a knowledge-intensive company) then the whole share issue will not qualify for EIS relief.

As well as the current share issue and any other relevant risk finance investment in the issuing company itself up to the date of the current investment, the calculation is to include:

- Relevant risk finance investments in any company that has been a 51% subsidiary of the issuing company, including investments before the subsidiary became a subsidiary, but not including investments after it stopped being a subsidiary.
- Relevant risk finance investments in any other company if the money raised by those investments has been employed for the purposes of a trade, and before the date of the current share issue, all or part of that trade was transferred to the issuing company, to a 51% subsidiary or to a partnership of which the issuing company or a 51% subsidiary is a member. If only a part of the money raised by an earlier relevant risk finance investment is used for a transferred trade, then only that part is taken into account for the purposes of this requirement.

Maximum risk capital amount during Period B

This is a new condition which must be met at all times during the qualifying period for the shares. If within that period the issuing company either:

- acquires a 51% subsidiary which uses some or all of the current share issue for a trade which it carries on and which it carried on before becoming a subsidiary, or
- has transferred to it, or to a 51% subsidiary, a trade which was previously carried on by another company and for which some or all of the monies raised by the share issue is used

then the total amount of relevant risk finance investment at that point is to be calculated. If the amount exceeds £12m (£20m in the case of a knowledge-intensive company) then the current share issue will cease to qualify for EIS relief. As well as the amount of the current investment and any other relevant risk finance investment in the issuing company itself, the calculation is to include:

- any relevant risk finance investments in any company which has been a 51% subsidiary of the issuing company, including investments before the subsidiary became a subsidiary, but not including investments after it stopped being a subsidiary.
- Any other relevant risk finance investments in a company, where those investments were used for a trade, and after the date of those investments but before the date of the current investment, that trade was transferred to the issuing company or to a 51% subsidiary of the issuing company. If only a part of the money raised by an earlier relevant investment is used for a transferred trade, then only that part is taken into account for the purposes of this requirement.

Employment of money

This existing requirement is amended in relation to how EIS monies must be used by an issuing company in order for the investors to retain their relief.

The new legislation prevents all the following types of acquisitions from being a qualifying use of money:

- An interest in another company such that that company becomes a 51% subsidiary of the issuing company
- A further interest in another company which is already a 51% subsidiary of the issuing company
- A trade
- intangible assets employed for the purposes of a trade
- goodwill employed for the purposes of a trade

There is a provision which will allow Treasury to make regulations specifying types of intangible assets which are not to be caught by the above new rules.

No change has been made to the time limits within which the monies must be used for a qualifying purpose, which continues to be two years from the date of share issue, or, if later, two years from date of trade being commenced (providing that trade is commenced within two years of share issue).

Permitted age requirement

This new requirement imposes an age limit on companies issuing EIS shares. The age limit is 7 years from the date of first commercial sale, or 10 years in the case of a knowledge-intensive company. The age limit does not apply in either of the following circumstances:

- There was a previous relevant risk finance investment in the issuing company during the 7 (or 10) year period from first commercial sale and that previous investment was used for the same activities for which the monies raised by the current share issue are to be used. The first applicable commercial sale is the earliest such sale by:
    - The issuing company
    - A company which is or has been a 51% subsidiary of the issuing company, including sales before it became a subsidiary but not after it had ceased being a subsidiary

- Any person who transferred a trade to the issuing company or a 51% subsidiary, including where the trade was transferred to the subsidiary before it become a subsidiary, but not which was carried on by it only after it ceased to be a subsidiary.
    - A company which becomes a 51% subsidiary after the date of share issue, where some or all of monies raised by the current share issue will be used for that company's trade; or the first commercial sale by a person who previously carried on a trade which was transferred to such a subsidiary
    - If any of the money raised by the current investment is used for a trade transferred after the investment date to the issuing company or a 90% subsidiary, the first commercial sale by that person

- The total amount of investment, including the current issue of shares, in the 30 day period up to and including the share issue date, is at least 50% of the average turnover. For this purpose, the average turnover is calculated as 20% of the total turnover for the 5 year period ending immediately before the last accounts filing period, or, if later, 12 months before the investment date. If the issuing company is the parent company of a group, then the calculation is based on the total group turnover for the 5 year period.

Employee numbers at time of investment

The existing limit of fewer than 250 employees in the company or group remains unchanged as the general requirement. A knowledge-intensive company (or group) must have fewer than 500 employees at time of the share issue.

Employee numbers post investment

If an issue of shares in a company qualifies only because the company is a knowledge-intensive company which does not meet the innovation condition of that definition, then in the 3 years following the share issue the number of full-time-equivalent "skilled employees" in the company or group must be at least 20% of the total full-time-equivalent number of employees.