Raising Finance
& the Tax Reliefs

Raising Finance

A new business can raise finance in a number of ways. There is loan finance, which involves loans from individuals, corporations or financial institutions. The interest paid on these is normally deductible against taxable income. An alternative way of raising finance is through equity financing. In particular, the tax regime specifically helps small and medium-sized companies. This is done via EIS, SEIS and VCT.

It is not sufficient to just look at the level of reliefs available and choose the plan with the highest relief. This does not work because it is over simplistic.

The Seed Enterprise Investment Scheme (SEIS) offers more generous reliefs on the face of it than the Enterprise Investment Scheme (EIS). However, this is an approach which does not take into account the specific needs of the client.

As a general rule, EIS is likely to be preferable where:

- A company is likely to grow rapidly and therefore quickly have further financing requirements;
- CGT deferral was required and either the investor has a substantial interest in the company or the gain exceeds £100,000
- the individual has insufficient income to benefit from the 50% income tax relief and 30% relief is sufficient

Therefore an individual with a specific capital gains tax challenge is more likely to want to invest in the EIS plan than the SEIS plan.

It is also more likely that a company at its start will pose a greater investment risk than one that has been established for a significant period of time. Moreover, the amount of capital allowed in a company wanting the benefit of the investment is considerably greater in an EIS plan than in an SEIS. Again, one would need to look at the risk profile of the clients before deciding on whether an EIS or SEIS is better for them.

A VCT plan is inherently less risky than either an EIS or SEIS plan. This is because the VCT normally invests in a range of companies and therefore diversifies its investment risk. It is therefore important to look at the risk/reward ratio in any investment to ensure that it is appropriate for the client.

In terms of risk, the Government has restricted investments to qualifying companies and a number of industries have been excluded because, they are felt to be less risky or sufficiently asset rich that the underlying risk of the investment is not sufficient to warrant the tax relief. The thinking behind some of the exclusions is that even if the business fails, there would be sufficient assets to protect a substantial amount of the shareholders interest.

Whether this is true or not, depends on the prevailing economic circumstances, as these rules were set up, many years ago and have roots in the Business Expansion Scheme, one could certainly argue that they are in need of some updating.

These include:

- dealing in land or property development
- leasing
- banking or insurance
- providing legal or accountancy services
- farming, market gardening, forestry or timber production
- hotels or nursing/residential care homes
- shipbuilding
- coal and steel production
- wholesale or retail distribution

EIS or SEIS – Which Offers the Better Tax Reliefs?

This section examines whether EIS and SEIS rules are the same or whether there are differences in what is being offered.

The enterprise investment scheme (EIS) and seed enterprise investment scheme (SEIS) provide for equity investment into qualifying small companies that are seen to be high risk to the investor.

The SEIS is a recent development for shares issued on or after 6 April 2012. It offers tax relief at a higher rate than EIS. This is a reflection that for very early stage companies, attracting investment without tax reliefs would be difficult. Whilst broadly based on the same rules and principles, there are a number of differences between the two schemes.

Income tax and IHT reliefs

EIS	SEIS
Income tax relief at 30%	Income tax relief at 50%
Maximum annual investment of £1 million	Maximum annual investment of £100,000
Order of tax relief, first EIS	After EIS reliefs, deduct SEIS
Carry back tax relief in full to previous tax year at the rate for the earlier year	Can carry back

Income tax reliefs are more generous under the SEIS, but the annual investment allowed is ten times less than the EIS. You must have a tax liability to reduce otherwise the relief is lost, unless carried back to a previous year.

Capital gains tax reliefs

EIS	SEIS
Gain free from GCT on disposal *if you have received income tax relief* and hold the shares for three years	Gain free from CGT on disposal *if you have received income tax relief* and hold the shares for three years
No CGT reinvestment relief.	CGT reinvestment relief from the 2013/14 tax year at 50% for reinvesting gains from the disposal of assets in SEIS shares up to £50,000. You must also claim SEIS income tax relief to get reinvestment relief.
CGT deferral relief – the gain arising from any disposal is deferred when investing one year before and three years after gain is made. Amount unlimited	No CGT deferral is possible.

If you dispose of shares before three years, then the gain is taxable. If you have not claimed income tax relief, the CGT exemption does not apply. SEIS reinvestment relief reduces CGT by 50% and is not a deferred tax. The EIS route does not offer reinvestment relief, merely CGT deferral.

General differences

EIS	SEIS
Small, unlisted company with 250 employees or less and maximum gross assets of £15 million (before the investment, and 16 million after it)	Very small unlisted company with up to 25 employees and £200,000 gross assets
Amount to raise is limited £12M for most companies and £20M for knowledge intensive companies. This limit includes any amounts from	Can only raise up to £150,000

VCT's	
EIS investment can follow SEIS investment provided 70% of SEIS cash is spent	SEIS investment cannot be made after an EIS investment or venture capital trust investment
Tax relief is available after trading for four months Money cannot be raised to buy an existing business	No tax relief until at least 70% of the money raised is spent on qualifying activities. Certification process differs from EIS
SEIS investment cannot be made after an EIS investment	

The previous page gives some of the main differences in approach and eligibility between EIS and SEIS.

