VCT and EIS Qualifying Investments

Is your company looking to raise investment from venture capital trusts (VCTs) or from individuals seeking tax relief under the enterprise investment scheme (EIS)?

If it is, you need to read this note – because it will give you an overview of the key conditions that must be met in order to attract that investment.

A bit of background

The VCT and EIS regimes encourage investment in unquoted trading companies by offering generous tax reliefs to investors.

Under EIS, individuals (the "EIS Investors") invest directly into unquoted trading companies for ordinary shares. They enjoy upfront income tax relief on their investment, as well as tax free gains on sale of the shares.

Under the VCT rules, individuals invest in shares in a quoted company (the VCT). The VCT then invests that money into unquoted trading companies by way of shares and (in some cases) debt. Again, the VCT investors enjoy upfront income tax relief on their investment into the VCT, and tax free gains on sale of those VCT shares, as well as tax free dividends.

But all tax-breaks come with strings attached. EIS Investors and VCTs can only invest in companies that meet a lengthy list of conditions. And any individual looking to claim EIS relief on an investment must also meet certain criteria.

So in this note we aim to give you an understanding of those key conditions and criteria.

Please bear in mind that this is a complex area of law, so what you're about to read is a summary only.

This note is based on law and practice as at 3 January 2017. Except where stated the following conditions are common to both VCT and EIS schemes.

Conditions for the Company

First of all, let's look at the conditions the company must meet in order to qualify for investment by VCTs or by EIS Investors:

Unquoted status: The company must be unquoted at the time of the investment with no arrangements in existence for its flotation. A company whose shares are traded on AIM is treated as unquoted.

Number of employees: The company (or group) must have fewer than 250 full time employees (or their equivalents) at the time of the investment, or 500 for a “knowledge-intensive company”.

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 one of the previous three years, or at least 10% in each of the previous 3 years (the 3 years ending immediately before the company’s last accounts); and either:

- which is engaged in intellectual property creation from which within 10 years it is expected will derive the greater part of the company’s or group’s business; 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 full time equivalent workforce.

Annual and lifetime limit on money raised: The company may not raise more than £5 million in any 12-month period from risk capital investments, which includes the venture capital schemes (SEIS, EIS, SITR and VCTs) and any other source which counts as aid under the EU guidelines on risk finance investments in SMEs. In addition, there is a lifetime limit of £12 million for such investments in any company (or £20 million for knowledge-intensive companies). In assessing both limits, account must be taken of money raised by subsidiaries, partnerships of which the company or its subsidiaries are members and businesses acquired by the company and its subsidiaries.

Maximum age: EIS or VCT investments must not be made in a company which made its first “commercial sale” more than 7 years before the date the investment is made (or 10 years for a knowledge-intensive company). This age limit is waived where the aggregate amount to be invested by VCTs and EIS Investors exceeds 50% of the company’s (or group’s) annual turnover averaged over the last 5 years, and all VCT and EIS monies are to be used to enter a new product market or a new geographical market. The age limit is also waived if the company raising the investment had previously received state aid funding (including VCT or EIS investment) within 7 years of the date the first commercial sale was made and some or all of the new investment is to be employed for similar purposes.

Gross assets: The gross assets of the company (or the group if applicable) must not be more than £15 million immediately before the investment is made, and not more than £16 million immediately afterwards.

Independence: The company must not be a 51% or more subsidiary of another company, or under the control of another company (or another company and a person “connected” with that other company).

Qualifying subsidiaries: Any company under the “control” of the company raising the investment must be a “qualifying subsidiary”, that is, a bona fide subsidiary. For this purpose “control” includes a right to more than 50 per cent of a) the voting rights or (b) income of a company or (c) the assets of a company on its winding up.

Financial Health: The company must not be in “financial difficulty” (under EU guidelines) when the investment is made.

UK permanent establishment: The company must have a permanent establishment in the UK.

Business of company: The company must either exist wholly for the purpose of carrying on *qualifying trade(s)*, or be the *parent company of a trading group*.

A trade is a qualifying trade if it is carried on in a commercial manner, and it does not include to a “substantial” extent (broadly more than 20%) any “excluded activity”.

