Enterprise Investment Centre

Guide to the Seed Enterprise Investment Scheme ("SEIS")

Summary of SEIS benefits

SEIS is broadly comprised of four core reliefs. On the basis that an investment and the investor satisfies certain conditions, then the following reliefs may be available to the investor:

- Income tax relief @50% on up to a maximum of £100k invested in a tax year;
- Exemption from Capital Gains Tax (CGT) on the sale of shares which attracted income tax relief;
- Unlimited capital gains deferral (of which 50% may be exempt on the eventual sale of the EIS shares);
- Income tax or capital gains tax loss relief for losses on sale of the EIS shares.

Other potential reliefs may include:

- Business Property Relief (BPR) for Inheritance Tax (IHT) purposes once shares have been held for at least two years;
- Business Investment Relief (BIR) may be available for non-domiciled investors using their foreign income and gains to invest.

Introduction

General

Of course, investment in unquoted trading companies is not for the faint-hearted. It does, by definition, carry a high degree of risk. The undoubtedly attractive tax reliefs that underpin the SEIS scheme are intended to offer a partial safety net to investors who are contemplating any such investment.

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SEIS offers reliefs in respect of income tax and CGT to investors who subscribe for shares in qualifying trading companies. One might therefore say that the scheme offers a 'subsidised' source of equity finance to companies. It is aimed at Companies which might otherwise find the cost of finance prohibitive or, indeed, impossible!

This guide

This is a summary of some of the key features of the reliefs, which investors might seek when investing. This might be income tax relief or the deferral of CGT by reinvestment of gains. Of course, in many cases, it might well be both.

Qualifying conditions – cross-over in to other reliefs

It is worth mentioning that the qualifying conditions set out for SEIS companies in this guide are also used as the basis for qualifying conditions companies under the Enterprise Investment Scheme ('EIS'), the Enterprise Management Incentive Scheme ('EMI') and for Venture Capital Trusts ('VCT').

As a result, there are a number of potential opportunities for tax efficient funding for these types of companies.

Similarly, these rules are mirrored in BIR. This relief allows non-UK domiciled individuals to remit their foreign income and gains without being subject to tax. Usually such a course of action would result in a tax charge. This is a handy relief to make these funds available for use in UK commercial activities. Generally the SEIS rules are more restrictive, so many investments that qualify under the EIS scheme should qualify for BIR. One should check that a proposed investment met the conditions for BIR before undertaking such a course of action.

It is also possible that some SEIS qualifying companies may also meet the requirements to be considered a qualifying investment in order to secure a Tier 1 Investment Visa. Again, a would-be investor should check that themselves before investing.

Investors may also be able to claim BPR for IHT purposes once the SEIS qualifying shares have been held for at least 2 years.

A risk warning

SEIS might well be a statutory relief but that does not make it a simple relief. In fact, it is far from simple and contains many traps for the unprepared. Investors and companies should not take any action without first obtaining further professional advice.

The reliefs

Income tax relief

For the 2015/16 tax year onwards, income tax relief is available at a maximum rate of 50% in respect of a subscriptions of up to £100,000 in any tax year, i.e. a maximum of £50,000 of income tax relief is available.

An investor may elect to carry back to the previous tax year the amount he subscribes in a tax year, subject to the applicable annual limit, and his income tax liability for the year. Relief will be given at the rate applicable to that previous year.

CGT reliefs

The CGT reliefs are presented in two different forms and are engaged at two different times.

Firstly, on investment, an investor may claim to defer capital gains (though up to 50% of this amount may be exempt on future sale) up to the amount of his investment. There is more on this below.

Secondly, on disposal, if the conditions for income tax relief have been met then any gain on the sale of the EIS shares is exempt from CGT. If there is a loss, capital gains tax relief is available as an alternative to the income tax relief mentioned above.

Deferral relief

Deferral relief is available for gains arising on the disposal of any asset. It is obtained by reinvesting part or all of the gain by subscribing for shares in an EIS qualifying company.

There is one fundamental difference between EIS and SEIS in this regard. Under SEIS, up to 50% of the deferred gain will actually be exempt on the sale of the SEIS shares. Only the balance of 50% will 'recrystallise' on sale.

