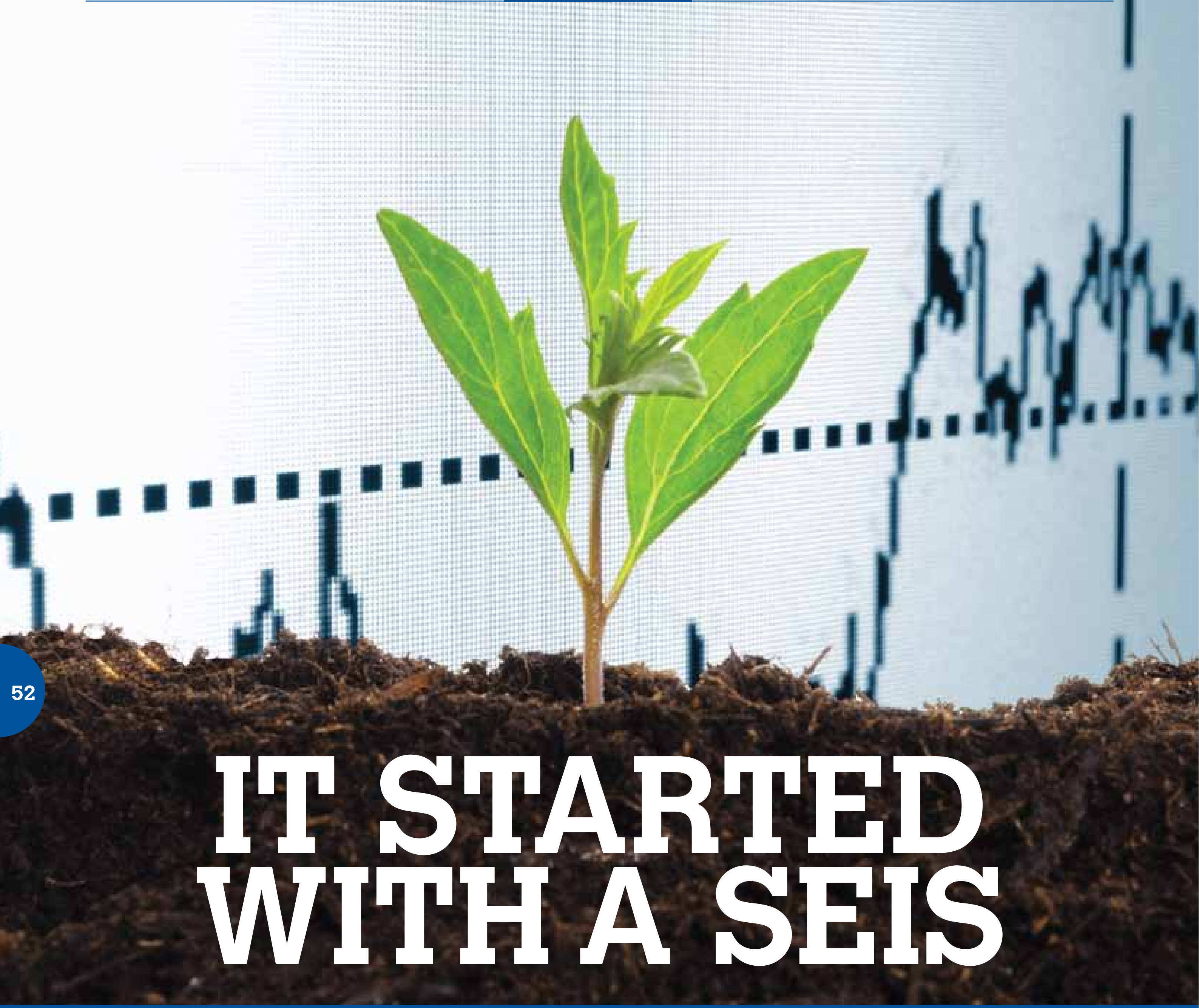

IT STARTED WITH A SEIS

The new Seed Enterprise Investment Scheme gives valuable tax breaks for equity funding investment in business start-ups, says Peter Rayney

George Osborne clearly values the contribution that owner-managed businesses make to the UK economy. Owner managers often face difficulties in obtaining funding and hence the UK's tax regime offers significant tax breaks for equity capital finance, largely through the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs).