July Budget changes to EIS

- specifies the age of a company that is eligible for investment under EIS and VCT
- caps the total amount of tax-advantaged investment a company may receive over its lifetime
- stops the use of EIS and VCT money for acquisitions of businesses
- provides that investors are independent from the company in which they invest
- introduces higher limits on total investment, age of company and number of employees to provide support for knowledge-intensive companies that are particularly likely to struggle to access finance
- Smooths the interaction between SEIS and EIS

If an individual subscribes for shares in a company and that individual already holds shares in the company, the new shares will not be eligible for EIS unless the individual has made a risk finance investment in the company before Royal Assent or the individual's shares in the company (excluding founders' shares) were a risk finance investment. A risk finance investment is an investment under EIS, SEIS or Social Investment Tax Relief.

A new rule will be introduced to prevent companies from using EIS and VCT investments to acquire a business.

Companies must raise their first investment under EIS, VCT or other risk finance investment within 7 years of making their first commercial sale or 10 years if the company is a knowledge-intensive company. However, no age limit will apply to companies raising an investment where the amount of the investment is at least 50% of the company's annual turnover, averaged over the previous five years. The age limit will apply also to any business that has been owned previously by another company.

In addition to the existing cap on annual investments of £5 million, a new cap will be introduced on the total amount of investments a company may raise under EIS, VCT or other risk finance investment, of £12 million or £20 million for knowledge-intensive companies. Any risk finance investments used by a business previously owned by another company will count towards the total funding limit.

A knowledge-intensive company is a company:

- whose costs of research and development or innovation are at least 15% of the company's operating costs in at least 1 of the previous 3 years, or at least 10% of the company's operating costs in each of the previous 3 years and either:

    - which has created, is creating or is intending to create, intellectual property, or
    - which has employees with a relevant Masters or higher degree who are engaged in research and development or innovation and who comprise at least 20% of the company's total workforce

For knowledge-intensive companies, the limit on employees will be raised from less than 250 to less than 500 employees.

Crowdfunding

How does it work?

‘Crowdfunding’ works on the principle of finding large numbers of small investors, in contrast to the traditional method of finding a small number of large investors or a bank loan. Typically, it is an online phenomenon, with specialised websites offering exposure in exchange for a fee.

In many cases, the investors are in the position of lenders, and receive interest and have a timetable for repayment, or they become owners of some of the equity in the business, usually in the form of shares and quite often, these shares will themselves qualify for tax relief under the enterprise investment scheme or its more generous little sister, the seed enterprise investment scheme.

At the smaller end of the scale, however, the investors get nothing in return beyond the satisfaction of contributing to something they approve of and want to feel a part of.

In some cases there is a further reward, such as a mention on the recipient’s website, or in its literature, or (in the case of a struggling pop group) on the DVD or album cover.

None of this need cause a problem – the rules for debt and equity are well known, and the tax implications for creditors and shareholders are clear. The same applies to what might be called ‘personal’ crowdfunding where the money is being raised for personal reasons – to fund treatment for a sick child, for example, or to raise donations to a registered charity.

Taxable transactions?

Some crowdfunding offers, however, give something in return for the money donated to them. It may be tickets to a concert or a play, or a sample of the goods produced by the fundraising entity.

I fear this may be another example of tax law not fitting well with modern society. There was a time when it was widely (and wrongly) believed that buying and selling over the internet was a sort of hobby, and not a taxable trading activity. Obviously, the giants such as Amazon were taxable (at least to some extent!) but Mr Jones in his front room with his laptop somehow thought he was not really in business. It was, I think, the novelty of the medium that confused people – if Mr Jones had rented a shop for his buying and selling, he would have thought of himself as a dealer in goods, and taxable on his profits.

If a business raises money through crowdfunding, and in return gives its funders goods or services in return, it is difficult to see how this could fail to make the 'donation' taxable income for both direct (income or corporation) tax and indirect (VAT) tax.

People are confused because the motive for the donation may not be to acquire whatever is offered in return, and as a 'donation' it is entirely voluntary. Unfortunately, there is good case law to support the proposition that if a trader receives a voluntary donation towards its business expenses, the donation is a taxable receipt of the trade.

Where the donation leads to a 'gift' of goods or services, the position is even clearer. A trader has received money, and in accordance with the terms offered on the crowdfunding website, the trader gives the payer its services or some of its trading stock. In what way is that not a trading transaction?

Practical Tip:

If you decide to raise money for a business through crowdfunding, make quite sure you are aware of the tax implications, and avoid an unexpected bill for income tax, corporation tax, or VAT.

Please contact Mitch for further advice mitch@fusionconsult.co.uk