After making a claim, the relief will be given as a deferral of the chargeable gain, by matching it with a subscription for eligible shares. The result is that 50% of the capital gain is deferred or 'held-over' until the EIS shares are sold. The other 50% will be exempt on disposal.

The gain will also re-crystallise if EIS relief is withdrawn due to a 'disqualifying event'.

The EIS investment must be made in the period which commences one year before and ends 3 years after the capital gain. HMRC has discretion to extend this period in certain circumstances.

Deferral relief is only available where a gain arises on an actual disposal of an asset or on a clawback of relief given on an earlier investment under the EIS, reinvestment relief or VCT provisions.

Income tax loss relief

Finally, income tax relief may be claimed where there is a loss on the final sale of the SEIS shares if income tax relief was claimed or, alternatively, was available on them if not so claimed.

This provides the final part of the 'safety net' meaning that an investor who lost all of his investment would obtain income tax relief of up to 72.5% of this assuming he was a 45% income tax payer.

The provisions relating to tax relief against income for losses on shares in unquoted

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trading companies permit a claim for the year of loss or the previous year. Therefore, if a loss arose in 2015/16, a claim could be made for loss relief in 2014/15 and 2015/16 respectively.

The Finance Act 2013 introduced (with effect from 6 April 2013) for the tax year restrictions on the amount of income tax reliefs including for losses on disposal of shares in unquoted trading companies.

These restrictions will apply to losses arising on the disposal of shares where Deferral Relief only has been claimed. There is an exclusion from these rules for shares where SEIS income tax relief has been claimed and not withdrawn.

The limit on the total income tax relief where relevant in a tax year will be £50,000 or, if greater, 25% of the taxpayer's adjusted total income for the year.

Example of income tax relief and deferral relief

Mrs Miggins sells a painting on 3 July 2015 making a capital gain of £50,000.

On 3 October 2015 she subscribes the full £50,000 for 25% of the ordinary shares in Piemakers Limited, an unquoted trading company manufacturing world leading meat pies.

Piemakers Limited is a qualifying company for SEIS purposes and Mrs Miggins claims SEIS relief.

Her taxable income in 2015/16 is expected to be £300,000 so is likely to pay income tax at a rate of 45% on the majority of her income. She has made no other SEIS or EIS investment during 2015/16.

- Income tax 2015/16 £50,000 50% £25,000
- CGT deferred 2015/16 £50,000 28% £14,000
- Total tax saving and deferral on £250k invested 78% £39,000

If Mrs Miggins and Piemakers Ltd continue to meet the qualifying conditions for EIS income tax relief purposes until 3 October 2018, Mrs Miggins will be able to sell her

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shares in Piemakers Ltd with no liability to capital gains tax on any profit which arises on those shares.

The deferred gain of £50,000, on the disposal of the Piemakers shares, will be dealt with as follows:

- 50% of the deferred gain (£25,000): Taxed at 28%
- 50% of the deferred gain (£25,000): Exempt

What conditions must the investor meet?

Income tax relief

For an individual to obtain (and, importantly, retain) his or her SEIS income tax relief and have a CGT exempt disposal they will need to:

- Subscribe for qualifying shares on his or her behalf. However, the subscription may be made via a nominee;
- Continue to hold the shares until three years after subscription;

The requirements relating to an individual investor are that:

- They (nor an associate) should not be employed by the issuing company or its subsidiary in the period of 3 years from the issue of shares. A person who was previously an employee of the company can qualify. Anyone who is a director of the company or its subsidiary is not regarded as an employee for the purposes of this rule;
- They (after also aggregating also the interests of their associates) must not have a substantial interest in the Company within the period starting from incorporation and ending 3 years after the share issue. 'Substantial' is regarded as holding or being entitled to acquire:
- In excess of 30% of the share capital of the issuing company or its subsidiary;
- Such rights as would entitle them to in excess of 30% of the assets on a winding

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up;
- There are no ‘reciprocal’ arrangements;
- Their investment is not a ‘loan linked’ investment. In other words, it was backed by a loan which would not have been made had they not been not been intending to subscribe for shares in the company;

There must be no tax avoidance purpose.

The fact that a director may qualify for SEIS relief is an important one for both the individual and the company. This offers an individual the opportunity to be involved with the company in which he invests with the possibility of a tax free capital gain, and the company the potential opportunity to attract both management skill and investment monies.

