eisa
enterprise investment scheme association

# EIS: new landscape, new opportunities

## About the EIS Association

The EIS Association (EISA) is the official trade body for the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) industry. EISA is a highly effective not-for-profit organisation that exists to aid the provision of capital to UK small and medium-sized enterprises (SMEs) through these two schemes.

EISA works closely with HM Treasury, HM Revenue and Customs, government ministers, MPs and the Financial Conduct Authority to enhance EIS and SEIS and promote their benefits to investors, companies and advisers.

EISA also collaborates with other trade bodies that support investment into SMEs.

Our membership is drawn from all areas of the EIS/SEIS industry and includes EIS/SEIS fund managers, lawyers, accountants, tax advisers, corporate financiers, IFAs and wealth managers throughout the UK.

Visit www.eisa.org.uk to learn more.

## In this guide

# About this guide

The 2017 Autumn Budget clearly demonstrated the UK government's continued commitment to the Enterprise Investment Scheme (EIS). This has allowed investors and advisers to have even greater confidence in attempts to finance the expansion and development of some of the country's most promising companies.

Yet such a positive outcome was by no means guaranteed in the months leading up to the Chancellor's statement. For some time the signals emanating from HM Treasury (HMT) and HM Revenue and Customs (HMRC) suggested that the overall view of EIS in government circles was becoming increasingly negative.

A key reason was the perception that too many schemes might involve investments broadly defined by capital preservation, predictable income and lower risk. It was argued that such investments should be seen as contrary to the spirit of EIS, which was launched specifically to assist companies whose focus on innovation makes them inherently high-risk from an investment perspective.

This presented EISA and the EIS industry as a whole with a challenge, as there was a very real danger of the baby being thrown out with the bathwater. Aware of the importance of preserving the generous tax reliefs that help encourage investor interest in EIS, we reasoned that some change was inevitable – and, crucially, that we should be at the leading edge of shaping that change. We therefore made every effort to collaborate with HMT and HMRC to drive the agenda and reach a mutually beneficial consensus on the future of EIS.

The result, as we discuss in this guide, is a subtly redefined EIS landscape. It is one that is in some ways even more attractive than its predecessor but whose terrain must nonetheless be navigated with care. In the following pages we explore how it has evolved and explain why, on balance, this evolution is good news for the UK's brightest companies, for those who help them fulfil their potential and for the economy in general.

**Mark Brownridge**

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# EIS: a quick reminder of the basics

The essential purpose of EIS is to serve as a conduit for early-stage investment into smaller and younger UK companies that have high growth potential. As is widely acknowledged, such companies are at the mercy of a significant “finance gap” – meaning many promising businesses struggle to obtain the funding they need to survive and thrive.

EIS’s counterpart, the Seed Enterprise Investment Scheme (SEIS), explicitly targets start-ups and companies in the very early stages of development. EIS is geared towards larger and more mature firms, although these are still relatively small and young in the context of the UK’s business and corporate landscape.

EIS has delivered almost £16bn in funding since its launch in 1994, helping around 30,000 businesses to take root. By incubating early-stage and pre-profit companies, the model has played a vital role in maintaining the UK’s efforts to produce innovative – and in some cases world-leading – firms.

## Which companies qualify for EIS?

Not every smaller and younger company qualifies for EIS. A firm has to meet the following requirements:

It must have fewer than 250 employees (or fewer than 500 in the case of a knowledge-intensive company).

It must have been trading for less than seven years (or less than 10 years in the case of a knowledge-intensive company).

It must have gross assets valued at no more than £15m.

In addition, the maximum lifetime amount that can be raised by SEIS, EIS and Venture Capital Trusts (VCTs) for such a company is £12m (or £20m for a knowledge-intensive company – one of the important changes announced in the 2017 Autumn Budget relates to the additional attractions of investing in knowledge-intensive companies).

## What are the tax benefits for individuals investing through EIS?

EIS investors can enjoy substantial tax benefits.

- 30% initial income tax relief – actual net cash outlay of 70p in the £
- CGT freedom – no Capital Gains Tax to pay
- CGT deferral relief – potential unlimited and indefinite deferral of an existing CGT bill
- Loss relief – maximum exposure of 38.5p in the £ for a 45% income tax payer
- Inheritance tax relief – potential saving of 40p in the £

The government took the view that tax reliefs of this level of generosity should be enjoyed only as a result of investments involving high risk. By extension, they should *not* be enjoyed as a result of investments broadly defined by capital preservation, predictable income and lower risk. As we will explain further in the next section, this concern was among the issues at the heart of a recent major review of the funding of innovative companies in the UK.