Even greater investment risk attaches to business start-ups, which has now been recognised in the 2012 Budget. From 6 April 2012, individuals can enjoy some very attractive tax breaks for equity investment in fledgling companies under the Seed Enterprise Investment Scheme (SEIS).

The SEIS contains three key tax reliefs:

- Income tax relief of 50% (in 2012/13) on the amount subscribed (up to a maximum of £100,000 per tax year) for new ordinary shares in qualifying companies. The 50% relief is given irrespective of the investor's marginal tax rate;
- After three years, the qualifying SEIS shares can be sold completely free of CGT;
- For SEIS investments made in 2012/13 only, investors can 'roll-over' capital gains made in 2012/13 (on any type of asset) against their qualifying SEIS investment (up to the maximum £100,000 subscription).

The SEIS is closely modelled on the EIS regime but there are some notable differences. This article reviews the key qualifying conditions for SEIS and the operation of the various SEIS tax reliefs. Unless stated otherwise, all statutory references refer to the proposed new provisions in Part 5A, Income Tax Act 2007 (which are subject to change while the Finance (No. 4) Bill 2012 progresses through parliament). This article can only provide general guidance and reference should always be made to the detailed SEIS legislation when giving advice.

INCOME TAX RELIEF ON SHARES

Individual investors can claim 50% SEIS income tax on the amount subscribed (wholly for cash) for ordinary shares in a qualifying company in a tax year, with the maximum subscription being 'capped' at £100,000. This is much lower than the post-Budget 2012 EIS subscription limit of £1,000,000, which may encourage some 'would-be' investors to seek relief under EIS instead.

The investor's tax relief is given as a reduction in computing their income tax liability and therefore they must have sufficient tax in charge for offset (see case study).

Investors can carry-back all or part of their SEIS subscription to the previous tax year and obtain relief at the relevant SEIS rate for that year (but no carry back is permitted before 2012/13). A company cannot receive more than £150,000 under SEIS in any three year period.

Investors can only claim SEIS relief if they have a compliance certificate from the investee company. The SEIS relief must be claimed within five years from 31 January following the tax year in which the shares are issued.

The SEIS shares must be retained for at least three years with relief being withdrawn if the investor disposes of their shares during that period. However, investors can transfer SEIS shares to their spouse/civil partner without jeopardising the tax reliefs. Similarly, as with EIS and VCT, if the company or investor breaches one of the relevant SEIS qualifying conditions during the relevant three-year period, the income tax relief will be withdrawn (as will the appropriate CGT exemptions).

There are a number of anti-avoidance rules preventing reciprocal arrangements and those mainly designed to secure a tax advantage.

EMPLOYEES AND DIRECTORS

Current employees of the investee company (and any qualifying subsidiary) are not eligible for SEIS relief although past employees may qualify. Similarly, relief is denied to any associates of the investor who are employed by the relevant company (s257BA). The 'employee' prohibition test runs from the date of incorporation up to the third anniversary of the relevant share issue (known as Period A).

However, it is possible for directors to make a qualifying SEIS investment. Section 257BA(2) provides that directors are not treated as employees for this purpose.

SIGNIFICANT 30% INTEREST TEST

SEIS relief is not available to investors who hold a 'significant interest' in the investee company at any time during Period A, although pre-trading subscriber shares are excluded. The significant interest test (in s257BF) prevents investors qualifying for SEIS relief where they, together with their associates, have more than a 30% interest in the investee company's:

- ordinary share capital;
- issued share capital; or
- voting power.

For these purposes, the 'associates' test is narrower than the one that normally applies for other tax purposes – notably brothers and sisters are not treated as associates (see case study).

The substantial interest rule is augmented by an economic ownership test. This also treats investors as having a significant interest if they would be entitled to more than 30% of the assets available to equity holders on a winding-up.