As mentioned in the introduction, an SEIS company may ‘grow’ and become an EIS company and a director who qualified for SEIS relief for monies he invested in a company, may qualify for EIS relief in respect of monies subscribed for further shares before the third anniversary of the issue of the SEIS qualifying shares.

What shares will qualify?

- The shares must be newly issued ordinary shares and:
- Must carry no preferential rights to dividends;
- Must carry no preferential rights to assets on a winding up; and
- Are not redeemable.

A right is ‘preferential’ with regard to dividends if the amount or date of payment of the preferential right may be determined to any extent by the company, the holder of the share or any other person. The shares must meet these conditions for the ‘relevant period’ described below.

In order that the shares are SEIS qualifying, they must be issued to raise money for the purpose of a qualifying business activity carried on, or to be carried on, by the company or a qualifying 90% subsidiary.

The money that is raised must be spent for the purpose of the qualifying business

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activity for which it was raised. Spending the money on the acquisition of shares in another company does not of itself meet that requirement.

As noted earlier, these tax reliefs are given to encourage investment in riskier companies. It therefore stands to reason that, where there are provisions included to 'de-risk' an investment it will no longer qualify for relief. There are known as "specified arrangements" and include arrangements for:

- Subsequent repurchase or disposal of the shares;
- Cessation of the trade;
- The disposal of the company's assets; and
- Providing protection from risk for investors, other than normal commercial protection arrangements.

'Arrangements' are broadly defined and will include any arrangements even if they are not legally enforceable.

HMRC takes the view that anti-dilution clauses and conversion rights are prohibited by this legislation.

What companies may qualify?

Background

There are a number of conditions to be met.

These fall into two categories:

- those which must be met throughout the three year qualifying period commencing with the issue of the shares, and
- those which must be met at the time the SEIS shares are issued.

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When the shares are issued – conditions

Unquoted

It is necessary for the company to be unquoted under the scheme and, furthermore, there must be no plans in place for this to change.

Helpfully, in theory anyway, 'unquoted' includes shares that are quoted on the Alternative Investment Market ('AIM') at the time they are issued to qualify. However, although this may be helpful for EIS shares it highly unlikely in practice that an SEIS would be quoted on AIM.

Gross assets

There is a cap on the balance sheet of the company £200,000 immediately before it receives a subscription for eligible shares. This applies to the gross assets of the Company. If the company is a parent company, the value of the group's gross assets must not exceed £200,000 immediately before it receives the subscription for eligible shares.

Amount raised

The maximum amount that a company may receive from SEIS investors is £150,000 in any three-year period ending with the investment then being made.

In considering compliance with this £150,000 limit, aid within the meaning of Article 2 of the Commission Regulation (EC) No 1998/2006 must be taken in to account.

No previous EIS or VCT investment

Importantly, bearing in mind the overlap of these reliefs, neither the investee company nor any subsidiary may have previously received any EIS or VCT investment.

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It is important to note that EIS and VCT monies may be subscribed after 70% of the SEIS monies have been spent for the qualifying business activity for which they were raised.

Number of employees

Investee companies or groups must have fewer than 25 full-time employees (or the full-time equivalent) at the date of issue of shares to SEIS investor

Financial health

A company which is regarded as an 'enterprise in difficulty' under the EU Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (2004/C244/02) is not eligible to receive funding under the SEIS. The guidelines do not include any company which is less than 3 years old so it is to be expected that most SEIS companies will not have a difficulty meeting this test.

For the entire qualifying period – conditions

The company must, throughout its 'qualifying period':

- Not be under the control of another company or control another company other than a qualifying subsidiary.
- The requirement that a qualifying company should never have been under the control of another company has meant that 'off-the-shelf' companies, set up and owned by corporate formation agents, could never qualify for SEIS reliefs.
- The Finance Act 2013 has amended this and for shares issued on or after 6 April 2013, the period during which a company is held by another company (including a formation agent) will be ignored for the purposes of 'the independence condition', provided only the original subscriber shares are in issue and there have been no preparations for the trade during that period;
- Must carry on a qualifying trade or is preparing to carry on such a trade.
- There is no requirement that the company or group must commence trade within any specified period of time. However, the company must be clear what its intended trade is.