# The Patient Capital Review

Announced by the Prime Minister in 2016, the Patient Capital Review set out to consider how best to support the UK's fledgling innovative companies in accessing the finance required to achieve scale. It used the term "patient capital" to describe investments made with no expectation of a quick profit, arguing that such investments should underpin the long-term development of the country's most promising businesses.

One of the review's key objectives was to assess possible changes in government policy in anticipation of the 2017 Autumn Budget. Any such changes would be implemented with a view to facilitating "the expansion of long-term capital for growing innovative firms".

In the months leading up to the Budget, during the review's consultation period, EISA and the EIS industry as a whole urged restraint. It was obvious at this point that the government planned to impose new restrictions on EIS's operation in a bid to prevent the perceived exploitation of tax breaks by investments broadly defined by capital preservation, predictable income and lower risk. Our fear was that the response might be excessive and that the challenge of financing the UK's high-growth-potential companies would therefore be magnified rather than mitigated.

Naturally, we recognised that abuses of the existing EIS rules' spirit should be stamped out. We stressed that the market was already acknowledging that EIS funding should move away from capital preservation, and we made plain our willingness to collaborate with HMT and HMRC to accelerate this trend.

Outlining our case in an official response to *Financing Growth in Innovative Firms*, the Patient Capital Review's consultation document, we said: "We firmly believe tax-advantaged schemes are very much aligned with the review's aims... We recognise that some changes are needed to refocus the schemes, and we wish to work with the government to achieve this in order to make long-term finance available to firms looking to scale up. In return, we hope the government can give its full support to tax-advantaged schemes."

On November 22 2017, as the Chancellor delivered his statement, we learned whether our arguments had been successful.

# The 2017 Autumn Budget

Contrary to widespread expectations, the 2017 Autumn Budget did not target EIS for reductions in tax relief. Instead it raised the annual individual investment limit from £1m to £2m – an unmistakable signal of the government's continued commitment to this form of financing.

As a result, from April 6 2018 an individual investor will be able to enjoy up to £600,000 in initial income tax relief. Previously, as discussed earlier, the maximum amount of relief was £300,000.

There is only one condition for the doubling of the annual individual investment limit: any amount above the first £1m must be invested in knowledge-intensive companies. Similarly, the annual total investment limit for knowledge-intensive companies is also set to double – from £5m to £10m.

These changes underline the government's determination to direct more funds into growing the UK's most promising and innovative firms. HMT has calculated that they could result in an extra £7bn being channelled through EIS and VCTs over the next decade.

At the same time – not least in light of the survival of the various tax reliefs available through EIS – moves to crack down on lower-risk, capital-preservation-type investments were announced. A principles-based test of tax-advantaged schemes is to be introduced to ensure that investments are focused on companies' long-term growth and development. HMT has already published new draft guidance on what it calls a "risk-to-capital condition".

Given all of the above, we might summarise the impact of the Patient Capital Review and the 2017 Autumn Budget in two questions that now demand very careful consideration when assessing any prospective investment through EIS:

- How does a company meet the government's definition of "knowledge-intensive"?
- How does an investment satisfy the government's new risk-to-capital condition?

Let us take a closer look at each in turn.

# Key questions to ask amid the new EIS landscape

## How does a company meet the government's definition of "knowledge-intensive"?

We have already touched on how the rules governing EIS differ slightly when applied to investments in companies defined as "knowledge-intensive". For example, such businesses are permitted to benefit from EIS if they have fewer than 500 employees (compared to fewer than 250 for other firms) and if they have been trading for less than 10 years (compared to less than seven years for other firms); they are also allowed to receive up to £20m in lifetime funding through SEIS, EIS and VCTs (compared to up to £12m for other firms).

These distinctions reflect a belief that knowledge-intensive companies can play a notably valuable role in boosting the UK economy and are therefore particularly worthy of support. The same thinking lies behind the doubling of the individual investment limit and the annual total investment limit.

It is now especially important to appreciate how a company qualifies as knowledge-intensive in the eyes of HMT and HMRC. In addition to the stipulations revisited above, the official guidance, as outlined in HMRC's *Venture Capital Schemes Manual* at the end of 2017, is as follows:

### Operating costs

At least one of the following conditions must be satisfied:

- The company must have spent at least 15% of its relevant operating costs on research and development or on innovation in one of the three relevant years[1] preceding the date of the investment.
- The company must have spent at least 10% of its relevant operating costs on research and development or on innovation in each of the three relevant years preceding the date of the investment.

### Skilled employees/innovation

At least one of the following conditions must be satisfied:

- A minimum of 20% of the company's full-time-equivalent employees must be classified as skilled employees[2] at the time of the investment and for the following three years.
- The company should be engaged in work to create intellectual property (IP) at the time of the investment, and within 10 years most of the company's business activities might be expected to consist of (i) the exploitation of the IP, (ii) business that uses the IP or (iii) both.