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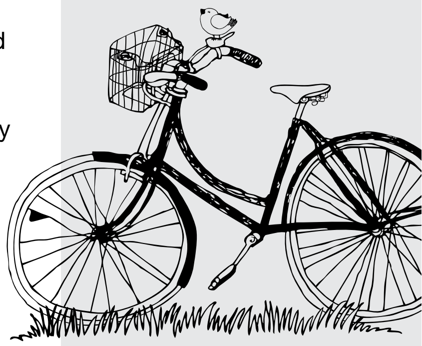
CASE STUDY

SEIS INVESTMENT – INCOME TAX RELIEF

Peter Green has persuaded his brother, Albert Green, to invest £80,000 into 'his' new company (PG Bikes Ltd). The company incorporated in January 2012 and is about to commence a trade of designing and building specialised custom-made bikes.

Peter will procure an issue of 200 £1 ordinary shares in the company to Albert, giving him a 25% interest (with the remaining 80% being held by Peter). Albert's £80,000 investment will therefore reflect a 'share premium' of £79,800. Peter has also promised to give Albert a seat on the board.

Assuming all the relevant SEIS conditions are met, Albert will be able to claim SEIS income tax relief of £40,000 (50% x £80,000) provided he has sufficient taxable income. There are no SEIS obstacles with Albert being a director. Further, although they are brothers, they are not 'associated' for SEIS purposes and hence Albert does not breach the substantial (30%) interest condition.



CHECKLIST: HOW TO QUALIFY FOR SEIS RELIEF

1 TRADING

Throughout Period B (ie, the three years following the share issue), the issuing company must exist wholly for the purpose of carrying on one or more new qualifying trades or research and development (ignoring any incidental purposes).

Importantly the trade must be a 'new' trade. This means that it must have been carried on for less than two years before the relevant SEIS share issue and the company must not have carried on any other trade.

Broadly, if the issuing company is a parent company, the group (taken as a whole) must carry on qualifying activities throughout Period B, although any non-qualifying activities are ignored provided they are not substantial.

For these purposes, qualifying activities follow the normal EIS provisions and hence would exclude property development, leasing, farming, financial services and running care homes and hotels.

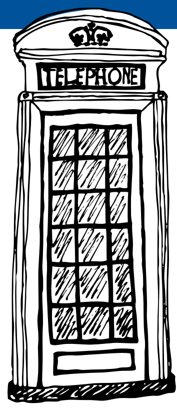
If the company goes into administration (for genuine commercial reasons) this does not affect its trading status

2 QUALIFYING BUSINESS

Only the issuing company or any 90% qualifying subsidiary must carry on the new qualifying activity (including any preparatory work or research and development) during Period B

3 UK PERMANENT ESTABLISHMENT

Throughout Period B the issuing company must carry on its trade in the UK through a permanent establishment. This means that an overseas company could qualify if it is carrying on a UK-based trade



The 30% significant interest rule means that it is feasible for as few as four directors to qualify for 50% SEIS income tax relief up to the maximum £150,000 SEIS company limit (for example, £37,500 for each director). Importantly, loan capital is excluded from the significant interest test. This means that investors can provide some loan funding to the company without prejudicing their SEIS relief, although care must be exercised to ensure that any repayment of such loans falls outside the receipt of value rules (see below).

RECEIPT OF VALUE RULES

As with EIS relief, the SEIS legislation contains provisions which completely withdraws or reduces the original SEIS relief where investors (or connected persons) receive value from the investee company at any time in Period A. This will also lead to a cancellation of any CGT exemption or CGT reinvestment relief claimed on the shares. The type of transactions which constitute a receipt of value are widely defined in s275FE. Insignificant receipts are ignored. As far as director investors are concerned, they will need to ensure that their remuneration packages are reasonable and that any dividends taken represent a normal commercial return on the investment.