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- Carry on the qualifying activity itself or through its 90% subsidiary.
- Therefore companies which carry on their trade through a partnership for instance, would not meet the qualifying conditions – but being a member of a partnership is in any event specifically prohibited
- Have a 'permanent establishment' in the UK
- Not control any company which is not a qualifying subsidiary

Qualifying subsidiaries

In general terms a qualifying subsidiary is one which is more than 50% held (i.e. the majority of its issued share capital must be owned, directly or indirectly, by the issuing company), and it is not under the control of any other company.

If the company which spends the funds raised is a subsidiary of the issuing company, it must be a qualifying 90% subsidiary. It can be a directly owned subsidiary in which at least 90% of the shares are held, or a subsidiary which is a 100% subsidiary of a direct 90% subsidiary of the parent, or a 90% subsidiary of a 100% subsidiary of the parent. Thus monies may be spent by subsidiaries two tiers down in a group;

Any group property management subsidiary must also be a qualifying 90% subsidiary of the issuing company as described above.

What is a 'qualifying trade' or business activity?

General

Most trading companies will be regarded as carrying on a qualifying trade and business activity for SEIS purposes.

The main restriction is that Company cannot operate any of the following activities:

- Dealing in land, in commodities or futures, or in shares, securities or other finan-

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cial instruments;

- Dealing in goods otherwise than in the course of an ordinary trade of whole or retail distribution. There are specific rules about dealing in goods to ensure that relief is available only where the company's trade is genuine, and not a disguised investment activity;
- Banking, insurance, money lending, debt factoring, hire purchase financing or other financial activities;
- Most leasing activities and some letting of ships on charter;
- Receiving royalties or licence fees, except royalties or licence fees resulting from the exploitation of particular intangible assets described below;
- Providing legal or accountancy services;
- Property development;
- Farming or market gardening, forestry and timber production;
- Operating or managing hotels or guest houses, nursing or residential care homes;
- Coal production, Steel production or Shipbuilding
- Subsidised generation or export of electricity.
- Royalties and licence fees

The SEIS legislation defines certain types of intangible assets from which royalties and licence fees may be received without prejudice to the company's qualifying status.

Broadly, the intangible asset (or at least the greater part of its value) must result from the company's own research and development work. Research and development from which it is intended a qualifying trade will be derived may of itself be a qualifying business activity.

Intangible assets for this purpose are assets treated as such under normal accounting practice. Where the intangible asset is intellectual property the right to exploit it must rest with the company. Intellectual property means any patent, trademark, registered design, copyright, design right, performer's right or plant breeder's right.

This exemption for receipt of royalties and licence fees is important, as certain technology companies might not otherwise qualify under the SEIS.

Application of funds and commencement of trade

The funds raised under the SEIS must be applied by the company to the qualifying activity within two years of subscription or, if later, commencement of the activity.

Commencement of trade must occur within 2 years of the share issue.

Claiming the reliefs

General

A very useful non-statutory advance assurance (clearance) service is offered by HMRC for companies wishing to raise funds from investors who, in turn, wish to avail themselves of SEIS relief.

Such companies will need to supply certain details about themselves, their business and the proposed terms of the investment. On reviewing this information, HMRC will confirm whether the company will be a qualifying company for SEIS purposes, prior to the issue of the shares.

HMRC will not confirm whether a specific individual will qualify for the tax reliefs.

However, provided subscribers meet the conditions applicable to them, they may subscribe with the comfort that relief is available. This assumes that the company does what it told HMRC it would do, and subject to satisfactory completion of form SEIS 1. HMRC is bound by the advance assurance it has given and the SEIS relief will be available for qualifying investors.

The process

We always recommend that companies should seek an advance assurance where investors are hoping to obtain tax reliefs. Clearly, having a piece of paper from HMRC confirming qualification is a useful marketing tool to provide to investors!

Once the shares have been issued, there are two stages to the claim for relief.

1. Initially, the company must make a claim that it is a qualifying company.
2. Subsequently, the individual investors may claim relief.

The company makes its claim using the Compliance Statement (also referred to as SEIS(1). The formal claim by the company for relief cannot be made until the company has carried on the qualifying trade (or research and development) for at least four months. The claim must be made within two years after the end of the tax year in which the subscription for shares was made, or, if later, two years after the end of the period of four months of trading mentioned above.