These rules are not especially complex or prohibitive. Some are actually deliberately generous. The threshold for skilled employees, for example, has been set low to avoid complicated regulations for firms that might employ individuals who fall short of a certain level of qualification but are nonetheless experienced and expert researchers. This, again, underscores the government's commitment to EIS.

Encouragingly, even greater flexibility has been promised in the near future. HMT has indicated its intention to consult on a "new knowledge-intensive approved fund structure" with a view to providing "further incentives to attract investment".

1 The relevant three years are those pertaining to the company's most recent filed (and, where appropriate, audited) accounts.

2 A "skilled" employee is defined as one who is directly engaged in research-and-development or innovation activities; who holds a master's degree or above; or whose job requires the holding of a master's degree or above.

## How does an investment satisfy the government's new risk-to-capital condition?

According to a study commissioned by EISA, the number of EIS funds aiming to preserve capital has fallen dramatically in recent years. Our research indicates that the percentage of total funding raised by such funds stood at just 26% in the 2017/2018 tax year, compared to 62% in 2016/2017 and 71% in 2015/2016.

HMT and HMRC have quoted a somewhat higher percentage, but now is not the time to argue over figures. The important point – and it is one on which there is agreement – is that the reduction in the number of capital-preservation-type investments through EIS should continue, particularly if the industry hopes to retain the tax reliefs currently available.

With this in mind, the Finance Bill 2017-2018 will introduce a new principles-based test to identify investments that are not in the spirit of EIS. Going forward, this will be a key element of what is known as advance assurance – the process by which HMRC provides an opinion as to whether a proposed investment is eligible under a specific scheme (e.g. SEIS, EIS, VCT etc).

A new "risk-to-capital condition" will be central to the test. To quote the latest guidance published by HMT: "The risk-to-capital condition is intended to ensure that tax-motivated investments where the tax relief provides a substantial part of the return for an investor, with limited risk to the investor's capital, will not be eligible for relief. Therefore it is companies that present a low-risk investment opportunity that are most likely to be affected."

The government says the test will take a "reasonable" view as to whether an investment has been structured to provide a low-risk return. According to the latest guidance, an investment should meet the following requirements to satisfy the risk-to-capital condition:

- The company in which the investment is made must have objectives to grow and develop over the long term.
- The investment must carry a significant risk that investors will lose more capital than they gain as a return (including any tax relief).

HMT and HMRC say the test, which will also be applied to investments through SEIS and VCTs, constitutes a "principled approach" that should guard against the future exclusion of genuinely entrepreneurial businesses. The process will also offer a useful degree of flexibility, with the government stressing that all relevant factors will be "considered in the round".

Once again, on balance, this is good news for investors who are willing to accept the risks associated with financing the growth and development of some of the country's most promising new companies.

# Beyond relief: refocusing on investment

Nobody would dispute that the continuation of the tax reliefs available through EIS, particularly in the wake of the uncertainty that attended the Patient Capital Review, is a cause for celebration. However, we should not lose sight of the fact that EIS is about much more than generous tax breaks.

This was perhaps one of the disappointments of the Patient Capital Review, which focused on the issue of tax to such an extent that other considerations often seemed in danger of being completely overlooked. It was certainly our feeling that the consultation concentrated too heavily on the cost of tax relief, with no analysis of EIS's many benefits – among them job creation, exports, revenue, the stimulation of the economy, the closing of the skills gap and the generation of wealth for investors.

Investors and advisers alike should not fall into the same trap. Tax relief is undoubtedly a powerful incentive for EIS investors, but to think of it as the be-all and end-all is both wrong and – if the Patient Capital Review is any guide – potentially deleterious to EIS's future. As has been made abundantly clear, the government has no appetite for investors who regard EIS as a means of enjoying tax breaks while taking little in the way of risk. This is not the way forward.

Encouragingly, as our own research has shown, the prevalence of this mindset has decreased substantively during the past few years. There has been a steady and organic move towards investments that are growth-orientated. More money has been flowing into companies that are knowledge-intensive and which would satisfy the new risk-to-capital condition.

This trend is likely to accelerate in the wake of the measures announced in the 2017 Autumn Budget. We believe such a positive trajectory represents a win for all concerned – for the UK's brightest businesses, for those who are prepared to help them develop and for the economy as a whole.