REQUIREMENTS RELATING TO SEIS SHARES

There are various requirements relating to the shares, which are summarised below:

- Shares must be fully paid-up ordinary shares, which must not contain any preferential right to assets on a winding-up or redemption (s 257CA). Furthermore the company cannot raise funds under EIS or VCT investment before any SEIS shares are issued;
- The shares must be issued for the purposes of qualifying business activities carried on by the company or a 90% qualifying subsidiary (s 257CB);
- All the share subscription monies must be spent on the qualifying activities within three years of the share issue (known as Period B), although 'insubstantial' amounts not spent by the end of year three can be ignored (s 257CC). Money invested in purchasing shares in another company does not count; and
- There must be no pre-existing arrangements to secure an exit for the investor (s 257DD).

QUALIFYING COMPANY CONDITIONS

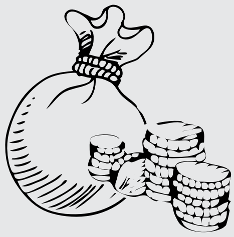
The SEIS places numerous highly prescriptive restrictions on the qualifying company to ensure

Investors can transfer SEIS shares to their spouse/civil partner without jeopardising the tax reliefs

4

FINANCIAL HEALTH

The issuing company must not be in financial difficulty when the 'SEIS' shares are issued (as determined under EU regulations (2004/C 244/02)



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UNQUOTED COMPANY STATUS

When the shares are issued, the company must be unquoted (i.e. none of its shares must be listed on a recognised stock exchange) and no arrangements must be in existence for it to become listed

8

GROSS ASSETS TEST

Immediately before the shares are issued, the company's gross assets (per its balance sheet) must not exceed £200,000. Where a parent company makes the SEIS share issue, the £200,000 'gross assets' test is based on the 'consolidated' group assets

6

CONTROL AND INDEPENDENCE

Throughout Period A, the issuing company must be independent (i.e. not under the control of any other company) and there must be no arrangements for it to become so. During Period A, the issuing company must not control any subsidiary that is not a qualifying subsidiary

7

NO PARTNERSHIP CONNECTION

During Period A, the issuing company and any 90% qualifying subsidiary must not be a member of a partnership or limited liability partnership

9

EMPLOYEE COUNT

When the shares are issued, the company/group must have less than 25 full-time equivalent employees (including directors and calculated on a 'just and reasonable' basis)

10

NO PRIOR EIS/VCT SHARE ISSUES

The company must not have had made any EIS or VCT share issues before (and on the day of) any SEIS issue

that the relief is targeted towards very small 'fledgling' businesses. The key conditions are summarised in the checklist above.

CGT RELIEFS

CGT exemption: After three years from the share issue date, capital gains arising on the sale of SEIS-relieved shares are completely exempt from CGT (provided the SEIS income tax relief has not been withdrawn). The exemption is only given where SEIS income tax relief was originally claimed. If the SEIS shares are sold at a loss, the capital loss is reduced by the income tax relief.

CGT reinvestment relief: As an additional fiscal 'carrot', SEIS deferral relief is available for gains made in 2012/13 that are 'reinvested' in SEIS investments made in the same year. This relief is not therefore available for any SEIS investment made after 5 April 2013.

For this type of deferral, the investor's SEIS subscription must be at least equal to the entire capital gain(s) realised in 2012/13 to ensure full deferral of the gain(s).

In simple terms, this means that for a full £100,000 SEIS investment, it is possible to secure tax relief of £78,000 (income tax at 50% and CGT at (say) 28%), which would reduce the net cost of the investment to only £22,000.

COMPLEXITY

The policy intent behind SEIS is clearly laudable. However, given that the relief is relatively small compared to EIS and VCT, it is perhaps disappointing that it is cloaked with so many complex restrictions.

This is largely due to HMRC's paranoia that the relief could be subject to abuse, such as arrangements being designed to seek SEIS by recycling existing trades.

As a result, advisers and investors will need to tread carefully to ensure that legitimate equity investment in start-up businesses attracts the intended SEIS relief, which is likely to involve significant professional costs. Importantly, once the maximum SEIS relief has been exhausted, companies can seek additional funding under the EIS or VCT regimes.

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