Once HMRC is satisfied that everything is in order with the information on the form SEIS1, form SEIS2 will be issued to the company. This authorises the company to issue form SEIS3 to the investors.

Once the investors have forms SEIS3, they may make the relevant claims in their self assessment tax returns. The claim must be made not later than the fifth anniversary of 31 January following the year of assessment for which the relief is claimed. If the investor does not hold form SEIS 3 he may not claim to defer payment of tax because of his SEIS investment.

If form SEIS3 is received during the year of assessment for which the relief is claimed, investors may apply to HM Revenue & Customs to adjust their PAYE code, or to amend their payments on account if appropriate.

Withdrawal of reliefs

SEIS income tax reliefs

Income tax relief may be withdrawn if within a specified period:

- The company ceases to be a qualifying company;
- The investor ceases to be a qualifying individual;
- The shares cease to be eligible shares;

- The investor disposes of his shares other than to a spouse or to a new company which issues its own shares in exchange; or
- There is a significant receipt of value which is not returned.

The specified period is one which:

- commences with the issue of the shares; and
- ends after three years, or if later, three years from commencement of trade by the company.

Relief may also be withdrawn if the company does not apply the funds raised and commence to trade within the timescale set out above.

Deferral relief

A deferred gain will recrystallize and be subject to CGT if within the period specified above if:

- The company ceases to be a qualifying company;
- The shares cease to be eligible shares;
- The investor becomes non-resident, otherwise than for an employment all the duties of which are outside the UK and in which he will become resident again within 3 years, still owning the shares; or
- There is a significant receipt of value that is not returned.

Deferral relief will also be withdrawn if:

- The funds raised have not been applied for the purpose of the qualifying activity within two years of the share issue or two years of the commencement of trade, if later. Commencement of trade must occur within two years of the share issue; or
- The investor disposes of his shares at any time other than to a spouse or to a new company which issues its own shares in exchange.

A chargeable gain will arise at the time of the event which causes the relief to be withdrawn.

Interaction with Entrepreneurs' Relief (ER)

The prevailing rate of CGT is currently either 18% or 28% for higher rate taxpayers. However, this may effectively be reduced to 10% where ER is available.

Previously, although there may have been a cash flow advantage in making a claim for deferral relief under the EIS, there may be an absolute cost depending on the taxpayer's situation. This is because ER could not be claimed on the gain that recrystallized on the subsequent sale of the SEIS shares.

However, from 2015/16 this position has been remedied such that ability to avail oneself of ER may also be deferred.

Prevention of tax avoidance

General

There are other provisions that act to deny relief either at the outset or clawing back such relief where it has already been given.

For SEIS Income Tax Relief, these include provisions relating to reciprocal arrangements and replacement capital. For both SEIS Income Tax Relief and Deferral Relief there is a general provision denying relief where the motive is tax avoidance.

A loan raised specifically to acquire SEIS or Deferral Relief shares may, depending upon its terms, prevent relief being available.

The 'no disqualifying arrangements' requirement

This was introduced to prevent the reliefs being used to deliver tax avoidance products to investors where the underlying company has little or no other commercial purpose.

The intention is to disqualify companies which would have been unlikely to exist in the first place, or would have been unlikely to carry on the particular activities in

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question, were it not for the wish to claim the relief.

The 'No disqualifying arrangements' requirement is wide-reaching in its effect and great care is needed in seeking advance assurance for companies as to ensure sufficient information is given to HMRC to enable them to determine if this requirement is met.

Summary

The SEIS scheme offers individuals really attractive income and CGT reliefs to invest in qualifying unquoted trading companies.

These Companies, once have spent 70% of the funds raised under SEIS may go on to avail themselves of the main EIS relief.

Due to the overlap between the qualifying conditions, the company might receive funding from a Venture Capital Trust as well. It might also issue options to employees under the Enterprise Management Incentive (EMI) Scheme.

Small and growing companies can now go to market armed with a host of attractive tax incentives when looking to raise funds. We would be delighted to advise on any of these tax efficient opportunities. It should be noted that the legislation is quite complex and both the investor and the company should take care when looking at obtaining these reliefs.

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