The list of “excluded activities” is too long to reproduce here, but it includes:

- dealing in land, shares or financial instruments
- providing finance or insurance
- leasing or receiving royalties or license fees
- legal or accountancy services
- certain property-based trades such as property development, farming, market gardening, hotel management and operating or managing nursing homes or residential care homes
- the generation or export of electricity or the generation of heat or any other form of energy
- producing gas or fuel.

A company is a parent company of a trading group if:

- all its subsidiaries are qualifying subsidiaries (see above), and
- when activities of the company and its subsidiaries are taken together and assessed as a whole, these do not include to a “substantial” extent either any excluded activity and/or any non-trading activity (eg investment activity or non-commercial activity).

Conditions for the Investment

Now we’ll look at the conditions that apply to the actual investment terms:

EIS: The shares issued to EIS Investors must be ordinary shares and must not carry any present or future preferential rights to dividends (with certain exceptions), to the company’s assets on a winding-up, or to be redeemed. In addition, no ‘arrangements’ for an exit route for the investor may exist.

VCT: At least 10% of a VCT’s investment in a company must be in “eligible shares”, which are shares with the same lack of preferential rights referred to above. The remainder of a VCT’s investment in a company can comprise any class of shares (even preference shares) or loans. However, loans must not be guaranteed (other than by subsidiaries of the company raising the investment), or repayable within 5 years (other than in default situations).

Conditions on the use of funds

Next we turn to the restrictions on when and how monies invested by VCTs and by EIS Investors must be used:

Those monies must be:

- raised for the growth and development of a qualifying trade carried on either by the company raising the investment or by a 90% subsidiary of that company, and
- employed within two years of the date the investment is made.

Monies raised from VCTs or from EIS Investors cannot be used to fund (directly or indirectly) the acquisition of a company, a business, goodwill or certain intellectual property, cannot be used to refinance existing loans or liabilities, and cannot be employed on the acquisition of any shares in other companies.

Conditions for the investor (EIS only)

Finally, we'll summarise the key criteria that any individual investor must meet in order to be able to claim EIS relief on an investment into an EIS-qualifying company:

First, the investor must be an individual (although investment via a nominee is possible).

Secondly, if an individual subscribes for shares in a company and that individual already holds shares in that company (or a subsidiary), the new shares will not be eligible for EIS unless all of those existing shares either are subscriber shares issued when the relevant company was first incorporated, or were issued under the SEIS, EIS or SITR schemes.

Thirdly, the investor must not be "connected" with the company at any time during the period commencing two years prior to the issue of the shares and ending on the third anniversary. There are different types of connections:

Material interest connections: An individual is "connected" with a company if he or she has a "material interest" i.e. that individual directly or indirectly owns more than 30% of:

- the issued ordinary share capital of the company or any subsidiary;
- the issued share capital of the company or any subsidiary; or
- the voting power in the company or any subsidiary.

For this purpose, an individual is treated as owning any asset or share which he is entitled to acquire (e.g. on exercise of an option) and which any of his "associates" owns or is entitled to acquire.

Also, if any investor would, on a winding up (or any other capital distribution) be entitled to receive more than 30% of the assets available for distribution to equity shareholders of the company or any subsidiary, that investor is treated as having a "material interest" and so is not eligible to claim EIS relief.

Business connections: An investor is connected with a company if he was at any time involved in carrying on the trade carried on by that company or a subsidiary whether as a sole trader, partner, director or employee.

Work connections: An individual is connected with a company if he or any of his associates is an employee or director of the company or any subsidiary (unless the *"business angel"* exception applies (see below)) or a partner in a business partnership with the company or any subsidiary.

Business angels

There are special rules for "business angel" investors. In general, a "business angel" is someone who not previously been connected with the company and only becomes a director of the company when the shares are issued and is thereafter entitled to receive only reasonable remuneration for services provided to the company.

If the investor is connected with the company, most EIS reliefs will be unavailable but *capital gains tax deferral relief* would still be available provided that the other conditions are met.

As a general rule, the conditions for the capital gains tax deferral elements of EIS relief are now much less stringent than for the income tax relief and capital gains exemption elements, with several of the above-mentioned conditions not being relevant.

Interested in knowing more?

At Mills & Reeve we have a great deal of experience advising companies raising funding from VCTs and EIS Investors, and also in setting up and acting for VCTs and EIS funds and investor groups.

So if you want to know more, we'd love to help - here's who you need to contact:

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