# Some final thoughts about risk

Given everything we have discussed in this guide, it seems fair to infer that one of the fundamental messages to emerge from the Patient Capital Review and the 2017 Autumn Budget is that EIS investors should be prepared to accept a significant level of risk. This is why EIS investors are incentivised with substantial tax breaks and why the government has taken steps to stamp out practices that are contrary to the spirit of investing in high-risk ventures.

By way of conclusion, then, we might usefully give some thought to the matter of risk in EIS investments. As touched on in the preceding section, this is an issue that has often attracted surprisingly little attention – not least when capital preservation has been allowed to obscure the basic notion of EIS as an inherently risky but potentially rewarding undertaking.

Let us first briefly examine the role that EIS can play in a broader investment portfolio. We will then look more closely at the nature and management of specific risks.

## EIS as a means of portfolio diversification

Faced with concerns such as short-term stock-market volatility, meagre bond yields and historically low interest rates, investors have widened their hunt for outperformance since the global financial crisis. Ideally, what they are looking for are returns that are both higher than and relatively uncorrelated with those available from mainstream asset classes such as stocks and bonds. As a result, alternative investments of various kinds have attracted increasing interest.

An ever-broadening investor demographic is recognising EIS's ability to tick the required boxes. Whether investing via financial advisers, wealth managers, EIS investment managers, the direct purchasing of shares or crowdfunding platforms[3], more and more investors – some institutional, some retail, all of them UK taxpayers – are gaining exposure to an asset class classically defined not just by tax efficiency but by long-term horizons, comparative illiquidity and potentially impressive returns.

The appeal of these attributes earned renewed acknowledgment in the wake of the Patient Capital Review. In November 2017 HMT confirmed that, as part of government efforts to "support long-term investment", the Pensions Regulator is to clarify guidance on how trustees can incorporate investments through EIS and similar schemes "in a diverse portfolio".

## Managing risk in EIS investments

Any investment carries a risk that its value might go down as well as up. It is essential to note that with EIS investments, due to their focus on younger and smaller companies, the risk is inherently high.

While the scope for mitigating such risk in relation to an individual company is limited, there are means by which risk can be spread. For example, a portfolio of EIS investments might feature several companies of different maturities. It is conceivable that one successful exit of an investment, whether through a sale or a public offering, could more than cover the total investment across a portfolio. Of course, the new risk-to-capital condition should be borne in mind when constructing a portfolio of EIS investments.

3 Crowdfunding proved something of a bone of contention in the course of the Patient Capital Review. The review's consultation document, *Financing Growth in Innovative Firms*, correctly identified crowdfunding as a source of some of the recent growth in the financing of earlier-stage companies; but it failed to acknowledge that the vast majority of equity crowdfunding – more than 85% – is raised using EIS and/or SEIS.

Since EIS investments are usually longer-term in nature, illiquidity presents a further risk. Remember that there is no liquid, tradeable market for EIS companies and no independent or objective means of valuing them, so planning a route to exit usually requires lots of time, resource and, above all, expertise.

EIS companies are often nearing a point at which, provided they receive the right support, they can take a major step forward in their development. This can lead to a multiple increase in valuation and, by extension, marked shareholder gain upon exit. In the meantime, however, investors are highly unlikely to have access to their capital. EIS providers should therefore be exit-focused but should aim for optimum, return-driven outcomes rather than taking a “churn” approach that is principally geared towards the claiming of tax reliefs.

Finally — and this brings us back to where we started — there is the question of political risk. For much of 2017, with EIS investments under intense scrutiny from HMT and HMRC, it appeared that this type of risk might be the most difficult of all to mitigate.

Thankfully, fears have proven largely unfounded in this regard. EIS has emerged from the Patient Capital Review and the 2017 Autumn Budget with enhanced government backing, a revised and forward-thinking framework and an even clearer mandate to assist in the growth and development of the country’s most innovative young businesses. Ultimately, a new landscape has brought new opportunities. The EIS success story can continue.

## The benefits for individuals of investing through EIS and SEIS

### EIS

30% RELIEF

**30% initial income tax relief**
Actual net cash outlay of 70p in the £

CGT

**CGT freedom**
No capital gains tax to pay

**CGT deferral relief**
Potential unlimited and indefinite deferral of an existing CGT bill

**Loss relief**
Maximum exposure of 38.5p in the £ for a 45% income tax payer

**Inheritance tax relief**
Potential saving of 40p in the £

### SEIS

50% RELIEF

**50% initial income tax relief**
Actual net cash outlay of 50p in the £

CGT

**CGT freedom**
No capital gains tax to pay

**CGT deferral relief**
Potential exemption of 50% of an existing CGT bill

**Loss relief**
Maximum exposure of 27.5p in the £ for a 45% income tax payer

**Inheritance tax relief**
Potential saving of 40p in the £

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